Using Home Equity for Business Needs

Article Highlights:

- Business Interest
- Home Mortgage Interest
- Excess Interest
- Standard Deduction
- Alternative Minimum Tax
- Self-Employment Tax
- Allocations

Small business owners frequently find it difficult to obtain financing for their businesses without pledging their personal assets. With home mortgage interest rates at historic lows, tapping into your home equity is a tempting alternative but one with tax ramifications that should be carefully considered.

Generally, interest on debt used to acquire and operate your business is deductible against that business. However, depending upon the circumstances of the loan structure, debt secured by your home may be nondeductible, only partially deductible or wholly deductible against your business.

Home mortgage interest is limited to the interest on $1 million of acquisition debt and $100,000 of equity debt secured by a taxpayer's primary residence and designated second home. The interest on the debts within these limits can only be treated as home mortgage interest and must be deducted as part of your itemized deductions. Only the excess can be deducted for your business, provided that the use of the funds can be traced to your business use. This creates a number of problems:

- **Using the Standard Deduction** – If you do not itemize your deductions, you will be unable to deduct the interest on the first $100,000 of the equity debt, which cannot be allocated to your business.
- **Subject to the AMT** – Even if you do itemize your deductions, if you happen to be subject to the alternative minimum tax (AMT), you still would not be able to deduct the first $100,000 of equity debt interest, since it is not allowed as a deduction for AMT purposes.
- **Subject to Self-Employment (SE) Tax** – Your self-employment tax (Social Security and Medicare) is based on the net profits from your business. If the net profit is higher, because not all of the interest is deductible by the business, your SE tax may also be higher.

Example: *Suppose the mortgage you incurred to purchase your home (acquisition debt) has a current balance of $165,000 and your home is worth $400,000. You need $150,000 to acquire a new business. To obtain the needed cash at the best interest rates, you decide to refinance your home mortgage for $315,000. The interest on this new loan will be allocated as follows:*

New Loan:	*$ 315,000*	
Part Representing Acquisition Debt	*<165,000>*	*52.38%*
Balance	*$ 150,000*	
First $100,000 Treated as Home Equity Debt	*<100,000>*	*31.75%*
Balance Traced to Business Use	*$ 50,000*	*15.87%*

If the interest for the year on the refinanced debt was $10,000, then that interest would be deducted as follows:

Itemized Deduction Regular Tax	*$ 8,413*	*84.13%*
Itemized Deduction Alternative Minimum Tax	*$ 5,238*	*52.38%*
Business Expense	*$ 1,587*	*15.87%*

There is a special tax election that allows you to treat any specified home loan as not secured by the home. If you file this election, then interest on the loan can no longer be deducted as home mortgage interest, since tax law requires that qualified home mortgage debt be secured by the home. However, this election would allow the normal interest tracing rules to apply to that unsecured debt. This might be a smart move if the entire proceeds were used for business and all of the interest expense could be treated as a business expense. However, if the loan were a mixed-use loan and part of it actually represented home debt (such as a refinanced home loan), then the part that represented the home debt could not be allocated back to the home, and the interest on that portion of the debt would become nondeductible and would provide no tax benefit.

Example: *Using the same scenario as the previous example but electing to treat the mortgage as unsecured by the home, the deductible business interest for the year would be $4,762 [($150,000/$315,000) x $10,000]. None of the balance of the interest would be deductible.*

As you can see, using equity from your home can create some complex tax situations. Please contact this office for assistance in determining the best solution for your particular tax situation.