

Tax Efficient Borrowing for the High Income Taxpayer

Topic:	Use of Margin Loans Can be Useful Borrowing Method
Author:	Samuel D. Swisher, JD
Sponsor:	Vantage Financial Partners Limited
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Executive Summary:	High income executives find that most of their itemized deductions can be phased out to only 20% of the otherwise allowable amount. Home equity loans are subject to this phase out. However, margin interest loans from their broker can be a tax efficient form of borrowing in the right situation.

Corporate executives and other high income taxpayers are often faced with the problem of how to borrow most economically. Most people are aware that personal debt interest is not deductible and many will therefore turn to a home equity loan to achieve at least partial tax deductibility (generally only interest on the first \$100,000 of a home equity loan is deductible). However, for higher bracket taxpayers home equity interest may be disallowed along with other itemized deductions. A useful alternative could be a margin loan if used in the right situation.

Phase out of Itemized Deductions

High income taxpayers effectively incur a higher tax rate due to the phase out of itemized deductions. An individual whose adjusted gross income (AGI) exceeds a threshold amount must reduce the amount of itemized deductions by 3% of the excess over the threshold amount. In 2004, the threshold amount is \$142,700 (\$71,350 for married filing separately). For example, an executive with an AGI of \$400,000 would lose \$7,719 of itemized deductions ($400,000 - 142,700 \times 3\%$). The threshold amounts adjust annually and should increase slightly in 2005. However, after 2005 there is good news, the limitation on itemized deductions is scheduled to be phased out by 2010.

The current limitation on itemized deductions can result in up to 80% of the otherwise deductible amount being disallowed. For example, if one has \$10,000 in itemized deductions, the most that can be disallowed is \$8,000. There are, however, certain itemized deductions that are not subject to the limitation. No reduction is required for medical expenses, casualty, theft or wagering losses, and investment interest expense.

Investment Interest Exception

The investment interest expense exception may provide the high income taxpayer a tax-efficient avenue for borrowing funds. Typically a corporate executive will have a stock brokerage account that earns interest, dividends, and capital gains. A potentially advantageous form of borrowing is to take out a margin loan in a brokerage account because any interest paid to purchase taxable investments such as stocks, bonds, and other investment securities, will be deductible to the extent it offsets "Net Investment Income" without reduction for itemized deductions.

For example, assume the executive wants to buy a car at a cost of \$80,000. He is considering borrowing or selling some of his stocks. Interest from a home equity loan would be disallowed up to 80% due to his high income. Assume further that the executive will have \$10,000 in "Net Investment Income" from his taxable brokerage account for the

year. The executive could liquidate some of his stock holdings (triggering a taxable event) and raise the \$80,000 to buy the car. If he wanted to reinvest in additional taxable securities, he could take out a margin loan and pay up to \$10,000 in interest charges without any deduction disallowance.

There are additional risks with a margin loan that are not found with a more conventional borrowing alternative. If the securities drop in value, a margin call may require additional cash to be contributed. In addition, the firm can force the sale of the securities without contacting the client if the equity account falls below the maintenance margin requirements.

Unlike the home equity loan that limits the deductible interest to the first \$100,000 of non-acquisition debt, a margin loan for the purchase of taxable investments can be for any amount so long as the interest charge does not exceed the "Net Investment Income" for the year. Moreover, any disallowed investment interest can be carried over to a year where there is Net Investment Income.

If the executive is subject to the alternative minimum tax (AMT), then there is an adjustment for the investment interest deduction. Essentially there is a separate AMT calculation for allowable investment interest deduction and only the difference between the regular deduction and AMT deduction is added back to become part of taxable income for AMT purposes.

Net Investment Income

Unfortunately the definition of "Net Investment Income" is not simple. Essentially it includes all interest, non-qualifying dividends and all net short term capital gains less any investment expenses. Net Investment Income does not include income that is taxed at more favorable rates than ordinary income (qualifying dividends and net long term capital gains are both taxed at 15% to the high income taxpayer). However, a taxpayer may elect to treat some or all of the qualified dividends and long term capital gains as part of the Net Investment Income to allow the interest deduction, but the effect of the election is to limit the tax benefit on this amount to a 15% tax benefit.

Using the margin interest loan deduction makes sense for the high income executive who has large interest income or short term capital gains. In addition, a very high income taxpayer could also benefit from this election if most of the interest expense would be disallowed as an itemized deduction but instead is offset against 15% dividend or long term capital gain income.

The information contained herein is of a general nature and should not be relied upon without first consulting a financial advisor. If you would like further information please email info@vantagefinancial.com.

VANTAGE FINANCIAL PARTNERS LIMITED
Nine North Vail Avenue, Arlington Heights, IL 60005-1430
(847) 590-9191 Fax (847) 590-9009
www.vantagefinancial.com

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