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Interest Allocation Rules: The Nightmare Continues

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Another 1986 Act Nightmare

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A. Introduction. The Tax Reform Act of 1986 (1986 Act) constituted a sea change in Federal income tax policy not only because of its dramatically lowered marginal tax rates for individuals and corporations, but also for its repeal of many tax benefits long held to be sacrosanct. The attractiveness of lower tax rates may have blinded many policy makers to the negative impact of the repeal of many tax deductions and credits on an essentially retroactive basis. One of the more significant changes in the individual area was the repeal of the deductibility of personal interest. In order to make the provision politically palatable, a deduction for "qualified residence" interest was retained and the repeal of the personal interest deduction was phased-in over a short period of years. However, even before taxpayers and their advisers had a chance to adjust to the 1986 Act changes, the Congress struck again in the Omnibus Budget Reconciliation Act of 1987 (1987 Act), amending not only the definition of "qualified residence" interest but also for the first time enacting into law an upper limit on the amount of home mortgage interest that is deductible for Federal income tax purposes. Then, in 1988, the Congress enacted the Technical

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and Miscellaneous Revenue Act of 1988 (1988 Act) which included not only technical corrections to the 1986 Act and the 1987 Act, but also adopted additional revenue enhancement measures.

Observation: Although the Omnibus Reconciliation Act of 1989 did not make further changes to the personal interest deduction, rumors abound this year concerning an overall limitation on itemized deductions. Unfortunately, especially after the 1982, 1984, 1986, 1987 and 1988 Tax Acts, the big revenue individual tax items are the remaining itemized deductions, such as state and local taxes and home mortgage interest.

Query: Having established a precedent of placing a cap on home mortgage interest, will a future Congress be able to resist the temptation to raise more tax revenue by lowering the cap or otherwise limiting the home mortgage interest deduction?

B. 1986 Act Changes

1. Prior Law. Prior to the 1986 Act, no limitation was imposed on the deductibility of personal interest such as interest on automobile loans, credit card loans, school loans, and tax underpayments. Also, trade or business interest was generally deductible. The main limitations were the investment interest limitations of section 163(d) and the denial of an interest deduction under section 265 with respect to indebtedness used to purchase or carry tax-exempt bonds.
2. In General. Effective for taxable years beginning after December 31, 1986, the 1986 Act generally disallows a deduction for personal interest paid or accrued during the taxable year, section 163(h)(1). Personal interest generally includes all individual interest, other than interest incurred or continued in connection with a trade or business (other than the performance of services as an employee), investment interest, and interest taken into account in computing the taxpayer's income or loss from passive activities for the year, qualified residence interest and certain interest on deferred estate tax payments, section 163(h)(2). Thus, personal interest includes, for example, interest on an automobile loan and credit card interest incurred for personal expenses. Also, interest incurred on debt to finance an employee business expense (such as an automobile used for the convenience of an employer) will be disallowed as personal interest. Further, personal interest includes interest on tax underpayments (other than deferred estate taxes). The personal interest deduction is phased out over a 5-year period, section 163(h)(6). For 1988, only 40 percent was allowed as an itemized deduction. For 1989, the amount is reduced to 20 percent.

Note: Treas. Reg. §1.163-9T(b)(2)(i) provides that personal interest includes interest on Federal income tax deficiencies, "regardless of the source of the income generating the tax liability." The regulation further provides an example of a tax deficiency arising out of the individual's S corporation and holds that the interest on the S corporation item tax deficiency is
personal "the same if A's business had been operated as a sole proprietorship." Is this position correct? See the 1986 Act Conference Report at p. II-154 which provides that "Personal interest also generally includes interest on tax deficiencies." (Emphasis added.) The 1986 Act General Explanation at p. 266 provides, however, that "Personal interest also includes interest on underpayments of individual Federal, State or local income taxes notwithstanding that all or a portion of the income may have arisen in a trade or business because such taxes are not considered derived from the conduct of a trade or business." Note that the qualifier "generally" was dropped from the General Explanation.

Note: As of the time of drafting this outline, the Budget negotiators had reportedly agreed to disallow the interest deduction for corporate underpayments of tax.

3. Qualified Residence Interest Defined. Qualified residence interest is interest paid or accrued on indebtedness which is secured (at the time the interest is paid or accrued) by the taxpayer's principal residence or a second residence, formerly section 163(h)(3)(A). The deduction for qualified residence interest is limited to indebtedness that does not exceed the cost basis of the residence (including the cost of any improvements), plus any additional indebtedness incurred after August 16, 1986, that is for qualified educational or qualified medical expenses, formerly section 163(h)(4)(A). Qualified residence interest does
not include interest on any portion of such debt in excess of the
cash market value of the residence at the time the debt was
incurred, formerly section 163(h)(3)(B)(i).

Note: Temp. Reg. §1.163-10T(f)(2) provides that "the cash market
value of a qualified residence that is real property under state
law is presumed irrebuttably to be not less than the adjusted
purchase price of the residence as of the last day of the taxable
year."

Interest on outstanding debt secured by the taxpayer's principal
or second residence, incurred before August 17, 1986, generally is
treated as fully deductible (to the extent the debt does not
exceed the cash market value of the residence), regardless of the
purpose for which the borrowed funds are used. Also, interest on
indebtedness incurred after August 16, 1986, to refinance
qualified pre-August 17, 1986, debt is fully deductible but only
to the extent the principal amount of the refinancing does not
exceed the principal amount of the refinanced debt (immediately
before the refinancing) and only until such time as the original
indebtedness would have expired or, if the principal of the debt
is not amortized over its term, the expiration of the term of the
first refinancing (or if earlier, the date which is 30 years after
the date of such refinancing). See section 163(h)(3)(C).

