Treasury Decision 8145, 26 CFR, IRC Sec(s). 42

July 02, 1987

AGENCY:

Internal Revenue Service, Treasury.

ACTION:

Temporary regulations.

SUMMARY:

This document contains temporary regulations relating to the allocation of interest expense among a taxpayer's expenditures. Changes to the applicable tax law were made by the Tax Reform Act of 1986 (the "Act"). The temporary regulations affect taxpayers subject to the passive loss limitation, the investment interest limitation, or the disallowance of deductions for personal interest and provide them with the guidance needed to comply with the law. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations for the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the Federal Register.

EFFECTIVE DATE:

The temporary regulations are effective with respect to interest expense paid or accrued in taxable years beginning after December 31, 1986.

FOR FURTHER INFORMATION CONTACT:

Michael J. Grace of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224, Attention: CC:LR:T, (202) 566-3288 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

This document amends the Income Tax Regulations (26 CFR Part 1) to provide temporary rules relating to the allocation of interest expense for purposes of applying the limitations on passive activity losses and credits, investment interest, and personal interest. The temporary regulations reflect the amendment of the Internal Revenue Code of 1986 (the "Code") by sections 501 and 511 of the Act (100 Stat. 2233 and 2244), which added sections 469 (relating to the limitation on passive activity losses and credits) and 163(h) (relating to the disallowance of deductions for personal interest) and amended section 163(d) (relating to the limitation on investment interest).

Section 469 provides that deductions from passive activities generally may not offset income other than passive income. Section 163(d)(1) limits the investment interest deduction of a noncorporate taxpayer for any taxable year to the taxpayer's net investment income for the taxable year. Section 163(h)(1) disallows deductions for personal interest paid or accrued by a noncorporate taxpayer. Qualified residence interest described in section 163(h)(3) does not constitute personal interest.

Section 469(e)(1)(A)(i)(III) provides that in determining the income or loss from any passive activity there shall not be taken into account interest expense properly allocable to certain items of gross income including gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. Section 469(k)(4) provides that the Secretary of the Treasury shall prescribe such regulations as may be necessary or appropriate to carry out the provisions of section 469, including regulations which provide for the determination of the allocation of interest expense for purposes of section 469.

The Joint Explanatory Statement of the Committee of Conference accompanying the Act (the "Conference Report") states that the conferees anticipate the Treasury will issue regulations providing guidance to taxpayers with respect to interest allocation. The Conference Report further provides that these regulations should be consistent with the purpose of the passive loss rules to prevent sheltering of income from personal services and portfolio investments with passive losses, and that the regulations should attempt to avoid inconsistent allocations of interest deductions under different Code provisions.

Although regulations allocating interest expense are specifically authorized by section 469(k)(4), these regulations are being published under section 163 because it is believed most taxpayers seeking guidance concerning the tax treatment of interest expense will first consult the regulations under section 163.

Scope of Rules

These temporary regulations prescribe rules for allocating interest expense for purposes of applying the passive loss limitation and the limitations on investment interest and personal interest. Except as otherwise specifically provided, these rules do not control the allocation of interest for other purposes (e.g., the windfall profit tax). Other limitations on the deductibility of interest expense generally apply without regard to the manner in which interest expense is allocated under the temporary regulations. Thus, for example, section 265(a)(2) may disallow deductions for interest expense allocated under the temporary regulations to an expenditure in connection with a trade or business producing taxable income. Similarly, section 263A(f) may require the capitalization of interest allocated under the temporary regulations to a noncapital expenditure. (The temporary regulations provide, however, that interest expense allocated to a personal expenditure cannot be capitalized.) Interest expense may also be deferred to a later year by one of the other limitations on the deductibility of interest (by the operation, for example, of section 267(a)(2)). In that case, the interest expense is allocated to expenditures under the temporary regulations as it would have been had the deferral provision not applied, but is not taken into account for purposes of applying the passive loss, investment interest and personal interest limitations until the taxable year in which the deferral provision ceases to apply. Qualified residence interest is deductible without regard to the manner in which such interest is allocated under these rules.

Allocation Rules in General

Interest expense on a debt is allocated in the same manner as the debt to which the interest relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. Thus, the allocation of interest is not affected by the use of an interest in any property to secure repayment of the debt to which the interest relates. The regulations provide specific rules for determining the manner in which debt is allocated if the debt proceeds are deposited to the borrower's account. Rules are also provided for cases in which debt proceeds are not disbursed to the borrower (as in the case of seller financing) or in which the borrower receives debt proceeds in cash.

Interest expense generally is subject to the limitation applicable to the expenditure to which the underlying debt is allocated. Thus, for example, if debt proceeds are allocated to an expenditure in connection with a passive activity, any otherwise allowable deduction for interest expense on the debt is subject to the passive loss limitation.

Specific Rules for Allocation of Debt

If debt proceeds are deposited to the borrower's account, and the account also contains unborrowed funds, the debt generally is allocated to expenditures by treating subsequent expenditures from the account as made first from the debt proceeds to the extent thereof. If the proceeds of two or more debts are deposited in the account, the proceeds are treated as expended in the order in which they were deposited.

There are two exceptions to this rule. First, a taxpayer may treat any expenditure made from an account within 15 days after debt proceeds are deposited in the account as made from those proceeds to the extent thereof. Second, if an account consists solely of debt proceeds and interest income on the proceeds, the taxpayer may treat any expenditure as made first from the interest income to the extent of such income at the time of the expenditure.

Special rules apply if the debt proceeds are not disbursed to the borrower. If the lender disburses the proceeds directly to a person selling property or providing services to the borrower, the disbursement is treated as an expenditure from the debt proceeds. If the debt does not involve cash disbursements (as in the case of assumptions or seller financing), the debt is treated as if the borrower had made an expenditure from the debt proceeds for the property, services, or other purpose to which the debt relates.

A taxpayer may treat any cash expenditure made within 15 days after receiving debt proceeds in cash as made from the debt proceeds. In any other case, debt proceeds received in cash are treated as used to make personal expenditures.

Treatment of Amounts Held in an Account

Amounts held in an account are treated as property held for investment, regardless of whether the account bears interest. Thus, debt is allocated to an investment expenditure when the debt proceeds are deposited in an account. Debt allocated to such an investment expenditure is reallocated in accordance with the rules described above when the debt proceeds are expended from the account. In general, the reallocation occurs on the date of the expenditure, but the taxpayer may elect to reallocate the debt as of the first day of the month in which the expenditure occurs (or the day on which the debt proceeds are deposited in the account, if later). A taxpayer may use this first-day-of-the-month convention only if all other expenditures from the account during that month are similarly treated.

Repayments and Refinancings

Debt repayments are applied against the debt in a manner intended to minimize the limitations on the deductibility of interest expense. For example, if a debt is allocated to a personal expenditure and an expenditure in connection with a passive activity, a repayment will be applied first against the portion of the debt allocated to the personal expenditure.

A special rule applies in the case of a repayment made from the proceeds of another debt. To the extent the proceeds of the other debt are used for the repayment, such debt is allocated to the expenditures to which the repaid debt was allocated. The normal allocation rules apply, however, to the extent proceeds of the debt are used for purposes other than the repayment.

Reallocation of Debt

Debt allocated to an expenditure properly chargeable to capital account with respect to an asset must be reallocated whenever the asset is sold or the nature of the use of the asset changes. For example, if a debt-financed asset used in a trade or business is converted to personal use, the debt must be reallocated to a personal expenditure. If the proceeds from the disposition of an asset exceed the amount of debt allocated to the asset, the proceeds from the disposition are treated in the same manner as an account containing both borrowed and unborrowed funds. The extent to which expenditures from this account are made from debt proceeds is determined under the normal allocation rules. A similar rule applies in the case of deferred payment sales.

Debt in Connection with Passthrough Entities

Interest expense of partnerships and S corporations, and of partners and S corporation shareholders, is generally allocated in the same manner as the interest expense of other taxpayers. Special rules will be provided, however, for cases in which partnerships and S corporations distribute debt proceeds to interest holders in the entity, and for cases in which taxpayers incur debt to acquire or increase their interests in partnerships or S corporations. The treatment of these transactions is not addressed in these temporary regulations because the Internal Revenue Service is still studying the interest-allocation issues such transactions raise and invites public comment.

