I. Introduction. The Tax Reform Act of 1986 significantly changed the interest expense deduction available for personal interest and investment interest and broadened the number of categories of interest expense for noncorporate taxpayers. Under the Act, personal interest is nondeductible (subject to phase-in), trade or business interest is fully deductible unless subject to capitalization, and investment interest and passive activity interest are deductible subject to limitations. Newly proposed regulations would categorize interest expense by tracing the use of the debt proceeds. The nature of the security is irrelevant. These rules do not apply to qualified residence interest on debt secured by the taxpayer's principal residence or second residence. Debt incurred or continued to acquire or carry tax-exempt securities continues to be nondeductible.

II. Personal Interest

A. General. Personal interest paid or accrued during a taxable year is not deductible by a noncorporate taxpayer (subject to a phase-in). Section 163(h)(1). The stated rationale for elimination of the deduction for personal interest is that prior law encouraged taxpayers to invest in consumer durables rather than income-producing assets and therefore inappropriately encouraged taxpayers to consume rather than to save. Blue Book, page 263.

B. Personal interest - defined. The term personal
interest means all interest expense other than interest in five separate categories:

1. Trade or business interest: interest paid or accrued on debt incurred or continued in connection with the conduct of a trade or business (other than the trade or business of performing services as an employee); Section 105(c)(4) of the Technical Corrections Bill would replace the words "incurred or continued in connection with the conduct of" with the words "properly allocable to";

2. Investment interest: interest paid or accrued on debt incurred or continued to purchase or carry property held for investment. Section 105(c)(1) of the Technical Corrections Bill would replace the words "incurred or continued to purchase or carry" with the words "properly allocable to";

3. Passive activity interest: interest taken into account in computing income or loss from a passive activity of the taxpayer;

4. Qualified residence interest: interest paid or accrued on debt secured by any property which (at the time such interest is paid or accrued) is a "qualified residence" of the taxpayer; and

5. 6601 interest: Interest payable under Section 6601 on any unpaid portion of the estate tax for the period during which an extension of time for payment of such tax is in effect under section 6163 (reversionary or remainder interest in property) or section 6166 (value of estate consists substantially of interest in closely-held business). Section 163(h)(1).

Consequently, personal interest is all interest except the five categories of interest set forth above, and all personal interest is nondeductible, except for certain transitional rules.

C. Examples of personal interest. The Blue Book provides that personal interest includes:

1. interest on debt to purchase an automobile,

2. interest on debt to purchase a life insurance policy, and

3. credit card interest

where such interest is not trade or business, investment, or passive interest. Blue Book, page 266.
Personal interest also includes interest on underpayments of individual federal, state or local income taxes, regardless of whether the income taxes are related to trade or business income. Blue Book, page 266 and n. 60. Personal interest does not include:

1. interest on taxes, other than income, allocable to a trade or business, such as sales taxes and property taxes;

2. interest of an S corporation attributable to income tax of the corporation when it was a C corporation;

3. interest on taxes imposed by sections 1374 or 1375; and

4. interest on corporate tax liability payable by a shareholder on a transferee tax liability under section 6901. Blue Book, page 266, n. 60.

D. Capitalization of personal interest. The capitalization provisions of section 263A do not override the personal interest limitation. Consequently, personal interest may not be included in a capital or inventory account and recovered through depreciation or amortization deductions, as a cost of sales, or in any other manner. Technical Corrections Bill section 108(b)(1) and Technical Corrections Description, page 67.

E. Transitional rules. The limitation on personal interest is phased in over a five-year period. For taxable years beginning in 1987, 35 per cent of personal interest is nondeductible; in 1988, 60 percent; in 1989, 80 percent; in 1990, 90 percent; after 1990, the deduction for personal interest is eliminated completely.

III. Qualified Residence Interest

A. General. Congress determined that providing incentives for home ownership is an important policy goal. Consequently, Congress excluded qualified residence interest from the ambit of personal interest. Section 163(h)(2)(D). Congress also excluded qualified residence interest from: (i) the definition of investment interest; (ii) the restrictions on passive activity losses; and (iii) the uniform capitalization rules. Sections 163(d)(3)(B)(i), 469(j)(7) and 263A(f)(2)(B). Qualified residence interest is, however, subject to the rules relating to interest or debt incurred or carried to purchase tax-exempt obligations.

