ROUND TABLE
WEALTH MANAGEMENT

# USING MORTGAGE INTEREST TO FUND INVESTMENTS: THE INTEREST TRACING RULES

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Finding the capital to make investments, whether into one's business or other traditional investments, can often be challenging. The more stringent lending rules emanating from the latest economic downturn have made it even more difficult. For many, the equity in their home represents a significant source of untapped wealth that might be available in order to fund these investments. Currently, individuals who borrow against the value of their homes receive an income tax deduction (up to certain limits) for the mortgage interest they pay. However, the availability of the income tax deduction for mortgage interest[1] is one that has been debated by Congress as a way to raise more tax revenue. Given that we are in the midst of a Presidential election cycle this issue might gain traction. In the event that the mortgage interest deduction is reduced or eliminated, the interest tracing rules in the Tax Code might provide a mechanism to borrow funds from the equity in one's principal residence to fund investments and still receive an income tax deduction for the interest.[2] To better understand how the interest tracing rules work, we will first review how the main categories of interest are treated for income tax purposes.

## BACKGROUND - THE 5 MAIN CATEGORIES OF INTEREST

There are five main categories of interest, each with different rules for tax deductibility.

### QUALIFIED RESIDENCE INTEREST

Currently, all individuals are allowed an itemized deduction (if they itemize) on Schedule A for "qualified residence interest."[3] Qualified residence interest is interest on "acquisition indebtedness" and "home equity indebtedness." Acquisition indebtedness is debt that is secured by a "qualified residence" - one's primary and one other residence - and is used to acquire, construct or substantially improve the residence. Interest is deductible on debt of up to $1 million in total ($500,000 if married filing separately). "Home equity indebtedness" is debt secured by a qualified residence up to a maximum of $100,000 but limited to the amount by which the fair market value of the residence exceeds the acquisition debt on that residence. Note that in order to deduct interest as qualified residence interest the debt must be ***secured by*** a qualified residence.

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[1] IRC Sec 163(h)(3)
[2] IRC Reg. Sec. 1.163-8T
[3] IRC Sec. 163(h), et seq.

### *BUSINESS INTEREST*

Business interest is interest incurred on debt that is used to finance the operations of a trade or business. The interest is a business deduction that is taken on the appropriate business schedule (e.g. Schedule C). [4]

### *PASSIVE ACTIVITY INTEREST*

Passive activity interest is interest incurred in a trade or business in which the taxpayer does not materially participate. The deduction is subject to the passive loss limitation rules and is taken, as allowable, on Schedule E.[5]

### *INVESTMENT INTEREST*

Investment interest is interest incurred on debt that is used to purchase property that is held for investment. Property held for investment is generally any property that generates portfolio income such as interest, dividends or royalties. The deduction for investment interest is limited to the amount of net investment income generated in the tax year and is taken on Schedule A.[6] Any unused investment interest in a tax year can be carried forward indefinitely.

### *PERSONAL INTEREST*

Personal interest is interest on debt used to purchase any personal, non-business, non-investment property. Personal interest is not deductible.[7]

## THE INTEREST TRACING RULES

The Regulations under Internal Revenue Code ("IRC") Section 1.163-8T define the method for allocating interest in order to apply the appropriate deduction limitations for passive activity interest, investment interest and personal interest and are commonly referred to as the "interest tracing rules." These rules do not apply to the deduction for qualified residence interest. The qualified residence interest rules as outlined above define the security interest (the qualified residence) and use of proceeds rules in order to determine the appropriate deduction.

## USE OF FUNDS IS MOST IMPORTANT

The most important determining factor contained in the interest tracing rules is the ***use*** of the debt proceeds. Unlike the qualified residence interest rules, the security interest for the debt is not relevant when applying the tracing rules. The only relevant factor is what the proceeds are used to purchase. For example, if one took out a loan that was secured by business assets and used the funds to purchase

[4] IRC Sec. 162
[5] IRC Sec. 469
[6] IRC Sec. 163(d)
[7] IRC Sec. 163(h)(2)

a boat or other personal asset, one might believe the interest is deductible business interest. However, it is actually non-deductible personal interest under the interest tracing rules since the proceeds of the debt were used to buy a personal asset. Since it is the use of the debt proceeds that is determinative, these same rules can be utilized to convert what may be otherwise non-deductible interest into deductible interest.

Even if the mortgage interest deduction were repealed or substantially reduced under new tax rules or if existing debt on one's residence was at the maximum deductible amount, there may still be a way to obtain a deduction for the interest on the mortgage. If one were to take out a mortgage secured by their residence and used the proceeds for another purpose such as to fund trade or business operations or to purchase an investment asset, the interest could become deductible, subject to any limitations of that interest category. One could apply the same logic across interest categories to obtain the most favorable results. Again, remember that the security interest for the debt is not important; the use of the proceeds is the only relevant factor.

## MAKE SURE YOU ARE ABLE TO TRACE THE FUNDS

What is of utmost importance when applying the interest tracing rules is the ability to clearly trace the funds from receipt of loan proceeds to disbursement of funds. If the loan proceeds are commingled with other funds, complicated rules come into effect in order to allocate the interest to the appropriate category. The best suggestion is to create a clear trail by opening separate accounts into which loan proceeds are deposited and from which funds are withdrawn to be able to identify the use of proceeds.

## NOW MIGHT BE A GOOD TIME TO BORROW

Given that mortgage interest rates are at or near all-time lows, now may be a good time to borrow against your principal or second residence in order to invest in a business or to make other investments. Although lending standards have increased in recent years, for those borrowers with excellent credit many banks are willing to make loans. Investigate the differences in interest rates between mortgage debt and business debt and also take into consideration the length of the loan term when making a determination of which type of loan is most efficient. Mortgages can have fixed rates for up to 30 years while typical business loans generally have much shorter loan terms.

## CONCLUSION

Using the interest tracing rules outlined above and the equity in one's home can result in a tax efficient way to invest in a business or to make other investments. As well, given current low mortgage rates, borrowing against the equity in one's home could provide the least expensive funding.

The interest tracing rules can be quite complex and if the proper accounting and tracing is not done, the intended tax benefits could be lost. As is always the case with income tax planning, following the rules and documenting the transactions are most important to ensure the desired results are achieved.

## ABOUT THE AUTHOR:

**Bruce Hyde, CPA** is a Wealth Advisor at Round Table Wealth Management and has over 25 years of experience in the financial services industry. He is responsible for advising clients on the full range of financial matters including investments, insurance, estate, gift and income tax issues as well as financial decision making. For the past 13 years, Bruce has been working closely with partners at major law firms to serve their unique financial planning needs.

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