Tax-aware borrowing

Interest paid on certain types of personal debt can help reduce the true cost of borrowing for U.S. taxpayers. If the debt falls into one of two categories—mortgage or investment loan interest—you may qualify for substantial deductions. In some cases, these rules can allow borrowing to play an integral role in your overall wealth strategy.

Taxpayers who understand the rules governing mortgage and investment loan interest may find they are able to:

- Lower their federal and state tax obligations
- Improve their cash flow
- Reduce their effective borrowing costs, which can be particularly beneficial in high-tax jurisdictions, such as New York and California

For example, an individual in the top federal income tax bracket of 37% paying $100,000 of loan interest this year could, in theory, turn that into a $40,800 tax savings. He or she might also enjoy a tax break at the state level, which could be particularly beneficial in a high-tax jurisdiction.

Not all types of personal loans qualify for an interest deduction: For example, car loans and credit card interest are not deductible. Similarly, interest can only be deducted by the taxpayer who is primarily liable for the debt; thus, guarantors generally cannot take the deduction, even if they make some of the loan payments for the original debtor.

To qualify as a deduction, interest on personal debt must fall into one of several categories, each of which is subject to certain restrictions. To get the benefit of these deductions, a taxpayer must itemize. The most common categories are described as follows:

**MORTGAGE INDEBTEDNESS**
It is possible to deduct mortgage interest on up to $750,000 of principal indebtedness secured by one primary and one secondary residence. (Interest due on mortgage indebtedness incurred before December 15, 2017, is grandfathered under prior law and is thus deductible on up to $1 million of indebtedness, likely including refinancing of that debt, subject to certain limits.) Mortgage interest on a qualified residence is deductible only if the loan proceeds are used to build, acquire or make capital improvements on the property.

The Internal Revenue Service (IRS) enforces this rule in part by tracing the use of the proceeds to determine deductibility. This tracing doctrine is generally a consideration in determining the deductibility of interest on any type of credit facility. The issue of deductibility may be triggered, for example, on an audit of your income tax return if the IRS notices an interest deduction and asks how you used the loan proceeds. If the IRS finds out that you have used the money for some other purpose, the interest deduction may be disallowed.

**INVESTMENT LOAN INTEREST**
Interest paid on money borrowed for taxable investing is generally deductible up to the amount of the net investment income the taxpayer recognizes in any given year.

Investment income qualifying for the interest deduction generally includes interest, dividends that do not qualify for the preferential 20% top tax rate, annuity income and certain royalties. It does not include qualified dividends or net capital gain unless a choice is made to include

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1 Includes $37,000 from income tax savings and $3,800 from Medicare surtax savings.
2 Deductions discussed in this article consider the regular tax calculations for individuals; however, the remarks are generally applicable to alternative minimum tax (AMT) calculations as well, albeit at a reduced marginal tax rate of 28%.
3 The 2017 tax act repealed the ability to deduct interest on $100,000 of home equity indebtedness. This change is scheduled to sunset after 2025, as will the reduction in the mortgage deduction limit from $1 million to $750,000.
4 Taxpayers who entered into binding contracts before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and who purchase the residence before April 1, 2018, are also grandfathered up to the $1 million limit.

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these. Rent received is generally not considered investment income.\textsuperscript{5}

Special rules apply to passive activities. This type of investment, generally made through a limited partnership or limited liability company, is an equity interest in an operating business in which the investor does not materially participate. The current deduction of interest and other related passive activity expenses is limited to passive activities income.

The deduction for investment interest may do more than the mortgage interest deduction to minimize taxes. Unlike the mortgage interest deduction, there is no cap on what you may deduct, as long as your investment income equals or exceeds your borrowing costs.\textsuperscript{6}

If the interest paid is more than you earn, you can carry the deduction forward indefinitely to future years. The key caveat is that you must use the loan proceeds to invest in something taxable. Investment earnings need not be taxable in the year in which you take the deduction.

For example, an investor may borrow to buy small-cap stock that doesn’t generate a dividend. In such cases, the interest could not be deducted against income from this particular small-cap stock, since none was realized, but it may be deducted against other sources of investment income in the investor’s portfolio.

