

Home Equity or Business Loan

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Joe is a sole proprietor who owns an Auto Shop. He needed new equipment for his shop and a loan to buy it. He decided to take out a home equity loan of \$25,000 to buy this equipment. When Joe goes to prepare his tax return he has two options as to how to handle this loan.

Since it's a home equity loan less than \$100,000 he can deduct the interest as an itemized deduction on Schedule A of his tax return, subject to the itemized deduction phase-out rules. Joe will still have \$75,000 of home equity debt that he could later take as a tax break on additional loans. This may be beneficial if Joe is able to itemize his deductions, but under Joe's circumstances, a better way to go would be to elect not to treat the debt as secured by his residence. **This is an irrevocable election.**

If he were to make the election not to treat the debt as home equity debt, then he would deduct it under what is called "general tracing rules". This would make the interest expense from the \$25,000 loan **fully deductible as business interest** on his Schedule C. Using this election, the interest expense will reduce his regular and self-employment tax. It also decreases his adjusted gross income (AGI), which may increase AGI sensitive deductions and credits. Making this election also preserves the full \$100,000 of home equity debt available to use as a tax break on other loans.

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