Mass Asset Situations

The temporary regulations provide that debt allocated to an asset must be reallocated when the asset is sold or the nature of the use of the asset changes (for example, from use in a passive activity to use in a former passive activity). The Internal Revenue Service realizes that the application of this rule may be difficult in the case of taxpayers who continually acquire and dispose of debt-financed inventory or other assets and invites public comment on possible ways to facilitate administrability of the rule.

Transitional Rules

The temporary regulations apply to interest expense paid or accrued in taxable years beginning after December 31, 1986, regardless of when the underlying debt was incurred. In certain cases, however, the manner in which interest expense is allocated may be determined under a transitional rule.

The first transitional rule applies to expenditures made on or before August 3, 1987. Under this transitional rule, a taxpayer may treat any expenditure made from an account within 90 days after debt proceeds are deposited in the account or any cash expenditure made within 90 days after receiving debt proceeds in cash as made from the debt proceeds to the extent thereof. As previously described, the rules applicable to expenditures made after August 3, 1987 permit taxpayers to treat an expenditure in this manner only if it is made within 15 days after the debt proceeds are deposited or received in cash.

Under the second transitional rule, debt outstanding on December 31, 1986, that is properly attributable to a business or rental activity is allocated to the assets held for use or sale to customers in such business or rental activity. Debt is properly attributable to a business or rental activity for purposes of this transitional rule if the taxpayer has properly and consistently deducted interest expense (including interest expense subject to limitation under section 163(d) before its amendment by section 511 of the Act) on the debt on Schedule C, E, or F of Form 1040 in computing income or loss from the business or rental activity for taxable years beginning before January 1, 1987.

Debt subject to the second transitional rule must be allocated among assets in a reasonable and consistent manner. Examples of allocations of debt that are not reasonable and consistent include (i) an allocation of debt to goodwill in excess of the basis of the goodwill, and (ii) an allocation of debt to an asset in excess of the fair market value of the asset if the amount of debt allocated to any other asset is less than the fair market value (lesser of basis or fair market value in the case of goodwill) of such other asset. A market value in the case of goodwill) of such other asset. A taxpayer shall specify the manner in which debt is allocated under this second transitional rule by attaching an allocation statement to the taxpayer's return for the first taxable year beginning after December 31, 1986. If the taxpayer does not file an allocation statement or fails to allocate the debt in a reasonable and consistent manner, the Commissioner will allocate the debt.

Debt allocated to an asset under the second transitional rule may be repaid or refinanced after December 31, 1986, or there may be a disposition or change in use of the asset after that date. The effect of these events is determined under the normal repayment, refinancing and reallocation rules. Thus, for example, if an asset is sold after December 31, 1986, any debt allocated to the asset under the second transitional rule must be reallocated. Similarly, a repayment or refinancing of debt subject to the transitional rule is treated in the same manner as a repayment or refinancing of any other debt.

The second transitional rule does not apply if the taxpayer elects to allocate debt outstanding on December 31, 1986, based on the use of the debt proceeds (taking into account the first transitional rule). The election not to apply the transitional rule is made by attaching an election statement to the taxpayer's return for the first taxable year beginning after December 31, 1986.

In addition, the applicability of the transitional rule may be limited in the case of debt of a partnership or S corporation used to fund a distribution or loan to a partner or shareholder. Transitional issues with respect to such debt will be addressed in the special rules to be provided for passthrough entities.

Alternative Allocation Methods and Possible Antiabuse Rules

In developing the tracing method of interest allocation in these temporary regulations, the Internal Revenue Service seriously considered allocation based on pro rata apportionment of interest expense among a taxpayer's assets. Pro rata apportionment accords with the notion that money is fungible, regardless of whether borrowed or earned, and is used in certain Code provisions such as section 864(e). Depending on the apportionment base, recordkeeping requirements may be less burdensome than under a tracing regime. An apportionment approach may also result in lower transaction costs because taxpayers would have less incentive to arrange borrowings and expenditures based on the tax consequences.

Despite these possible advantages, the Service rejected pro rata apportionment for a number of reasons. First, there is not theoretically or practically satisfactory overall apportionment base. The use of either adjusted or unadjusted basis as an apportionment base could distort the amount of debt associated with particular assets. Apportionment based on the fair market value of assets might result in more appropriate allocations, but would also require burdensome and otherwise unnecessary appraisals of asset value.

Second, in order to apportion the proper amount of interest expense to consumer assets, taxpayers would be required to determine and report either the basis or fair market value of all consumer assets. Many taxpayers would consider such requirements unduly intrusive and burdensome. In addition, it would be extremely difficult to enforce such requirements.

Third, any general apportionment base would have to be adjusted in various ways in order to allocate a reasonable amount of interest to noncapital expenditures. For example, to maintain the integrity of the rule that personal interest is not deductible, it might be necessary to apportion some interest to personal consumption. Similarly, labor-intensive businesses would be disadvantaged relative to capital-intensive businesses unless expenditures for noncapital items such as salaries, supplies, and research and development were capitalized for interest allocation purposes.

Finally, a rule apportioning debt among all of a taxpayer's assets would distort certain economic decisions by ignoring the fact that such decisions are made by comparing the marginal cost of borrowing, the marginal return from an expenditure, and the opportunity costs of liquidating other assets in order to make the expenditure with unborrowed funds.

Despite the practical and theoretical problems that a comprehensive pro rata apportionment system would present, the Service is not foreclosing the possibility that future regulations may impose some form of pro rata apportionment.

The Service recognizes that some taxpayers will attempt to manipulate the tracing rules in the temporary regulations to maximize their interest deductions. For example, a sole proprietor may be able to maximize the amount of fully deductible interest expense allocated to trade or business expenditures by borrowing to pay business expenses and making personal expenditures from business receipts. Similarly, upper-income taxpayers may have sufficient liquidity to make business and investment expenditures from borrowed funds and personal expenditures from unborrowed funds. Finally, the fact that the allocation of interest expense is not affected by the use of any property to secure repayment of a debt may permit manipulation. For example, a taxpayer may use unborrowed funds to purchase an automobile for personal use, incur debt secured by that asset, and use the debt proceeds to replace the unborrowed funds.

The Service therefore is considering rules to prevent abuses of the tracing method. For example, taxpayers whose gross income and total interest expense exceed specified amounts might be treated as having a minimum amount of personal interest. Alternatively, such taxpayers might be required to allocate interest expense based on pro rata apportionment. The rule that the security for a debt is irrelevant for purposes of allocating interest expense on the debt might be modified in certain cases involving debt secured by an asset and incurred within a short period of time after the purchase of the asset. The Service invites comment on these approaches and on other possible methods of preventing abuses of the rules in the temporary regulations.

Special Analyses

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The collection of information requirements contained in this regulation have been submitted to the Office of Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduction Act of 1980. These requirements have been approved by OMB.

Drafting Information

The principal author of these temporary regulations is Michael J. Grace of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing regulations on matters of both substance and style.

List of Subjects

26 CFR 1.61-1-1.281-4

Income taxes, Taxable income, Deductions, Exemptions.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of amendments to the regulations

For the reasons set out in the preamble, Subchapter A, Part 1, and Subchapter H, Part 602, of Title 26, Chapter 1 of the Code of Federal Regulations are amended as set forth below:

Income Tax Regulations

Part 1- [Amended]

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority:

26 U.S.C. 7805. Section 1.163-8T also issued under 26 U.S.C. 469 (k)(4).

Par. 2. The following new section is added to Part 1 in the appropriate place:

§1.163-8T Allocation of interest expense among expenditures (temporary).

(a) In general-(1) Application. This section prescribes rules for allocating interest expense for purposes of applying sections 469 (the "passive loss limitation") and 163 (d) and (h) (the "nonbusiness interest limitations").

(2) Cross-references. This paragraph provides an overview of the manner in which interest expense is allocated for the purposes of applying the passive loss limitation and nonbusiness interest limitations and the manner in which interest expense allocated under this section is treated. See paragraph (b) of this section for definitions of certain terms, paragraph (c) for the rules for allocating debt and interest expense among expenditures, paragraphs (d) and (e) for the treatment of debt repayments and refinancings, paragraph (j) for the rules for reallocating debt upon the occurrence of certain events, paragraph (m) for the coordination of the rules in this section with other limitations on the deductibility of interest expense, and paragraph (n) of this section for effective date and transitional rules.

