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# Tracing and Ordering Home Equity Debt

**Taxpayers—and their tax preparers—should look closely at their interest expense related to home equity indebtedness to ensure they are compliant and aren't missing any potential tax benefits.**

Before home equity debt interest rates increase, as many anticipate happening, homeowners may feel the urge to borrow more in the near future for many possible cash needs. As long as their total amount of home equity indebtedness doesn't exceed $100,000 ($50,000 for married filing separate) per IRC §163(h)(3)(C)(ii), all of the attributable interest expense should be deductible as an itemized deduction. If the indebtedness exceeds the $100,000 limit and there are reasons other than personal interest for the interest expense per IRC §163(h)(2), tracing and ordering rules need to be considered to maximize the deduction opportunity and to keep taxpayers compliant.

Suppose that a single taxpayer borrowed money during tax year 2013 using the equity in her home and will incur interest expense. This taxpayer also plans to repay part of the loan in the beginning of the next tax year in 2014. The taxpayer borrows $170,000 from a bank's equity line of credit on her principal residence. When preparing her taxes, she or her tax preparer may simply recall the $100,000 limit on the debt for purposes of the deductible interest and stop there, but the use of the borrowed funds should be investigated for additional tax benefits. The taxpayer used $50,000 of the $170,000 loan for her Schedule C business, and the other $120,000 was used to renovate her home. Assume the amount of total interest expense incurred on the loan in 2013 was $5,120 and the taxpayer is planning to repay $20,000 of the loan at the start of 2014. In this example, the taxpayer needs to know how much of the interest expense is deductible in 2013—and in what manner—and how the $20,000 repayment would affect future interest expense deductibility.

**The interest expense on a debt is generally allocated in the same manner as the debt itself.**

From the facts listed above, the incurred debt is for both business and renovating the home. Interest expense is deductible if it isn't personal per IRC §163(h). The interest on the portion of the loan for the business isn't personal per IRC §163(h)(2)(A), and, as such, it's deductible as a business expense. The interest on the portion of the loan used for renovating the home, which is considered qualified residence interest, also isn't considered personal per IRC §163(h)(2)(D). For the qualified residence interest, however, there is a limitation on what's called "home equity indebtedness," which is any debt that wasn't part of the acquisition of the property. Being that the debt is from an equity line of credit, the interest deduction will be limited to only the amount of interest attributable to $100,000 of that debt for any given tax year, per IRC §163(h)(3)(C). The interest expense on a debt is generally allocated in the same manner as the debt itself. This is done by tracing the disbursements of the debt proceeds to specific expenditures [Regulation §1.163-8T(a)(3)]. Therefore, of the $5,120 interest expense that was incurred in 2013, $1,506 is deductible for the business ($5,120 × $50,000/$170,000), $3,012 is deductible as home mortgage interest as an itemized deduction

($5,120 × $100,000/$170,000), and $602 isn't deductible due to the "home equity indebtedness" limitation ($5,120 × $20,000/$170,000).

Because there is a larger deductible limit that exists for certain types of qualified mortgage interest, the $120,000 used to renovate the home could be delved into further for additional benefits for the taxpayer. If the renovation qualifies as acquisition indebtedness, the taxpayer may deduct the interest associated with up to $1 million of the total amount of acquisition indebtedness per IRC §163(h)(3)(B). Acquisition indebtedness is the debt a taxpayer incurs in acquiring, constructing, or substantially improving his or her residence. For this example, the renovation of the taxpayer's home won't be considered to substantially improve her residence. This is a topic that would in itself need further discussion but is beyond the scope of this article.

Returning to our simple example, the taxpayer needs to demonstrate that the $50,000 is for the business and the $120,000 is for renovating her home. The best way to achieve this documentation is to keep the money separated. This way the disbursements can be traced to specific uses. In other words, the $50,000 should be deposited in and paid out through the business accounts and separated from the personal funds.

Because of the general ordering rules for debt repayments, when and if the taxpayer repays $20,000 at the start of tax year 2014 as planned, the payment will reduce the portion of the loan attributable to the "home equity indebtedness." In this example, repayments will be allocated to business use last per Regulation §1.163-8T(d)(1). This is good for the taxpayer because if the $20,000 is paid at the beginning of the year, then the "home equity indebtedness" should be equal to or below the $100,000 debt limitation and most, if not all, of the interest expense attributable to the home will be deductible.

**All of the tracing and ordering rules as described are subject to change when...**

For debt tracing rules, per Regulation §1.163-8T(a)(3), "Interest expense on a debt is allocated in the same manner as the debt to which such interest expenses relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures." This regulation prescribes rules for tracing debt proceeds to specific expenditures. Thus, the allocation of the interest expense isn't based on the home used to obtain the borrowed funds. This is substantiated in the publication and explanation of Temporary Regulation §1.163-8T as found in the preamble of Treasury Decision 8145, Internal Revenue Service (July 1, 1987). In the section Allocation Rules in General, it states that "the allocation of interest is *not affected by the use of an interest in any property to secure repayment* of the debt to which the interest relates" (emphasis added).

The general ordering rules for debt repayments are spelled out in Regulation §1.163-8T(d)(1). The amounts allocated to personal expenditures is considered paid first. There is no mention of any type of apportionment or proration needed based on the way the debt is allocated. This may seem too good to be true, but this benefit to the taxpayer is supported in the publication and explanation of Temporary Regulation §1.163-8T as found in the preamble of Treasury Decision 8145, Internal Revenue Service (July 1, 1987). Under Repayments and Refinancing, it states that "debt repayments are applied against the debt in a manner *intended to minimize the limitations on the deductibility* of interest expense" (emphasis added).

All of the tracing and ordering rules as described are subject to change when either the temporary regulations are amended or the final regulations are put in place. For now, there are opportunities for the taxpayer's interest deductions to be maximized with some digging into the facts. **SF**

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