

Financing and Home Equity

Are Home Equity Loans As Attractive As You Think?

Obtaining a home equity loan or line of credit provides access to cash and a boost to your tax deductions, but it may put your financial well being at risk if not used wisely.

Home equity loan or line of credit?

Before deciding whether to borrow against your home's equity, it's helpful to know the difference between a home equity loan and a home equity line of credit. A home equity loan is essentially a second mortgage.

You borrow a lump sum on a fixed rate and pay it back in monthly installments over a fixed term, usually 10 to 15 years. A home equity loan is best suited for a one-time use such as a major home improvement project, college tuition, or debt consolidation. It's a good option for borrowers who prefer knowing exactly how much they will owe each month.

A home equity line of credit works more like a credit card and provides increased flexibility. The lender assigns you a credit limit and when you need cash, you draw against that limit by writing a check or using a special debit card. As you pay back the loan, the money becomes available to you again.

Advantages of borrowing against your home's equity

One of the key advantages to borrowing against your home's equity is the ability to deduct the interest you pay. In most cases, you can deduct the interest on up to \$100,000 (\$50,000 for married couples filing separately) of home equity debt secured by your residence.

Basically, if you pay \$5,000 in interest on your home equity loan, your taxable income is reduced by that amount. Credit cards, car loans and other types of personal loans do not offer this tax benefit.

In addition to significant tax savings, home equity loans and lines of credit allow you to borrow more money at a lower interest rate than other types of loans. This makes them ideal for paying off high interest credit card debt. As an incentive to borrow, many lenders offer teaser rates with an initial period at an even lower interest rate. Adding to their appeal, home equity loans and lines of credit are relatively easy to obtain since the loan is secured by your property.

Applying for a home equity line of credit means you always have ready access to money. This can be helpful in the event of an emergency, such as a job loss or serious illness.

Disadvantages of home equity loans and lines of credit

The biggest disadvantage to a home equity loan or line of credit is that it puts ownership of your home at risk. If you default on this type of loan, you can lose your home. Before borrowing against your home, it's important to have a contingency plan for making the payments in the event you lose your job or are unable to work due to an illness.

For some individuals, a home equity loan or line of credit can lead to serious credit problems. For example, you can realize significant savings by using a home equity loan to pay high-interest credit card debt, but this strategy only makes sense if you have the discipline to stop using your credit cards.

Finally, keep in mind that, because of the deduction phase-out rules, not all taxpayers are able to fully deduct the interest paid on home equity loan debt. A CPA can help you determine the impact of a home equity loan or line of credit on your particular tax situation.