DEDUCTING STUDENT LOAN INTEREST

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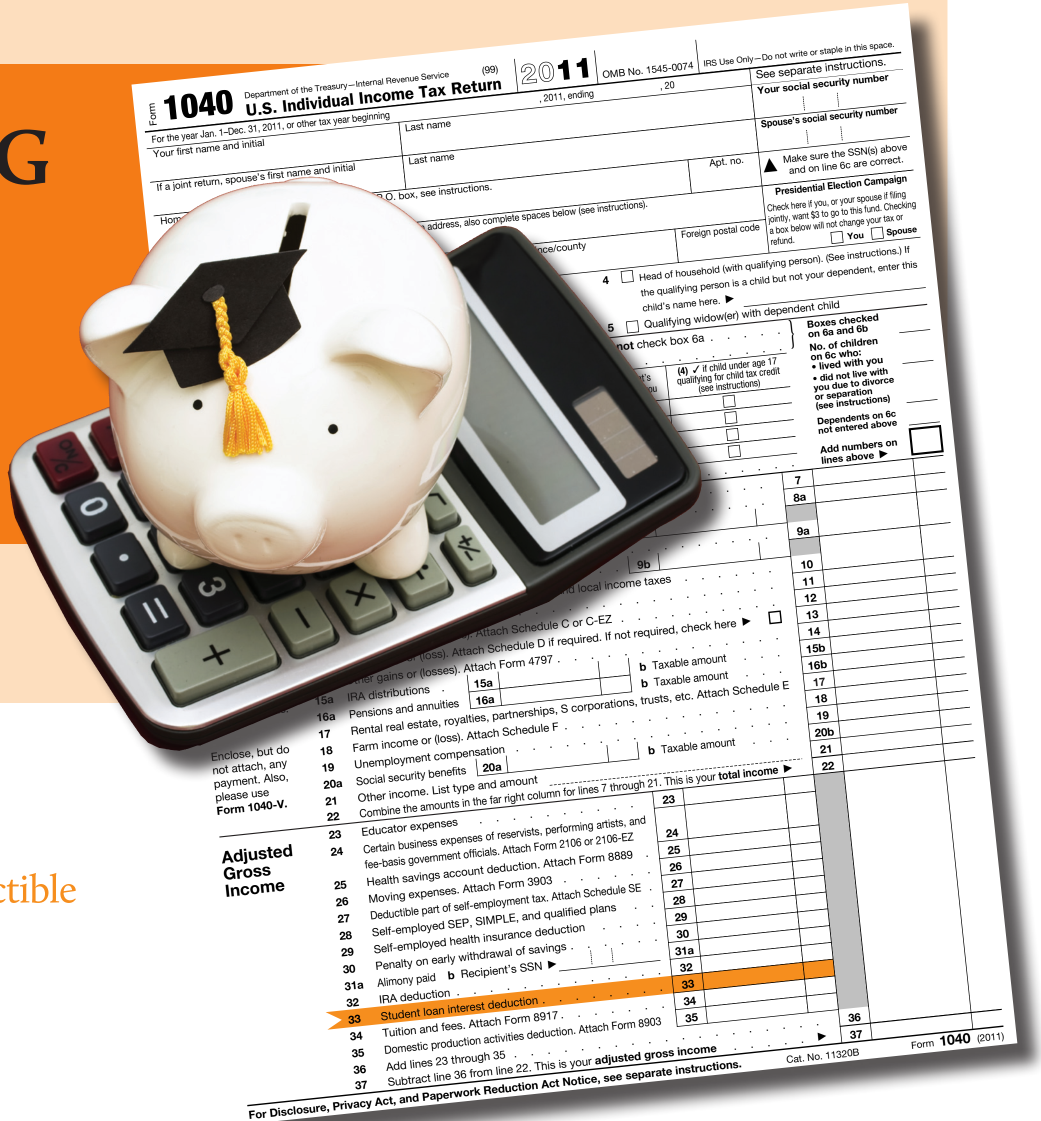

Student loan interest is deductible for any taxpayer but there are significant limitations. According to the Annual Resident Survey conducted by Bentson, Clark & Copple (See article in the October issue of *The Progressive Orthodontist* magazine), orthodontic residents expect to have amassed student debt of between $100,000 and $400,000 upon completion of their education. That is certainly consistent with the amounts we see among our clients.

Some orthodontists may have the ability to deduct interest incurred during their residencies as a business expense if certain steps are taken and certain conditions are met.