(3) Manner of allocation. In general, interest expense on a debt is allocated in the same manner as the debt to which such interest expense relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. This section prescribes rules for tracing debt proceeds to specific expenditures.

(4) Treatment of interest expenses-(i) General rule. Except as otherwise provided in paragraph (m) of this section (relating to limitations on interest expense other than

the passive loss and nonbusiness interest limitations), interest expense allocated under the rules of this section is treated in the following manner:

(A) Interest expense allocated to a trade or business expenditure (as defined in paragraph (b)(7) of this section) is taken into account under section 163 (h)(2)(A);

(B) Interest expense allocated to a passive activity expenditure (as defined in paragraph (b)(4) of this section) or a former passive activity expenditure (as defined in paragraph (b)(2) of this section) is taken into account for purposes of section 469 in determining the income or loss from the activity to which such expenditure relates;

(C) Interest expense allocated to an investment expenditure (as defined in paragraph (b)(3) of this section) is treated for purposes of section 163(d) as investment interest;

(D) Interest expense allocated to a personal expenditure (as defined in paragraph (b)(5) of this section) is treated for purposes of section 163(h) as personal interest; and

(E) Interest expense allocated to a portfolio expenditure (as defined in paragraph (b)(6) of this section) is treated for purposes of section 469(e)(2)(B)(ii) as interest expense described in section 469(e)(1)(A)(i)(III).

(ii) Examples. The following examples illustrate the application of this paragraph (a)(4):

Example (1). Taxpayer A, an individual, incurs interest expense allocated under the rules of this section to the following expenditures: $6,000 Passive activity expenditure.$4,000 Personal expenditure.

The $6,000 interest expense allocated to the passive activity expenditure is taken into account for purposes of section 469 in computing A's income or loss from the activity to which such interest relates. Pursuant to section 163(h), A may not deduct the $4,000 interest expense allocated to the personal expenditure (except to the extent such interest is qualified residence interest, within the meaning of section 163(h)(3)).

Example (2). (i) Corporation M, a closely held C corporation (within the meaning of section 469 (j)(1)) has $10,000 of interest expense for a taxable year. Under the rules of this section, M's interest expense is allocated to the following expenditures: $2,000 Passive activity expenditure.$3,000 Portfolio expenditure. $5,000 Other expenditures.

(ii) Under section 163(d)(3)(D) and this paragraph (a)(4), the $2,000 interest expense allocated to the passive activity expenditure is taken into account in computing M's passive activity loss for the taxable year, but, pursuant to section 469(e)(1) and this paragraph (a)(4), the interest expense allocated to the portfolio expenditure and the other expenditures is not taken into account for such purposes.

(iii) Since M is a closely held C corporation, its passive activity loss is allowable under section 469(e)(2)(A) as a deduction from net active income. Under section 469(e)(2)(B) and this paragraph (a)(4), the $5,000 interest expense allocated to other expenditures is taken into account in computing M's net active income, but the interest expense allocated to the passive activity expenditure and the portfolio expenditure is not taken into account for such purposes.

(iv) Since M is a corporation, the $3,000 interest expense allocated to the portfolio expenditure is allowable without regard to section 163(d). If M were an individual, however, the interest expense allocated to the portfolio expenditure would be treated as investment interest for purposes of applying the limitation of section 163(d).

(b) Definitions. For purposes of this section-

(1) "Former passive activity" means an activity described in section 469(f)(3), but only if an unused deduction or credit (within the meaning of section 469(f)(1) (A) or (B)) is allocable to the activity under section 469(b) for the taxable year.

(2) "Former passive activity expenditure" means an expenditure that is taken into account under section 469 in computing the income or loss from a former passive activity of the taxpayer or an expenditure (including an expenditure properly chargeable to capital account) that would be so taken into account if such expenditure were otherwise deductible.

(3) "Investment expenditure" means an expenditure (other than a passive activity expenditure) properly chargeable to capital account with respect to property held for investment (within the meaning of section 163(d)(5)(A)) or an expenditure in connection with the holding of such property.

(4) "Passive activity expenditure" means an expenditure that is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer or an expenditure (including an expenditure properly chargeable to capital account) that would be so taken into account if such expenditure were otherwise deductible. For purposes of this section, the term "passive activity expenditure" does not include any expenditure with respect to any low-income housing project in any taxable year in which any benefit is allowed with respect to such project under section 502 of the Tax Reform Act of 1986.

(5) "Personal expenditure" means an expenditure that is not a trade or business expenditure, a passive activity expenditure, or an investment expenditure.

(6) "Portfolio expenditure" means an investment expenditure properly chargeable to capital account with respect to property producing income of a type described in section 469(e)(1)(A) or an investment expenditure for an expense clearly and directly allocable to such income.

(7) "Trade or business expenditure" means an expenditure (other than a passive activity expenditure or an investment expenditure) in connection with the conduct of any trade or business other than the trade or business of performing services as an employee.

(c) Allocation of debt and interest expense-(1) Allocation in accordance with use of proceeds. Debt is allocated to expenditures in accordance with the use of the debt proceeds and, except as provided in paragraph (m) of this section, interest expense accruing on a debt during any period is allocated to expenditures in the same manner as the debt is allocated from time to time during such period. Except as provided in paragraph (m) of this section, debt proceeds and related interest expense are allocated solely by reference to the use of such proceeds, and the allocation is not affected by the use of an interest in any property to secure the repayment of such debt or interest. The following example illustrates the principles of this paragraph (c)(1):

Example. Taxpayer A, an individual, pledges corporate stock held for investment as security for a loan and uses the debt proceeds to purchase an automobile for personal use. Interest expense accruing on the debt is allocated to the personal expenditure to purchase the automobile even though the debt is secured by investment property.

(2) Allocation period-(i) Allocation of debt. Debt is allocated to an expenditure for the period beginning on the date the proceeds of the debt are used or treated as used under the rules of this section to make the expenditure and ending on the earlier of-

(A) The date the debt is repaid; or

(B) The date the debt is reallocated in accordance with the rules in paragraphs (c)(4) and (j) of this section.

(ii) Allocation of interest expense-(A) In general. Except as otherwise provided in paragraph (m) of this section, interest expense accruing on a debt for any period is allocated in the same manner as the debt is allocated from time to time, regardless of when the interest is paid.

(B) Effect of compounding. Accrued interest is treated as a debt until it is paid and any interest accruing on unpaid interest is allocated in the same manner as the unpaid interest is allocated. For the taxable year in which a debt is reallocated under the rules in paragraphs (c) (4) and (j) of this section, however, compound interest accruing on such debt (other than compound interest accruing on interest that accrued before the beginning of the year) may be allocated between the original expenditure and the new expenditure on a straight-line basis (i.e., by allocating an equal amount of such interest expense to each day during the taxable year). In addition, a taxpayer may treat a year as consisting of 12 30-day months for purposes of allocating interest on a straight-line basis.

(C) Accrual of interest expense. For purposes of this paragraph (c)(2)(ii), the amount of interest expense that accrues during any period is determined by taking into account relevant provisions of the loan agreement and any applicable law such as sections 163(e), 483, and 1271 through 1275.

(iii) Examples. The following examples illustrate the principles of this paragraph (c)(2):

Example (1). (i) On January 1, taxpayer B, a calendar year taxpayer, borrows $1,000 at an interest rate of 11 percent, compounded semiannually. B immediately uses the debt proceeds to purchase an investment security. On July 1, B sells the investment security for $1,000 and uses the sales proceeds to make a passive activity expenditure. On December 31, B pays accrued interest on the $1,000 debt for the entire year.

(ii) Under this paragraph (c)(2) and paragraph (j) of this section, the $1,000 debt is allocated to the investment expenditure for the period from January 1 through June 30, and to the passive activity expenditure from July 1 through December 31. Interest expense accruing on the $1,000 debt is allocated in accordance with the allocation of the debt from time to time during the year even though the debt was allocated to the passive activity expenditure on the date the interest was paid. Thus, the $55 interest expense for the period from January 1 through June 30 is allocated to the investment expenditure. In addition, during the period from July 1 through December 31, the interest expense allocated to the investment expenditure is a debt, the proceeds of which are treated as used to make an investment expenditure. Accordingly, an additional $3 of interest expense for the period from July 1 through December 31 ($55×.055) is allocated to the investment expenditure. The remaining $55 of interest expense for the period from July 1 through December 31 ($1,000×.055) is allocated to the passive activity expenditure.

