When a House Is More Than a Home

When the Tax Reform Act of 1986 phased out income tax deductions for interest paid on auto loans, personal loans, and credit card debt, many consumers turned to **home equity loans** to help finance a variety of personal purchases. You can still deduct interest on up to $100,000 of home equity indebtedness (incurred after October 13, 1987) used for purposes other than improving your home.

More recently, home equity loans have been used to consolidate other outstanding debts, such as credit card bills. Some observers are becoming concerned, however, about people jeopardizing the roofs over their heads because of overburdensome debt.

Debt Basics

Any mortgage on a home is *secured* debt. When you borrow against your home, you are pledging your house as collateral against the loan. Should you be unable to repay the loan, the lender would have the right to force foreclosure, with the loan being repaid from the eventual sale of the property.

In contrast, credit card debt is *unsecured* in that assets are not pledged against the outstanding balance. In this case, the lender's recourse would be to sue and obtain a judgment against the debtor. This might adversely affect your ability to borrow in the future and, in serious debt situations, could lead to bankruptcy.

In addition to the tax deduction for the interest paid, one attraction of home equity loans is usually a lower interest rate and the ability to stretch out payments. However, when you consolidate credit card debt with a home equity loan, you are replacing unsecured debt with secured debt—potentially placing your house at risk.

Why a Home Equity Loan?

Here are some guidelines for judicious use of home equity lines of credit.

It *may* make sense to borrow against your house under the following circumstances:

- You are consolidating credit card debt and plan to repay the loan quickly.

- You use the cash to purchase a vehicle, taking advantage of a favorable interest rate and the tax write-off. Also, you plan to pay off the loan over the same term, as you would have with a vehicle loan.

- You use the funds for expenditures, such as education, that have the potential to return more than the cost of the loan.

- You can handle the payments comfortably within your current budget. Also, if your income were to decrease, you would not have to sell other assets to make the payments.

It may be *inadvisable* to borrow against your house in the following situations:

- You are unsure of your job security, and repaying the loan would be difficult if your income were to drop.

- You are financing a consumable purchase, such as a vacation.

- Home sales have slowed in your neighborhood.

The equity in your home can be an important source of “opportunity” capital. By weighing the potential advantages and disadvantages of tapping this money supply, you can make sure that you’ll still have a roof over your head on rainy days.

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