The taxpayer's cost basis in his principal or second residence is
adjusted by taking into account only the cost of any improvements
to the residence, formerly section 163(h)(3)(B)(i)(II). Adjustments relating to the rollover of gain on sale of the taxpayer's principal residence, involuntary conversions, or depreciation are not taken into account for this purpose, Temp. Reg. §1.163-1OT(k)(1)(i).

4. Qualified Medical and Educational Loans. Qualified residence interest includes interest for qualified medical and qualified educational expenses even if the total debt is in excess of the taxpayer's basis, formerly section 163(h)(4)(B) and (C). Qualified medical expenses are amounts paid for medical care, e.g., expenses for diagnosis, care, or prevention of a disease (but not for insurance coverage) of the taxpayer, his spouse and dependents. Qualified educational expenses include, for example, reasonable living expenses while away from home and tuition expenses for primary, secondary, college, and graduate-level education for the taxpayer, his spouse, or dependents. The qualified medical and qualified educational expenses must be incurred within a reasonable period of time before or after the debt is incurred.

Note: Temp. Reg. §1.163-1OT(n)(2) provides that the proceeds of a debt will be treated as used to pay qualified medical or educational expenses to the extent that the taxpayer pays such expenses "within 90 days before or after the date that amounts are actually borrowed with respect to the debt, the proceeds of the debt are not directly allocable to another expense under section
1.163-8T(c)(3) (allocation of debt; proceeds not disbursed to borrower) and the proceeds of any other debt are not allocable to the medical or educational expenses under section 1.163-8T(c)(3)." Also, debt allocated to qualified medical or educational expenses under any of the other provisions of the interest tracing rules may be treated as used to pay for such qualified expenditures.

5. Qualified Residence. Temp. Reg. §1.163-10T(p)(1) defines a "qualified residence" as the taxpayer's principal residence or the taxpayer's second residence.

Note: A taxpayer cannot have more than one principal residence (within the meaning of section 1034) at any one time.

If the taxpayer owns more than one second residence, the taxpayer may designate, on an annual basis, which second residence is to be considered the qualifying second residence, section 163(h)(4)(A)(i)(II). A taxpayer may elect a different second residence for each taxable year, Temp. Reg. §1.163-10T(p)(3)(iv).

A "residence" may include "a house, condominium, mobile home, boat, or house trailer, that contains sleeping space and toilet and cooking facilities. A residence does not include personal property, such as furniture or a television, that, in accordance with local law, is not a fixture," Temp. Reg. §1.163-10T(p)(3)(ii). See also LTR 8814035 (Sale of long-term prepaid leases held to be
the sale of equity interests in condominium units. Interest on
loan to finance the purchase of the long-term lease could be
deductible as qualified residence interest if the purchaser uses
the unit as a qualified residence.)

**Note:** Time-share property can qualify as a second residence.
Important, "a taxpayer will not be considered to have used or
rented a residence during any period that the taxpayer does not
have the right to use the property or to receive any benefits from
the rental of the property," Temp. Reg. §1.163-10T(p)(6).

* The 1988 Act provided that a residence can include property
owned by a trust or estate if the residence would be a
qualified residence if owned by the beneficiary of the trust
or estate, section 163(h)(4)(C).

* A residence can include stock in a cooperative housing
corporation owned by a tenant-stockholder if the stockholder
uses the co-op unit as a residence, Temp. Reg.
§1.163-10T(q)(1).

* Rental property can qualify as a residence if it is used for
personal purposes the greater of 14 days or 10 percent of
days rented, Temp. Reg. §1.163-10T(p)(3)(iii). However, "if
a residence is not rented at any time during the taxable
year, it shall be considered to be used as a residence." See
section 163(h)(4)(A)(iii).
Note: If a residence is rented out for a portion of the year and is used for personal purposes less than the greater of 14 days or 10 percent of the rental days, none of the interest is deductible as qualified residence interest. The interest allocable to personal use would be subject to the personal interest limitations and the passive loss rules may restrict the interest deduction for the portion allocable to the rental activity.

A residence under construction may be treated as a qualified residence "for a period of up to 24 months, but only if the residence becomes a qualified residence ... as of the time that the residence is ready for occupancy," Temp. Reg. §1.163-10T(p)(5).

6. Secured by the Residence. Even though the debt proceeds were used to construct, acquire or improve a qualified residence, the interest will be qualified residence interest only if the indebtedness is secured by the taxpayer's first or second residence.

Query: How can construction loan proceeds which are used to build a residence meet the "secured by" requirement when the residence is still under construction? Compare LTRs 8742025 (Interest on loan secured by tax-deferred annuity held not to constitute qualified residence interest where the proceeds of the loan were used to build a taxpayer's principal residence) and 8743063
(Interest on construction loan secured by savings account held not to constitute qualified residence interest) with LTR 9038023.

(Interest on loan secured by house under construction and a certificate of deposit qualified as residence interest "notwithstanding the additional security of the amount on deposit"). Also, Notice 88-74, 1988-27 I.R.B. (July 5, 1988), makes clear that permanent financing which is secured by the now completed principal or second residence can qualify under section 163(h) even though the permanent loan proceeds were used to pay off the construction financing which did not meet the "secured by" test.

Temp. Reg. §1.163-10T(o)(1) defines a secured debt as one "that is on the security of any instrument (such as a mortgage, deed of trust or land contract) — (i) that makes the interest of the debtor in the qualified residence specific security for the payment of the debt, (ii) under which, in the event of default, the residence could be subjected to the satisfaction of the debt with the same priority as a mortgage or deed of trust in the jurisdiction in which the property is situated, and (iii) that is recorded, where permitted, or is otherwise perfected in accordance with applicable State law."

