



Wealth
Management

Address rising interest rates in tax season and beyond: know your options for loan interest deductibility

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In a rising interest market, borrowers are rightly concerned about their loans that carry floating interest rates. These include auto loans, credit cards, securities-based loans (i.e., loans where the collateral consists of your investment portfolio) and even HELOCs.

One often overlooked factor to rising loan rates is the potential tax deductibility of interest that may result in an “after-tax interest rate” that can be significantly lower than one’s non-deductible rate.

While the rules can be complicated depending upon the situation, there are some general high-level guidelines which may be helpful. Please consult with your independent tax advisor on your particular situation.

Do I potentially qualify for an interest deduction on a loan (whether future or existing)?

The extent to which you may potentially deduct interest on any loan depends upon tracing the purpose for which the loan is used. For example, interest paid on a loan for business expenses may be deductible, while interest paid on a loan for personal expenditures generally cannot. The purpose of the debt has a critical impact on the deductibility of the associated interest payments. Tracing the use of proceeds allocates the debt and interest, depending upon the type of expenditure to which the proceeds are used. The underlying property used to secure the loan (e.g., an investment account held with your professional financial advisor) is generally irrelevant with some exceptions; only the loan’s use is significant (subject to a limited exception for personal residences to be discussed below). In certain circumstances, such as

when using a securities-based loan for residential rental property, investments such as business expenditures or private equity capital calls, the interest deductibility guidelines may be of interest to you.

Does a loan to purchase or improve investment property qualify for an interest deduction?

Loan interest may be the single biggest deductible expense attributed to your rental property. Common examples of interest that you can deduct include interest payments on loans used to acquire or improve rental property, and interest on credit cards for goods or services used in a rental activity. Whether you decide to make repairs or improvements that cannot be expensed immediately, such as new appliances or a new in-ground pool where the cost must be depreciated over time, any loan interest to finance the cost of these repairs or improvements may still be deductible. Consider the example of someone who uses a securities-based loan to acquire a home or other investment real estate solely for the purpose of receiving rental income. Interest payments (not principal) on loans used to:

- Acquire rental property
- Improve rental property
- Refinance credit card debt for goods or services used in a rental activity
- Other expenses related to rental activities, such as insurance, maintenance, cleaning, etc.

These expenses may be deductible from rental income depending upon your circumstances. Unlike the Home Mortgage Interest Deduction that has certain limitations (i.e., only mortgages up to \$750,000 qualify and the loan

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must be collateralized by the residence itself), there may be no limitations on the amount of interest one can write off against a securities-based loan, or even a credit card, used for a rental property, when applicable. Rental property owners with a loan, therefore, will find that loan interest is likely their largest deductible expense.

To determine your potential tax savings for deductible interest payments, simply multiply your annual interest payment by your tax rate. For example, if you paid \$5,000 in loan interest for repairs and/or improvements to your residential property and your tax rate is 37%, your tax savings would be \$1,850 ($\$5,000 \times .37$).

More important, even if you have no rental income, but you made repairs, paid loan interest and covered all applicable rental expenses, it is considered a loss for tax purposes. Taking losses never sounds like a good thing, particularly when it comes to investments. For rental property owners, however, a tax loss carry forward (a loss today that can be used in the future) might be something to get excited about for years to come because you can carry forward these losses to future years, indefinitely to when rental income returns.

Does using my loan for business expenses and capital expenditures qualify for an interest deduction?

You can generally deduct, as an expense, all interest paid during the tax year on a loan related to your trade or business if certain criteria are met. These may include expenses incurred during the course of regular business, such as employee compensation, rent or business-related insurance. It's important to remember that the deduction begins only when the borrowed funds are spent for business purposes. In contrast to business expenses, a capital expenditure is incurred when a business spends money on either buying a new asset or adding to the value of an existing asset with the expectation of receiving benefits for longer than a single tax year. Essentially, a capital expenditure represents an investment in the business rather than an expense. Examples of capital expenditures include the purchase of fixed assets, such as new buildings, trucks or business equipment, or upgrades to existing facilities. For example, you borrow \$1 million against your investment portfolio to buy new office equipment and pay 6% interest on the loan, your annual interest expense of \$60,000 may be deductible because the loan is a business loan, even though the purchase is a capital expenditure and the collateral consists of

assets in your brokerage account. In other words, as in the previous example for rental property, it is tracing the use of proceeds that is relevant, rather than the collateral used for the loan. In contrast, if you borrow from your business's line of credit for personal purposes, as well as business purposes (so-called "mixed purposes"), you may only deduct the interest on the part properly allocated for business purposes. In this case, it may be prudent to have one loan for personal use and another for business, or segregate the loans for more efficient tax reporting. The tax rules around specific transactions can be complicated. As always, you should consult your own tax advisor about the application of these rules to your own particular circumstances as RBC Wealth Management does not provide tax advice.

How do I calculate my actual savings from deductible interest as well as my "after-tax interest rate"?

If you and your outside tax advisor have determined that your loan interest is deductible, remember this simple equation: $(DIP \times TR) = \$ \text{ saved}$; that is, (DIP) Deductible Interest Paid \times (TR) your Tax Rate = dollars saved. For example, if you paid \$5,000 in deductible interest on a \$100,000 loan (5% rate), and you are in the highest tax bracket (37% for married couples filing jointly earning $> \$693,750$ in 2023), you saved \$1,850. Or, expressed differently, your after-tax interest rate is 3.15% ($[(\text{interest rate}) \times (1 - \text{your tax rate})]$) rather than 5%. That's very good news in this rising rate environment if your use of loan proceeds is for a deductible purpose.

Risks

One final consideration in the determination of your ideal loan type is risk. While everyone's risk appetite is different, you should be aware that your investment portfolio is subject to margin calls and can be sold without notice if it is pledged as collateral for a loan. For loans secured by your home, the risk is obvious and careful consideration should be taken when putting your home at risk for uses other than a home purchase or improvement which likewise may affect tax deductibility of interest. Finally, business loans often require personal guarantees from the business owner. That means that your personal assets may be at risk for the failure of your business which is not an insignificant consideration.

Please reach out to discuss your strategic credit strategies.

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24-31-00554_31425 (03/24)