For starters, let's look at the typical taxpayer's ability to deduct student loan interest. The maximum deduction allowed is $2,500. If you have a loan of $100,000 at 7.5% you will pay $7,500 in interest – three times the deduction allowed. Now for the bad news: If you earn $75,000 as a single taxpayer or $150,000 as a married taxpayer filing joint tax returns, your $2,500 deduction phases out; meaning you get no deduction at all. ("Phase-out" is a term you will hear a lot when asking your Dental CPA whether something is deductible). Graduates from dental school or an orthodontic residency may qualify for the $2,500 student loan deduction in their first year working, especially if they finish their programs in the spring, only work half a year and earn below the income phase-out amounts. Often, however, student loans are in deferment for six months or more with no interest paid in that first year so there is nothing to deduct.

For dentists going into the workforce after dental school, it is not likely one would ever qualify for a student loan deduction. For orthodontists and other specialists, it is possible to work around this problem.

Here's how, according to a "Private Letter Ruling" given by the IRS in 1974: "Expenditures incurred in taking postgraduate studies in orthodontics by a dentist engaged in general practice who returned to dental school on a full-time basis while continuing his practice on a part-time basis and, after completing his training, limited his practice to orthodontic patients, are deductible under section 162 of the Internal Revenue Code, Trade or Business Expenses." Specifically, "expenditures made by a taxpayer for his education may be deductible as ordinary and necessary business expenses even though the education may lead to a degree if the education maintains or improves skills required by the taxpayer in his trade or business." Simply stated, the education expenses are not deductible if they lead to the taxpayer being qualified in a new trade or business. The ruling concludes, "in this case the expenditures by the dentist for postgraduate studies in orthodontics were not incurred in connection with qualifying him for a new trade or business but were in connection with improving his skills as a dentist. Accordingly, such expenditures are deductible as ordinary and necessary expenditures under section 162 of the Code."

LET'S BREAK THIS DOWN INTO PLAIN ENGLISH:

- Deductible education expenditures include tuition, books, supplies, lab fees and "similar items." If you have to borrow money to pay for these expenditures, the interest on that debt is also deductible.

- The most critical statement in the private letter ruling (PLR) is that the dentist continued his practice part-time while in the orthodontic residency. That is why I said "some orthodontists may have the ability to deduct their student loan interest..."

  - If dental school graduates go immediately to specialty school, the IRS considers them to still be dental students pursuing a trade or business, not someone improving their skills as a dentist. Thus, no deduction for student loan interest.

- How does a dental student get around this? Upon graduation from dental school, they must take the boards and get licensed. And, they must work as a dentist before going off to a residency.

  - This is not always easy given the timing involved and that many of the 60+ orthodontic residency programs in the United States do not permit their residents to work.

  - Perhaps any restrictions on work refer to permanent employment and not an occasional day worked here or there, or, working during any breaks in the academic year. Or, maybe permission can be obtained to work on a limited basis under some conditions or on a case by case basis.

  - If work is permitted, that work simply needs to require a dental license which means it can include doing hygiene that can be arranged through a temp agency.

  - What if you become licensed in California and your residency is somewhere on the east coast? You will need to be licensed to practice near your residency or travel home a lot. I have a client who did his residency at NYU and traveled home to San Francisco during breaks to visit his family and work.

  - While most states will recognize licenses issued in other jurisdictions, almost all of them have requirements that you be licensed in good standing for 2 – 5 years beforehand, so you may have to take another set of board exams.

What is the tax benefit to an orthodontist who is able to deduct interest on debt incurred during their residency as a business expense? On a loan of $100,000 at 6% interest for 20 years, the total interest paid would be $74,000. Assuming a 40% tax bracket, the tax savings from that interest deduction would be almost $30,000. For a loan of $300,000, total interest paid in 20 years would be $223,000 and the tax savings would be just over $89,000 using the same 40% tax rate.