B. Qualified residence interest. The term generally means interest on debt secured by any property which (at the time such interest is paid or accrued) is a qualified residence
of the taxpayer. The term does not include interest on debt which is secured by a qualified residence to the extent the debt exceeds the amount of the taxpayer's basis for the residence (including the cost of home improvements), plus the amount of the taxpayer's qualified medical and qualified educational expenses. Also, qualified residence interest does not include interest on any portion of debt to the extent it exceeds the fair market value of the residence. Sections 163(h)(3)(A) and (B).

1. Qualified residence. Qualified residence means (i) the taxpayer's principal residence (within the meaning of section 1034) and (ii) one other residence of the taxpayer which is selected by the taxpayer for this purpose for the taxable year and which is used by the taxpayer as a residence (within the meaning of section 280A(d)(1)). Section 163(h)(5)(A)(i).

   a. The taxpayer's principal residence is intended to be the residence that would qualify for gain rollover under section 1034 if sold. A principal residence may be a condominium or cooperative unit. A principal residence may also include a houseboat or house trailer. Blue Book, page 267 n. 63.

   b. A dwelling unit will qualify as a second residence if it is used by the taxpayer for personal purposes for the greater of 14 days or 10 percent of the number of days it is rented. Sections 163(h)(5)(A)(i)(II) and 280A(d)(1). However, if the taxpayer does not rent the second residence at any time during the taxable year, the taxpayer does not need to satisfy the requirement that the residence be used for personal purposes for the greater of 14 days or 10 percent of the number of days it is rented. Section 163(h)(5)(A)(iii).

   i. In the case of a joint return, a second residence includes a residence used by the taxpayer or his spouse and which is owned by either or both spouses. Technical Corrections Bill section 105(c)(8); Blue Book, page 267.

   ii. If the taxpayer owns more than two residences, he may annually designate the residence to be treated as his second residence for purposes of the qualified residence interest deduction. S. Rep. No. 313, 99th Cong., 2d Sess. 807 (1986).
2. Basis limitation. Subject to the exceptions described below, qualified residence interest is limited to interest on debt secured by the residence up to the taxpayer's basis in the residence plus the cost of improvements. The taxpayer's basis for this purpose does not include basis adjustments under section 1034(e) (relating to involuntary conversions) or other adjustments to basis, such as depreciation. Blue Book, page 268. Accordingly, depreciation deductions taken with respect to a second residence will not lower the basis limitation for purposes of the qualified residence interest deduction. If the taxpayer's basis in the residence is determined under Section 1014 (relating to the basis of property acquired from a decedent), the taxpayer's Section 1014 basis is his basis for this purpose. Blue Book, page 268.

a. Under the Technical Corrections Bill, the basis limitation on debt may be increased by the amount of secured debt incurred by a spouse in connection with the acquisition of the other spouse's interest in the residence incident to a divorce or legal separation. The amount of the increase, however, would be limited to the excess of (i) the lesser of the debt or the fair market value of the spouse's interest in the residence; over (ii) the basis of the spouse's interest in the residence. Technical Corrections Bill section 105(c)(8).

b. If the taxpayer's debt secured by a residence exceeds the fair market value of the residence, interest on the debt in excess of the fair market value amount is not qualified residence interest. Section 163(h)(3)(B)(i). The determination of fair market value is made only at the time the debt is incurred. Section 163(h)(3)(D). Consequently, a subsequent reduction in value does not affect the qualified residence interest deduction.

3. Exceptions to basis limitation:

a. August 16, 1986 indebtedness. If the taxpayer incurred debt secured by a residence before August 17, 1986 and the debt was secured by the residence on August 16, 1986, the amount of the basis limitation shall not be less than the amount of such debt as reduced by any principal payments thereon. Consequently, in determining the basis limitation, the taxpayer uses the greater of his basis, as determined above in paragraph 2, or his pre-August 17, 1986 debt as
b. Qualified medical or educational expenses. The basis limitation rule does not apply if debt secured by a residence is incurred after August 16, 1986 to pay for qualified medical or educational expenses. Consequently, interest on this debt is considered qualified residence interest even though the debt exceeds the taxpayer's basis in the residence. Sections 163(h)(3)(B)(ii)(II) and 163(h)(4). However, the qualified medical or educational expenses must be paid or incurred within a reasonable time before or after the debt is incurred. Section 163(h)(4)(A). The debt may be secured at any time after August 16, 1986.