Note: A debt will not be treated as secured until and as of such time as all three of the requirements stated above are complied with, regardless of when the debt proceeds were borrowed, Temp. Reg. §1.163-10T(o)(3).
Observation: In certain states, such as Texas, local law does not allow the security interest to be enforced against the taxpayer's homestead. Nevertheless, Temp. Reg. §1.163-10T(o)(2) provides that a debt will not fail the security test "solely because, under any applicable State or local homestead law or other debtor protection law in effect on August 16, 1986, the security interest is restricted." The regulation was codified in the 1988 Act as section 163(h)(4)(C).

Note: Even though the security interest may be unenforceable, it still is necessary to comply with the literal requirement of the law and obtain a security interest.

Also, the loan must be secured by the residence which was acquired or improved with the loan proceeds. For example, a loan to acquire a second residence which is secured by the first residence does not satisfy the "secured by" test.

7. Regulations. In late December 1987, the Treasury Department issued Temp. Reg. §1.163-10T which provides detailed rules to determine the amount of qualified residence interest. Specifically, the regulations adopt an annual test by comparing the qualified residence interest limitations with the average principal balance of the debt during the year. Also, a taxpayer's basis in a residence is determined as of the end of each year, not at the time a debt is incurred. However, the fair market value of the residence is determined as of the time a debt is incurred.
The regulations provide two methods - the "simplified method" and the "exact method" - which a taxpayer may use to determine the amount of "qualified resident interest." Of course, if the average balance as of the end of the taxable year of a taxpayer's debt secured by a residence is less than the residence's adjusted purchase price, then all the interest expense is qualified residence interest. However, if the combined average balance exceeds the adjusted purchase price, the taxpayer must use either the simplified or the exact method, Temp. Reg. §1.163-10T(c)(1).

**Note:** A taxpayer may use a different method for each qualified residence in each taxable year, Temp. Reg. §1.163-10T(g).

Under the simplified method, the amount of qualified residence interest is determined by multiplying the total interest paid or accrued on all debt secured by a qualified residence by a fraction, the numerator of which is the adjusted purchase price of the qualified residence and the denominator of which is the combined average balances of all secured debt with respect to such residence, Temp. Reg. §1.163-10T(d)(1). Any excess interest is deemed to be personal interest, Temp. Reg. §1.163-10T(d)(2).

By way of contrast, under the exact method, the amount of qualified residence interest is determined on a debt-by-debt basis by computing the applicable debt limit for each secured debt and comparing each such applicable debt limit to the average balance of the corresponding debt, Temp. Reg. §1.163-10T(e)(1). If the
average balance for any debt is less than its applicable debt limit (i.e., generally, the lesser of the fair market value of the residence at the time the debt was first secured or its adjusted purchase price determined as of the last day of the year less the average balance of each debt, if any, previously secured by the property), then all the interest is qualified residence interest. If the average balance is greater than the applicable debt limit, then the amount of qualified residence interest is determined by multiplying the interest paid or accrued by a fraction, the numerator of which is the applicable debt limit for that debt and the denominator of which is the average balance of the debt.

Note: Taxpayers who wish to take advantage of the qualified medical or educational loan rules or who wish to trace the nonqualified residence interest portion to expenditures other than personal expenditures, i.e., to investment interest, must use the exact method, Temp. Reg. §1.163-10T(e)(4).

8. Pre-1987 Act Strategy. Since interest on debt secured by a principal and second residence remained deductible in 1987 for indebtedness up to the purchase price plus improvements, many taxpayers found it advantageous to borrow to the fullest extent possible using their principal or second home as security for the debt. The big growth in consumer debt secured by a residence probably helped spur the Congress into changing the rules in the 1987 Act.
C. 1987 Act Changes

1. In General. Effective for taxable years beginning after December 31, 1987, the 1987 Act both simplified and toughened the rules governing the deduction for qualified residence interest. Qualified residence interest was redefined as interest paid or accrued during the taxable year on "acquisition indebtedness" and "home equity indebtedness" with respect to a taxpayer's qualified residences, section 163(h)(3)(A).

Note: Many of the 1986 Act concepts remain unchanged by the 1987 Act, such as the definition of a qualified principal or second residence as well as the requirement that the debt be "secured by" a qualified residence.

Observation: As of the time the outline was prepared, the IRS had not yet issued any regulations with respect to the 1987 Act changes. Guidance was provided in Notice 88-74, 1988-27 I.R.B. (July 5, 1988), on what is meant by acquisition indebtedness and also with respect to a single debt which may qualify as part-acquisition, part-home equity indebtedness.

Query: Was the announcement released in lieu of further section 163(h) regulations? Certainly, recent experience shows that the IRS is using announcements in many situations where they have been unable to publish timely regulations.
2. **Acquisition Indebtedness.** Acquisition indebtedness is defined as any indebtedness "incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer" that is secured by such residence, section 163(h)(3)(B)(i). It also includes any indebtedness secured by the residence resulting from the refinancing of an indebtedness that meets the above requirements, "but only to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness," id. The amount of acquisition indebtedness is reduced as principal payments are made and cannot be increased by refinancing unless the additional refinancing proceeds are used to make substantial improvements to the residence.

**Example:** Taxpayer A acquires a principal residence for $200,000 using $150,000 of mortgage financing. The entire $150,000 is acquisition indebtedness. If the taxpayer subsequently pays down $50,000 of the mortgage balance and obtains a second mortgage of $50,000, the funds from which are used to acquire an automobile, only the remaining $100,000 balance of the original indebtedness is acquisition indebtedness. If the taxpayer used the $50,000 second mortgage to make substantial improvements to the principal residence, then the additional $50,000 borrowing would be acquisition indebtedness.
Query: If a taxpayer builds a deck or furnishes his basement, does this constitute a substantial improvement? Does it depend upon the amount expended?