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Student Loan Amortization Schedules

Loan Amount		$100,000				
Interest Rate		6.0%				
Number of Years		20				
	1	2	3	4	5	6
Year	Payment	Interest	Principal	Balance	Tax Savings	After-tax Payment
2011				$100,000		
2012	$8,718	$6,000	$2,718	97,282	$2,400	$6,318
2013	8,718	5,837	2,882	94,400	2,335	6,384
2014	8,718	5,664	3,054	91,346	2,266	6,453
2015	8,718	5,481	3,238	88,108	2,192	6,526
2016	8,718	5,286	3,432	84,676	2,115	6,604
2017	8,718	5,081	3,638	81,038	2,032	6,686
2018	8,718	4,862	3,856	77,182	1,945	6,774
2019	8,718	4,631	4,088	73,094	1,852	6,866
2020	8,718	4,386	4,333	68,761	1,754	6,964
2021	8,718	4,126	4,593	64,169	1,650	7,068
2022	8,718	3,850	4,868	59,300	1,540	7,178
2023	8,718	3,558	5,160	54,140	1,423	7,295
2024	8,718	3,248	5,470	48,670	1,299	7,419
2025	8,718	2,920	5,798	42,871	1,168	7,550
2026	8,718	2,572	6,146	36,725	1,029	7,690
2027	8,718	2,204	6,515	30,210	881	7,837
2028	8,718	1,813	6,906	23,304	725	7,993
2029	8,718	1,398	7,320	15,984	559	8,159
2030	8,718	959	7,759	8,225	384	8,335
2031	8,718	494	8,225	0	197	8,521
Grand Totals	$174,369	$74,369	$100,000		$29,748	$144,622

Loan Amount		$300,000				
Interest Rate		6.0%				
Number of Years		20				
	1	2	3	4	5	6
Year	Payment	Interest	Principal	Balance	Tax Savings	After-tax Payment
2011				$300,000		
2012	$26,155	$18,000	$8,155	291,845	$7,200	$18,955
2013	26,155	17,511	8,645	283,200	7,004	19,151
2014	26,155	16,992	9,163	274,037	6,797	19,359
2015	26,155	16,442	9,713	264,323	6,577	19,578
2016	26,155	15,859	10,296	254,027	6,344	19,812
2017	26,155	15,242	10,914	243,114	6,097	20,059
2018	26,155	14,587	11,569	231,545	5,835	20,321
2019	26,155	13,893	12,263	219,282	5,557	20,598
2020	26,155	13,157	12,998	206,284	5,263	20,893
2021	26,155	12,377	13,778	192,506	4,951	21,205
2022	26,155	11,550	14,605	177,901	4,620	21,535
2023	26,155	10,674	15,481	162,419	4,270	21,886
2024	26,155	9,745	16,410	146,009	3,898	22,257
2025	26,155	8,761	17,395	128,614	3,504	22,651
2026	26,155	7,717	18,439	110,176	3,087	23,069
2027	26,155	6,611	19,545	90,631	2,644	23,511
2028	26,155	5,438	20,718	69,914	2,175	23,980
2029	26,155	4,195	21,961	47,953	1,678	24,477
2030	26,155	2,877	23,278	24,675	1,151	25,004
2031	26,155	1,481	24,675	0	592	25,563
Grand Totals	$523,107	$223,107	$300,000		$89,243	$433,864

The tax savings might not seem like that much money each year but if you consider options for the use of those dollars (Emergency Fund, IRA contribution, College Savings, Life Insurance, etc.), the deduction becomes more compelling and the up-front planning and extra effort to achieve this result may not seem so insurmountable. At a minimum, it is worth discussing the idea with your Dental CPA/Financial Planner to determine whether or not the cost in time, heartache and money outweighs the benefit of being able to enjoy a tax deduction for the student loan interest paid on debt incurred during your residency.

A final thought: keep careful track of all your student loans (undergrad, dental school and residency). And, unless a reduction in interest rates or modification of terms makes it extremely compelling, try to avoid consolidating your loans so the interest paid may be allocated to the proper phase of your education and deducted where appropriate.

For an illustration of these numbers, see "Student Loan Amortization Schedules" at left. There are two schedules. One is for a loan of $100,000 and the other is for a loan of $300,000. Columns 1,2,3 & 4 in each represent the basic loan schedules (amortizations) showing 1) the total payment, 2) the interest portion of the payment, 3) the principal portion of the payment, and, 4) the loan balance after each months' principal payment. Note that only the interest is deductible (if the conditions referred to above are met). The principal is repaid with after-tax dollars. Column 5 is the tax saved (at 40%) from the interest deduction. Column 6 is the total payment from column 1 minus the tax saved in column 5 and illustrates the after-tax cost of the total loan payment.

Next time we will talk about how to also deduct the costs of instruments, supplies and books purchased in dental school or a residency and other basic tax and financial planning issues.