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The Tax Facts of Home Equity Loans

Home equity loans have been extremely popular financing options with homeowners for over a decade now. These loans involve turning the accrued equity in one's home into cash for various other financial ventures. Home equity loans use the home as collateral, meaning if you are unable to repay the loan for any reason, the mortgage lender may be able to repossess your house and sell it to recover the loan losses. Yet even with this risk, the default rate on home equity loans has remained quite low over the years because the loan amounts and repayment schedules are generally manageable.

One of the reasons for the popularity of these equity-based loans versus non-secured bank loans is that the Internal Revenue System allows homeowners to deduct the interest on home equity loans. (Interest on regular loans is not tax-deductible.) In fact, the government permits married tax filers to fully deduct interest on home equity loans that are as much as $100,000. Those who are single or are filing jointly may deduct the interest on home equity loans totaling $50,000 or less.

If you are contemplating taking out some cash to finance an upcoming project or event, you should figure out how the tax benefits of home equity loans could help you. First, you need to determine whether or not you would even profit from itemizing your deductions rather than simply taking the standard deduction. Usually it is those in the higher tax brackets that benefit most from taking the home equity tax deductions. Tax deductions come mostly from home loan interest (including first mortgages and home equity loans,) state and property taxes, and charitable contributions. The standard deduction for those married and filing jointly is $7,200. A head of household can deduct up to $6,350, and those married but filing separately get a standard deduction of $3,600. Single individuals get a $4,300 tax deduction. If these standard deductions total more than your combined deductions, you may not benefit much tax-wise from a home equity loan.

If your personal deductions add up to more than the standard deduction though, you will want to know more about how home equity loan interest tax rules. The interest you pay each year on your loan is deductible in that year, just like with your first home mortgage. Any points you pay are also deductible, but this amount must be amortized (or spread) over the entire course of the loan, meaning you only get to deduct a part of your points each year you have the loan. If you refinance the loan or simply pay it off early, you can deduct the complete balance of those points in that year.

Be aware, however, that there are certain exceptions to home equity loan tax deductions. You are not allowed to deduct interest paid on home equity mortgages that are tied to any other property than your first or second home. Also, if you take out a loan that exceeds the amount of equity you have in the house, you are not permitted to deduct any of the interest paid on the difference between the value of the house and the mortgage balance.

Be sure to consult your trusted tax professional for more specific information on your situation. It is nice to know, however, that a home equity loan may doubly benefit you; you get both cash for your needs immediately and tax deductions to save you money in the long run!