

New Law Limits Investment Interest Expense Deductions

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The tax law divides interest expense into several different categories, each with its own limitation on deductibility. The three most important categories are business interest, investment interest, and personal interest. First, interest expense that is allocable to a trade or business is typically deductible. However, the deduction is generally limited to the sum of the taxpayer's business interest income and 30% of the taxpayer's adjusted taxable income. This limitation does not apply to electing real estate businesses, as well as to certain small businesses whose gross receipts are under a specified threshold. Second, interest expense that is allocable to property held for investment is generally deductible only to the extent of the taxpayer's investment income, which includes dividends, interest, and capital gain from investment assets such as stock and bonds (but generally not income from real estate). Finally, interest expense that is considered personal interest is not deductible at all.

Regulations provide that when a taxpayer incurs debt, the character of the interest expense on the debt is determined by tracing how the taxpayer used the proceeds of the debt. The collateral for the debt is not relevant to this determination. Thus, if a taxpayer borrows money with a loan secured by real estate and uses the proceeds for personal expenses, the interest expense will be considered personal interest and therefore not deductible. If the taxpayer uses the debt proceeds to invest in a business, including a real estate business, the interest expense will be considered business interest. If the taxpayer instead uses the debt proceeds to purchase investment assets such as stocks and bonds, the interest expense will be considered investment interest. Interest expense on debt proceeds deposited into a bank account is also initially considered investment interest until the proceeds are withdrawn from the bank account, in which case the proceeds are further traced to their ultimate use.

When a partnership borrows money and distributes the proceeds to its partners, each partner's share of the partnership's interest expense similarly depends on how the partner used its share of the debt proceeds. This rule is implicated in many cash-out real estate financings. For example, if a partnership borrows money secured by its real estate and distributes the proceeds to a partner who then uses the money to fund personal expenses, that partner's share of the partnership's interest expense will not be deductible. Similarly, if the partner instead left the proceeds in a bank account or used them to purchase stocks and bonds, the partner's share of the interest expense would be considered investment interest and could be deducted only to the extent of investment

income. Alternatively, if the partnership had retained the money to fund expenses relating to its property (or to acquire other real estate), then the interest generally would be business interest.

Although these rules have existed for many years, a recent legislative change to the deductibility of investment interest expense has made the character of interest expense even more important. Unlike business interest, investment interest is considered an itemized deduction. The law commonly known as the One Big Beautiful Bill Act, which was enacted on July 4, 2025, imposed new limitations on itemized deductions, including deductions for investment interest, which went into effect starting in 2026. Specifically, the amount of a taxpayer's itemized deductions that otherwise would be deductible is reduced by 2/37 (or approximately 5.4%) of the amount of such deductions, or, if lower, by the amount of income that would be subject to the highest 37% income tax bracket. (In 2026, the highest income tax bracket applies to income above \$640,600 for singles and \$768,700 for married couples filing jointly.)

In light of this change in law, taxpayers, especially those in the real estate business, are often better off having interest expense characterized as business interest rather than investment interest, even if they have investment income in excess of investment interest expense. Since money is fungible and the characterization of interest expense depends on the tracing of specific debt proceeds, it is often possible to achieve better results with advance planning. For example, a taxpayer that refinances real estate used in a trade or business could use any excess refinancing proceeds to fund the acquisition of additional real estate or operating expenses, thus freeing up other sources of cash to make investments in stocks and bonds or to fund personal expenses.

Although taxpayers in New York State have long faced limits on itemized deductions at the state level, the new federal limitation on itemized deductions is yet another addition to a complicated and sometimes overlapping set of rules that can limit the use of interest deductions and losses more generally, including the investment interest expense and business interest expense limitations and the passive loss rules. However, the fact that interest deductibility is based on a tracing concept both allows for advance planning and creates a trap for the unwary, and any planning that avoids the investment interest expense limitations could have both federal and state income tax benefits.

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