The 1987 Act placed a limit on the maximum amount of debt that can be treated as acquisition indebtedness by a taxpayer for any year. The limit is $1 million ($500,000 if married filing separately), section 163(h)(3)(B)(ii). The $1 million limitation is an annual limitation on all acquisition indebtedness, i.e., the limit applies to debt on both a principal and a second residence. For example, if a taxpayer acquires a principal residence using mortgage financing of $700,000 and acquires a vacation home using mortgage financing of $400,000, the taxpayer would exceed the annual acquisition indebtedness limitation by $100,000.

Note: Notice 88-74 clarifies the definition of acquisition indebtedness in many respects:

(1) The determination of a debt as acquisition debt is made independently of the determination of whether the debt is secured by the residence or whether the residence is a qualified residence.

(2) A debt may qualify as acquisition indebtedness either under the tracing rules of Temp. Reg. §1.163-8T or under a special 90-day rule.
(3) A debt may be treated as acquisition debt "to the extent of expenditures to acquire the residence made within 90 days before or after the date that the debt is incurred." (Emphasis added.)

(4) Debt incurred prior to the time the construction or substantial improvement of a residence is complete may be treated as acquisition indebtedness "to the extent of any expenditures to construct or improve the residence which are made no more than 24 months prior to the date that the debt is incurred."

(5) Debt incurred after the residence or improvement is complete "but not later than the date 90 days after such date" may be acquisition indebtedness "to the extent of any expenditures to construct or improve the residence which are made within the period beginning 24 months prior to the date the residence or improvement is complete and ending on the date the debt is incurred."

(6) Debt is treated as incurred "on the date that the loan proceeds are disbursed to or for the benefit of the taxpayer (i.e., generally the loan closing date)." However, a debt may be treated as incurred on the date that a written application is made, "but only to the extent that the debt proceeds are actually disbursed within a reasonable time
after approval of the application." The Announcement further states that 30 days will be considered a reasonable time.

(7) Where a written loan application is timely made and rejected, "a reasonable additional time will be allowed to make a new application for such debt."

(8) The total amount of debt that can be treated as acquisition indebtedness "may not exceed the cost of the residence (including the cost of any improvements)."

(9) Debt incurred to acquire a spouse's interest in a residence, "incident to a divorce or legal separation, will be eligible to be treated as debt incurred in acquiring a residence ... without regard to the treatment of the transaction under section 1041.

3. **Refinancings.** Any indebtedness secured by a principal or second residence incurred on or before October 13, 1987, is treated as acquisition indebtedness and is not subject to the $1 million limitation, section 163(h)(3)(D). This is true apparently even if the prior law cost-plus-improvements limitation was exceeded. For example, if a taxpayer obtained a $500,000 mortgage in March 1987, on a principal residence worth $750,000 and a cost basis (including improvements) of $200,000, generally only interest on up to $200,000 of the mortgage is fully deductible in 1987.
Apparently, in 1988, the entire $500,000 mortgage is treated as acquisition indebtedness so interest on the entire balance is fully deductible.

Note: The special refinancing rule only applies to indebtedness "incurred" on or before October 13, 1987. Is a loan treated as incurred before October 14, 1987, if a taxpayer made a written loan application on October 1, 1987, but approval occurred after October 13? Does your answer change if the loan approval occurred before October 14th, but the actual loan closing date (and disbursement of funds) did not occur until October 17th? Notice 88-74 makes clear that "the rule that a taxpayer may treat debt as being incurred on the date that a written application is made to incur the debt does not apply, however, for purposes of determining if debt is pre-October 13 indebtedness." Although this conclusion appears correct based on the statutory language, the effective date appears rather arbitrary considering the fact that final resolution of the 1987 Act did not occur until December of 1987.

Note: To date, various legislative efforts to change this result have been unsuccessful.

Although not subject to the $1 million limitation, pre-October 13, 1987, indebtedness reduces the million dollar limitation for purposes of future acquisition indebtedness, section 163(h)(3)(D)(ii). If in 1988 the taxpayer in the example above finances the acquisition of a vacation home with a $600,000 mortgage, only $500,000 of the $600,000 mortgage would be treated
as acquisition indebtedness because the $500,000 pre-October 13, 1987, indebtedness reduced the acquisition indebtedness limitation from $1,000,000 to $500,000.

A special rule also treats any indebtedness secured by a principal or second residence incurred after October 13, 1987, to refinance pre-October 13, 1987, indebtedness as acquisition indebtedness, but only if the refinancing indebtedness is used to directly pay off the pre-October 13, 1987, indebtedness and only "to the extent" that the principal amount of the refinancing indebtedness does not exceed the principal amount of the refinanced indebtedness, section 163(h)(3)(D)(iii)(II). For example, a taxpayer who intends to refinance existing pre-October 13, 1987, indebtedness, but before refinancing pays off the old debt with unborrowed funds, apparently loses pre-October 13, 1987, grandfathering on any subsequent refinancing. Limitations are also imposed on the period of the refinancing that generally cause the debt to lose its grandfathered status after the expiration of the term of the original indebtedness, section 163(h)(3)(D)(iv).

Note: Notice 88-74 provides that the refinancing of post-October 13, 1987, acquisition debt will be treated as acquisition debt "if the proceeds of the second debt are used within the meaning of section 1.163-8T to refinance the first debt."
4. **Home Equity Loans.** Qualified residence interest also includes interest on any home equity indebtedness; that is, any indebtedness other than acquisition indebtedness secured by a taxpayer's principal or second residence to the extent the aggregate amount of the indebtedness does not exceed the fair market value of the qualified residence reduced by the amount of acquisition indebtedness relating to that residence, section 163(h)(3)(C)(i). The maximum amount of debt a taxpayer can treat as home equity indebtedness for any year is $100,000 ($50,000 in the case of a separate return filed by a married taxpayer), section 163(h)(3)(C)(ii).