i. Qualified medical expenses are those amounts paid for medical care within the meaning of section 213(d)(1)(A) and (B) (not including amounts paid for insurance covering medical care) of the taxpayer, his spouse, or dependents. Section 163(h)(4)(B). Reimbursed medical expenses are not treated as qualified medical expenses. Blue Book, page 269.

ii. Qualified educational expenses are those amounts paid for: (a) reasonable living expenses while away from home and (b) tuition and fees required for enrollment or attendance and fees, books, supplies and equipment required for courses of instruction at the educational organization, for the taxpayer, his spouse or dependent, while a student at an educational organization described in Section 170(b)(1)(A)(ii). Section 163(h)(4)(C). Tuition expenses for primary, secondary, college and graduate level education are generally included. Blue Book, page 269.

4. Security interest in qualified residence. The debt must be secured by a qualified residence. The security interest must be valid against a subsequent purchaser under local law. A loan secured by a recorded deed of trust, mortgage or other security interest in a qualified residence is sufficiently "secured" even though, in a state such as Texas, the recorded instrument would be rendered ineffective or its enforceability restricted by state and local laws.
such as the Texas homestead law. Blue Book, page 266.
"The fact that, under applicable state or local law, a
buyer does not acquire legal title to a residence he
has purchased by means of debt until the debt is paid
is not intended to have the result that the debt is
treated as not secured by the residence..." Blue Book
pages 266-267.

a. Jointly-owned property. Debt secured by a
qualified residence of the taxpayer that he owns
jointly or as tenant in common satisfies the
security interest requirement. Blue Book, page
267.

b. Housing cooperative. Debt secured by the
taxpayer's stock in a housing cooperative unit
that is a qualified residence, or by his
proprietary lease with respect to the unit,
satisfies the security interest requirement.

i. If stock in the housing cooperative unit
cannot be used as security under state or
local law or under the cooperative agreement,
the stock nevertheless can be treated as
securing the debt, if the taxpayer
establishes to the satisfaction of the IRS
that the debt was incurred to acquire the

ii. Qualified residence interest may include
the taxpayer's share of interest expense of
the housing cooperative allocable to his unit
and his share of common residential areas
(not commercial areas) of the cooperative.

IV. Investment Interest

A. General. Under old law, a noncorporate taxpayer
generally could deduct investment interest to the extent of
net investment income plus $10,000. Disallowed investment
interest expense could be carried forward indefinitely and
deducted, subject to the same limitation. The Act expanded
the investment interest limitation by prohibiting the
deduction of investment interest expense in excess of net
investment income and eliminating the $10,000 annual
threshold amount. Section 163(d)(1). The amount of
investment interest expense in excess of net investment
income can be carried forward indefinitely and treated as
investment interest expense paid or accrued by the taxpayer
in the succeeding taxable year. Section 163(d)(2).
B. **Investment interest.** The term investment interest means any interest otherwise allowable as a deduction which is paid or accrued on debt incurred or continued to purchase or carry property held for investment, subject to various exceptions. Section 163(d)(3)(A). Section 105(c)(1) of the Technical Corrections Bill changes the definition of investment interest to be interest on debt "properly allocable" to property held for investment.

1. **Exceptions.** The term investment interest does not include:

   a. Qualified residence interest. See Section III of this Outline. Consequently, if interest on debt qualifies as qualified residence interest, the debt proceeds can be used to purchase or carry property held for investment and the interest will not be considered investment interest. Section 163(d)(3)(B)(i).

   b. Passive activity interest. Interest taken into account under Section 469 in computing the taxpayer's income or loss from a passive activity. Section 163(d)(3)(B)(ii). However, investment interest does include the portion of interest expense on debt incurred or continued to purchase or carry an interest in a passive activity, to the extent attributable to portfolio income within the meaning of Section 469(e)(1). Blue Book, page 264.

C. **Property held for investment.** The term "property held for investment" includes any property that generates (i) interest, dividends, annuities or royalties not derived in the ordinary course of a trade or business; (ii) gain or loss attributable to the disposition of property generating the type of income described in (i); or (iii) gain or loss attributable to the disposition of property held for investment. Sections 163(d)(5)(A)(i) and 469(e)(1). Property held for investment also includes any interest in an activity involving the conduct of a trade or business which is not a passive activity (within the meaning of Section 469) and with respect to which the taxpayer does not materially participate. Section 163(d)(5)(A)(ii).

   1. Property subject to net lease. This type of property is not treated as property held for investment to the extent it constitutes a rental activity that is treated as a passive activity under the passive loss rules. Blue Book, page 265.

