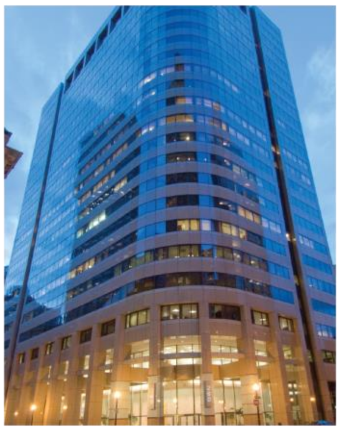
FINANCIAL PLANNING UPDATE
April 25, 2018

OUR VIEW



Debt Considerations in 2018

The passage of the Tax Cuts and Jobs Act of 2017 in December introduced changes in the tax treatment of interest paid on certain types of debt for Federal tax purposes. While further clarification is still pending from the IRS, these changes have nevertheless spurred discussions with clients about how they should be considering debt as part of their overall financial strategy.

The incorporation of debt strategies into cross-generational tax and estate planning continues to be relevant to many clients, along with the alignment of goals, timeline and resources for large purchases (such as buying a home, funding education or starting a business).

In light of the recent tax changes and on-going client questions, this update is aimed at starting the conversation around how to think about debt (both existing and new) in 2018.

Areas addressed:

- Home Mortgages and Home Equity Lines of Credit
- Student Loan Debt
- Treatment of Other Debt Interest

Home Mortgages and Home Equity Lines of Credit (HELOCs)

The Tax Cuts and Jobs Act of 2017 outlined a few changes to the treatment of debt for home mortgages and home equity lines of credit (HELOC).

Starting in 2018, the interest paid on the first $750,000 of home acquisition debt (used to acquire, build or substantially improve a first or second home) is deductible for Federal income tax purposes. After 2025, the law reverts back to the previous rules, which allowed for the interest paid on the first $1,000,000 of home acquisition debt to be deductible.

The criteria for loan deductibility is now dependent on how the loan proceeds were used, not how the original loan was structured.

An important stipulation in the 2017 Federal tax bill was a change in the treatment of debt taken out for purposes other than home acquisition – specifically called home equity indebtedness. Many times these types of loans were taken out as home equity lines of credits (HELOC). Under the new law, you can no longer deduct the interest paid on home equity debt (which previously allowed a deduction on the interest for loans up to $100,000). This law is also set to sunset back to the previous rules after the 2025 tax year.

Existing Debt: Loans that were taken out before December 16, 2017 are grandfathered under the $1,000,000 limit of interest deductibility (as long as the loan proceeds were used to acquire, build or substantially improve a first or second home). However, loans taken out against the home but used for other purposes will no longer qualify for the interest deduction. The criteria for loan deductibility is now dependent on how the loan proceeds were used, not how the original loan was structured. For home acquisition loans grandfathered under the limit of $1,000,000, the interest will remain deductible even upon refinancing, as long as the new mortgage loan amount does not exceed the value of the existing loan being refinanced.

The cost of taking out a loan for purposes other than home acquisition indebtedness has effectively increased.

Future guidance is needed from the IRS regarding the reporting and tracking requirements for qualified residence interest and how to handle loans with both home acquisition and home equity debt. It's important to work closely with your CPA to determine deductibility of existing home mortgages and/or home equity lines of credit.

<u>New Debt:</u> Although the interest on new debt taken out to acquire, build or substantially improve a home for loans up to $750,000 is technically deductible on the Federal level, the impact for taxpayers with smaller loans (or those with few other itemized deductions) may be minimal. The standard deduction has increased to $12,000 for individuals and $24,000 for married couples in 2018, which may in fact off-set the benefit of itemizing taxes altogether.

Additionally, the cost of taking out a loan for purposes other than home acquisition indebtedness has effectively increased now that the interest will no longer be tax deductible on the Federal level for loans of any size.

<u>Intra-family loan options:</u> An option that could allow for a large upfront transfer from a family member that is not taxable as a gift is an intra-family loan. The IRS outlines specific guidelines for how a loan must be structured to qualify as a loan and not a gift, so it's important to consult your legal counsel and tax advisors to prepare the required documentation. The key stipulations include using a minimum interest rate charged on the loan (called the Applicable Federal Rate or AFR) and adequate documentation surrounding the loan and repayment schedule. The minimum interest rates required are often lower than what could be obtained from a financial institution. Additionally, if the loan is for home acquisition indebtedness, the interest payments may be deductible by the borrower. However, interest income received by the lender will be taxed at ordinary rates.

