Strategic Borrowing for Individuals: Maximizing Deductible Interest Expense to Minimize Tax Liability

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Individuals seeking to lower their federal and state tax liabilities may want to consider opportunities to save based on the deductibility of interest costs. The tax treatment of interest on personal debt depends on the category of interest. Therefore, how loans are structured can have a significant impact on an individual's tax liabilities, as well as cash flow and borrowing costs.

Although changes made by the Tax Cuts and Jobs Act (TCJA) of 2017 restrict what interest is deductible as qualified residence interest, interest tracing rules may provide a mechanism for an individual taxpayer to borrow money secured by the equity in their home to fund taxable investments and receive an income tax deduction for the interest. However, there are some important limitations to consider in determining if this planning opportunity can be of benefit to a specific taxpayer.

Interest Tracing

A tracing doctrine is a consideration in determining the deductibility of interest on any type of credit facility. If a taxpayer does not have sufficient evidence for tracing the loan proceeds to qualified expenditures, the interest expense may be nondeductible. The general interest tracing rules in Reg. 1.163-8T provide that debt is allocated to the proper category of interest incurred by the taxpayer by tracing disbursements of the debt proceeds to specific expenditures. The type of property that secures the debt does not impact the allocation except for home mortgage interest.

Loan interest on the purchase of a qualified residence is deductible if the loan proceeds are used to build, acquire or make capital improvements on the residence. If the loan proceeds are not used for these purposes, then loan interest will not be deductible. The TCJA reduced the amount of acquisition indebtedness eligible for the mortgage interest deduction from $1,000,000 to $750,000 (for married taxpayers filing jointly) for tax years beginning in 2018 through 2025. Homes already owned before the TCJA's enactment were grandfathered at the $1,000,000 threshold.

Investment loan interest is another common interest category and 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. The deduction for investment interest may do more than the mortgage interest deduction to minimize taxes. There is no cap on the investment interest you may deduct, as long as investment income equals or exceeds borrowing costs. If investment interest exceeds net investment income, the deduction may be carried forward indefinitely to future years. The Medicare surtax, a 3.8% tax on net investment income of taxpayers with modified adjusted gross income over $250,000 for married couples filing jointly, can also be reduced by deducting investment interest.

How to Make the Interest Deduction Rules Work for You

If a taxpayer is planning to buy a new home he or she may consider whether to borrow to fund part of the purchase price or instead cash out investments to buy the home. Taking out a mortgage would allow the taxpayer to only deduct interest on up to $750,000. On the other hand, if the taxpayer liquidates investments and uses the money to purchase the home, he or she could later—after a sufficient period of time and unrelated to the home purchase—borrow the same amount of money against the equity in the home and invest it in taxable securities. This could provide a deduction for the cost of the loan as an investment interest expense, which could in turn directly offset the taxpayer's net investment income.

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A taxpayer who is not investing in a new home but still wants to maximize their interest expense deductions could pay down an existing mortgage using cash or cash equivalents to reduce the outstanding mortgage to $750,000. After a period of time and unrelated to the reduction in the outstanding mortgage amount, the taxpayer could refinance the mortgage to take cash out secured by the home and invest in taxable investments. The taxpayer should elect out of the qualified residence interest rules on the refinanced mortgage so that the general tracing rules apply. This would generate fully deductible interest expense, which could be used by the taxpayer to offset net investment income.

Important Considerations

Investment interest is deductible against net investment income, which includes income from taxable stocks and bonds, taxable interest, nonqualified dividends, annuity income, certain royalties and short-term capital gains. For purposes of deductible investment income, net investment income does not include qualified dividends and long-term capital gains. Special rules apply to passive activities.

Investment interest expense is reported on Schedule A of a taxpayer's income tax return. It is deductible only if the taxpayer itemizes deductions and is limited to the amount of reported net investment income. Unlike the mortgage interest deduction, there is no limit to the investment interest deduction as long as investment income equals or exceeds your borrowing costs. Investment expense in excess of investment income is carried forward and can be treated as interest expense in the next tax year.

A seasoning period of time should pass between the taxpayer's liquidation of investments in order to fund a purchase and the point at which the taxpayer later borrows funds for investment income purposes. The period of time should be long enough to subject the taxpayer to rate and market risk so as to avoid the disallowance of the interest expense deduction under the step transaction doctrine.

The Takeaway

By leveraging the investment loan interest rules, individual taxpayers might be able to lower their federal and state tax liabilities while improving their cash flow and borrowing costs. Contact your Andersen tax advisor to discuss this planning opportunity further and determine whether it may be appropriate given your tax position and goals.

For more information please contact your Andersen advisor.