Tax-aware borrowing

Interest paid on certain types of personal debt can help reduce the true cost of borrowing for U.S. taxpayers.

Taxpayers who understand the rules governing mortgage, home equity 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 39.6% paying $100,000 of loan interest this year could, in theory, turn that into a $43,400 tax savings.1 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 the following categories, each of which is subject to certain restrictions:2

Mortgage and home equity indebtedness
It is possible to deduct mortgage interest on up to $1 million of principal indebtedness secured by one primary and one secondary residence. A taxpayer can also deduct interest on a home equity line of credit, or HELOC, for up to $100,000 of principal indebtedness. While you can use the HELOC for almost any purpose without forfeiting the interest deduction, mortgage interest on a qualified residence is only deductible 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.

In addition to the cap on deductible indebtedness, another drawback of the qualified residence interest deduction is that it’s subject to the reinstated Pease limitation on itemized deductions contained on Schedule A of the federal tax return. This “haircut,” as the limitation is often called, applies, for example, to married taxpayers filing a joint return with adjusted gross income, or AGI, of more than $309,900 for 2015. Such taxpayers who are subject to the limitation generally must reduce their itemized deductions by 3% of the amount by which their AGI exceeds $309,900 or 80% of their allowable itemized deductions, whichever is less. The limit on itemized deductions for high-income taxpayers was fully reinstated under the American Taxpayer Relief Act of 2012 (ATRA), effective for tax years beginning in 2013.

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.

1 Includes $39,600 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 usage of 28%.
3 Qualified residence interest includes up to $1 million of acquisition indebtedness (mortgage note) and $100,000 of home equity indebtedness (HELOC).
Investment income qualifying for the interest deduction generally includes interest, dividends that do not qualify for the 20% tax rate, annuity income and certain royalties. It does not include qualified dividends or net capital gain unless a choice is made to include these. Rent received is generally not considered investment income.4

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.

In two respects, 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.

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Example: Structuring borrowing to minimize taxes
A taxpayer interested in owning a $10 million residence may want to consider whether to borrow to fund part of the purchase price. Consider these options for financing the purchase, keeping in mind that the net worth of the individual is the same in each case.

**SCENARIO 1** Take out a $5 million mortgage
With this strategy, the purchaser could only deduct interest on $1 million of the mortgage and on a $100,000 home equity line of credit, as these are the limits for home equity indebtedness. Deductibility may also be limited by itemized deduction rules for high-net-worth taxpayers.

**SCENARIO 2** Liquidate $5 million in investments by offsetting gains and losses
The purchaser uses the cash proceeds from the investment sale to buy the house. At a later date and unrelated to the home closing, the purchaser borrows $5 million and invests it in taxable securities. In this case, the entire carrying cost of the loan may be deductible as an investment interest expense, which has no ceiling limits as to the amount; is not subject to itemized deduction limitations and directly offsets other taxable income.

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4 Income from private equity investments and hedge funds may also qualify.
Second, when there is indirect evidence linking the tax-exempt portfolio to the borrowing (for example, 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.
- 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 ATRA, the tax on qualifying dividends and long-term capital gains was fixed at 20% rather than at the 39.6% 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 new lower tax rate on those dividends and/or capital gains.

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**Leveraging investment positions may require a decision about more overall deductible interest or a lower tax rate on dividends and capital gains.**

Below certain levels of investment income, therefore, borrowers have to choose between 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 new Medicare surtax on unearned income in their decisions. This surtax, which imposes an additional 3.8% tax on modified AGI\(^5\) over $250,000 for married couples filing jointly, can also be reduced by deducting investment interest.\(^6\)

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**Taking tax deductions for loan interest: Rules of the road**

<table>
<thead>
<tr>
<th>TYPE OF DEBT</th>
<th>LIMIT ON DEDUCTIBILITY</th>
<th>WHAT YOU CAN USE THE MONEY FOR</th>
<th>OTHER RESTRICTIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>MORTGAGE</td>
<td>Interest on up to $1 million of indebtedness secured by a principal or secondary personal residence</td>
<td>Build, buy or make capital improvements on the property</td>
<td>Subject to Schedule A limitations on itemized deductions (“haircut”)</td>
</tr>
<tr>
<td>HOME EQUITY LINE OF CREDIT</td>
<td>Interest on up to $100,000 of indebtedness secured by a principal or secondary personal residence</td>
<td>Any purpose</td>
<td>Subject to Schedule A limitations on itemized deductions</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>
<td>Must use the loan proceeds for taxable investments—not to acquire personal property, such as a yacht</td>
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<td>Current deduction limited in connection with passive activity investments</td>
</tr>
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<td></td>
<td>Collateralizing the loan with tax-exempts will cause you to lose the interest deduction</td>
</tr>
</tbody>
</table>

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

\(^5\) Modified AGI is AGI plus the amount excluded from income as foreign earned income, net of certain disallowed deductions and exclusions.

\(^6\) Deductibility for Medicare surtax is based on the recently published Treasury Regulation under Section 1.1411.
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