(iii) Alternatively, under the rule in paragraph (c)(2)(ii)(B) of this section, B may allocate the interest expense on a straight-line basis and may also treat the year as consisting of 12 30-day months for this purpose. In that case, $56.50 of interest expense (180/360×$113) would be allocated to the investment expenditure and the remaining $56.50 of interest expense would be allocated to the passive activity expenditure.

Example (2). On January 1, 1988, taxpayer C borrows $10,000 at an interest rate of 11 percent, compounded annually. All interest and principal on the debt is payable in a lump sum on December 31, 1992. C immediately uses the debt proceeds to make a passive activity expenditure. C materially participates in the activity in 1990, 1991, and 1992. Therefore, under paragraphs (c)(2) (i) and (j) of this section, the debt is allocated to a passive activity expenditure from January 1, 1988, through December 31, 1989, and to a former passive activity expenditure from January 1, 1990, through December 31, 1992. In accordance with the loan agreement (and consistent with §1.1272-1(d)(1) of the proposed regulations, 51 FR 12022, April 8, 1986), interest expense accruing during any period is determined on the basis of annual compounding. Accordingly, the interest expense on the debt is allocated as follows: -- Year Amount Expenditure -- 1988 .... $10,000 x .11 .... $1,100 Passive activity. 1989 .... 11,100 x .11 .... 1,221 Passive activity. 1990 .... 12,321 x .11 = 1,355 .... --------- 1,355 x 2,321/12,321 .... 255 Passive activity. 1,355 x 10,000/12,321 .... 1,100 Former passive activity. --------- 1,355 1991 .... 13,676 x .11 = 1,504 .... --------- 1,504 x 2,576/13,676 .... 283 Passive activity. 1,504 x 11,100/13,676 .... 1,221 Former passive activity. --------- 1,504 1992 .... 15,180 x .11 = 1,670 .... --------- 1,670 x 2,859/15,180 .... 315 Passive activity. 1,670 x 12,321/15,180 .... 1,355 Former passive activity. --------- 1,670 --

(e) Allocation of debt; proceeds not disbursed to borrower-(i) Third-party financing. If a lender disburses debt proceeds to a person other than the borrower in consideration for the sale or use of property, for services, or for any other purpose, the debt is treated for purposes of this section as if the borrower used an amount of the debt proceeds equal to such disbursement to make an expenditure for such property, services, or other purpose.

(ii) Debt assumptions not involving cash disbursements. If a taxpayer incurs or assumes a debt in consideration for the sale or use of property, for services, or for any other purpose, or takes property subject to a debt, and no debt proceeds are disbursed to the taxpayer, the debt is treated for purposes of this section as if the taxpayer used an amount of the debt proceeds equal to the balance of the debt outstanding at such time to make an expenditure for such property, services, or other purpose.

(4) Allocation of debt; proceeds deposited in borrower's account-(i) Treatment of deposit. For purposes of this section, a deposit of debt proceeds in an account is treated as an investment expenditure, and amounts held in an account (whether or not interest bearing) are treated as property held for investment. Debt allocated to an account under this paragraph (c)(4)(i) must be reallocated as required by paragraph (j) of this section whenever debt proceeds held in the account are used for another expenditure. This paragraph (c)(4) provides rules for determining when debt proceeds are expended from the account. The following example illustrates the principles of this paragraph (c)(4)(i):

Example. Taxpayer C, a calendar year taxpayer, borrows $100,000 on January 1 and immediately uses the proceeds to open a noninterest-bearing checking account. No other amounts are deposited in the account during the year, and no portion of the principal amount of the debt is repaid during the year. On April 1, C uses $20,000 of the debt proceeds held in the account for a passive activity expenditure. On September 1, C uses an additional $40,000 of the debt proceeds held in the account for a personal expenditure. Under this paragraph (c)(4)(i), from January 1 through March 31 the entire $100,000 debt is allocated to an investment expenditure for the account. From April 1 through August 31, $20,000 of the debt is allocated to the passive activity expenditure, and $80,000 of the debt is allocated to the investment expenditure for the account. From September 1 through December 31, $40,000 of the debt is allocated to the personal expenditure, $20,000 is allocated to the passive activity expenditure, and $40,000 is allocated to an investment expenditure for the account.

(ii) Expenditures from account; general ordering rule. Except as provided in paragraph (c)(4)(iii) (B) or (C) of this section, debt proceeds deposited in an account are treated as expended before-

(A) Any unborrowed amounts held in the account at the time such debt proceeds are deposited; and

(B) Any amounts (borrowed or unborrowed) that are deposited in the account after such debt proceeds are deposited.

The following example illustrates the application of this paragraph (c)(4)(ii):

Example. On January 10, taxpayer E opens a checking account, depositing $500 of proceeds of Debt A and $1,000 of unborrowed funds. The following chart summarizes the transactions which occur during the year with respect to the account: -- Date Transaction --- Jan. 10 .... $500 proceeds of Debt A and $1,000 unborowed funds deposited. Jan. 11 .... $500 proceeds of Debt B deposited. Feb. 17 .... $800 personal expenditure. Feb. 26 .... $700 passive activity expenditure. June 21 .... $1,000 proceeds of Debt C deposited. Nov. 24 .... $800 investment expenditure. Dec. 20 .... $600 personal expenditure. ---

The $800 personal expenditure is treated as made from the $500 proceeds of Debt A and $300 of the proceeds of Debt B. The $700 passive activity expenditure is treated as made from the remaining $200 proceeds of Debt B and $500 of unborrowed funds. The $800 investment expenditure is treated as made entirely from the proceeds of Debt C. The $600 personal expenditure is treated as made from the remaining $200 proceeds of Debt C and $400 of unborrowed funds. Under paragraph (c)(4)(i) of this section, debt is allocated to an investment expenditure for periods during which debt proceeds are held in the account.

(iii) Expenditures from account; supplemental ordering rules.-(A) Checking or similar accounts. Except as otherwise provided in this paragraph (c)(4)(iii), an expenditure from a checking or similar account is treated as made at the time the check is written on the account, provided the check is delivered or mailed to the payee within a reasonable period after the writing of the check. For this purpose, the taxpayer may treat checks written on the same day as written in any order. In the absence of evidence to the contrary, a check is presumed to be written on the date appearing on the check and to be delivered or mailed to the payee within a reasonable period thereafter. Evidence to the contrary may include the fact that a check does not clear within a reasonable period after the date appearing on the check.

(B) Expenditures within 15 days after deposit of borrowed funds. The taxpayer may treat any expenditure made from an account within 15 days after debt proceeds are deposited in such account as made from such proceeds to the extent thereof even if under paragraph (c)(4)(ii) of this section the debt proceeds would be treated as used to make one or more other expenditures. Any such expenditures and the debt proceeds from which such expenditures are treated as made are disregarded in applying paragraph (c)(4)(ii) of this section. The following examples illustrate the application of this paragraph (c)(4)(iii)(B):

Example (1). Taxpayer D incurs a $1,000 debt on June 5 and immediately deposits the proceeds in an account ("Account A"). On June 17, D transfers $2,000 from Account A to another account ("Account B"). On June 30, D writes a $1,500 check on Account B for a passive activity expenditure. In addition, numerous deposits of borrowed and unborrowed amounts and expenditures occur with respect to both accounts throughout the month of June. Notwithstanding these other transactions, D may treat $1,000 of the deposit to Account B on June 17 as an expenditure from the debt proceeds deposited in Account A on June 5. In addition, D may similarly treat $1,000 of the passive activity expenditure on June 30 as made from debt proceeds treated as deposited in Account B on June 17.