What’s not allowable is borrowing to buy tax-exempt investments and claiming the interest as a deduction. Here, too, the IRS applies the tracing doctrine to scrutinize the facts. IRS rulings on the subject distinguish between direct and indirect evidence linking the borrowings to tax-exempt investments. These rulings and interpretations based on related tax cases are complex, but two points stand out.

The deduction for investment interest may do more than the mortgage interest deduction to minimize taxes.

First, where there is direct evidence linking the tax-exempt portfolio to the borrowing (either because the tax-exempt obligations were used as collateral for indebtedness, or the proceeds of the borrowing are directly traceable to the tax-exempt bond portfolio), the IRS has determined that no part of the interest paid or incurred on that indebtedness may be deducted.

Second, when there is indirect evidence linking the tax-exempt portfolio to the borrowing (e.g., the taxpayer has an outstanding loan for taxable investment purposes, but the taxpayer’s aggregate investments also include tax-exempts), the general IRS policy is to disallow an allocable portion of the taxpayer’s interest expense. The likelihood of interest deductibility is largely dependent on an individual’s particular circumstances, but here are a few rules of thumb:

- In general, don’t collateralize debt with tax-exempts
- Timing is important: If you’re planning to purchase tax-exempts, don’t do it immediately after borrowing

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\textsuperscript{5} Income from private equity investments and hedge funds may also qualify.
\textsuperscript{6} Similarly, as a general matter, interest expense on debt incurred in connection with the trade or business of a material participant may be fully deductible.
RULES OF THE ROAD

Taking tax deductions for loan interest

<table>
<thead>
<tr>
<th>TYPE OF DEBT</th>
<th>LIMIT ON DEDUCTIBILITY</th>
<th>WHAT YOU CAN USE THE MONEY FOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage</td>
<td>Interest on up to $750,000 of indebtedness secured by a principal or secondary personal residence*</td>
<td>Build, buy or make capital improvements on the property</td>
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<tr>
<td></td>
<td>RESTRICTIONS</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Taxpayer must itemize to benefit from this deduction</td>
<td></td>
</tr>
<tr>
<td>Investment loan interest</td>
<td>No cap, as long as investment income exceeds borrowing cost; carryover permitted</td>
<td>Taxable investments; no purchase of tax-exempts</td>
</tr>
<tr>
<td></td>
<td>RESTRICTIONS</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Must use the loan proceeds for taxable investments—not to acquire personal property, such as a yacht</td>
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<td></td>
<td>Current deduction limited in connection with passive activity investments</td>
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<tr>
<td></td>
<td>Collateralizing the loan with tax-exempts will cause you to lose the interest deduction</td>
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<tr>
<td></td>
<td>Taxpayers must itemize to benefit from this deduction</td>
<td></td>
</tr>
</tbody>
</table>

Source: J.P. Morgan, U.S. Department of the Treasury

*Interest on mortgage indebtedness incurred before December 15, 2017, is grandfathered up to the prior $1 million principal limit.

• It may be a good idea to deposit any borrowed funds in a segregated account. That way, if you use the funds for a tax-deductible purpose, such as purchasing taxable securities, there will be no commingling of the acquired assets with other assets, which should best preserve the deductibility of interest charges under the tracing doctrine.

WEIGHING ALTERNATIVE TAX CHOICES

Under the American Taxpayer Relief Act of 2012 (ATRA), the tax on qualifying dividends and long-term capital gains was fixed at a maximum rate of 20% rather than at the 39.6% (now 37%) maximum ordinary income tax rate. The tax law excludes qualifying dividend income and capital gains from the definition of investment income that qualifies for an interest deduction, thereby reducing the investment interest that can be deducted in any year. But taxpayers can elect to include qualifying dividend income and capital gains in investment income if they forgo the lower tax rate on those dividends and/or capital gains.

Below certain levels of investment income, therefore, borrowers are faced with a choice: more deductible investment interest or a lower tax rate on dividends or capital gains, and carrying excess investment interest forward for use in a subsequent year. Borrowers should also consider the Medicare surtax on unearned income in their decisions. This surtax, which imposes an additional 3.8% tax on modified AGI over $250,000 for married couples filing jointly, can also be reduced by deducting investment interest.8

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7 Modified AGI is AGI plus the amount excluded from income as foreign earned income, net of certain disallowed deductions and exclusions.
8 Deductibility for Medicare surtax is based on the Treasury Regulation under Section 1411.
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