Tax Breakdown of Interest Expenses
What you can deduct on 2010 returns

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

Did you pay any interest expenses last year? The interest may be wholly deductible, partially deductible or not deductible at all. Generally, the amount of the deduction depends on the use of the loan proceeds. Here's the basic breakdown for the 2010 tax year:

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: Other qualified debt, 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 other types of interest, the interest on home equity debt may be deducted no matter how the loan proceeds are used.

In a new ruling, the IRS says that acquisition debt exceeding the $1 million limit can be treated as home equity debt up to the $100,000 limit. Thus, the total limit is effectively $1.1 million.

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" for the year. Any excess is carried over to the next year.

Net investment income 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-preferred treatment. The maximum tax rate for long-term capital gain and qualified dividends in 2010 is 15%, as opposed to ordinary income taxed at rates up to 35%. However, you can elect to include long-term capital gain and qualified dividends as net investment income if you forfeit the preferential tax rate.

Business interest: The interest incurred in a trade or business, or in the production of rental or royalty income can be fully deductible. The only possible limitation would be due to passive activity losses.

Personal interest: If an interest expense doesn't fall into one of the other categories, it is generally treated as personal interest (although certain exceptions may apply). 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 if the loan is in your name. The maximum annual deduction of $2,500 is phased out for high-income taxpayers.

This is only a brief summary of the main rules. Contact Henry & Horne when filing your 2010 tax return.

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