**8522.01. What types of interest are deductible?**

Whether or not interest is deductible depends on its classification as one of the following types of interest: (1) investment interest, (2) trade or business interest, (3) qualified residence interest, (4) interest relating to passive activities, (5) interest incurred on extended payment of estate tax, (6) interest on education loans or (7) personal interest. The deductibility of these seven types of interest is discussed in detail in Q 8522.02-Q 8522.08.

The proper allocation of interest generally depends on the use to which the loan proceeds are put, except in the case of certain qualified residence interest. Detailed rules for classifying interest by tracing the use of loan proceeds are contained in temporary regulations.[[1]](#footnote-1)

In some cases, the Code may specifically disallow the deductibility of interest. For example, no deduction is allowed for interest paid on a loan used to buy or carry tax-exempt securities.[[2]](#endnote-1) The rationale for the disallowance is to prevent the taxpayer from receiving an unwarranted double tax benefit. ( first, the exclusion of the interest from gross income; and, second, a deduction for the interest on a loan used to purchase the underlying tax-exempt security).

Interest expense that is deductible under the rules outlined in Q8522.02-Q8522.08 may also be subject to the additional limitations on itemized deductions (unless it is investment interest, which is not subject to that provision). See Q 8520 for a discussion of the limits on itemized deductions.

**8522.02. What are the rules for the deductibility of investment interest by an individual taxpayer?**

 Any interest expense on indebtedness properly allocable to property held for investment is classified as investment interest.[[3]](#footnote-2) However, there is a limitation as investment is deductible to the extent of net investment income. Any excess is carried forward to subsequent tax years subject to the same terms and conditions. Net investment income is investment income less investment expenses (other than interest). Investment income is income from property held for investment such as interest, dividends, annuity income and royalties.[[4]](#endnote-2)

 *Example:* In 2014, Asher has net investment income of $7,500 and investment interest of $10,000. Because the deductibility of investment interest is limited to net investment income, only $7,500 of the $10,000 of investment interest is deductible. The excess disallowed investment interest of $2,500 is carried forward to subsequent years.[[5]](#endnote-3)

 Excluded from the definition of investment income is net long-term capital gain and “qualified dividends.” These types of income are taxed at a maximum rate of 15% or 20% depending on the taxpayer’s overall income (i.e., the 20% rate applies to high income taxpayers). On the other hand, other types of investment income such as non-qualified dividends, interest income, etc. are taxed at ordinary income rates (up to 39.6%). However, if a taxpayer elects to treat long-term capital gains or qualified dividends as ordinary income (waives the application of the 15% and 20% maximum rates), that income does count as investment income.

 *Example*: Same as the above example, except that Asher has a combined $2,500 of qualified dividends and net long-term capital gain. If Asher makes an election waiving the 15% and 20% maximum rates with respect to that income (meaning it could be taxed to up toe 39.6%), he may include it as investment income. If he does, Asher can deduct the full $10,000 of investment interest because adding the $2,500 of qualified dividends and net long-term capital gain to the $7,500 of other net investment income, there would be a total offset.[[6]](#endnote-4)

**8522.03. What is deductible trade or business interest?**

 Trade or business interest, as the name suggests, includes any interest incurred in the conduct of a trade or business. So for example, if a taxpayer borrows funds for working capital in a trade or business, the interest payments would be deductible.

**8522.04. What is deductible qualified residence interest?**

 Qualified residence interest is interest paid or accrued during the taxable year on debt that is secured by the taxpayer’s qualified residence and that is either (a) “acquisition indebtedness” (that is, debt incurred to acquire, construct or substantially improve the qualified residence, or any refinancing of such debt), or (b) “home equity indebtedness” (any other indebtedness secured by the qualified residence).