**Observation:** Unlike acquisition indebtedness or 1986 Act law, there are no restrictions on the use of debt proceeds for home equity indebtedness.

**Note:** Notice 88-74 makes clear that the aggregate amount of acquisition indebtedness and home equity loans is $1.1 million ($550,000 for a married individual filing a single return).

5. **Post-1987 Act Strategy.** To ensure the deductibility of interest, taxpayers need to maximize the amount of acquisition indebtedness (up to the $1.0 million cap) as well as home mortgage debt of up to $100,000.
Observation: The 1987 Act mortgage interest deduction rules will most adversely affect taxpayers living in areas of the country that have recently experienced high appreciation in real estate values (e.g., the Northeast, the West Coast). At the same time, the rules provide relief from the burdensome record keeping requirements of 1986 Act law for many taxpayers since the cost-plus-improvements limitation as well as the special rules for medical and educational expenses were repealed. Also, although some in Congress attempted to restrict the use of boats and motor homes as second residences, the 1987 Act rules contain no such limitations.

D. Interest Allocation Regulations

1. In General. On July 2, 1987, the IRS issued Temporary Regulation 1.163-8T (Allocation of interest expense among expenditures) which contains an account concept and a system of rules for matching expenditures made with borrowings. The general rule is that interest expense is allocated to debt, which is allocated by tracing the disbursements, Temp. Reg. §1.163-8T(a)(3). Various presumptions apply where a taxpayer cannot directly trace, for example, because he has co-mingled different borrowings and expenditures.
2. **Alternatives to Tracing.** In the preamble to the regulations, the IRS admitted that in lieu of the tracing method of interest allocation, they "seriously considered allocation based on pro rata apportionment of interest expense among a taxpayer's assets." However, because of a variety of practical and theoretical problems, the IRS rejected pro rata apportionment. Nevertheless, "the Service is not foreclosing the possibility that future regulations may impose some form of pro rata apportionment." In fact, the 1988 Act Conference Report provides that: "the Treasury could consider rules relating to the securing of property to mitigate some of the complexities of tracing where simplicity is desirable, so that, for example, any interest on a loan secured by personal use property could be considered personal interest, and any interest on a loan secured by investment assets could be considered investment interest."

Alternatively, should there be tables for how much interest a taxpayer can deduct in lieu of using the tracing rules?

**Query:** In reality, in many instances aren't taxpayers already using short-cut methods to approximate the results of the tracing rules?

3. **Allocation of Debt and Interest Expense.** Debt is allocated to expenditures solely in accordance with use of proceeds (and, subject to potential application of anti-abuse rules, not by the
collateral securing repayment of the loan). For example, interest on a loan used to buy an automobile is personal interest notwithstanding the fact that marketable securities may be used to secure repayment. Interest expense for any time period is allocated to expenditures in the same manner debt is allocated during such time period, Temp. Reg. §1.163-8T(c)(1).

* Allocation Period. Debt is allocated to a particular expenditure beginning on the date the proceeds of the debt are treated as used to make the expenditure and ending on the earlier of repayment of the debt or reallocation of the debt, Temp. Reg. §1.163-8T(c)(2)(i).

* Interest Allocation. Interest expense is allocated in the same manner as the debt, regardless of when the interest is paid, Temp. Reg. §1.163-8T(c)(2)(ii). See also Temp. Reg. §1.163-8T(c)(2)(iii) Examples 1 and 2.

* Interest on unpaid interest is allocated in the same manner as the unpaid interest is allocated, Temp. Reg. §1.163-8T(c)(2)(ii)(B). This is true even though the underlying debt has been reallocated prior to payment of the interest because the accrued interest is itself a debt with respect to which interest thereon must be characterized.
Accrual of Interest. The amount of interest expense that accrues during any period is determined by taking into account the provisions of the loan agreement and "any applicable law, such as sections 163(e), 483, and 1271 through 1275," Temp. Reg. §1.163-8T(c)(2)(ii)(C).

4. Allocation of Debt: No Cash Proceeds

Third-Party Financing. If loan proceeds are disbursed to a person (other than the borrower), the debt is treated as if the borrower used an amount of debt proceeds equal to the disbursement to make such expenditure, Temp. Reg. §1.163-8T(c)(3)(i).

Note: If a taxpayer incurs or assumes a debt in consideration for the sale or use of property, for services, or for any other purpose and no debt proceeds are disbursed to the borrower, 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, services, or other purpose," Temp. Reg. §1.163-8T (c)(3)(ii).


(i) General Rule. A deposit in a borrower's 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 until reallocated whenever the debt proceeds are used for another expenditure, Temp. Reg. §1.163-8T(c)(4)(i).

(ii) **Ordering.** Debt proceeds deposited in an account are generally deemed expended prior to any unborrowed funds held in the account at the time the debt proceeds are deposited and any amounts (borrowed and unborrowed) that are deposited in the account after debt proceeds are deposited, Temp. Reg. §1.163-8T(c)(4)(ii). As indicated below, in certain circumstances, a taxpayer may override this FIFO ordering rule.

(iii) **Checks.** Payments from a checking or similar account are treated as made at the time the check is written on the account, provided delivery or mailing of the check follows within a reasonable period of time. Also, checks written on the same day may be treated by the taxpayer as written in any order, Temp. Reg. §1.163-8T(c)(4)(iii)(A).

**Note:** The Regulations provide that a check is presumed written on the date appearing on the check.
(iv) **15-Day Override Rule.** Temp. Reg. 1.163-8T(c)(4) (iii)(B) provides a special exception to the FIFO rule that any expenditure made from an account within 15 days of deposit of the debt proceeds may be treated by the taxpayer as made from such proceeds to the extent thereof and such expenditures will be disregarded in applying the FIFO ordering rule.

