It's rare when tax return preparers advise their clients to look a gift horse in the mouth. But it might happen when a taxpayer is affected by the limits for deducting investment interest expenses. Depending on the situation, it may make sense to elect preferential tax treatment for certain long-term capital gains or qualified dividends – much to your client's surprise!

Before we go any further, here's some background information: As a general rule, you can deduct investment interest expenses you incur – such as when you buy stock on margin or use home equity loan proceeds to invest in bonds — but only up to the

sales of investment property and income from annuities. "Investment expenses" are income-producing expenses that constitute allowable deductions after applying the 2%-of-adjusted gross income (AGI) floor on miscellaneous expenses.

But here's the kicker: Long-term capital gain and qualified dividends, which generally receive tax-favored treatment, do **not** count as investment income under the tax law definition. Usually, the maximum tax rate on long-term capital gains and qualified dividends is only 15 percent, increasing to 20 percent for taxpayers in the top ordinary income tax bracket. This rule could severely limit your investment interest deduction – in fact, you may not be entitled to any deduction at all.

Alternatively, you can elect to include long-term gains and/or qualified dividends in the computation of net investment income to the extent that you want, but you must reduce the gain eligible for the maximum tax rate by the same amount. This election is made when you file your tax return.

Example: Suppose that your top ordinary income tax rate in 2014 is 35%, you realized $5,000 in long-term capital gains last year and you incurred $4,000 in investment interest expenses above your net investment income.

By foregoing the tax break on $4,000 of your capital gains, you may deduct an extra $4,000 of investment interest expenses. That means that instead of paying $600 in tax on those capital gains (15% of $4,000), your tax bill for the capital gains is $1,400 (35% of $4,000), or $800 more, but the increase in the investment interest is worth $1,400 to you. Therefore, you save $600 overall ($1,400 – $800). The savings would be even greater for someone in the top tax bracket.

Of course, other tax complications, such as limits on passive activities, may affect the outcome. Practical advice: Don't rush into a quick decision. Make a through analysis of a client's situation before the tax return is filed.