Example (2). The facts are the same as in the example in paragraph (c)(4)(ii) of this section, except that the proceeds of Debt B are deposited on February 11 rather than on January 11. Since the $700 passive activity expenditure occurs within 15 days after the proceeds of Debt B are deposited in the account, E may treat such expenditure as being made from the proceeds of Debt B to the extent thereof. If E treats the passive activity expenditure in this manner, the expenditures from the account are treated as follows: The $800 personal expenditure is treated as made from the $500 proceeds of Debt A and $300 of unborrrowed funds. The $700 passive activity expenditure is treated as made from the $500 proceeds of Debt B and $200 of unborrowed funds. The remaining expenditures are treated as in the example in paragraph (c)(4)(ii) of this section.

(C) Interest on segregated account. In the case of an account consisting solely of the proceeds of a debt and interest earned on such account, the taxpayer may treat any expenditure from such account as made first from amounts constituting interest (rather than debt proceeds) to the extent of the balance of such interest in the account at the time of the expenditure, determined by applying the rules in this paragraph (c)(4). To the extent any expenditure is treated as made from interest under this paragraph (c)(4)(iii)(C), the expenditure is disregarded in applying paragraph (c)(4)(ii) of this section.

(iv) Optional method for determining date of reallocation. Solely for the purpose of determining the date on which debt allocated to an account under paragraph (c)(4)(i) of this section is reallocated, the taxpayer may treat all expenditures made during any calendar month from debt proceeds in the account as occurring on the later of the first day of such month or the date on which such debt proceeds are deposited in the account. This paragraph (c)(4)(iv) applies only if all expenditures from an account during the same calendar month are similarly treated. The following example illustrates the application of this paragraph (c)(4)(iv):

Example. On January 10, taxpayer G opens a checking account, depositing $500 of proceeds of Debt A and $1,000 of unborrowed funds. The following chart summarizes the transactions which occur during the year with respect to the account (note that these facts are the same as the facts of the example in paragraph (c)(4)(ii) of this section): -- Date Transaction -- Jan. 10 .... $500 proceeds of Debt A and $1,000 unborrowed funds deposited. Jan. 11 .... $500 proceeds of Debt B deposited. Feb. 17 .... $800 personal expenditure. Feb. 26 .... $700 passive activity expenditure. June 21 .... $1,000 proceeds of Debt C deposited. Nov. 24 .... $800 investment expenditure. Dec. 20 .... $600 personal expenditure. --

Assume that G chooses to apply the optional rule of this paragraph (c)(4)(iv) to all expenditures. For purposes of determining the date on which debt is allocated to the $800 personal expenditure made on February 17, the $500 treated as made from the proceeds of Debt A and the $300 treated as made from the proceeds of Debt B are treated as expenditures occurring on February 1. Accordingly, Debt A is allocated to an investment expenditure for the account from January 10 through January 31 and to the personal expenditure from February 1 through December 31, and $300 of Debt B is allocated to an investment expenditure for the account from January 11 through January 31 and to the personal expenditure from February 1 through

December 31. The remaining $200 of Debt B is allocated to an investment expenditure for the account from January 11 through January 31 and to the passive activity expenditure from February 1 through December 31. The $800 of Debt C used to make the investment expenditure on November 24 is allocated to an investment expenditure for the account from June 21 through October 31 and to an investment expenditure from November 1 through December 31. The remaining $200 of Debt C is allocated to an investment expenditure for the account from June 21 through November 30 and to a personal expenditure from December 1 through December 31.

(v) Simultaneous deposits-(A) In general. If the proceeds of two or more debts are deposited in an account simultaneously, such proceeds are treated for purposes of this paragraph (c)(4) as deposited in the order in which the debts were incurred.

(B) Order in which debts incurred. If two or more debts are incurred simultaneously or are treated under applicable law as incurred simultaneously, the debts are treated for purposes of this paragraph (c)(4)(v) as incurred in any order the taxpayer selects.

(C) Borrowings on which interest accrues at different rates. If interest does not accrue at the same fixed or variable rate on the entire amount of a borrowing, each portion of the borrowing on which interest accrues at a different fixed or variable rate is treated as a separate debt for purposes of this paragraph (c)(4)(v).

(vi) Multiple accounts. The rules in this paragraph (c)(4) apply separately to each account of a taxpayer.

(5) Allocation of debt; proceeds received in cash-(i) Expenditure within 15 days of receiving debt proceeds. If a taxpayer receives the proceeds of a debt in cash, the taxpayer may treat any cash expenditure made within 15 days after receiving the cash as made from such debt proceeds to the extent thereof and may treat such expenditure as made on the date the taxpayer received the cash. The following example illustrates the rule in this paragraph (c)(5)(i):

Example. Taxpayer F incurs a $1,000 debt on August 4 and receives the debt proceeds in cash. F deposits $1,500 cash in an account on August 15 and on August 27 writes a check on the account for a passive activity expenditure. In addition, F engages in numerous other cash transactions throughout the month of August, and numerous deposits of borrowed and unborrowed amounts and expenditures occur with respect to the account during the same period. Notwithstanding these other transactions, F may treat $1,000 of the deposit on August 15 as an expenditure made from the debt proceeds on August 4. In addition, under the rule in paragraph (c)(4)(v)(B) of this section, F may treat the passive activity expenditure on August 27 as made from the $1,000 debt proceeds treated as deposited in the account.

(ii) Other expenditures. Except as provided in paragraphs (c)(5) (i) and (iii) of this section, any debt proceeds a taxpayer (other than a corporation) receives in cash are treated as used to make personal expenditures. For purposes of this paragraph (c)(5), debt proceeds are received in cash if, for example, a withdrawal of cash from an account is treated under the rules of this section as an expenditure of debt proceeds.

(iii) Special rules for certain taxpayers.[Reserved.]

(6) Special rules-(i) Qualified residence debt. [Reserved.]

(ii) Debt used to pay interest. To the extent proceeds of a debt are used to pay interest, such debt is allocated in the same manner as the debt on which such interest accrued is allocated from time to time. The following example illustrates the application of this paragraph (c)(6)(ii):

Example. On January 1, taxpayer H incurs a debt of $1,000, bearing interest at an annual rate of 10 percent, compounded annually, payable at the end of each year ("Debt A"). H immediately opens a checking account, in which H deposits the proceeds of Debt A. No other amounts are deposited in the account during the year. On April 1, H writes a check for a personal expenditure in the amount of $1,000. On December 31, H borrows $100 ("Debt B") and immediately uses the proceeds of Debt B to pay the accrued interest of $100 on Debt A. From January 1 through March 31, Debt A is allocated, under the rule in paragraph (c)(4)(i) of this section, to the investment expenditure for the account. From April 1 through December 31, Debt A is allocated to the personal expenditure. Under the rule in paragraph (c)(2)(ii) of this section, $25 of the interest on Debt A for the year is allocated to the investment expenditure, and $75 of the interest on Debt A for the year is allocated to the personal expenditure. Accordingly, for the purpose of allocating the interest on Debt B for all periods until Debt B is repaid, $25 of Debt B is allocated to the investment expenditure, and $75 of Debt B is allocated to the personal expenditure.

(iii) Debt used to pay borrowing costs-(A) Borrowing costs with respect to different debt. To the extent the proceeds of a debt (the "ancillary debt") are used to pay borrowing costs (other than interest) with respect to another debt (the "primary debt"), the ancillary debt is allocated in the same manner as the primary debt is allocated from time to time. To the extent the primary debt is repaid, the ancillary debt will continue to be allocated in the same manner as the primary debt was allocated immediately before its repayment. The following example illustrates the rule in this paragraph (c)(6)(iii)(A):

Example. Taxpayer I incurs debts of $60,000 ("Debt A") and $10,000 ("Debt B"). I immediately uses $30,000 of the proceeds of Debt A to make a trade or business expenditure, $20,000 to make a passive activity expenditure, and $10,000 to make an investment expenditure. I immediately use $3,000 of the proceeds of Debt B to pay borrowing costs (other than interest) with respect to Debt A (such as loan origination, loan commitment, abstract, and recording fees) and deposits the remaining $7,000 in an account. Under the rule in this paragraph (c)(6)(iii)(A), the $3,000 of Debt B used to pay expenses of incurring Debt A is allocated $1,500 to the trade or business expenditure ($3,000 × $30,000/$60,000), $1,000 to the passive activity expenditure ($3,000 × $20,000/$60,000), and $500 ($3,000 × $10,000/$60,000) to the investment expenditure. The manner in which the $3,000 of Debt B used to pay expenses of incurring Debt A is allocated may change if the allocation of Debt A changes, but such allocation will be unaffected by any repayment of Debt A. The remaining $7,000 of Debt B is allocated to an investment expnditure for the account until such time, if any, as this amount is used for a different expenditure.

