

Tax deductibility of interest on yacht loans.

Q: Does a boat qualify as a residence for purposes of deducting interest expenses on a residence under Internal Revenue Code 163?

A: Under IRC section 163 (h)(2) a taxpayer may deduct any qualified interest on a qualified residence, which is defined as a principal residence and one other residence owned by the taxpayer for purpose of deductibility for the tax year. IRC section 163 (h)(3) defines qualified residence interest as any interest, which is paid or accrued during the tax year on acquisition or home equity indebtedness with respect to any qualified residence of the taxpayer. In accordance with IRC section 163 (h)(4), a boat will be considered a qualified residence if it is one of the two residences chosen by the taxpayer for purposes of deductibility in the tax year as long as it provides basic living accommodations such as sleeping space (berth), a toilet (head), and cooking facilities (galley). If the boat is chartered out, the taxpayer will have to use the boat for personal purposes for either more than 14 days or 10% of the number of days during the year the boat was actually rented, in accordance with IRC section 280A (d)(1).

Q: If the interest expense is deductible, is it necessary for the boat owner to receive a Form 1098 from the lender to be able to claim the deduction?

A: Form 1098 is not necessary in order to receive the qualified interest deduction. In accordance with IRS instructions for Schedule A, form 1040, if the taxpayer does not receive Form 1098, deductible mortgage interest should be reported in line 11 instead of line 10 on Schedule A.

Q: Why should I not borrow against my home, which I own free and clear?

A: Home mortgage interest deduction is limited to interest paid on mortgage debt used to purchase or improve a residence, or to refinance the remaining balance on a purchase or improvement. If the money isn't used for the home, the interest expense does not qualify for the deduction.

Q: How about a home equity loan?

A: Home mortgage interest deduction is limited to interest paid on home equity loans up to \$100,000. By using a home equity loan, you may limit the amount of interest that is deductible, if your loan balance exceeds \$100,000.

Q: I can borrow against my stock on a margin loan, at an attractive rate. Because the money is used to buy the boat, is the interest still deductible?

A: Second home mortgage interest deduction is limited to interest paid on second homes that are secured by that second home. You would need to have a written collateral agreement (security agreement) indicating the boat as collateral, which is probably not something your broker would be prepared to provide.

The preceding information was prepared by Gary Boudreau, Deloitte & Touche, LLP, Newport Beach, California.

Should I Finance?

In the example below it's easy to see that investment earnings can far exceed the cost of marine financing. In this particular case we are assuming a rate of 8.5% fixed for 20 years on a loan of \$100,000, requiring a monthly principal and interest payment of \$867.82.

The interest cost of this loan over an anticipated life of 60 months is \$40,196.30. If you are in the 30% tax bracket, this interest expense deduction will save you \$12,058.91, effectively reducing the cost of the loan to \$28,137.39.

This same \$100,000, if invested earning 9%, would grow to \$137,703.68 (after tax) in the same time period. Tax-free municipal bonds yielding 6% could earn \$34,885.02 over 60 months. More aggressive investments could obviously make earnings even more attractive.

It's easy to see how financing your yacht could cost you less.