

income from personal services and portfolio investments with passive losses, and that the regulations should attempt to avoid inconsistent allocations of interest deductions under different Code provisions.

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

Scope of Rules

the case of assumptions or seller financing), the debt is treated as if the borrower had made an expenditure from the debt proceeds for the property, services, or other purpose to which the debt relates.

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

Treatment of Amounts Held in an Account

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

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

Under the second transitional rule, debt outstanding on December 31, 1986, that is properly attributable to

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

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

security. On July 1, B sells the investment security for \$1,000 and uses the sales proceeds to make a passive activity expenditure. On December 31, B pays accrued interest on the \$1,000 debt for the entire year.

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

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

Example (2). On January 1, 1988, taxpayer C borrows \$10,000 at an interest rate of 11 percent, compounded annually. All interest and principal on the debt is payable in a lump sum on December 31, 1992. C immediately uses the debt proceeds to make a passive activity expenditure. C materially participates in the activity in 1990, 1991, and 1992. Therefore, under paragraphs (c)(2) (i) and (j) of this section, the debt is allocated to a passive activity expenditure from January 1, 1988, through December 31, 1989, and to a former passive activity expenditure from January 1, 1990, through December 31, 1992. In accordance with the loan agreement (and consistent with §1.1272-1(d)(1) of the proposed regulations, 51 FR 12022, April 8, 1986), interest expense accruing during any period is determined on the basis of annual compounding. Accordingly, the interest expense on the debt is allocated as follows:

Year	Amount	Expenditure
1988	$\$10,000 \times .11$	\$1,100 Passive activity.
1989	$11,100 \times .11$	1,221 Passive activity.
1990	$12,321 \times .11 = 1,355$	-----
	$1,355 \times 2,321/12,321$	255 Passive activity.
	$1,355 \times 10,000/12,321$	1,100 Former passive activity.

	1,355	
1991	$13,676 \times .11 = 1,504$	-----
	$1,504 \times 2,576/13,676$	283 Passive activity.
	$1,504 \times 11,100/13,676$	1,221 Former passive activity.

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

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

(4) Allocation of debt; proceeds deposited in borrower's account-(i) Treatment of deposit. For purposes of this section, a deposit of debt proceeds in an account is treated as an investment expenditure, and amounts held in an account (whether or not interest bearing) are treated as property held for investment. Debt allocated to an account 82()10.4112()JTJ 18.6 6.60236()-0.478582.4112()JTJ 1 taid2.50g449(l)-5.05495(i)-5.157164(f)

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

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

(B) Expenditures within 15 days after deposit of borrowed funds. The taxpayer may treat any expenditure made from an account within 15 days after debt proceeds are deposited in such account as made from such proceeds to the extent thereof even if under paragraph (c)(4)(ii) of this section the debt proceeds

calendar month are similarly treated. The following example illustrates the application of this paragraph (c)(4)(iv):

Example. On January 10, taxpayer G opens a checking account, depositing \$500 of proceeds of Debt A and \$1,000 of unborrowed funds. The following chart summarizes the transactions which occur during the year with respect to the account (note that these facts are the same as the facts of the example in paragraph (c)(4)(ii) of this section):

Date	Transaction
Jan. 10	\$500 proceeds of Debt A and \$1,000 unborrowed funds deposited.
Jan. 11	\$500 proceeds of Debt B deposited.
Feb. 17	\$800 personal expenditure.
Feb. 26	\$700 passive activity expenditure.
June 21	\$1,000 proceeds of Debt C deposited.
Nov. 24	\$800 investment expenditure.
Dec. 20	\$600 personal expenditure.

Example. Taxpayer F incurs a \$1,000 debt on August 4 and receives the debt proceeds in cash. F deposits \$1,500 cash in an account on August 15 and on August

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

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

Example (1). Taxpayer B borrows \$100,000 (“Debt A”) on July 12, immediately deposits the proceeds in

allocated to personal expenditure 2, (3) amounts allocated to passive activity expenditure 1, and (4) amounts allocated to passive activity expenditure 2.

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

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

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

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

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

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

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

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

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

was \$15,000. The proceeds of the disposition are treated as an account consisting of \$15,000 of debt proceeds and \$10,000 of unborrowed funds to which paragraph (c)(4) of this section applies. Thus, if D immediately makes a \$10,000 personal expenditure from the proceeds and within 15 days deposits the remaining proceeds in an account, D may, pursuant to paragraph (c)(4)(iii)(B) of this section, treat the entire \$15,000 deposited in the account as proceeds of a debt.

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

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

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

(l) Reserved.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(ii) Disallowance provisions. A disallowance provision is any provision (other than the passive loss and nonbusiness interest limitations) that disallows a deduction for interest expense for all taxable years and is not a capitalization provision. Disallowance provisions include sections 163(f)(2), 264(a)(2), 264(a)(4), 265(a)(2), -4.602360458(n)-0.07(s)-3.05229()-0.478582(a)-2.50724(n)-0.957164(y)9.93324()-0.478582(p)-0.957164(r)-0

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

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