(B) Borrowing costs with respect to same debt. To the extent the proceeds of a debt are used to pay borrowing costs (other than interest) with respect to such debt, such debt is allocated in the same manner as the remaining debt is allocated from time to time. The remaining debt for this purpose is the portion of the debt that is not used to pay borrowing costs (other than interst) with respect to such debt. Any repayment of the debt is treated as a repayment of the debt allocated under this paragraph (c)(6)(iii)(B) and the remaining debt is the same proportion as such amount bear to each other. The following example illustrates the application of this paragraph (c)(6)(iii)(B):

Example. (i) Taxpayer J borrows $85,000. The lender disburses $80,000 of this amount to J, retaining $5,000 for borrowing costs (other than interest) with respect to the loan. J immediately uses $40,000 of the debt proceeds to make a personal expenditure, $20,000 to make a passive activity expenditure, and $20,000 to make an investment expenditure. Under the rule in this paragraph (c)(6)(iii)(B), the $5,000 used to pay borrowing costs is allocated $2,500 ($5,000 × $40,000/$80,000) to the personal expenditure, $1,250 ($5,000 × $20,000/$80,000) to the investment expenditure. The manner in which this $5,000 is allocated may change if the allocation of the remaining $80,000 of debt is changed.

(ii) Assume that J repays $50,000 of the debt. The repayment is treated as a repayment of $2,941 ($50,000 x $5,000/$85,000) of the debt used to pay borrowing costs and a repayment of $47,059 ($50,000 x $80,000/$85,000) of the remaining debt. Under paragraph (d) of this section, J is treated as repaying the $42,500 of debt allocated to the personal expenditure ($2,500 of debt used to pay borrowing costs and $40,000 of remaining debt). In addition, assuming that under paragraph (d)(2) J chooses to treat the allocation to the passive activity expenditure as having occurred before the allocation to the investment expenditure, J is treated as repaying $7,500 of debt allocated to the passive activity expenditure ($441 of debt used to pay borrowing costs and $7,059 of remaining debt).

(iv) Allocation of debt before actual receipt of debt proceeds. If interest properly accrues on a debt during any period before the debt proceeds are actually received or used to make an expenditure, the debt is allocated to an investment expenditure for such period.

(7) Antiabuse rules. [Reserved.]

(d) Debt repayments-(1) General ordering rule. If, at the time any portion of a debt is repaid, such debt is allocated to more than one expenditure, the debt is treated for purposes of this section as repaid in the following order:

(i) Amounts allocated to personal expenditures;

(ii) Amounts allocated to investment expenditures and passive activity expenditures (other than passive activity expenditures described in paragraph (d)(1)(iii) of this section);

(iii) Amounts allocated to passive activity expenditures in connection with a rental real estate activity with respect to which the taxpayer actively participates (within the meaning of section 469(i));

(iv) Amounts allocated to former passive activity expenditures; and

(v) Amounts allocated to trade or business expenditures and to expenditures described in the last sentence of paragraph (b)(4) of this section.

(2) Supplemental ordering rules for expenditures in same class. Amounts allocated to two or more expenditures that are described in the subdivision of paragraph (d)(1) of this section (e.g., amounts allocated to different personal expenditures) are treated as repaid in the order in which the amounts were allocated (or reallocated) to such expenditures. For purposes of this paragraph (d)(2), the taxpayer may treat allocations and reallocations that occur on the same day as occurring in any order (without regard to the order in which expenditures are treated as made under paragraph (c)(4)(iii)(A) of this section).

(3) Continuous borrowings. In the case of borrowings pursuant to a line of credit or similar account or arrangement that allows a taxpayer to borrow funds periodically under a single loan agreement-

(i) All borrowings on which interest accrues at the same fixed or variable rate are treated as a single debt; and

(ii) Borrowings or portions of borrowings on which interest accrues at different fixed or variable rates are treated as different debts, and such debts are treated as repaid for purposes of this paragraph (d) in the order in which such borrowings are treated as repaid under the loan agreement.

(4) Examples. The following examples illustrate the application of this paragraph (d):

Example (1). Taxpayer B borrows $100,000 ("Debt A") on July 12, immediately deposits the proceeds in an account, and uses the debt proceeds to make the following expenditures on the following dates: August 31-$40,000 passive activity expenditure 1.October 5-$20,000 passive activity expenditure 2.December 24-$40,000 personal expenditure.

On January 19 of the following year, B repays $90,000 of Debt A (leaving $10,000 of Debt A outstanding). The $40,000 of Debt A allocated to the personal expenditure, the $40,000 allocated to passive activity expenditure 1, and $10,000 of the $20,000 allocated to passive activity expenditure 2 are treated as repaid.

Example (2). (i) Taxpayer A obtains a line of credit. Interest on any borrowing on the line of credit accrues at the lender's "prime lending rate" on the date of the borrowing plus two percentage points. The loan documents provide that borrowings on the line of credit are treated as repaid in the order the borrowings were made. A borrows $30,000 ("Borrowing 1") on the line of credit and immediately uses $20,000 of the debt proceeds to make a personal expenditure ("personal expenditure 1") and $10,000 to make a trade or business expenditure ("trade or business expenditure 1"). A subsequently borrows another $20,000 ("Borrowing 2") on the line of credit and immediately uses $15,000 of the debt proceeds to make a personal expenditure ("personal expenditure 2") and $5,000 to make a trade or business expenditure ("trade or business expenditure 2"). A then repays $40,000 of the borrowings.

(ii) If the prime lending rate plus two percentage points was the same on both the date of Borrowing 1 and the date of Borrowing 2, the borrowings are treated for purposes of this paragraph (d) as a single debt, and A is treated as having repaid $35,000 of debt allocated to personal expenditure 1 and personal expenditure 2, and $5,000 of debt allocated to trade or business expenditure 1.

(iii) If the prime lending rate plus two percentage points was different on the date of Borrowing 1 and Borrowing 2, the borrowings are treated as two debts, and, in accordance with the loan agreement, the $40,000 repaid amount is treated as a repayment of Borrowing 1 and $10,000 of Borrowing 2. Accordingly, A is treated as having repaid $20,000 of debt allocated to personal expenditure 1, $10,000 of debt allocated to trade or business expenditure 1, and $10,000 of debt allocated to personal expenditure 2.

(e) Debt refinancings-(1) In general. To the extent proceeds of any debt (the "replacement debt") are used to repay any portion of a debt, the replacement debt is allocated to the expenditures to which the repaid debt was allocated. The amount of replacement debt allocated to any such expenditure is equal to the amount of debt allocated to such expenditure that was repaid with proceeds of the replacement debt. To the extent proceeds of the replacement debt are used for expenditures other than repayment of a debt, the replacement debt is allocated to expenditures in accordance with the rules of this section.

(2) Example. The following example illustrates the application of this paragraph (e):

Example. Taxpayer C borrows $100,000 ("Debt A") on July 12, immediately deposits the debt proceeds in an account, and uses the proceeds to make the following expenditures on the following dates (note that the facts of this example are the same as the facts of example (1) in paragraph (d)(4) of this section): August 31-$40,000 passive activity expenditure 1.October 5-$20,000 passive activity expenditure 2.December 24-$40,000 personal expenditure 1.

On January 19 of the following year, C borrows $120,000 ("Debt B") and uses $90,000 of the proceeds of repay $90,000 of Debt A (leaving $10,000 of Debt A outstanding). In addition, C uses $30,000 of the proceeds of Debt B to make a personal expenditure ("personal expenditure 2"). Debt B is allocated $40,000 to personal expenditure 1, $40,000 to passive activity expenditure 1, $10,000 to passive activity expenditure 2, and $30,000 to personal expenditure 2. Under paragraph (d)(1) of this section, Debt B will be treated as repaid in the following order: (1) amounts allocated to personal expenditure 1, (2) amounts allocated to personal expenditure 2, (3) amounts allocated to passive activity expenditure 1, and (4) amounts allocated to passive activity expenditure 2.

