

How to deduct home-equity loan interest as business expense

If you took out a home-equity loan last year and injected the resulting cash into your pass-through business (sole proprietorship, S corps, partnership or LLC), you can typically deduct the related in-terest expense. But *don't* report the interest as an itemized deduction on your Schedule A. Here's why:

As long as you "materially participate" in the business, you can take a business deduction for interest on a loan that's used to inject capital into a pass-through entity business. If you run the business, you will almost certainly pass that test.

That allows you to deduct the interest on the appropriate business tax form: Schedule C for sole proprietorships and single-member LLCs, and Schedule E for partnerships, S corporations and multimember LLCs.

You'll gain the following advantages by deducting the interest on Schedule C or Schedule E (instead of Schedule A):

- Your interest deduction is exempt from phaseout rules that can curtail itemized deductions for high-income individuals.
- Your interest deduction reduces your adjusted gross income (AGI), which cuts the odds that various other unfavorable AGI-based phaseout rules will curtail various other tax breaks.
- Your interest deduction reduces your self-employment tax bill.
- Your interest deduction won't be completely or partially wiped out if you are subject to the alternative minimum tax.

Strategy: To reap all those sweet tax benefits, you must "disclaim" your Schedule A itemized deduction and instead deduct the home-equity loan interest on Schedule C or E.

Make your disclaimer by attaching that statement to your 2003 return: "Taxpayer hereby elects to treat the following debt as not secured by taxpayer's residence." List the loan amount and lender's name. (*IRS Temp. Reg. 1.163-10T(o)(5)*)

By making that special election, you preserve the right to deduct interest on home-equity debt taken out in future years on your Schedule A. So if you decide in 2004 to take out another home-equity loan to pay off your credit card balance, no problem! You generally can borrow up to another \$100,000, and deduct all the interest on Schedule A.