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Randy P. Siller

Jeffrey S. Cohen

Siller & Cohen

Family Wealth Advisors

IRS Okays Home Equity Deductions

The Tax Cuts and Jobs Act of 2017 affected the tax deduction for interest paid on home equity debt as of 2018. Under prior law, you could deduct interest on up to $100,000 of home equity debt, no matter how you used the money. The old rule is scheduled to return in 2026.

The bad news is that you now cannot deduct interest on home equity loans or home equity lines of credit if you use the money for college bills, medical expenses, paying down credit card debt, and so on. The good news is that the IRS has announced "Interest on Home Equity Loans Often Still Deductible Under New Law." The details are in IR 2018-32, a news release from the IRS.

The book, not the cover

According to the IRS, even if a loan is labeled "home equity," the interest may be deductible on your tax return. The key is how the borrowed money is used. In addition, the $100,000 ceiling doesn't apply.

For home loan interest to be tax deductible, the taxpayer that secures the loan must use the money to buy, build, or substantially improve his or her home. Beginning in 2018, taxpayers may only deduct interest on $750,000 of such "qualified residence loans," or $375,000 for a married taxpayer filing separately.

Those numbers apply to the total of a taxpayer's home loans, but older loans up to $1 million and $500,000, respectively, may have fully deductible interest. As before, home loan interest on debt that exceeds the cost of the home won't be eligible for an interest deduction, among other requirements.

Fine points

For home loans obtained in 2018 and future years, some tax rules are clear, but some are more complex.

Consider four examples below. In each example, Eve Harper gets two loans, one from Main Street Bank and one from Broad Street Bank.

Example 1: Eve Harper gets a $500,000 loan from Main Street Bank to buy a home in July 2018. In November 2018, Eve gets a $50,000 "home equity" loan from Broad Street Bank, which she uses to buy a car. The interest on the Main Street Bank loan is tax deductible because it is secured by the home which it is used to buy. The interest on the Broad Street Bank loan is not tax deductible because it is used to buy a car, which has nothing to do with the home that secures it.

Example 2: Same as example 1, except that Eve uses the Broad Street Bank loan to install central air conditioning, add a powder room, and upgrade plumbing throughout her new home. The interest on both of these loans will be deductible. The interest on the Broad Street Bank loan is now tax deductible because it is used to substantially improve the home that secures it.

Example 3: Same as example 1, except that the Broad Street Bank loan is used to make a down payment on a mountain cabin, where Eve plans to go for vacations. Interest on this $50,000 loan is deductible because the total of both loans does not exceed $750,000, and the $50,000 loan is secured by the cabin. Indeed, Eve could get a loan up to $250,000 (for a $750,000 total of home loans) to buy the cabin and still deduct the interest, as long as this loan is secured by the cabin.

Example 4: Same as example 3, except that the Broad Street Bank loan is secured by Eve's main home, not by the cabin she's buying. Now, the interest on the Broad Street Bank loan would not be tax deductible no matter how much was borrowed, because the loan is secured by Eve's main home, but used to purchase the cabin. Therefore, the loan is not being used to buy, build, or substantially improve the property that secures it.

Over the limit

What would happen if Eve gets a $500,000 loan in June to buy her main house and another $500,000 loan in November to buy a vacation home? She would be over the $750,000 debt limit for deducting interest on 2018 home loans, so only a percentage of the interest paid would be tax deductible.

The bottom line is that if you intend to use a home equity loan to buy, build, or substantially improve a home, you should be careful about how the debt is secured. Be prepared to show that the money really was used for qualified purposes.

Moreover, qualified home loans obtained on or before December 15, 2017, are grandfathered, with tax deductions allowed for interest up to $1 million (or $500,000 for a married taxpayer filing separately), as explained. Some questions remain, though, about how refinancing those grandfathered loans will affect the tax treatment.

Trusted advice

Secured debt

- Home loan interest is deductible, up to the applicable limit, only if the obligation is a secured debt.
- You must sign an instrument, such as a mortgage, deed of trust, or land contract, that makes your ownership interest in a qualified home security for payment of the debt.
- A *qualified home* includes a house, condominium, mobile home, boat, or house trailer with sleeping, cooking, and toilet facilities that is your main home or second home.
- In case of default, the home used as security can satisfy the debt.
- This arrangement must be recorded or otherwise officially noted under the relevant state or local law.

Don't Neglect Estate Planning

As you may know, the Tax Cuts and Jobs Act (TCJA), which took effect in 2018, increased the federal estate tax exemption to $11.18 million per person, making the combined exemption for a married couple $22,360,000. For those of you over the $22,360,000 limit, there are a variety of planning techniques we would be happy to share with you to both reduce your estate tax exposure by as much as possible, and ensure that your heirs have enough liquidity to cover any remaining estate tax liability.

