IRS Tracing Rules for Interest Deductions

Before 1987, deducting interest was not only more liberal, it was also much simpler. Save for a couple of exceptions, any type of interest was tax-deductible with generally no limit on the amount of the deduction. Today, deducting interest is neither automatic nor simple. Under complex rules, the tax treatment of interest for an individual taxpayer can range from fully deductible to partially deductible to not deductible at all, depending on the category of interest.[1] A list of these interest categories appears below. How the interest is deducted and the IRS from used to state the deduction is briefly stated in the parentheses.

- Category 1: Qualified residence interest (Itemized deduction – Schedule A).
- Category 2: Business interest (Business deduction—Business schedule).
- Category 3: Passive-activity interest (Rental property deduction with possible limits—Schedule E).
- Category 4: Investment interest, such as stocks, bonds, etc. (Itemized deduction with possible limits - Schedule A).
- Category 5: Consumer (personal) interest (this is not deductible at all).

Note:

Except for Category 1 (residence interest), the deductibility of interest will depend on how the loan monies are used (not the type of collateral security used for the loan). Accordingly, for Categories 2 through 5, the deductibility (or non-deductibility) of interest depends on why one spends the money. These rules are called "tracing" rules.

Example 1:
Ms. Investor refinances her rental property and takes out $30,000 in cash, which she uses to open up her own realty company to be operated as a single proprietorship. The related interest on the refinancing loan is treated as Category 2 (business interest) and is fully deductible as a business expense on her Schedule C. It will not be deducted on a rental schedule, even through the security for the loan is a rental property. Had the loan funds been used for personal purposes, the interest would be treated as Category 5 (Consumer (personal) interest) and would not be deductible at all. Again, it makes no difference that the rental property is the security for the loan.

Example 2:
Mr. Investor refinances his rental property and takes out $25,000 in cash to invest in stocks. The related interest on the refinancing loan is treated as Category 4 (investment interest) and is deductible up to the amount of investment income such as interest and dividends (unused deductions can be carried over). Again, it will not be deducted on the schedule for rental properties, even though the security for the loan is a rental property. If Mr. Investor used a margin account to buy the securities, the interest would again be investment interest.

Planning point:

If the borrowed funds are commingled with other funds that were not borrowed ("un-borrowed funds"), then potential interest deductions on the loan can be lost. Basically, separate accounts for one's business, rental properties, investments, and personal affairs must be kept. Do not commingle borrowed funds with un-borrowed funds. Try not to use the borrowed monies for personal expenditures. If one wants to borrow to buy a personal-use item, make the purchase first from the savings account, then restore the savings account with the borrowed money. In this scenario, the savings account is an "investment," and therefore, the loan interest is deductible as investment interest (which is better than it being nondeductible personal interest).

Exception To Tracing Rules

Category 1 (qualified residence interest) includes home-equity loans on a principal or second residence.[2] For the home –equity loan to be deductible as qualified residence interest the loan must be specifically secured by the primary or second residence.[3] Such security is accomplished by a mortgage, a deed of trust, or a land contract, all of which are instruments that must be recorded, preferably with experienced legal counsel.

Note:

For home-equity loans up to $100,000, it makes no difference how the funds are used.[4] The related interest is fully deductible as residence interest that is an itemized deduction on Schedule A of Form 1040. (Loan funds exceeding $100,000 would come under the previously discussed tracing rules.)

Example:

X takes out a home-equity loan for $100,000 on X's residence. The loan is secured by a mortgage on X's home. The money is used for the following purchases.

Home improvements	$ 20,000
Rental property	50,000
Business equipment	10,000
To fund X's Keogh plan	10,000
Personal and recreational	10,000
Total:	$100,000

The tax treatment of the related interest expense is fully deductible as residence interest on Schedule A, regardless of how these loan proceeds are used. (Note: Even the personal and recreational portion is deductible under this exception.)

Securing Interest Deductions On Refinancing The Rental Property

Do not commingle funds. If cash from the loan will be used for different purposes (such as business and investment), then the funds should be kept in separate accounts so the particular type of interest can be clearly identified.

Example:

If one anticipates buying $25,000 of business equipment, the loan funds should be put into the business account before sending the check to the vendor. The same holds true for the purchase of stocks – open up a separate “investment account.” For investment real estate, put the funds in a separate “rental account” and then purchase the real estate. Use separate non-personal accounts for each purpose.

When it is uncertain where the refinancing funds will go, immediately deposit them into a new separate (taxable) interest-bearing savings account. As stated previously, a savings account is an investment, and therefore, the interest is deductible as investment interest.

Do not use the money to purchase or improve a primary residence or second home.

Caution:

This is a major tax trap because if this is done, the interest will not be deductible at all. This is because the money is being used for personal purposes and the residence-interest exception is not available where the loan is not secured by the primary residence or second home. It is secured by the rental property.[5]

Do not put the money in the personal bank account.

Do not make direct purchases of personal-use items (such as a fur coat).

Do not put the money into any type of tax-exempt securities (exempt bonds, exempt money-market accounts, etc). The loan interest is not deductible.

Deduct interest on home-equity loans used for business purchases. If a home-equity loan is used for business purposes (such as the purchase of business equipment or a car) the interest can be deducted on Schedule A - *Itemized Deductions*, as home mortgage interest. However, if all or part of a home-equity loan is used for business, one can instead elect to treat the home –equity interest as business interest and then deduct the interest as business interest on a business or rental schedule (not Schedule A). Deductions on these schedules are more valuable. To do this, one should make a separate written election and attach it to the return.

1 IRC Section 163(h)
2 IRC Section 163(h)(5)
3 Temp. Regs. Section 1.163-10T(j)(1); Temp. Regs. Section 1.163-10T(o)(1)
4 IRC Section 163(h)(3)(C)
5 TAM 9418001