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Annual Fall Sale

From October 18 through December 15, 2005, my annual fall sale offers a 20% discount on all services except IRS (or other government) audit assistance. So, save on year-end tax planning, getting your computerized accounting up and running before the new year, business consulting, and personal financial planning. Call today to set up your appointment. To take advantage of the discount, you need to pay your invoice within 10 days of billing. (Note: This is *not* the same as the prepayment plan for 2005 tax return preparation, which you will receive in December.)

Deductibility of Mortgage and Other Interest

With all the mortgage refinances that have occurred in the past couple of years, I'm going to review what kinds of interest are deductible, and some of the pitfalls that can arise due to a refinance. There's good reason why all the lenders write, "Consult your Tax Advisor," regarding the deductibility of interest. So let's start with the basic premise: *Interest is not deductible unless specifically allowed by the Internal Revenue Code.*

The most common allowed interest is that paid on a mortgage secured by your principal residence (and one other residence). Even this isn't automatic. As long as you've got just the **mortgage used to buy or build** the home (called "acquisition debt"), all the interest is deductible, unless the mortgage is for over $1,000,000. In addition to this, you can take out an equity line of credit on the above two homes. As long as the balance of this loan (called "equity debt") is under $100,000 the interest on this is also fully deductible. But equity debt interest is *not* deductible for the Alternative Minimum Tax.

Things get quite complex as soon as you either (a) refinance or (b) have home equity debt of more than $100,000. Only the part of the refi that directly paid off the acquisition debt still is automatically deductible. The rest gets lumped in with equity debt. After a few refis where you take cash out (or have high closing costs), you can end up with the first mortgage having over $100,000 of equity debt buried in it.

In order to deduct the interest on personal residence equity debt of over $100,000 or any other debt you need to trace the use of the proceeds to a purpose that is deductible under other provisions of the Internal Revenue Code. The tracing rules are quite complex, so it's important to plan ahead. The basic rule is to put the funds into a separate bank account from your every-day checking account. Track each expenditure so you can prove deductibility.

Here are some other kinds of debt and whether the interest is deductible:

- Debt to improve your residence: deductible the same as acquisition debt.
- Mortgage debt to buy a rental property: deductible against the rental income.
- "New" debt on a rental property: need to trace the proceeds.
- Credit card interest: generally not deductible, unless you can trace the proceeds.
- Car loans: not deductible except for business/farm/rental portion.
- Interest you pay the IRS, Colorado, or other government entities: not deductible, even if due to business reasons.
- Student loan interest: Deductible for low to low-middle income families.
- Debt (including equity debt, credit cards, personal loans) used to pay rental, business or farm expenses: generally deductible on the business tax return (Schedules C, E, or F; or corporate/partnership forms).
- Margin interest (in a securities account): need to trace to (a) personal expenses, (b) taxable investments, and (c) municipal bonds. Only that traced to taxable investments is deductible.
- Debt to finance investments: deductible if these are taxable investments (including IRAs); not deductible if these are municipal bonds. This interest is an itemized deduction called "investment interest." You get to deduct this only to the extent you have investment income; the disallowed portion gets carried to future years until you use it up or die. Investment income now includes just interest income and net short-term capital gains, though you can elect to include dividend income and long-term capital gains if you wish. I generally would not recommend that unless you see no prospect of being able to utilize the investment interest for many years.

So, when I ask you for details about your mortgages and other debt, it's to make sure that I put the interest in the correct place on your tax return (assuming it's allowed).

Recent classes

Last month I took a class that covered the life cycle of a small business from the initial concept through growth and its end through sale, liquidation, or merger. One interesting thing I learned is why the LLC is the entity of choice for most small businesses: It provides liability protection, but doesn't have the state-law requirements for boards of directors, minutes of meetings, etc. that corporations have. Most "mom-and-pop" businesses are run like LLCs even if they are corporations. If the corporate structure seems best from a tax perspective, the LLC can elect to be taxed as a corporation (I've helped at least one business go through this transition).

In August I took a three-day refresher class in connection with my Certified Senior Advisor (CSA) designation. We covered many aspects of serving seniors, including:

- Spirituality,
- Societal issues,
- Physiology (including perceptions of aging),
- Mental health,
- Social support systems (including housing),
- Nutrition and fitness,
- End-of-life planning,
- Estate planning,
- Long-term care,
- Funeral planning,
- Government programs such as medicare, social security, and medicaid, and, of course,
- Estate planning and financial choices.

As you can see, I have learned a basic understanding of many issues facing seniors. For areas outside my competence, I can refer you to other CSAs (throughout the US and Canada) who have subscribed to the high ethical standards required for membership.

Promote justice, equity, and compassion for everyone.