**Note:** In Notice 88-20, the IRS stated that it intends to issue regulations providing that for debt proceeds deposited into an account or received in cash on or before December 31, 1987, taxpayers may treat any expenditure made from an account or made from cash within 30 days before or 30 days after (90 days after in the case of expenditures made before August 4, 1987) debt proceeds are received or deposited as made from such proceeds to the extent thereof.

**Query:** Notice 88-20 applies the 30-day rule only for 1987. What is the rule for tax years after 1987? Notice 89-35, which was published in IRB 1989-13 (March 27, 1989), extended the 30-day rule for "debt proceeds received in cash or deposited in an account after December 31, 1987, and on or before the date on which further guidance is published."
(v) **Interest on a Segregated Account.** If an account consists solely of the proceeds of a debt and interest earned on the account, the taxpayer may treat any expenditure from such account as made first from amounts constituting interest (rather than debt proceeds) to the extent thereof, Temp. Reg. §1.163–8T(c)(4)(iii)(C).

(vi) **Elective Reallocation Method.** The general rule is that reallocation to an expenditure occurs on the date of the expenditure. However, the taxpayer may treat all expenditures made during any calendar month from debt proceeds in an account as occurring on the later of the first day of the month or the date on which such debt proceeds are deposited in the account. This election is available only if all expenditures from the same calendar month are treated in the same way, Temp. Reg. §1.163–8T(c)(4)(iv).

(vii) **Ordering of Deposits.** If proceeds of two or more debts are deposited in an account simultaneously, such proceeds are treated as deposited in the order in which the debts were incurred, Temp. Reg. §1.163–8T(c)(4)(v)(A).

If two or more debts were incurred simultaneously or were treated under local law as incurred simultaneously, the taxpayer may select the order in
which the debts were treated as incurred, Temp. Reg. §1.163-8T(c)(4)(v)(B).

(viii) Different Interest Rates. If a single loan does not accruE interest at the same fixed or variable rate on the entire amount of a borrowing, each portion of the borrowing on which interest accrues is treated as a separate debt, Temp. Reg. §1.163-8T(c)(4)(v)(C).

6. Allocation of Debt: Proceeds Received in Cash. If a taxpayer receives the proceeds of a debt in cash, the taxpayer may treat any cash expenditure made within 15 days of receipt of cash as made from the debt proceeds (to the extent thereof) and may treat such expenditure as made on the date the taxpayer received the cash, Temp. Reg. §1.163-8T(c)(5)(i).

* For these purposes, the deposit of the cash into an account is treated as an investment expenditure.

* If the 15-day rule is not involved, the cash is treated as used to make personal expenditures, Temp. Reg. §1.163-8T (c)(5)(ii).

Note: As stated above, in Notice 88-20 and Notice 89-35, the IRS extended the 15-day period to 30 days before or after for debt proceeds deposited into an account on or before the date further IRS guidance is provided.
7. **Debt Used to Pay Interest Expenses.** The portion of a debt used to pay interest is allocated in the same manner as the debt on which such accrued interest is allocated from time to time, Temp. Reg. §1.163-8T(c)(6)(ii).

8. **Debt Used to Pay Borrowing Costs.** To the extent the proceeds of a debt are used to pay the borrowing costs (other than interest) on another debt, the second debt is allocated in the same manner as the first debt to which the borrowing costs relate is allocated from time to time. If the first debt is repaid, the second debt will continue to be allocated in the same way as the first debt was allocated immediately prior to its repayment, Temp. Reg. §1.163-8T(c)(6)(iii)(A).

**Note:** Where a portion of the same debt was used to pay borrowing costs (other than interest) on that debt, the debt is allocated in the same manner that the remaining proceeds of the debt (other than those used to pay borrowing costs other than interest) are allocated from time to time. Any repayment of the debt is treated as a repayment of the respective portions of such debt on a proportionate basis, Temp. Reg. §1.163-8T(c)(6)(iii)(B).

8. **Debt Repayment.**

   (i) **General Ordering Rule.** Temp. Reg. §1.163-8T(d)(1) provides that if a debt was allocated to more than one
expenditure, the debt is treated as repaid in the following order:

- Personal expenditures;

- Investment expenditures and certain passive activity expenditures;

- Passive activity expenditures in connection with rental real estate activity with respect to which taxpayer actively participates;

- Former passive activity expenditures; and

- Trade or business expenditures and certain low-income housing projects which are subject to a special passive loss transition rule.

Note: The effect of the repayment ordering rule is to minimize the amount of nondeductible personal interest.

(ii) Same Class. Amounts allocated to two or more expenditures within the same class are treated as repaid in the order in which the amounts were allocated (or reallocated) to such expenditures, Temp. Reg. §1.163-8T(d)(2). For
purposes of this rule, the taxpayer may treat allocations and reallocations that occur on the same day as occurring in any order.

(iii) Continuous Borrowings. Under a line of credit or similar arrangement that allows periodic borrowings under a single loan agreement, all borrowings which accrue interest at the same fixed or variable rate are treated as a single debt. If portions of borrowings accrue interest at different fixed or variable rates, they are treated as separate debts and are treated as repaid in the order in which such borrowings are treated as repaid under the loan agreement, Temp. Reg. §1.163-8T(d)(3).

9. Debt Refinancings. Temp. Reg. §1.163-8T(e)(1) provides that to the extent proceeds of a new debt are used to repay any portion of an old debt, that portion of the new debt is allocated to the expenditures to which the old debt was allocated. To the extent the proceeds of the new debt exceed the old debt, the excess debt proceeds are allocated to the expenditures made with the excess.

10. Reallocation of Debt. Temp. Reg. §1.163-8T(j)(1)(i) provides that debt allocated to one expenditure is reallocated to another expenditure on the earlier to occur of the date on which proceeds from a disposition of such asset are used for another expenditure or the date on which the character of the first expenditure
changes by reason of a change in the use of the asset with respect to which the first expenditure was capitalized.

