Tax aware borrowing

The case for utilizing an investment interest deduction over a mortgage interest deduction.

Affluent home buyers can often make a choice in how they finance the purchase of a primary or secondary residence. The use of existing liquidity in coordination with a traditional mortgage may maximize tax benefits and create opportunities for positive arbitrage.

Two common structures for borrowing to minimize taxes

① Traditional mortgage with limited deductibility

This option involves directly taking out a $10 million mortgage for a home purchase. However, under this strategy, only the interest on the first $750,000 of the mortgage is tax-deductible or for mortgages secured before December 16, 2017, the deductible interest extends to the first $1 million. While the mortgage fulfills the immediate need for liquidity, the tax benefits are constrained by the capped deductible amount.

② Leveraging post-purchase liquidity for full deductibility

This option operates on a different timeline. Initially, $10 million of liquidity is used or created to facilitate the purchase of the property without a mortgage. After the property acquisition, you can obtain a subsequent $10 million loan, potentially using the property as collateral. The crucial distinction here is that these loan proceeds are then channeled directly into taxable securities or investments. This includes passive activities like limited partnerships (LPs) or limited liability companies (LLCs) where the investor isn't materially involved. Income from private equity, including carried interest, falls under this category, making this strategy particularly appealing to private equity professionals.

The deductible is typically allowable up to the net investment income recognized within a given tax year. Income from long-term capital gains interest, dividends and rent doesn't usually qualify, except in specific instances.

To leverage investment interest deductions effectively, certain guardrails must be observed to optimize benefits. These include:

No cap on investment interest deductions. The investment interest deduction comes with no upper limit other than it is limited to the extent there is deductible investment income for a given tax year. Any unused interest expenses can be carried forward indefinitely. The only caveat is the loan proceeds must be invested in something taxable in the year in which the deduction is taken.

Strategic investment choices. Choosing investments in non-dividend paying stocks such as small-cap or tech stocks that don't generate immediate income can allow you to use the interest expense deduction against other sources of investment income in your portfolio, such as returns from private equity. This applies even to investors not directly employed at private equity firms but earning income through LPs.

Avoidance of non-taxable investments. Loan proceeds should be strictly invested in taxable avenues. Investing in non-taxable investments, like municipal bonds, negates the interest deduction.

Segregated account tracking. Maintaining a separate account solely for borrowed funds simplifies tracking and provides clear evidence not only of their allocation toward taxable investments but also the clear direct distribution of loan proceeds to an investment, reducing the chance of disputes or misinterpretation.

Continued

Michael Goldberg is a Managing Director with BMO Family Office, an integrated wealth management provider that serves ultra-affluent individuals, families and family offices across their tax, estate, investment, philanthropic, risk and family capital needs. Michael serves as the team lead for the Financial Sponsors practice within BMO Family Office and BMO Wealth Management. He works exclusively with industry professionals to create bespoke solutions around liquidity, cash management and wealth transfer. Michael joined the organization in 2020 and has over 20 years of experience in the financial services industry.

Careful timing. To avoid IRS scrutiny, demonstrate clear intent by avoiding activities that might cast doubt on the investment purpose. Purchasing non-taxable investments soon after borrowing or using tax-exempt investments as collateral may raise red flags.

While this strategy offers substantial benefits, tax-aware borrowing has several complications to be weighed:

Tax rate considerations. Long-term capital gains (LTCG), which are traditionally excluded from investment income, are typically taxed at a lower rate (20%) compared to the maximum ordinary federal income tax rate (37%).[1] The law excludes qualified dividends and long-term capital gains from description of investment income. By converting capital gains to ordinary income to offset interest expenses, careful calculation is crucial to ensure overall tax benefits. As long as your interest expense is high enough to offset your regular tax rate, it's sufficient. It must be emphasized that carried interest and other types of income that receive LTCG treatment from LPs do not suffer this issue.