   2. Rental real estate--active participation. Property held for investment does not include a rental
real estate activity in which the taxpayer actively participates. This means that interest allocable to the $25,000 offset under section 469(i) is not subject to the investment interest limitations. Blue Book, page 265.

D. Net investment income. The term net investment income means the excess of investment income over investment expenses. Section 163(d)(4)(A).

1. Investment income. The term investment income means the sum of (i) gross income from property held for investment plus (ii) any net gain attributable to the disposition of property held for investment. Section 163(d)(4)(B). Investment income includes income from interests in activities, involving a trade or business, in which the taxpayer does not materially participate, provided the activity is not a passive activity under section 469. Blue Book, page 265. However, income from a rental real estate activity in which the taxpayer actively participates is not included in investment income. Blue Book, page 265.

   a. Rental income. Rental income does not constitute investment income because any rental activity constitutes a passive activity under section 469 and section 163(d)(4)(D) provides that investment income does not include any income from a passive activity. Future regulations may have exceptions such as for ground leases.

   b. Long-term capital gain. Under prior law, investment income did not include long-term capital gain. According to the Blue Book, continuation of this rule was inappropriate because long-term capital gain and ordinary income will be taxed at the same effective rate once the rates are fully phased in. Blue Book, page 263.

   c. Adjustments to investment income. Investment income is reduced by an amount equal to the taxpayer’s passive activity loss that is not subject to the passive loss limitation because of the phase-in rules under section 469(1). Section 163(d)(4)(E). Any deductible passive activity loss attributable to a rental real estate activity in which the taxpayer actively participates does not reduce investment income. Section 163(d)(4)(E).

2. Investment expenses. The term investment expenses means the deductions, other than interest, which are directly connected with the production of investment.
income. In determining deductible investment expenses, only those investment expenses in excess of an amount equal to 2% of adjusted gross income are offset against investment income. Blue Book, page 265. In computing the amount of expenses that exceed the 2% floor, expenses that are not investment expenses are disallowed before any investment expenses are disallowed. Blue Book, page 265.

a. Depreciation and depletion deductions. If depreciation or depletion deductions are directly connected with the production of investment income, investment expense is computed by using the actual depreciation or depletion deductions allowable. Old law permitted a taxpayer to use more favorable depreciation and depletion deductions in calculating investment expense. Blue Book, page 265.

E. Overlap with other sections. The investment interest limitation does not operate to disallow a deduction for interest expense that must be capitalized under sections 263A(f), 263(g) or 266. Temp. Reg. section 1.163-8T(m)(1)(iv) and (7). Investment interest expense treated as interest on debt to purchase or carry tax-exempt assets under section 265(a)(2) is nondeductible regardless of section 163(d). Temp. Reg. section 1.163-8T(m)(2)(i). See also Temp. Reg. section 1.163-8T(m)(1)(ii) and (iii) and (7)(ii) and (iii) and (6), Examples (1), (2) and (3).

1. Passive activity interest. Interest expense allocable to a passive activity is not subject to the investment interest limitation rules. Instead, the deductibility of the interest expense is subject to the passive loss limitations under section 469. Section 163(d)(3)(B)(ii).

F. Transitional rules. During the period from 1987 to 1990 the amount of disallowed investment interest expense is phased in. The phase in rule applies to the $10,000 threshold under old section 163(d)(1)(A) ($5,000 in the case of a separate return by a married individual). Consequently, in 1987 investment interest expense is deductible to the extent of net investment income plus $6,500 (35% of $10,000 is disallowed); in 1988, net investment income plus $4000 (60% of $10,000 is disallowed); in 1989, net investment income plus $2,000 (80% of $10,000 is disallowed); in 1990, net investment income plus $1,000 (90% of $10,000 is disallowed); in 1991, net investment income (100% of the $10,000 is disallowed). Section 163(d)(6).
V. **Interest Expense - Alternative Minimum Tax**

A. **General.** In computing alternative minimum taxable income, the amounts allowable as a deduction for investment interest under section 163(d) and personal interest and qualified residence interest under section 163(h) are adjusted under section 56(b)(1)(C).

B. **Adjustments to Investment Interest Expense Deduction:**

1. **Phase-in rules.** In computing the investment interest deduction for AMT purposes, the phase-in rules for investment interest do not apply. See Section IV.F of this outline. Section 56(b)(1)(C)(ii).