(f) Debt allocated to distributions by passthrough entities. [Reserved]

(g) Repayment of passthrough entity debt. [Reserved]

(h) Debt allocated to expenditures for interests in passthrough entities. [Reserved]

(i) Allocation of debt to loans between passthrough entities and interest holders. [Reserved]

(j) Reallocation of debt-(1) Debt allocated to capital expenditures-(i) Time of reallocation. Except as provided in paragraph (j)(2) of this section, debt allocated to an expenditure properly chargeable to capital account with respect to an asset (the "first expenditure") is reallocated to another expenditure on the earlier of-

(A) The date on which proceeds from a disposition of such asset are used for another expenditure; or

(B) The date on which the character of the first expenditure changes (e.g., from a passive activity expenditure to an expenditure that is not a passive activity expenditure) by reason of a change in the use of the asset with respect to which the first expenditure was capitalized.

(ii) Limitation on amount reallocated. The amount of debt reallocated under paragraph (j)(1)(i)(A) of this section may not exceed the proceeds from the disposition of the asset. The amount of debt reallocated under paragraph (j)(1)(i)(B) of this section may not exceed the fair market value of the asset on the date of the change in use. In applying this paragraph (j)(1)(ii) with respect to a debt in any case in which two or more debts are allocable to expenditures properly chargeable to capital account with respect to the same asset, only a ratable portion (determined with respect to any such debt by dividing the amount of such debt by the aggregate amount of all such debts) of the fair market value or proceeds from the disposition of such asset shall be taken into account.

(iii) Treatment of loans made by the taxpayer. Except as provided in paragraph (j)(1)(iv) of this section, an expenditure to make a loan is treated as an expenditure properly chargeable to capital account with respect to an asset, and for purposes of paragraph (j)(1)(i)(A) of this section any repayment of the loan is treated as a disposition of the asset. Paragraph (j)(3) of this section applies to any repayment of a loan in installments.

(iv) Treatment of accounts. Debt allocated to an account under paragraph (c)(4)(i) of this section is treated as allocated to an expenditure properly chargeable to capital account with respect to an asset, and any expenditure from the account is treated as a disposition of the asset. See paragraph (c)(4) of this section for rules under which debt proceeds allocated to an account are treated as used for another expenditure.

(2) Disposition proceeds in excess of debt. If the proceeds from the disposition of an asset exceed the amount of debt reallocated by reason of such disposition, or two or more debts are reallocated by reason of the disposition of an asset, the proceeds of the disposition are treated as an account to which the rules in paragraph (c)(4) of this section apply.

(3) Special rule for deferred payment sales. If any portion of the proceeds of a disposition of an asset are received subsequent to the disposition-

(i) The portion of the proceeds to be received subsequent to the disposition is treated for periods prior to the receipt as used to make an investment expenditure; and

(ii) Debt reallocated by reason of the disposition is allocated to such investment expenditure to the extent such debt exceeds the proceeds of the disposition previously received (other than proceeds used to repay such debt).

(4) Examples. The following examples illustrate the application of this paragraph (j):

Example (1). On January 1, 1988, taxpayer D sells an asset for $25,000. Immediately before the sale, the amount of debt allocated to expenditures properly chargeable to capital account with respect to the asset was $15,000. The proceeds of the disposition are treated as an account consisting of $15,000 of debt proceeds and $10,000 of unborrowed funds to which paragraph (c)(4) of this section applies. Thus, if D immediately makes a $10,000 personal expenditure from the proceeds and within 15 days deposits the remaining proceeds in an account, D may, pursuant to paragraph (c)(4)(iii)(B) of this section, treat the entire $15,000 deposited in the account as proceeds of a debt.

Example (2). The facts are the same as in example (1) except that, instead of receiving all $25,000 of the sale proceeds on January 1, 1988, D receives 5,000 on that date, $10,000 on January 1, 1989, and $10,000 on January 1, 1990. D does not use any portion of the sale proceeds to repay the debt. Between January 1, 1988, and December 31, 1988, D is treated under paragraph (j)(3) of this section as making an investment expenditure of $20,000 to which $10,000 of debt is allocated. In addition, the remaining $5,000 of debt is reallocated on January 1, 1988, in accordance with D's use of the sales proceeds received on that date. Between January 1, 1989, and December 31, 1989, D is treated as making an investment expenditure of $10,000 to which no debt is allocated. In addition, as of January 1, 1989, $10,000 of debt is reallocated in accordance with D's use of the sales proceeds received on that date.

Example 3. The facts are the same as in example (2), except that D immediately uses the $5,000 sale proceeds received on January 1, 1988, to repay $5,000 of the $15,000 debt. Between January 1, 1988, and December 31, 1988, D is treated as making an investment expenditure of $20,000 to which the remaining balance ($10,000) of the debt is reallocated. The results in 1989 are as described in example (2).

(k) Modification of rules in the case of interest expense allocated to foreign source income. [Reserved.]

(l) Reserved.

(m) Coordination with other provisions-(1) Effect of other limitations-(i) In general. All debt is allocated among expenditures pursuant to the rules in this section, without regard to any limitations on the deductibility of interest expense on such debt. The applicability of the passive loss and nonbusiness interest limitations to interest on such debt, however, may be affected by other limitations on the deductibility of interest expense.

(ii) Disallowance provisions. (Interest expense that is not allowable as a deduction by reason of a disallowance provision (within the meaning of paragraph (m)(7)(ii) of this section) is not taken into account for any taxable year for purposes of applying the passive loss and nonbusiness interest limitations.

(iii) Deferral provisions. Interest expense that is not allowable as a deduction for the taxable year in which paid or accrued by reason of a deferral provision (within the meaning of paragraph (m)(7)(iii) of this section) is allocated in the same manner as the debt giving rise to the interest expense is allocated for such taxable year. Such interest expense is taken into account for purposes of applying the passive loss and nonbusiness interest limitations for the taxable year in which such interest expense is allowable under such deferral provision.

(iv) Capitalization provisions. Interest expense that is capitalized pursuant to a capitalization provision (within the meaning of paragraph (m)(7)(i) of this section) is not taken into account as interest for any taxable year for purposes of applying the passive loss and nonbusiness interest limitations.

(2) Effect on other limitations-(i) General rule. Except as provided in paragraph (m)(2)(ii) of this section, any limitation on the deductibility of an item (other than the passive loss and nonbusiness interest limitations) applies without regard to the manner in which debt is allocated under this section. Thus, for example, interest expense treated under section 265(a)(2) as interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax is not deductible regardless of the expenditure to which the underlying debt is allocated under this section.

(ii) Exception. Capitalization provisions (within the meaning of paragraph (m)(7)(i) of this section) do not apply to interest expense allocated to any personal expenditure under the rules of this section.

(3) Qualified residence interest. Qualified residence interest (within the meaning of section 163(h)(3)) is allowable as a deduction without regard to the manner in which such interest expense is allocated under the rules of this section. In addition, qualified residence interest is not taken into account in determining the income or loss from any activity for purposes of section 469 or in determining the amount of investment interest for purposes of section 163(d). The following example illustrates the rule in this paragraph (m)(3):

Example. Taxpayer E, an individual, incurs a $20,000 debt secured by a residence and immediately uses the proceeds to purchase an automobile exclusively for E's personal use. Under the rules in this section, the debt and interest expense on the debt are allocated to a personal expenditure. If, however, the interest on the debt is qualified residence interest within the meaning of section 163(h)(3), the interest is not treated as personal interest for purposes of section 163(h).

(4) Interest described in section 163(h)(2)(E). Interest described in section 163(h)(2)(E) is allowable as a deduction without regard to the rules of this section.

(5) Interest on deemed distributee debt. [Reserved.]

(6) Examples. The following examples illustrate the relationship between the passive loss and nonbusiness interest limitations and other limitations on the deductibility of interest expense:

Example (1). Debt is allocated pursuant to the rules in this section to an investment expenditure for the purchase of taxable investment securities. Pursuant to section 265(a)(2), the debt is treated as indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax, and, accordingly, interest on the debt is disallowed. If section 265(a)(2) subsequently ceases to apply (because, for example, the taxpayer ceases to hold any tax-exempt obligations), and the debt at such time continues to be allocated to an investment expenditure, interest on the debt that accrues after such time is subject to section 163(d).

