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Interest Tracing Rules Can Unlock Tax Benefits

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When a taxpayer borrows funds, the deductibility of the related interest expense is determined by how the loan proceeds are ultimately used and not how the loan proceeds are collateralized. These are often referred to as the *interest tracing rules.* Planning early in your loan process and working with your tax advisors may result in substantial tax benefits that may otherwise be overlooked.

Types of Interest Expense

The various categories of interest expense are as follows:

- **Investment interest** is related to debt used to purchase property that is held for investment (such as stocks, mutual funds, and other investments) and is deductible to the extent a taxpayer has net investment income. It is worth noting that interest expense incurred to generate tax-exempt income is not deductible.

- **Home mortgage or residential interest** is related to your personal residence (primary and/or second home) and may be deductible as an itemized deduction (subject to certain debt limitations).

- **Trade or business interest** is related to activities that a taxpayer materially participates in.

- **Passive interest** is related to "income producing" activities where the taxpayer does not materially participate and is deductible to the extent a taxpayer has passive income.

- **Personal interest**, such as interest on a car loan or personal credit card, is not deductible.

Determining Interest Deductibility

An ongoing analysis is required to determine deductibility of the interest on an annual basis. One cannot simply determine deductibility based on how the funds were used initially. One example to illustrate this would be an intra-family loan. If a parent loans their adult child money and that child uses the proceeds to buy a car for their everyday use, that interest expense paid to the parent would be considered personal interest and is non-deductible. However, if the child uses the funds to invest in various securities, the interest paid on the loan could be deductible as investment interest expense. If the child uses the loan for both investment and personal purposes (buying a car and her investment portfolio) then the interest expense must be "traced" and allocated between the two uses, with the personal portion not being deductible.

Another point regarding the tracing rules is that a taxpayer can treat any payment within 30 days before or after they deposit loan proceeds into an account as being made from those proceeds. If planning is done properly, this allows for a great deal of flexibility to allow for interest expense that may otherwise be considered nondeductible to become tax deductible. For example, if a taxpayer uses $50,000 from an account to acquire various stocks and 20 days later the taxpayer deposits loan proceeds into that same account, under the interest tracing rules the taxpayer can treat their stock purchases as being made from those loan proceeds even though the purchases were done before the loan proceeds were received. The taxpayer is then able to categorize a portion of the interest as investment interest expense.

The Takeaway

As noted above, there are several categories of interest expense and the tax implications of each are different. The interest tracing rules can become complicated. To secure a tax deduction it is important to

discuss with your service team members early in the loan process so proper planning and implementation can be done.

Contact Us

If you have any questions about interest expense deductibility or any other tax matters, please contact your tax engagement partner or:

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