2. **Tax-exempt bond interest.** Interest on certain private activity bonds is treated as an item of tax preference under section 57(a)(5). In computing investment income for purposes of the minimum tax this tax-exempt interest is included after taking into account expenses related to the tax-exempt income.

3. **Passive loss - phase-in rules.** Because the passive loss rules are not phased in for minimum tax purposes, investment income is not reduced for minimum tax purposes by the amount of the passive activity loss allowed under the phase-in rules in computing regular tax. Section 58(b)(3); Section 163(d)(4)(E).

C. **Adjustments to personal interest expense deduction.** For minimum tax purposes, personal interest is not deductible. The phase-in rules for personal interest do not apply. See Section II.E of this outline. Section 56(b)(1)(C)(ii).

D. **Adjustments to qualified residence interest deduction.** The deduction for qualified residence interest is more restrictive under the minimum tax rules than under the regular tax rules. For minimum tax purposes, the taxpayer is entitled to deduct "qualified housing interest" (as defined in section 56(e) and not qualified residence interest. However, it is proposed that the interest must have been deductible for regular tax purposes to qualify as a deduction for minimum tax purposes. Technical Corrections Bill section 107(b)(6). Blue Book, page 463, n. 22.

1. **Qualified housing interest.** The term means interest paid or accrued during the taxable year on debt incurred to acquire, construct or substantially rehabilitate the taxpayer's qualifying principal or secondary residence. Section 56(e)(1).

   a. **Refinancing.** Qualified housing interest also includes interest on debt resulting from the
refinancing of debt meeting the requirements of the above paragraph, but only to the extent that the amount of the debt was not increased. Section 56(e)(1).

b. Pre-July 1, 1982 debt. Qualified housing interest also includes interest on debt incurred before July 1, 1982 that was secured by the taxpayer's qualifying principal or secondary residence at the time he incurred the debt.

2. Eligible second residence. To be an eligible second residence, it must be a "qualified dwelling" which is a qualified residence (within the meaning of section 163(h)(3)). The term "qualified dwelling" means any house, apartment, condominium or mobile home not used on a transient basis. Section 56(e)(2).

VI. Interest Expense on Certain Qualified Plan Loans

A. Key employee loans. The Act disallows the deduction for interest paid by key employees with respect to loans from any qualified plan or tax sheltered annuity or custodial account. No basis is created in a participant's account with respect to any nondeductible interest paid on a loan from a qualified plan or tax sheltered annuity or custodial account. Section 72(p)(3); Blue Book, page 728-729. "Key employee" is as defined in section 416(i) to include certain officers, highly compensated individuals or shareholders.

B. Loans secured by elective deferrals. The Act also disallows the deduction for interest paid by all employees on loans secured by elective deferrals (or the income attributable thereto) under a qualified cash or deferred arrangement or tax sheltered annuity or custodial account.

C. Effective date. These provisions are generally effective with respect to loans made after December 31, 1986. The provisions also apply to any renegotiation, extension, renewal, or revision, after December 31, 1986, of an existing loan.

VII. Allocation of Interest Expense

A. Scope. On July 2, 1987, Treasury issued proposed regulations under section 163 relating to the allocation of interest expense for purposes of applying the limitations on passive activity losses and credits, investment interest and personal interest. Other limitations on the deductibility of interest generally apply regardless of the manner in which the interest is allocated. For example, despite the allocation of interest expense to trade or business income or investment income, the interest may nevertheless be disallowed under section 265, capitalized under 263A(f), or
deferred under section 267(a)(2). Temp. Reg. section 1.163-8T(m).

B. Allocation rules in general. Interest expense is generally allocated by tracing disbursements of debt proceeds to specific expenditures. The nature of any property securing the debt is irrelevant, except that the allocation rules do not override the deductibility of qualified residence interest (or of "qualified housing interest" for AMT purposes). Temp. Reg. section 1.163-8T(c)(1) and (m)(3). For example, if a person incurs debt secured by investment assets and uses the debt proceeds to purchase a personal use asset, interest on the debt is considered personal interest, not investment interest.

1. Period of allocation. Debt is allocated to an expenditure for the period beginning on the date the proceeds are used or treated as used to make the expenditure and ending on the earlier of: (i) the date the debt is repaid; or (ii) the date the debt is reallocated. See section VII.J of this outline.

