American National Bank

Tax (and other) consequences of borrowing

Are you planning a major purchase or investment this year? If so, you may be considering borrowing what you need rather than selling one of your other investment assets. There are several financing sources to which you might turn for the needed capital, each of which carries its own rewards and risks.

First, an overview of taxes

We can discuss only the tip of the tax iceberg here. The rules as to when interest paid on a loan is tax deductible are extremely complex. You probably will want to discuss all the tax ramifications with your advisors before you undertake any new debt.

One important general rule is that interest paid on loans made to purchase an investment may be deductible, but only up to the amount of your net investment income. However, investment interest on a loan to buy tax-exempt securities is not deductible.

Mortgages and equity loans

If you are purchasing a new residence (perhaps a vacation or a retirement home), and interest rates are low, a mortgage is a good capital source. You might finance more than you need, making a smaller down payment. You can use the additional capital for any other purchase and be able to deduct all or most of the interest. Similarly, you may want to consider taking a home equity loan or line of credit for a home that you already own.

Interest on as much as $1 million of mortgages on one or two of your residences is tax deductible as long as they are "home acquisition loans," i.e., loans to buy, construct or improve a first or second home.

In most cases, interest on a home equity loan of up to $100,000 is deductible, and loan proceeds may be used for any reason. However, the deduction is not allowed for purposes of the Alternative Minimum Tax, unless the loan proceeds are used to improve your first or second home.

If your adjusted gross income exceeds a threshold amount, you're required to reduce the amount of certain itemized deductions—mortgage interest among them—by 3% of the "excess" income. In 2005 the threshold is $145,950, or $72,975 for married taxpayers who file separately. Thankfully, this "stealth tax" will begin to disappear in 2006 under the 2001 tax act.

Be certain that you are comfortable in carrying a large mortgage debt. If you at all foresee that there could be circumstances in which you couldn't meet the payments, you probably shouldn't use a home as a source of capital.

Your retirement plans

Many 401(k) and other company retirement plans permit participants to borrow from their accounts. Consult your plan administrator for availability, restrictions, rates and repayment schedules. With a Keogh plan you can borrow if you're an employee, but not an employer. You may never borrow from an IRA. You can borrow up to 50% of the assets in your retire-ment plan or $50,000, whichever is less, and the loan must be repaid in five years. The interest on these loans is rarely tax deductible (usually only when: you are borrowing your employer's contributions instead of your own; these funds have been segregated by your employer; and loan proceeds are used for a tax-deductible purpose, such as making an investment).

The major advantage of borrowing from your retirement plan is that the interest on the loan goes back into your account—in other words, you are paying yourself. Recognize, however, that the funds with which you repay the loan are taxed twice—you have paid the loan back with after-tax dollars, and you will pay tax again when you withdraw the money for good. Still, if your loan carries an interest rate low enough to make an "outside" investment that offers income (after taxes) in excess of what your investments earn in the plan, you will come out ahead.

The caveat here: Make sure that you plan to be with the company long enough to repay the loan. If you quit or are terminated, some companies may let you continue the payments as scheduled. Unfortunately, many will require you to repay the loan immediately. If you don't, the loan will be treated as a withdrawal. You will owe income tax on the remaining loan balance, plus if you are under age 55, you will have to pay an additional 10% penalty.

Your investments

Borrowing against your securities (a margin loan) is often a good source of capital for additional investments. There are maximum amounts that can be borrowed, often up to 50% of the market value of the stocks and up to 95% of the market value of your bonds (depending upon the kind of bond). Your brokerage firm may set its own limit at less than these maximum amounts.

Interest rates on margin loans are usually anywhere from 0.5 to 2.5 percentage points over the broker call rate (what banks charge brokers for their money). You need not make any loan repayments while you hold the underlying securities. Interest compounds in your brokerage account, and you can repay what you owe when the securities are sold.

What should you be concerned about with a margin loan? One possibility is that interest charges and sales commissions might turn out to be more than any profit that you've made on the securities purchased with the loans. Second, a big drop in the markets can spell trouble. You may be required to put up more collateral (a margin call), and if you don't have the ready cash, you could have to sell some of your securities at a time when you don't want to do so.

Look to us

In addition to the loans described, our institution is an excellent source for an unsecured loan or line of credit, especially when you need the terms of the loan tailored to your own particu-lar circumstances. We always are available to sit down with you to discuss your credit needs.

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