Interest Deductions: Divide and Conquer

Four Main Categories of Interest Expenses

By Jeremy Smith, CPA
(480) 839-4900 ~ JeremyS@hhcpa.com

How do you separate interest expenses on your 2013 tax return? There are four main categories for taxpayers to consider. (Technically, there are several other types of "interest" in the tax law.) Here is how it breaks down.

1. Personal Interest: If an interest expense does not fall into one of the other three categories, it is generally treated as personal interest. Simply put, personal interest is nondeductible. However, there is a key exception for interest paid on student loans. In brief, you can claim a limited deduction for interest paid for qualified higher education expenses—such as tuition, room and board, and books and fees—if the loan is in your name. The maximum deduction of $2,500 is phased out for high-income taxpayers.

2. Mortgage Interest: As a general rule, you can deduct "qualified residence interest" paid during the year. To qualify, you must be legally obligated to pay the mortgage, and the mortgage must be secured by a qualified home (i.e., your principal residence and one other home). The deduction limit depends on whether the debt is an acquisition debt or a home equity debt.

> **Acquisition debt:** This is a debt incurred to buy, build or improve a qualified home. The interest paid on up to $1 million of acquisition debt is fully deductible.
>
> **Home equity debt:** Any other qualified debt allowed by a state law, such as a home equity loan or line of credit, is treated as a home equity debt. The interest paid on up to $100,000 of home equity debt is fully deductible.

Unlike most other types of interest expenses, the interest on home equity debt may be deducted no matter how the loan proceeds are used. Home equity debt cannot exceed the fair market value of the home on the last day of the year reduced by the outstanding acquisition debt.

3. Investment Interest: If you borrow funds to buy property held for investment purposes (e.g., securities or real estate), the interest paid on the loan is treated as investment interest. The amount of investment interest you can deduct is generally limited to the amount of your net investment income (NII) for the year. Any excess is carried over to the next year.

For these purposes, NII includes gross income from property held for investment, such as interest, annuities and royalties. It does not include capital gains and qualified dividends eligible for tax-favored

treatment. The maximum tax rate for long-term capital gain and qualified dividends is generally 15% (20%, plus a possible 3.8% for some high-income taxpayers) as opposed to ordinary income taxed as high as 39.6%. You can elect to include long-term capital gain and qualified dividends as NII if you are willing to forfeit the preferential tax rate.

4. Business Interest: The interest incurred in a trade or business, or in the production of rental or royalty income is fully deductible. Unlike the deductions for mortgage interest and investment interest, there are no limits on deductible amounts.

Of course, this is only a brief summary of the main rules in this complex area of the tax law. Obtain professional advice from your Henry & Horne, LLP tax advisers for your personal situation.

Jeremy Smith, CPA is a Partner in the Tempe office of Henry & Horne, LLP. His areas of expertise include tax and consulting work for businesses and individuals. Contact Jeremy at (480) 839–4900 or JeremyS@hhcpa.com.

HENRY & HORNE, LLP
Certified Public Accountants

Tempe	Scottsdale	Casa Grande
2055 E. Warner Road	7098 E. Cochise	1115 E. Cottonwood
Suite 101	Suite 100	Suite 100
Tempe, AZ 85284	Scottsdale, AZ 85253	Casa Grande, AZ 85122
(480) 839-4900	(480) 483-1170	(520) 836-8201

www.henryandhorne.com