Note: The amount reallocated cannot exceed the proceeds from the disposition of the asset. Also, when a change in use of an asset occurs, the amount reallocated cannot exceed the fair market value of the asset on the date of change in use. Finally, if there are two or more debts properly allocable with respect to the same asset, only a ratable portion (determined by dividing the amount of such debt by the aggregate amount of all such debts) shall be taken into account, Temp. Reg. §1.163-8T(j)(1)(ii).

11. Disposition Proceeds in Excess of Debt. If an asset is disposed of for an amount which exceeds the 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 first used to pay the debt and then the excess disposition proceeds are allocated in accordance with the regular allocation rules, Temp. Reg. §1.163-8T(j)(2).

12. Deferred Payment Sales. Proceeds received subsequent to a disposition are treated for periods prior to their receipt as used to make an investment expenditure and debt reallocated by reason of the sale is allocated to such investment expenditure to the extent such debt exceeds the sale proceeds previously received (other than proceeds used to pay such debt), Temp. Reg. §1.163-8T(j)(3).
13. **Coordination With Other Provisions**

(i) **In General.** All debt is allocated among expenditures without regard to any limitations on the deductibility of the interest expense on the debt, Temp. Reg. §1.163-8T(m)(1)(i).

(ii) **Disallowance Provisions.** Interest expense that is not allowable as a deduction because of a disallowance provision, e.g., section 265, is not taken into account in applying the passive loss or the nonbusiness interest limitations, Temp. Reg. §1.163-8T(m)(1)(ii).

(iii) **Deferral Provisions.** Interest expense that is not allowable as a deduction for the taxable year because of a deferral provision, e.g., section 465, is allocated in the same manner as the debt that gives rise to the interest expense and is taken into account in the taxable year in which interest is allowable, Temp. Reg. §1.163-8T(m)(1)(iii).

(iv) **Capitalization Provisions.** Interest expense that is capitalized pursuant to a capitalization provision, e.g., section 263A(f), is not taken into account as interest for any taxable year, Temp. Reg. §1.163-8T(m)(1)(iv).
Note: In Notice 88-99, 1988-36 I.R.B. 1, the IRS gave a preview of the interest capitalization regulations to be published with respect to sections 263A(f) and 460. Of particular interest, the Notice provides that the production period of real property does not begin until physical activity is first performed upon the property, e.g., grading and clearing of land or the excavation of foundations or lines for utilities.

(v) Effect on Other Limitations. Temp. Reg. §1.163-8T(m)(2) makes clear that "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 the interest allocation rules. Thus, for example, the section 265 disallowance rules may apply without regard to these interest allocation rules.

14. Special Transition Rules

(i) Transition Rule 1. For purposes of determining whether debt is allocated to expenditures made on or before August 3, 1987, substitute 90 days for 15 days in the special allocation rule, Temp. Reg. §1.163-8T(n)(2).

Note: As stated above, for 1987, Notice 88-20 substituted 30 days for 15 days.
(ii) Transition Rule 2. Any debt (except for debt-financed distributions to pass-through entities) outstanding on December 31, 1986, that is properly attributable to a business or rental activity is treated as debt allocated to capital expenditures with respect to such activity if the taxpayer has consistently deducted interest expense on such debt on Schedule C, E or F of Form 1040 in computing taxable income or loss from such business or rental activity for taxable years beginning before January 1, 1987, Temp. Reg. §1.163-8T(n)(3)(i). This debt must be allocated in a reasonable and consistent manner among taxpayer’s business or rental assets held on the last day of the taxable year that includes December 31, 1986. If the taxpayer does not do so, the Commissioner shall allocate the debt, Temp. Reg. §1.163-8T(n)(3)(v).

Note: Unless these transition rules applied (and were properly elected) the debt proceeds apparently had to be allocated in accordance with the tracing rules. This presented insoluble problems where the debt (and expenditures) were "old and cold" and the record keeping in many cases was nonexistent. Unfortunately, it does not appear that the Treasury Department plans to amend the regulations to provide any additional transition rules.
15. Allocation of Interest for Pass-Through Entities

(i) **In General.** In Notice 88-20, as supplemented by Notice 88-37 and Notice 89-35, the IRS provided guidance for the allocation of interest expense in connection with debt-financed contributions to the capital of, and purchases of interests in, pass-through entities as well as debt-financed distributions by pass-through entities. Notice 88-20 applies to 1987 only. Notice 89-35 applies to 1988 and to any taxable year ending on or before the date on which further guidance is published.

**Note:** Notice 89-35 contains a warning: "For taxable years ending after the date on which ... regulations are issued, the regulations may require the allocation of interest expense in connection with such transactions in a manner different from that provided in Notice 88-20 or this Notice, without regard to when the debt was incurred."

(ii) **Debt-Financed Acquisitions.** In the case of debt proceeds allocated to the purchase of an interest in a pass-through entity (other than a purchase in which the entity receives proceeds from the purchase), the debt proceeds and the associated interest expense shall be allocated among the assets of the entity using any reasonable method. Reasonable methods of allocating debt among the assets of
a pass-through entity would ordinarily include a pro rata allocation based on the fair market value, book value, or adjusted basis of the assets, reduced by any debt of the pass-through entity or the owner allocated to such assets.

Interest expense on debt proceeds allocated to a contribution to the capital of a pass-through entity may be allocated using any reasonable method. Reasonable methods would ordinarily include allocating the debt among the assets of the entity or tracing the debt proceeds to the expenditures of the entity as if the contributed debt proceeds were the proceeds of a debt incurred by the entity. Also, whether a taxpayer's method is reasonable depends, in part, on "whether the taxpayer consistently applies the method from year to year."

