

Treas. Reg. Section 1.163-8T(a)(4)(i)(A)

Allocation of interest expense among expenditures (temporary)

(a) In general.

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

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

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

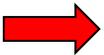
(4) Treatment of interest expense.

(i) General rule. Except as otherwise provided in paragraph (m) of this section (relating to limitations on interest expense other than the passive loss and nonbusiness interest limitations), interest expense allocated under the rules of this section is treated in the following manner:

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

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

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



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

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

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

Example (1). Taxpayer A, an individual, incurs interest expense allocated under the rules of this section to the following expenditures:

\$6,000 Passive activity expenditure

\$4,000 Personal expenditure

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

Example (2).

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

\$2,000 Passive activity expenditure

\$3,000 Portfolio expenditure

\$5,000 Other expenditures

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

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

(iv) Since M is a corporation, the \$3,000 interest expense allocated to the portfolio expenditure is allowable without regard to section 163(d). If M were an individual, however, the interest expense allocated to the portfolio expenditure

would be treated as investment interest for purposes of applying the limitation of section 163(d).

(b) Definitions. For purposes of this section-

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

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

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

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

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

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

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

(c) Allocation of debt and interest expense.

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

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

(2) Allocation period.

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

(A) The date the debt is repaid; or

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

(ii) Allocation of interest expense.

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

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

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

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

Example (1).

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

(ii) Under this paragraph (c)(2) and paragraph (j) of this section, the \$1,000 debt is allocated to the investment expenditure for the period from January 1 through June 30, and to the passive activity expenditure from July 1 through December 31. Interest expense accruing on the \$1,000 debt is allocated in accordance with the allocation of the debt from time to time during the year even though the debt was allocated to the passive activity expenditure on the date the interest was paid. Thus, the \$55 interest expense for the period from January 1 through June 30 is allocated to the investment expenditure. In addition, during the period from July 1 through December 31, the interest expense allocated to the investment expenditure is a debt, the proceeds of which are treated as used to make an investment expenditure. Accordingly, an additional \$3 of interest expense for the period from July 1 through December 31 ($\$55 \times .055$) 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), 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
1991	$13,676 \times .11 = 1,504$	
	$1,504 \times 2,576/13,676$ 283	Passive activity
	$1,504 \times 11,100/13,676$ 1,211	Former passive activity
1992	$15,180 \times .11 = 1,670$	
	$1,670 \times 2,859/15,180$ 315	Passive activity
	$1,670 \times 12,321/15,180$ 1,351	Former passive activity

(3) Allocation of debt; proceeds not disbursed to borrower.

(i) Third-party financing. If a lender disburses debt proceeds to a person other than the borrower in consideration for the sale or use of property, for services, or for any other purpose, the debt is treated for purposes of this section as if the borrower used an amount of the debt proceeds equal to such disbursement to make an expenditure for such property, services, or other purpose.

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

(4) Allocation of debt; proceeds deposited in borrower's account.

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

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

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

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

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

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

Example. On January 10, taxpayer E opens a checking account, depositing \$500 of proceeds of Debt A and \$1,000 of unborrowed funds. The following chart summarizes the transactions which occur during the year with respect to the account:

Date	Transaction
January 10	\$500 proceeds of Debt A and \$1,000 unborrowed funds deposited
January 11	\$500 proceeds of Debt B deposited
February 17	\$800 personal expenditure
February 26	\$700 passive activity expenditure
June 21	\$1,000 proceeds of Debt C deposited
November 24	\$800 investment expenditure
December 20	\$600 personal expenditure

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

(iii) Expenditures from account; supplemental ordering rules.

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

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

Example (1). Taxpayer D incurs a \$1,000 debt on June 5 and immediately deposits the proceeds in an account ("Account A"). On June 17, D transfers \$2,000 from Account A to another account ("Account B"). On June 30, D writes a \$1,500 check on Account B for a passive activity expenditure. In addition, numerous deposits of borrowed and unborrowed

amounts and expenditures occur with respect to both accounts throughout the month of June. Notwithstanding these other transactions, D may treat \$1,000 of the deposit to Account B on June 17 as an expenditure from the debt proceeds deposited in Account A on June 5. In addition, D may similarly treat \$1,000 of the passive activity expenditure on June 30 as made from debt proceeds treated as deposited in Account B on June 17. Example (2). The facts are the same as in the example in paragraph (c)(4)(ii) of this section, except that the proceeds of Debt B are deposited on February 11 rather than on January 11. Since the \$700 passive activity expenditure occurs within 15 days after the proceeds of Debt B are deposited in the account, E may treat such expenditure as being made from the proceeds of Debt B to the extent thereof. If E treats the passive activity expenditure in this manner, the expenditures from the account are treated as follows: The \$800 personal expenditure is treated as made from the \$500 proceeds of Debt A and \$300 of unborrowed funds. The \$700 passive activity expenditure is treated as made from the \$500 proceeds of Debt B and \$200 of unborrowed funds. The remaining expenditures are treated as in the example in paragraph (c)(4)(ii) of this section.

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

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

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

Date	Date	Transaction
January 10	\$500	proceeds of Debt A and \$1,000 unborrowed funds deposited
January 11	\$500	proceeds of Debt B deposited
February 17	\$800	personal expenditure
February 26	\$700	passive activity expenditure

June 21 \$1,000 proceeds of Debt C deposited

November 24 \$800 investment expenditure

December 20 \$600 personal expenditure

Assume that G chooses to apply the optional rule of this paragraph (c)(4)(iv) to all expenditures. For purposes of determining the date on which debt is allocated to the \$800 personal expenditure made on February 17, the \$500 treated as made from the proceeds of Debt A and the \$300 treated as made from the proceeds of Debt B are treated as expenditures occurring on February 1. Accordingly, Debt A is allocated to an investment expenditure for the account from January 10 through January 31 and to the personal expenditure from February 1 through December 31, and \$300 of Debt B is allocated to an investment expenditure for the account from January 11 through January 31 and to the personal expenditure from February 1 through December 31. The remaining \$200 of Debt B is allocated to an investment expenditure for the account from January 11 through January 31 and to the passive activity expenditure from February 1 through December 31. The \$800 of Debt C used to make the investment expenditure on November 24 is allocated to an investment expenditure for the account from June 21 through October 31 and to an investment expenditure from November 1 through December 31. The remaining \$200 of Debt C is allocated to an investment expenditure for the account from June 21 through November 30 and to a personal expenditure from December 1 through December 31.

(v) Simultaneous deposits.

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

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

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

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

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