C. Tracing rules. Use of debt proceeds is determined by tracing proceeds to specific expenditures.

1. Third-party financing. Proceeds paid directly by lender to seller or supplier (or person other than borrower) is traced to property or services purchased. Temp. Reg. section 1.163-8T(c)(3)(i).

2. Debt assumptions not involving cash disbursements. Debt assumed or taken "subject to" is traced to property or services purchased. The debt is treated 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 or services. Temp. Reg. section 1.163-8T(c)(3)(ii).

3. Debt proceeds placed in account or taken in cash. Proceeds placed in an account or taken in cash are subject to further rules for allocation of such debt. See Section VII.D of this outline for rules relating to debt proceeds placed in an account and Section VII.E for rules relating to debt proceeds taken in cash.

D. Proceeds placed in an account. The term "account" is not a defined term of art but rather has a common meaning. But, see Temp. Reg. sec. 1.163-8T(j)(2). The rules governing accounts apply separately to each account of the taxpayer. Temp. Reg. section 1.163-8T(c)(vi).

1. Treatment of deposit in account. Debt proceeds held in an account are treated as property held for
investment regardless of whether the account bears interest. Consequently, interest expense on unspent debt proceeds in an account is investment interest expense. When debt allocated to an account is used for another expenditure the debt proceeds must be reallocated. Temp. Reg. section 1.163-8T(c)(4)(i).

2. Tracing expenditures from account. Any expenditure made from an account within 15 days after debt proceeds are deposited in the account may be traced as the taxpayer chooses to the extent of the debt proceeds. Temp. Reg. section 1.163-8T(c)(4)(iii)(B). This special 15-day period is extended to 90 days for debt proceeds deposited before August 3, 1987. Temp. Reg. section 1.163-8T(n)(2). After 15 (or 90) days, expenditures are traced in the chronological order they are made. Temp. Reg. section 1.163-8T(c)(4)(ii).

a. An expenditure is treated as made on the day the check is written on the account, provided it is mailed or delivered promptly. Temp. Reg. section 1.163-8T(c)(4)(iii)(A).

b. Checks written on the same day can be treated as written in any order the taxpayer chooses. Id.

3. Interest on segregated account. If an account contains only debt proceeds and earns interest, interest can be treated as spent first. Temp. Reg. section 1.163-8T(c)(4)(iii)(C).

4. Alternative to tracing rule. As an alternative to the general tracing rules, taxpayer can choose to treat all expenditures during the month, or (if shorter) all expenditures following the first deposit of debt proceeds, as being made on the first day of such month or on the date of deposit of the borrowed funds. This choice will not be binding for any other month. Temp. Reg. section 1.163-8T(c)(4)(iv).

5. Ordering rules. Borrowed funds deposited in an account are treated as expended before (i) any unborrowed amounts held in the account at the time such debt proceeds are deposited; and (ii) any amounts (borrowed or unborrowed) that are deposited in the account after such debt proceeds are deposited. Temp. Reg. section 1.163-8T(c)(4)(ii). If proceeds of more than one debt are deposited simultaneously, they are deemed spent in the order the debts were incurred. Temp. Reg. section 1.163-8T(c)(4)(v)(A). If debts were both incurred and deposited simultaneously, the taxpayer can choose the ordering of their incurrence. Temp. Reg. section 1.163-8T(c)(4)(v)(B).
a. Example: On January 10, taxpayer opens a checking account and deposits Debt A proceeds of $500 and $1,000 of unborrowed funds. Taxpayer makes the following expenditures:

February 17 - $800 - personal expenditure
February 26 - $700 - passive activity expenditure

The $800 personal expenditure is treated as made from the Debt A proceeds of $500 and $300 from the unborrowed funds. The $700 passive activity expenditure is treated as made from the $700 balance of unborrowed funds. During the period from January 10 through February 16, the debt is allocated to an investment expenditure. Thus, interest expense during that period is subject to the investment interest limitations. Temp. Reg. sec. 1.163-8T(c)(4)(ii)

Example.

b. Example: On February 12, taxpayer opens a checking account and deposits Debt A proceeds of $500 and $1,000 of unborrowed funds. Taxpayer makes the following expenditures:

February 17 - $800 - personal expenditure
February 26 - $700 - passive activity expenditure

Because the passive activity expenditure occurred within 15 days after Debt A proceeds were deposited, taxpayer may treat $500 of the passive activity expenditure as being made from the Debt A proceeds. Accordingly, the $700 passive activity expenditure is treated as being made from the Debt A proceeds of $500 and $200 of unborrowed funds. The personal expenditure of $800 is treated as being made from the balance of the unborrowed funds.