Medicare surtax. Electing to forgo the lower tax rate on capital gains might trigger the Medicare surtax of 3.8% on net investment income for taxpayers with adjusted gross income exceeding $200,000 for single filers.[2]

Optimizing tax efficiencies

Tax-aware borrowing redefines real estate investment deductions by converting mortgage interest deduction limitations into investment expense deductions that don't have the same hard cap as the mortgage deduction. Redirecting borrowed funds directly into IRS-acceptable investments offers significant tax advantages, reducing federal income tax and cutting borrowing costs. Understanding your options optimizes tax efficiency and maximizes real estate impact amid tax complexities.

Feel confident about your future

BMO Wealth Management—its professionals, its disciplined approach, its comprehensive and innovative advisory platform—can help provide financial strategic planning.

For greater confidence in your future, call your BMO Wealth Management Advisor today.

[1] Tax Foundation, "2024 Tax Brackets," November 9, 2023, https://taxfoundation.org/data/all/federal/2024-tax-brackets/

[2] Congressional Research Service, "The 3.8% Net Investment Income Tax: Overview, Data, and Policy Options," Updated June 30, 2023.

"BMO Wealth Management" is a brand delivering investment management services, trust, deposit and loan products and services through BMO Bank N.A., a national bank with trust powers; family office services and investment advisory services through BMO Family Office, LLC, an SEC-registered investment adviser; investment advisory services through Stoker Ostler Wealth Advisors, Inc., an SEC-registered investment adviser; digital investment advisory and financial planning services through BMO Direct Invest Inc., an SEC-registered investment adviser; and trust and investment management services through BMO Delaware Trust Company, a Delaware limited purpose trust company. "BMO Family Office" is a brand name that refers to BMO Bank N.A., BMO Family Office, LLC, and BMO Delaware Trust Company. The BMO Family Office brand provides family office, investment advisory, investment management, trust, banking, deposit and loan products and services. These entities are all affiliates and owned by BMO Financial Corp., a wholly-owned subsidiary of the Bank of Montreal. BMO Delaware Trust Company operates only in Delaware, does not offer depository, financing or other banking products, and is not FDIC insured. You must be an existing customer of BMO Bank N.A. and enrolled in BMO Digital Banking to qualify for services from BMO Direct Invest Inc. Not all products and services are available in every state and/or location. Family Office Services are not fiduciary services and are not subject to the Investment Advisers Act of 1940 or the rules promulgated thereunder. Investment products and services are: **NOT A DEPOSIT–NOT INSURED BY THE FDIC OR ANY FEDERAL GOVERNMENT AGENCY–NOT GUARANTEED BY ANY BANK–MAY LOSE VALUE.** Capital Advisory Services are offered by a division of BMO Bank N.A. Member FDIC Equal Housing Lender NMLS #401052

BMO Private Bank is a brand name used in the United States by BMO Bank N.A. Member FDIC. Not all products and services are available in every state and/or location.

The opinions expressed here reflect our judgment at this date and are subject to change. Information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy. This publication is prepared for general information only. This material does not constitute investment advice and is not intended as an endorsement of any specific investment.

This information is being used to support the promotion or marketing of the planning strategies discussed herein. This information is not intended to be legal advice or tax advice to any taxpayer and is not intended to be relied upon as such. BMO Bank N.A. and its affiliates do not provide legal advice or tax advice to clients. You should review your particular circumstances with your independent legal and tax advisors.

Forward-looking statements in this presentation involve risks, uncertainties and other factors that may cause actual performance to differ materially from the projections and opinions contained in the presentation. Do not place undue reliance on these forward-looking statements, which reflect our opinions only as of the date of the presentation. The words "may," "could," "should," "would," "suspect," "believe," "expect," "intend," "forecast," and similar expressions identify forward- looking statements. Forward-looking statements are not guarantees of future performance or events. Forward-looking statements involve risks and uncertainties about general economic factors. It is possible that predictions, projections and other forward-looking statements will not be achieved. General factors that could cause our predications or projections to change include general economic, political and market factors; interest and foreign exchange rates; global equity and capital markets; commodities markets; business competition; technological changes; changes in laws and regulations; judicial or regulatory judgments; legal proceedings; and catastrophic events.

NMLS
401052

CAS00037529 (3/24)