Notice 88-37 and Notice 89-35 provided guidance on the proper reporting of such interest expense. Interest expense paid or incurred by individuals in connection with the debt-financed acquisition of an interest in a pass-through entity should be reported on either Schedule E or Schedule A of Form 1040, depending on the nature of the expenditure to which the underlying debt and related interest expense is allocated.
Interest expense allocated to a trade or business expenditure or to assets used in a trade or business activity of a pass-through entity should be reported in Part 2 of Schedule E, identified on a separate line as "business interest," followed by the name of the pass-through entity to which the interest expense relates.

Interest expense allocated to a passive activity expenditure or to assets used in a passive activity should be entered on Form 8582, "Passive Activity Loss Limitations," as a deduction from the activity in which the expenditure was made. Any amount of such interest deductible under the passive loss rules should be reported in Part 2, Schedule E, identified as "passive interest," followed by the name of the pass-through entity to which the interest expense relates.

Interest expense allocated to an investment expenditure or to assets held for investment by a pass-through entity should be entered on Form 4952, "Investment Interest Expense Deduction." Deductible investment interest expense should be reported on line 11 of Schedule A, except where the allowable investment interest expense is attributable to royalty income, in which case, it should be reported on Schedule E. Investment interest related to royalty income should be identified on a separate line of
Schedule E, Part 2, as investment interest, followed by the name of the pass-through entity to which the interest expense relates. Interest expense allocated to a personal expenditure should be reported on line 12A of Schedule A.

In the case of taxpayers other than individuals, interest expense on debt-financed acquisitions should be reported on the appropriate interest expense line of the taxpayer's return, and need not be separately identified, although it must be treated on the return in a manner consistent with any limitations that apply. For example, interest expense of a closely-held C corporation allocated to a portfolio expenditure under the passive loss rules is not taken into account in computing net active income.

(iii) Debt-Financed Distributions. The Notices provide that in the case of debt proceeds of pass-through entities used to make distributions to the owners of the entity, the debt proceeds and associated interest expense may, at the option of the entity, be allocated among the expenditures (other than distributions) of the entity during the taxable year to the extent that debt proceeds have not otherwise been allocated to such expenditures.
If, notwithstanding the optional allocation authorized in the preceding paragraph, debt proceeds of a pass-through entity are allocated to distributions to owners of the entity, each owner's share of the associated interest expense shall be allocated in accordance with the use of the debt proceeds distributed to such owner. To the extent that an owner's share of such interest expense exceeds the pass-through entity's interest expense on debt proceeds distributed to such owner, any reasonable method may be used to allocate the excess interest expense. Whether a particular allocation method is reasonable depends "on the facts and circumstances including, without limitation, whether the entity consistently applies the method from year to year."

Any repayment of debt of a pass-through entity allocated to distributions and to one or more other expenditures may, at the option of the pass-through entity, be treated first as a repayment of the portion of the debt allocated to such distributions.

Notice 88-37 and Notice 89-35 provide the following guidance on the proper reporting of such interest expense. If a pass-through entity does not elect to allocate debt otherwise allocable to pass-through entity distributions, to equity-financed expenditures of the
pass-through entity during the taxable year under the rules contained in Notice 88-20, each owner's share of pass-through entity interest expense on such debt proceeds (not to exceed interest expense on debt proceeds distributed to such owners) should be included on the Schedule K-1 line for "other deductions." A schedule attached to the K-1 should identify this amount as "interest expense allocated to debt-financed distributions." If there is more than one distribution during the year, interest expense should be allocated ratably to each distribution, and a statement should be attached listing all distributions to which debt proceeds are allocated and the amount allocated to each. Each owner will report the interest expense depending on the use to which the debt-financed distribution proceeds are put. For example, if debt-financed distribution proceeds are used to make personal expenditures, interest expense should be reported as personal interest on Schedule A.

If an owner's share of pass-through entity interest expense allocated to distributions exceeds the pass-through entity's interest expense on debt proceeds actually distributed to such owner, the excess interest expense may be allocated to expenditures under any reasonable method according to the rules containing in Notice 88-20. Such excess interest expense should be
reported in a manner consistent with the allocation, i.e., if excess interest is allocated to a rental activity, the interest expense should be taken into account by the entity computing the income or loss from the rental activity reported on Schedule K-1.

However, if the pass-through entity elects to allocate debt otherwise allocable to distributions, to equity-financed expenditures, such interest expense should be reported on Schedule K-1 in a manner consistent with the allocation. For example, if the pass-through entity allocates such debt proceeds to an expenditure in connection with a rental activity, the entity's related interest expense should be taken into account by the entity in computing the income or loss from the rental activity.

(iv) **Anti-Abuse Rule.** Notice 89-35 expresses the IRS' concern that the "flexible rules" provided in the Notices "could allow taxpayers to use pass-through entities to avoid or circumvent the interest allocation rules." Thus, a special anti-abuse rule will apply for taxable years beginning on or after January 1, 1989, to any pass-through entity formed or availed of by a taxpayer with a principal purpose of avoiding or circumventing the interest allocation rules. In such situations, the interest
expense will be required to be allocated "in a manner that reflects the way in which such interest expense would have been allocated among such expenditures under section 1.163-8T," whatever that means.

E. Conclusions

The interest allocation rules are a compliance nightmare. However, unless great care is exercised to trace debt proceeds to expenditures, i.e., by separate accounts or by complying with the allocation conventions of the regulations, the danger exists that the IRS may recharacterize a taxpayer's interest as nondeductible personal interest. Unfortunately, the IRS does not appear ready to adopt alternative tracing rules, such as pro rata allocation or a security interest test, and in any event none of these alternatives would eliminate the potential traps for the unwary caused by the unfortunate 1986 Act changes to the personal interest deduction rules.