E. Proceeds taken in cash

1. Tracing expenditures. If a taxpayer receives debt proceeds in cash, any cash expenditure within 15 days after debt proceeds are received may be traced as taxpayer chooses to the extent of the debt proceeds. Temp. Reg. section 1.163-8T(c)(5)(i). Presumably, a taxpayer must document the transaction with receipts or contemporaneous notes. This special 15-day period is extended to 90 days for debt proceeds received before August 3, 1987. Temp. Reg. section 1.163-8T(n)(2).

2. Personal interest. After the 15 (or 90) days, all interest on debt proceeds held in cash (as opposed to in an account) is considered personal interest. This same rule applies to cash withdrawals from an account.

F. Characterization and Calculation of Interest. Interest is characterized according to the use of the underlying debt proceeds during any given period, even though it may not be deductible or otherwise taken into account until a later year. Temp. Reg. section 1.163-8T(c)(2)(i) and (ii)(A). Interest of any particular character accrues from the time the debt proceeds are used for a particular purpose until the debt is repaid or the debt proceeds recharacterized because of a different use of the debt proceeds. Temp. Reg. section 1.163-8T(c)(2)(i)(A). Interest accruing on unpaid interest is characterized in the same manner as the unpaid interest. Compound interest accrued as of the end of a taxable year retains that character in later years. Compound interest accruing during a given year in which the use of the debt proceeds changes may be allocated pro rata to the respective periods on a straight line basis if the taxpayer so chooses (instead of daily compounding) and a year of 12 30-day months may be chosen for this purpose. Temp. Reg. section 1.163-8T(c)(2)(ii)(B). Interest taken into account includes not only stated interest but also OID, unstated interest under section 483, and other amounts treated as interest for tax purposes. Temp. Reg. section 1.163-8T(c)(2)(ii)(C).

G. Debt to pay interest and other borrowing costs. Debt incurred to a lender or a third party to pay interest, loan fees, or other borrowing costs, as well as loan proceeds withheld by a lender for these purposes, is characterized according to the uses of the basic loan or the available portion of it. Such debt retains its character even if the basic loan is repaid first.

1. Example. On January 1, taxpayer incurs a Debt A of $1,000 bearing interest at 10% payable on December 31. Taxpayer deposits the Debt A proceeds in an account on January 1. No other deposits are made to the account. On April 1, A writes a check for a personal expenditure in the amount of $1,000. On December 31, taxpayer incurs Debt B of $100 to pay the interest on debt A. From January 1 through March 31, Debt A is allocated to an investment expenditure since held in the account. From April 1 through December 31, Debt A is allocated to the personal expenditure. Consequently, $25 of the Debt A interest is investment interest and $75 of the Debt A interest is personal interest. For purposes 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. Temp. Reg. section 1.163-8T(c)(6)(ii) Example.
H. Repayments. The repayment rules are designed to minimize the limitations on interest deductibility. Thus, any debt classified as personal is deemed to be the first repaid. Temp. Reg. section 1.163-8T(d)(1). Repayments are then applied to the other categories of debt in the following order: (i) investment expenditures and passive activity expenditures; (ii) rental activity expenditures where the taxpayer actively participates; (iii) expenditures in connection with former passive activities; (iv) trade or business expenditures and expenditures with respect to certain low-income housing projects. Temp. Reg. section 1.163-8T(d)(1)(ii)-(v).

1. Ordering. Within each of these categories, expenditures are treated as repaid in the order they were made. Expenditures made on the same day can be treated as repaid in any order the taxpayer chooses, and he is not bound by his original choice under the same-day check rule. See Section VII.D.2.b of this Outline. Temp. Reg. section 1.163-8T(d)(2).

2. Lines of credit. Debts under lines of credit or other continuous borrowing arrangements are treated as repaid in the order specified in the loan agreement. The proposed regulations do not say what happens if the agreement does not specify the order. All borrowings on which interest accrues at a single rate, whether fixed or variable, are treated as a single debt. Each borrowing or portion thereof on which interest accrues at a different rate, fixed or variable, is treated as a separate debt. These rules are critical because the deduction maximizing rules for repayments apply only to repayments of a specific debt. Temp. Reg. section 1.163-8T(d)(3) and (1).