But what if you're under the combined exemption amount? Are you in the clear? Even if your family will not have an estate tax liability, there is much more to successful wealth transfer than reducing or eliminating estate tax. Ideally, you'll want your assets to pass to the desired recipients with a minimum of turmoil and expense.

To start, you should have a will prepared by an experienced attorney. Your will should not only name specific heirs for specific assets, but also identify an executor who will administer your estate and, if relevant, guardians who will care for any minor children.

Once your will has been prepared, don't file it away and forget about it. Review the document periodically, especially after major life events such as births, deaths, marriages, and divorces.

In addition to a will, other efforts should be included in your estate planning.

Beneficiary designations

Many assets will pass to a beneficiary or co-beneficiaries at your death. They include retirement accounts, annuities, and life insurance proceeds, as well as certain bank and investment accounts. The good news is that these assets usually pass without having to go through probate, which might be expensive and time consuming.

The bad news? Generally, a beneficiary designation will override what's in a will. Keeping beneficiary designations current can be vital. Except when legally agreed to, you probably won't want assets to pass to an ex-spouse under an old beneficiary form.

Employer-sponsored defined contribution retirement plans, such as 401(k)s, may be required to pass to a surviving spouse, unless a waiver has been signed. Complying with such rules may save your heirs from an unhappy ending.

Revocable trusts

In recent years, revocable trusts (also known as living trusts) have become popular. As the name indicates, these trusts can be undone, with trust assets reverting to the trust creator, known as the grantor. Meanwhile, the creator continues to control the assets in the trust and have access to income from such assets.

Assets transferred into such trusts can avoid going through probate at the creator's death. As mentioned previously, retirement plans and other assets avoid probate anyway. The same is true for assets held as joint tenants with right of survivorship, such property passes to the surviving owners.

Therefore, probate avoidance applies to other types of assets if they are held in a revocable trust. To get this benefit, assets must be transferred into the trust.

Beyond probate avoidance, revocable trusts also might reduce administrative expenses by helping the trustee to identify and gain control over the assets. Additionally, a revocable trust can be valuable in case of incapacity. Control of trust assets may pass to a successor trustee or co-trustee.

Example 1: Nancy Hunter creates a revocable trust into which she transfers her bank accounts, investment accounts, and real estate. Nancy names her daughter, Judy Palmer, as successor trustee. Now, if Nancy loses the ability to manage the trust assets, Judy will take control.

Before naming someone as successor trustee, consider this question: Is this person able and willing to serve? If not, a corporate co-trustee may be the answer. The latter solution will cost money but could be less expensive than losses caused by an unqualified trustee.

Irrevocable trusts

With irrevocable trusts, the grantor gives up control of assets transferred into the trust. Such trusts can serve many purposes, such as reducing estate tax, protecting beneficiaries who might handle money unwisely, and providing strong creditor protection. Modifying an irrevocable trust can require considerable effort and expense, if it can be done at all.

Other Components & Final Thoughts

A thorough estate plan also might include a letter of instruction, durable power of attorney, and health care directives. The lawyer who drafts your will and trusts, your financial advisor, and your CPA can all weigh in on what else you'll need for a comprehensive estate plan. It is often beneficial for these advisors to be introduced to one another and work together, as this allows for more thorough coordination across the various disciplines that play a role in your plan.

What's New At Siller & Cohen: 3rd Quarter 2018

Speaking Events:

- Randy Siller and Josh Marriott recently presented to a prominent Greenwich Family Law firm. Their presentation centered on issues surrounding Divorce Taxation, including Property Transfers, Qualified Domestic Relations Orders (QDROs), Alimony, Child-Related Issues, and changes related to the Tax Cuts and Jobs Act effective for 2018.

- Randy Siller moderated a panel discussion by two leading divorce attorneys to the New York State Society of CPAs Estate Planning Committee.

- Jeffrey Cohen recently presented to the Lincoln Executive Consulting Group. His presentation focused on end of year tax planning for high net worth clients, executives, and business owners.

Staff Achievements:

- We are proud to announce that Tyler Wolf has obtained his Series 7 and Series 63 Licenses.

Personal News:

- We would like to congratulate Nicholas and Nicolle Strang on the birth of their daughter, Alessandra, on 9/10/2018.

- We would also like to congratulate Randy's daughter, Meredith Siller, on her marriage to Harry Rimalower on 9/1/2018 in Los Angeles.