

STRATEGIC

LAW GROUP PC

Strategic Integrated Planning

MAXIMIZING YOUR HOME MORTGAGE DEDUCTION WITHOUT RUNNING AFOUL OF IRS REGULATIONS

There are four options for deducting interest costs secured by real estate. Real Estate Interest may be related 1) home mortgage acquisition debt; 2) home equity debt; 3) investment debt; and 4) business operating debt.

Home mortgage acquisition debt is any debt that is secured by the residence and was incurred in acquiring, constructing or substantially improving the residence. Interest on refinanced debt may be deductible, but only up to the amount refinanced.

Home equity indebtedness is any indebtedness, other than acquisition debt, secured by a qualified residence. Home equity debt may not exceed \$100,000 or the fair market value of the residence. This is an issue in the current real estate market. The internal revenue service is aware of this and has instituted a program specifically targeting home equity debt deductions.

Investment debt is debt allocable to property held for investment. The interest taken for investment purposes may not exceed the income from investments. If there is no investment income for that year the investment interest expense is carried forward to subsequent years and accrued until there is an investment income.

Business operating interest expense is interest on indebtedness used in the conduct of a trade or business. Business operating interest expense may be used to off-set income earned from a trade or business. Whether the expense may be used to offset your active business or your passive business income depends on the type of business.

Active business income is earned through your material participation in activities which earn an income. For instance, income earned as an employee, from your sole proprietorship, general partnership, member-managed limited liability company or subchapter S corporation.

Passive Business income is earned by operation of a trade or business in which you do not materially participate. For instance, income from real estate rentals with which you do not actively manage, investment in a limited partnership which is not publicly traded; a limited liability company which you do not manage or an S-Corp which you do not manage.

The Internal Revenue Service has stepped up enforcement of home mortgage interest deductions. In the current economic situation, real estate values have decreased substantially and many properties are under water. As such, a taxpayer may not be able to deduct home equity interest as an itemized deduction. If proceeds from a refinance were used for investment purposes, there is hope for you to overcome the \$100,000 limitation.

The Treasury Regulations allow interest that is not acquisition debt secured by a qualified personal residence to first be allocated to investment interest, business (passive or active) interest, then home equity interest. This means that if your home equity debt is greater than \$100,000 you may be able to still deduct the interest on the entire amount.

Requirements to ensure proper treatment by the Service: There are several items where you must exercise diligence when claiming these deductions on your return. First, be sure to keep your closing documents. Attempt to tie draws from your home equity credit accounts to investments made contemporaneously. Many business owners have drawn from their home equity and investment equity to finance business operations in the current slow economic conditions. Be sure to document these investments into the business on your accounting books. For instance, instead of “cash investment” in your journal entries, you would be better served by stating “cash from personal equity loan account”. This will provide you with significant ammunition when dealing with the IRS.

What if you have three homes? You may only deduct home acquisition debt for two homes. However, if you purchased a third home for its appreciation potential – the purpose for which almost all non-rented real estate investments are made – you may deduct the interest as investment interest to off-set income made through dividends, capital gains, and interest. Because you will pay capital gain tax on the amount realized through the appreciated value you may still use the “investment” for personal use.

Our office professionals are able to provide additional insight into these strategies. In addition, there may be additional tax and legal strategies to assist you in weathering the current economic storm.

Please contact the Firm Director, June Waage at 1-866-657-0246 or jwaage@strategiclawgrouppc.com to arrange a meeting with a member of our professional staff.