A “qualified residence” is the taxpayer’s principal residence and one other residence that is essentially a second home.[[7]](#endnote-5) A taxpayer may only treat an aggregate of $1,000,000 as acquisition indebtedness (spread over the two residences), *but* the amount of refinanced debt that may be treated as acquisition indebtedness is limited to the amount of debt being refinanced. The aggregate amount that may be treated as “home equity indebtedness” (that is, borrowing against the fair market value of the home, less the acquisition indebtednes to borrow against the “equity” in the home) is $100,000,[[8]](#endnote-6) or a combined maximum of $1,100,000 of indebtedness.

 *Example*: In 2012, Ashley and Asher, a married couple, purchase a principal residence for $400,000 financed in part by a $300,000 home acquisition loan. In 2014, pursuant to a refinancing they borrow $350,000 to pay off the initial $300,000 loan and the other $50,000 to purchase two cars. Of the amount borrowed, only $300,000 (the amount necessary to pay off the initial acquisition loan) is treated as acquisition debt. The other $50,000 does not qualify as acquisition indebtedness. However, assuming the residence is worth $400,000 (meaning there is $100,000 of equity), the $50,000 additional indebtedness would qualify as home equity indebtedness. As a result, the interest on the total indebtedness would be deductible as qualified residence interest.

**8522.05. To what extent is the deductibility of interest limited by the application of the passive activity loss rules?**

 A passive activity is generally an activity that involves the conduct of a trade or business in which the taxpayer does not materially participate, or any rental activity.[[9]](#endnote-7)  Generally, the deductibility of passive expenses is limited to the amount of passive income. The excess, passive loss, is not deductible. Instead, it is carried over to subsequent tax years for potential deductibility against passive income generated in those years. The same rules apply to the deductibility of interest related to a passive activity. So the extent that otherwise deductible interest is related to a passive activity, some or all of the interest deduction Interest deductions that are allocated to passive activities may be similarly disallowed.[[10]](#endnote-8) See Q 8603 to Q 8612 for a detailed discussion of the passive loss rules;

**8522.06. Is the interest on extended payments of estate tax deductible?**

If an extension to pay Federal estate tax over a period of time is in effect, the interest portion of the payment is deductible.[[11]](#endnote-9)

**8522.07. Is the interest on education loans deductible?**

 An above-the-line deduction is available to certain taxpayers for interest paid on a “qualified education loan.”[[12]](#endnote-10) In 2014, the deduction is limited to $2,500 of such interest. However, the deduction is phased out for taxpayers with modified AGI between $65,000 and $80,000 ($130,000 and $160,000 for joint returns).[[13]](#footnote-3) Certain other requirements must be met for the deduction to be available.[[14]](#endnote-11)

**8522.08. Is personal interest deductible?**

 Pursuant to IRC section 163(h)(1), all personal interest is deductible. However, in defining personal interest, all of the types of interest described Q8522.02 through Q8522.07 are not considered personal interest, and, thus, are deductible subject to the limitations discussed therein. Generally, non-deductible personal interest includes but is not limited to consumer credit card interest, car loans and interest on tax deficiencies.

1. . See Temp. Treas. Reg. §1.163-8T. [↑](#footnote-ref-1)
2. IRC Sec. 265. [↑](#endnote-ref-1)
3. . IRC Sec. 163(d)(3). [↑](#footnote-ref-2)
4. IRS Publication 530 (2013). [↑](#endnote-ref-2)
5. IRC Sec. 163(d). [↑](#endnote-ref-3)
6. IRC Sec. 1(h)(11)(D)(i), [↑](#endnote-ref-4)
7. IRC Sec. 164(h)(4)(A). [↑](#endnote-ref-5)
8. IRC Sec. 164(h)(3). [↑](#endnote-ref-6)
9. IRC Sec. 469. [↑](#endnote-ref-7)
10. IRC Sec. 469, Treas. Reg. §1.163-8T. [↑](#endnote-ref-8)
11. IRC Sec. 163(h)(2)€ [↑](#endnote-ref-9)
12. IRC Secs. 163(h)(2)(F), 221. [↑](#endnote-ref-10)
13. [↑](#footnote-ref-3)
14. See IRC Sec. 221; Treas. Reg. §1.221-1. [↑](#endnote-ref-11)