I. Refinancings. If new money is borrowed to repay an old debt, the new debt is allocated to particular expenditures in the same manner as the old. Any portion of the new debt not used to repay old debt is treated as a new debt in all respects and is allocated according to the general rules for new debt. Temp. Reg. section 1.163-8T(e).

J. Reallocation of debt proceeds first used for capital expenditure. Any debt traced to the acquisition of a capital asset will be reallocated on the earlier of: (i) the date on which proceeds from disposition of the asset are used for another expenditure (other than repayment of the debt), or (ii) the date on which the category of the capital asset changes (e.g., from passive to active or from business to personal). The tracing of the proceeds for disposition will generally be handled under the same rules as for an account although the use of the proceeds may in some cases be directly traceable to another expenditure. The amount of
debt reallocated upon disposition cannot exceed the disposition proceeds. Any remaining debt will retain its original character. If all or part of two or more debts were traced to the disposed asset, the debt reallocated will be prorated to all the debts in proportion to the respective amounts outstanding on the underlying indebtedness. Temp. Reg. section 1.163-8T(j).

1. A capital asset may be tangible personal use property as well as intangible property or property used in an active or passive business. The note receivable created through reloaning the borrowed money to a third party will also result in a capital asset, and any repayments by a third party will be treated as proceeds from disposition of the loan.

2. The deferred payments on deferred payment sales will be treated exactly the same as any other loan to a third party, with the one exception that no debt once allocated to it will be reallocated until the deferred payments received exceed the debt thus allocated. Temp. Reg. section 1.163-8T(j)(3).

3. Example. On January 2, Taxpayer sells an asset for $25,000. The amount of debt allocated to expenditures properly chargeable to capital account with respect to the asset was $15,000. The sales proceeds are treated as an account consisting of both $15,000 of debt proceeds and $10,000 of unborrowed funds. Thus, if taxpayer immediately makes a $10,000 personal expenditure from the proceeds and within 15 days deposits the remaining proceeds in an account, taxpayer may treat the entire $15,000 deposited in the account as proceeds of debt. Temp. Reg. section 1.163-8T(j)(4) Example (1).

K. Business or rental activity debt outstanding December 31, 1986. Debt outstanding at the end of 1986 was attributable to a business or rental activity if the taxpayer so treated it in computing interest for purposes of the Schedule C, E, or F of the Forms 1040 for years beginning before 1987, not including any amended return filed after July 2, 1987. A taxpayer can elect to apply to such debt the regular tracing rules applicable to any other debt proceeds received before August 3, 1987. If the taxpayer does not so elect, he must allocate the debt in a "reasonable and consistent manner" among the assets of the activity held for use or for sale to customers. The allocation is made among the assets held on the last day of the taxable year that includes December 31, 1986.
1. There are few restrictions in allocating in a "reasonable and consistent manner". The restrictions are:
   
a. That no asset can be allocated a debt greater than its fair market value if any other asset is allocated less than its fair market value, and
   
b. That the debt allocated to goodwill can never exceed basis, and cannot be less than the lesser of basis or fair market value before any other asset can be allocated a debt in excess of its fair market value.

2. Either the allocation or the election to follow the general rules must be set forth in a statement attached to the first return for a year beginning after 1986 and must satisfy the requirements of Treasury Regulation section 163-8T(n)(3).

L. Pass-through entities. All of the tracing and other rules generally apply to partnerships and S corporations in the same manner as to other taxpayers. Consequently, interest incurred by a pass-through entity is allocated based on the entity's use of the debt proceeds. Future regulations will describe the result when such entities distribute debt proceeds to the partners or shareholders or when debt is incurred to acquire or increase an interest in such an entity.

M. Alternative allocation method and possible anti-abuse rules. The preamble to Temporary Regulations section 1.163-8T provides that to prevent abuses of the tracing method, Treasury is considering other allocation methods. Examples of such methods include: (1) pro rata apportionment of interest expense among a taxpayer's assets; (2) treat taxpayers whose gross income and total interest expense exceed specified amounts as having a minimum amount of personal interest; (3) modify the rule that security for a debt is irrelevant for purposes of allocating interest expense on the debt in those cases involving debt secured by an asset and incurred within a short period of time after the purchase of the asset.

1.Potentially abusive situations.
   
a. A sole proprietor could manipulate the tracing rules to maximize his trade or business interest expense deduction by borrowing to pay business expenses and making personal expenditures from business receipts.
b. Wealthy taxpayers could make business and investment expenditures from borrowed funds and personal expenditures from unborrowed funds.