Example (2). An accrual method taxpayer incurs a debt payable to a cash method lender who is related to the taxpayer within the meaning of section 267(b). During the period in which interest on the debt is not deductible by reason of section 267(a)(2), the debt is allocated to a passive activity expenditure. Thus, interest that accrues on the debt for such period is also allocated to the passive activity expenditure. When such interest expense becomes deductible under section 267(a)(2), it will be allocated to the passive activity expenditure, regardless of how the debt is allocated at such time.

Example (3). A taxpayer incurs debt that is allocated under the rules of this section to an investment expenditure. Under section 263A(f), however, interest expense on such debt is capitalized during the production period (within the meaning of section 263A(f)(4)(B)) of property used in a passive activity of the taxpayer. The capitalized interest expense is not allocated to the investment expenditure, and depreciation deductions attributable to the capitalized interest expense are subject to the passive loss limitation as long as the property is used in a passive activity. However, interest expense on the debt for periods after the production period is allocated to the investment expenditure as long as the debt remains allocated to the investment expenditure.

(7) Other limitations on interest expense-(i) Capitalization provisions. A capitalization provision is any provision that requires or allows interest expense to be capitalized. Capitalization provisions include sections 263(g), 263A(f), and 266.

(ii) Disallowance provisions. A disallowance provision is any provision (other than the passive loss and nonbusiness interest limitations) that disallows a deduction for interest expense for all taxable years and is not a capitalization provision. Disallowance provisions include sections 163(f)(2), 264(a)(2), 264(a)(4), 265(a)(2), 265(b)(2), 279(a), 291(e)(1)(B)(ii), 805(b)(1), and 834(c)(5).

(iii) Deferral provisions. A deferral provision is any provision (other than the passive loss and nonbusiness interest limitations) that disallows a deduction for interest expense for any taxable year and is not a capitalization or disallowance provision. Deferral provisions include sections 267(a)(2), 465, 1277, and 1282.

(n) Effective date-(1) In general. This section applies to interest expense paid or accrued in taxable years beginning after December 31, 1986.

(2) Transitional rule for certain expenditures. For purposes of determining whether debt is allocated to expenditures made on or before August 3, 1987, paragraphs (c)(4)(iii)(B) and (c)(5)(i) of this section are applied by substituting "90 days" for "15 days."

(3) Transitional rule for certain debt-(i) General rule. Except as provided in paragraph (n)(3)(ii) of this section, any debt outstanding on December 31, 1986, that is properly attributable to a business or rental activity is treated for purposes of this section as debt allocated to expenditures properly chargeable to capital account with respect to the assets held for use or for sale to customers in such business or rental activity. Debt is properly attributable to a business or rental activity for purposes of this section (regardless of whether such debt otherwise would be allocable under this section to expenditures in connection with such activity) if the taxpayer has properly and consistently deducted interest expense (including interest subject to limitation under section 163(d) as in effect prior to the Tax Reform Act of 1986) on such debt on Schedule C, E, or F of Form 1040 in computing income or loss from such business or rental activity for taxable years beginning before January 1, 1987. For purposes of this paragraph (n)(3), amended returns filed after July 2, 1987 are disregarded in determining whether a taxpayer has consistently deducted interest expense on Schedule C, E, or F of Form 1040 in computing income or loss from a business or rental activity.

(ii) Exceptions-(A) Debt financed distributions by passthrough entities. [Reserved]

(B) Election out. This paragraph (n)(3) does not apply with respect to debt of a taxpayer who elects under paragraph (n)(3) (viii) of this section to allocate debt outstanding on December 31, 1986, in accordance with the provisions of this section other than this paragraph (n)(3) (i.e., in accordance with the use of the debt proceeds).

(iii) Business or rental activity. For purposes of this paragraph (n)(3), a business or rental activity is any trade or business or rental activity of the taxpayer. For this purpose-

(A) A trade or business includes a business or profession the income and deductions of which (or, in the case of a partner or S corporation shareholder, the taxpayer's share thereof) are properly reported on Schedule C, E, or F of Form 1040; and

(B) A rental activity includes an activity of renting property the income and deductions of which (or, in the case of a partner or S corporation shareholder, the taxpayer's share thereof) are properly reported on Schedule E of Form 1040.

(iv) Example. The following example illustrates the circumstances in which debt is properly attributable to a business or rental activity:

Example. Taxpayer H incurred a debt in 1979 and properly deducted the interest expense on the debt on Schedule C of Form 1040 for each year from 1979 through 1986. Under this paragraph (n) (3), the debt is properly attributable to the business the results of which are reported on Schedule C.

(v) Allocation requirement-(A) In general. Debt outstanding on December 31, 1986, that is properly attributable (within the meaning of paragraph (n)(3)(i) of this section) to a business or rental activity must be allocated in a reasonable and consistent manner among the assets held for use or for sale to customers in such activity on the last day of the taxable year that includes December 31, 1986. The taxpayer shall specify the manner in which such debt is allocated by filing a statement in accordance with paragraph (n)(3)(vii) of this section. If the taxpayer does not file such a statement or fails to allocate such debt in a reasonable and consistent manner, the Commissioner shall allocate the debt.

(B) Reasonable and consistent manner-examples of improper allocation. For purposes of this paragraph (n)(3)(v), debt is not treated as allocated in a reasonable and consistent manner if-

(1) The amount of debt allocated to goodwill exceeds the basis of the goodwill; or

(2) The amount of debt allocated to an asset exceeds the fair market value of the asset, and the amount of debt allocated to any other asset is less than the fair market value (lesser of basis or fair market value in the case of goodwill) of such other asset.

(vi) Coordination with other provisions. The effect of any events occurring after the last day of the taxable year that includes December 31, 1986, shall be determined under the rules of this section, applied by treating the debt allocated to an asset under paragraph (n)(3)(v) of this section as if proceeds of such debt were used to make an expenditure properly chargeable to capital account with respect to such asset on the last day of the taxable year that includes December 31, 1986. Thus, debt that is allocated to an asset in accordance with this paragraph (n)(3) must be reallocated in accordance with paragraph (j) of this section upon the occurrence with respect to such asset of any event described in such paragraph (j). Similarly, such debt is treated as repaid in the order prescribed in paragraph (d) of this section. In addition, a replacement debt (within the meaning of paragraph (e) of this section) is allocated to an expenditure properly chargeable to capital account with respect to an asset to the extent the proceeds of such debt are used to repay the portion of a debt allocated to such asset under this paragraph (n)(3).

(vii) Form for allocation of debt. A taxpayer shall allocate debt for purposes of this paragraph (n)(3) by attaching to the taxpayer's return for the first taxable year beginning after December 31, 1986, a statement that is prominently identified as a transitional allocation statement under §1.163-8T(n)(3) and includes the following information:

(A) A description of the business or rental activity to which the debt is properly attributable;

(B) The amount of debt allocated;

(C) The assets among which the debt is allocated;

(D) The manner in which the debt is allocated;

(E) The amount of debt allocated to each asset; and

(F) Such other information as the Commissioner may require.

(viii) Form for election out. A taxpayer shall elect to allocate debt outstanding on December 31, 1986, in accordance with the provisions of this section other than this paragraph (n)(3) by attaching to the taxpayer's return (or amended return) for the first taxable year beginning after December 31, 1986, a statement to that effect, prominently identified as as election out under §1.163-8T(n)(3).

(ix) Special rule for partnerships and S corporations. For purposes of paragraph (n)(3)(ii)(B), (v), (vii) and (viii) of this section (relating to the allocation of debt and election out), a partnership or S corporation shall be treated as the taxpayer with respect to the debt of the partnership or S corporation.

(X) Irrevocability. An allocation or election filed in accordance with paragraph (n)(3)(vii) or (viii) of this section may not be revoked or modified except with the consent of the Commissioner.

PART 602-OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority for Part 602 continues to read as follows:

Authority:

26 U.S.C. 7805.

§602.101 [Amended]

Par. 4. Section 602.101(c) is amended by inserting in the appropriate place in the table "§1.163-8T . . . 1545-0995".

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impractical to issue this Treasury decision with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,

Commissioner of Internal Revenue.

Approved: June 15, 1987.

J. Roger Mentz,

Assistant Secretary of the Treasury.