The investment interest expense deduction: Less beneficial than you might think

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Investment interest — interest on debt used to buy assets held for investment, such as margin debt used to buy securities — generally is deductible for both regular tax and alternative minimum tax purposes. But special rules apply that can make this itemized deduction less beneficial than you might think.

Limits on the deduction

First, you can't deduct interest you incurred to produce tax-exempt income. For example, if you borrow money to invest in municipal bonds, which are exempt from federal income tax, you can't deduct the interest.

Second, and perhaps more significant, your investment interest deduction is limited to your net investment income, which, for the purposes of this deduction, generally includes taxable interest, *non*qualified dividends and net *short*-term capital gains, reduced by other investment expenses. In other words, *long*-term capital gains and *qualified* dividends aren't included.

However, any disallowed interest is carried forward. You can then deduct the disallowed interest in a later year if you have excess net investment income.

Changing the tax treatment

You may elect to treat net long-term capital gains or qualified dividends as investment income to deduct more of your investment interest. But if you do, that portion of the long-term capital gain or dividend will be taxed at ordinary-income rates.

If you're wondering whether you can claim the investment interest expense deduction on your 2016 return, please contact us. We can run the numbers to calculate your potential deduction or to determine whether you could benefit from treating gains or dividends differently to maximize your deduction.

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