Taxpayers with modified adjusted gross income (MAGI) of less than $80,000 for a single filer (or less than $160,000 for a joint filer) in 2018 can deduct up to $2,500 of interest paid on student loans per year.

Student Loan Debt

The 2017 Federal tax bill did not directly impact the deductibility of student loan interest, tuition waivers for graduate students or the existence of Federal loan programs for loan forgiveness, cancellation or discharge.

Taxpayers with modified adjusted gross income (MAGI) of less than $80,000 for a single filer (or less than $160,000 for a joint filer) in 2018 can deduct up to $2,500 of interest paid on student loans per year. For taxpayers with income above these thresholds, student loan interest remains non-deductible at the Federal level. At the state level, the treatment of student loan interest varies by jurisdiction.

Graduate student tuition waivers (which provide an opportunity for graduate students teaching classes to offset the cost of their tuition due) remain tax-free under the new law.

Carefully evaluate the loan characteristics of outstanding loans before consolidating or refinancing.

Due to the large volume of outstanding student loans in the US and increasing default rates, the treatment of student loans will continue to be revisited and debated.

Federal programs that existed before the 2017 tax bill which offer repayment plans, loan consolidation and potentially loan forgiveness, cancellation or discharge to qualified taxpayers remain in place. The criteria for qualifying for these programs vary but many are based on a taxpayer's income level and/or are offered only to those employed in public service, who have a qualified financial hardship or who have become disabled.

<u>Existing debt:</u> Many times financial aid packages include student loans of various types from a variety of sources. Some loans may be offered through federal student loan programs and others by private lenders. Ultimately, the loan terms and conditions can vary drastically between types. Carefully evaluate the loan characteristics of outstanding loans before consolidating or refinancing.

- <u>Federal loan consolidation:</u> Combining multiple loans into a single loan can be a good strategy for simplifying one's debt situation, but the real savings occurs if you accelerate repayment of the consolidated loan. Through loan consolidation, one can alter the monthly payment amount, repayment timeline, change a variable interest rate loan to a fixed interest rate loan or it can help one gain access to public service loan forgiveness programs. Alternatively, loan consolidation could also disqualify a lender from certain loan forgiveness options or other income-driven repayment programs.

- <u>Federal/ private loan refinancing:</u> While only offered through private lenders, loan refinancing may provide better terms for a student loan borrower. Private lenders will determine rates and terms based on the lender's creditworthiness (unlike with Federal loans where the rates are set by Congress for all borrowers). Typically one can refinance both Federal and private student loans into one new loan but the terms will be with a private institution and many Federal benefits of repayment programs or forgiveness may be lost under the new loan.

<u>New debt:</u> There can be some qualitative and quantitative advantages to a student taking on *some* level of debt to pay for their education. On the qualitative size, it can be an opportunity to better appreciate the total cost of education and have some "skin in the game". Quantitatively, it can make sense in the long run to help a student build their credit history by taking out a loan and making payments on time over the course of the loan. The key caveat to the credit building strategy is that payments along the way need to be made in a timely fashion, as not to *negatively impact* the student's credit history.

<u>Future trends:</u> Due to the large volume of outstanding student loans in the US and increasing default rates, the treatment of student loans will continue to be revisited and debated. Additionally, the rise in interest rates will impact some student loans in the near term and future borrowing. Federal student loan rates are determined by Federal law and many private student loans are tied to either the Federal Reserve's Funds rate or London Interbank Offered Rate (LIBOR), both of which are on the rise.

Treatment of Other Debt Interest

In general, loan interest on personal debt is not deductible (outside of the qualified residence interest and student loan debt interest discussed above). However, interest paid on margin loans is deductible up to the amount of taxable investment income reported if the proceeds are used to purchase taxable investments. These terms did not change with the 2017 Federal tax bill, even though the deduction for other investment related expenses was eliminated.

Key Take-Aways

2018 is a good time to revisit the terms of any existing debt you have and appreciate how it might be impacted by the new regulations and a higher interest rate environment. For new debt, take the time to fully appreciate the loan terms and compare available funding options.

We recommend that you consult your TFC financial advisor, CPA and/or relevant legal counsel as you navigate the decisions around debt, while recognizing that the IRS is continuing to release further guidance on these and other topics related to the Tax Cuts and Jobs Act of 2017.

Sincerely,

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