

## **Borrowing tax smart: When you pay interest, make sure it's deductible**

Once upon a time, individual taxpayers could borrow freely, encouraged by the knowledge that the bitterness of the interest pill they would have to swallow which would be sweetened by its total deductibility. But the days of unlimited personal interest deductions are gone; gone the way of 7% savings passbook rates and 16% mortgage rates. Now, only a few types of interest payments are deductible by taxpayers, and creativity is the order of the day.

### **What is left to deduct**

With the elimination of personal interest, the only types of interest payments currently deductible by individuals are interest on some home mortgages; interest related to a trade or business (other than as an employee); interest on certain education loans; some investment related interest; and interest applied in calculating passive activity income or loss (e.g. from rental or royalty activities).

Every one of these deductions includes restrictions or limits. For example, interest on amounts borrowed to purchase tax exempt investments is not deductible, nor is investment interest in excess of net investment income. Home mortgage deductions are limited in amount and number. Interest on student loans and business related borrowings are only deductible if they are shown to be directly tied to their respective subjects. Faced with these limitations, financial institutions and taxpayers have developed various creative, often means-oriented, methods of borrowing in order to preserve interest deductions.

### **Qualified residence interest**

Certainly the most widely used method of borrowing to provide today's individual taxpayers with an interest deduction is qualified residence indebtedness, popularly referred to as home mortgage loans. Qualified home mortgages are available for up to two residences (your principle home and one other that satisfies minimal use requirements) and in two varieties; those intended for the acquisition, construction or substantial improvement of your home (acquisition debt), and home equity loans.

You can generally deduct "qualified residence" interest on up to \$1 million in acquisition debt related to up to two home mortgages at a time. If the first is tied to your principle residence, the second can be used to acquire one of a number of the options, including such "homes" as a boat, an RV, a vacation hideaway, or condo near your office. In this manner, the loss of yesterday's interest deduction, you would have had on the installment loan used to acquire your motor yacht or your Winnebago, is not lost—as long as you establish your yacht or your Winnebago as your second home. These second homes must have sleeping, kitchen and bathroom facilities to qualify.

### **Home equity loans**

Home equity loans are all debts that are secured by one of your qualified residences other than acquisition loans. It is the home equity loan that offers the most flexibility and is available to the greatest number of taxpayers; and because of its popularity, you will often find a number of appealing packages offered by competing institutions. Unlike acquisition loans, you may use the proceeds of a home equity loan for any purpose you wish; the interest will still be deductible even if it is used for personal expenditures. With the loss of personal interest deductions, the home equity loan market has understandably boomed. One caveat: interest on home equity loans is only deductible on loan amounts of up to \$100,000, and the total of all mortgages on your home can't exceed its fair market value.

### **Trade or business related interest**

You may also be able to borrow against a third residence (above and beyond your principal or second home) if you use the proceeds for investment or business purposes. In that case, you will not be using the "qualified residence" category, but will instead need to establish that the proceeds of the loan are used for your trade or business or are used to purchase qualified investments in order to show that the interest is not personal. Remember, whether interest is a personal or

business expense depends on the use of funds borrowed and not on the assets that secures the loan.

### **Tax wise borrowing**

With the restrictions and limitations placed on interest deductions, there are opportunities by which you can structure your borrowing so as to reap the maximum tax and financial benefits possible. Some suggestions are outlined here under. Of course, not all of these transactions will be available to every taxpayer. You should certainly contact tax professional before making any moves to recharacterize your finance. Nevertheless, the opportunities for strategizing and saving exist.

### **Convert personal debt into deductible debt**

Taxpayers are generally charged with highest rate of interest on credit card borrowing and installment loans for cars or boats. These loans should be paid off and replaced wherever possible by lower interest loans; e.g. home equity loans. Not only you save on rate of interest but interest paid will also be deductible.

### **Increase your mortgage for planned large purchases**

Since the \$ 1 million limit on acquisition mortgages can never be increased through refinancing, if you think you may need to borrow for large personal expenditures in the near future, consider increasing the original mortgage at the time of acquisition. If you wait, later equity borrowing would be subject to \$100,000 home equity limit as to deductible interest. With this, you will effectively pay less and deductible interest on the amount you use for those large purchases.

### **Convert excess mortgage debt to investment related debt**

If your total mortgage exceeds the qualified amount and you are not able to fully deduct your interest, you may be able to pay down the mortgage to the limit through the sale of income producing investments you hold, and then borrow enough to purchase more investments. The interest on new loan will be deductible up to your investment income.

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**The information presented here in above is only of general nature and accordingly cannot be regarded as tax advice.**

**For more guidance, please call the office of Anne Tahim, CPA at 714-772-4744.**