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Notice 89-35

Allocation of Interest Expense in Connection with Passthrough Entities and Modification of 15-day Rules in Section 1.163-8T (Extension of Guidance in Notice 88-20)

I. PURPOSE

This notice provides guidance with respect to the allocation of interest expense in connection with certain transactions involving partnerships and S corporations ("passthrough entities") and the allocation of interest expense on debt proceeds received in cash or deposited in an account.

II. BACKGROUND

Section 1.163-8T of the Income Tax Regulations (T.D. 8145 , 52 FR 24,996) provides rules for allocating interest expense for purposes of applying the passive activity loss limitation in section 469 of the Code, the investment interest limitation in section 163(d), and the personal interest limitation in section 163(h). The regulation provides that debt generally is allocated by tracing disbursements of the debt proceeds to specific expenditures and that interest expense on such debt is allocated in the same manner as the debt to which such interest expense relates. Section 1.163-8T does not address the treatment of debt allocated to expenditures for interests in passthrough entities and debt of passthrough entities allocated to distributions by such entities. For purposes of this notice, the term "expenditure" has the same meaning as when used in section 1.163-8T.

Notice 88-20, 1988-1 C.B. 487, provides guidance on the allocation of interest expense in connection with (a) debt-financed contributions to the capital of, and purchases of interests in, passthrough entities ("debt-financed acquisitions") and (b) debt-financed distributions by passthrough entities to owners of such entities ("debt-financed distributions"), for taxable years ending on or before December 31, 1987. Notice 88-20 also modifies certain rules for tracing debt proceeds received in cash or deposited in an account on or before December 31, 1987. Notice 88-37, 1988-1 C.B. 522, provides guidance on the reporting of interest expense with respect to debt-financed acquisitions and debt-financed distributions for taxable years beginning after December 31, 1986.<Page 676>

This notice expands the guidance provided in Notice 88-20 and Notice 88-37.

III. EFFECTIVE DATES

In the case of debt-financed acquisitions, owners of passthrough entities may rely on the guidance provided in this notice for taxable years of such owners ending after December 31, 1987, and on or before the date on which further guidance is published. In the case of debt-financed distributions, taxpayers may rely on the guidance provided in this notice for taxable years of passthrough entities ending after December 31, 1987, and on or before the date on which further guidance is published.

The Internal Revenue Service intends to issue regulations concerning the allocation of interest expense in connection with debt-financed acquisitions and debt-financed distributions. For

taxable years ending after the date on which such 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.

The Service recognizes that the flexible rules provided in this notice regarding the allocation of interest expense in connection with passthrough entities could allow taxpayers to use passthrough entities to avoid or circumvent the interest allocation rules of section 1.163-8T. Accordingly, the regulations concerning the allocation of interest expense in connection with passthrough entities will provide that, for taxable years beginning on or after January 1, 1989, the special rules described in this notice will not apply in any case in which a passthrough entity is formed or availed of by a taxpayer with a principal purpose of avoiding or circumventing the rules of section 1.163-8T. In such a case, interest expense incurred in connection with a passthrough entity shall be allocated among the expenditures of the taxpayer and the passthrough entity in a manner that reflects the way in which such interest expense would have been allocated among such expenditures under section 1.163-8T if the passthrough entity had not been formed or availed of to avoid or circumvent the rules of that section.

In the case of expenditures made from debt proceeds received in cash or deposited in an account, taxpayers may rely on the guidance provided in this notice with respect to 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.

IV. TREATMENT OF DEBT OF OWNERS OF PASSTHROUGH ENTITIES ALLOCATED TO EXPENDITURES FOR CONTRIBUTIONS TO OR PURCHASES OF INTERESTS IN SUCH ENTITIES (DEBT-FINANCED ACQUISITIONS)

A. Allocation Rules

.A. In the case of debt proceeds allocated under section 1.163-8T to the purchase of an interest in a passthrough entity (other than by way of a contribution to the capital of the entity), the debt proceeds and the associated interest expense shall be allocated among all the assets of the entity using any reasonable method. Reasonable methods of allocating debt among the assets of a passthrough entity 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 passthrough entity or the owner allocated to such assets.

Interest expense on debt proceeds allocated under section 1.163-8T to a contribution to the capital of a passthrough entity shall be allocated using any reasonable method. Reasonable methods for this purpose ordinarily include allocating the debt among all the assets of the entity or tracing the debt proceeds to the expenditures of the entity under the rules of section 1.163-8T as if the contributed debt proceeds were the proceeds of a debt incurred by the entity. For purposes of this notice, a purchase of an interest in a passthrough entity shall be treated as a contribution to the capital of the entity if and to the extent that the entity receives proceeds from the purchase.

For purposes of this notice, the determination of whether a particular method of allocating debt proceeds used to purchase an interest in or to make a capital contribution to a passthrough entity is reasonable depends on the facts and circumstances including, without limitation, whether the taxpayer consistently applies the method from year to year.

In general, to the extent that debt proceeds are allocated under this section IV among the assets of a passthrough entity, such proceeds shall be reallocated among the assets of the entity as the assets of such entity, or the use of such assets, changes. In general, to the extent that debt proceeds are allocated under this section IV by tracing the debt proceeds to the expenditures of the entity under the rules of section 1.163-8T, the debt proceeds shall be reallocated, when necessary, under the rules of section 1.163-8T.

.B. Reporting Rules

.B. Individuals should report allowable interest expense paid or incurred in connection with debt-financed acquisitions on either Schedule E or Schedule A of Form 1040, depending on the type of expenditure to which the interest expense is allocated. Subject to any applicable changes in the underlying forms and schedules (or their instructions), specific instructions contained in Notice 88-37 should be followed for (a) interest expense allocated to trade or business expenditures, (b) interest expense allocated to passive activity expenditures, (c) interest expense allocated to investment expenditures, and (d) interest expense allocated to personal expenditures.

Taxpayers other than individuals should report interest expense on debt-financed acquisitions on the line for interest expense on their returns, in accordance with section IV.B. of Notice 88-37.

V. TREATMENT OF DEBT OF PASSTHROUGH ENTITIES ALLOCATED TO DISTRIBUTIONS BY SUCH ENTITIES (DEBT-FINANCED DISTRIBUTIONS)

.A. General Allocation Rule

.A. Unless the optional allocation rule is used, debt of passthrough entities and the associated interest expense shall be allocated under the rules of section 1.163-8T. In general, when debt proceeds of a passthrough entity are allocated under section 1.163-8T to distributions to owners of the entity, the debt proceeds distributed to any owner and the associated interest expense shall be allocated under section 1.163-8T in accordance with such owner's use of such debt proceeds. For example, if the owner uses distributed debt proceeds to purchase an interest in a passive activity, the owner's share of the interest expense on such debt proceeds is allocated to a passive activity expenditure (within the meaning of section 1.163-8T(b)(4)).

An owner's share of a passthrough entity's interest expense on debt proceeds allocated to distributions to owners may exceed the entity's interest expense on the portion of the debt proceeds distributed <Page 677> to that particular owner. In such cases, the entity shall allocate the owner's excess interest expense using any reasonable method. The determination of whether a particular method of allocating such excess interest expense is reasonable depends on the facts and circumstances including, without limitation, whether the entity consistently applies the method from year to year.

.B. Optional Allocation Rule

.B. A passthrough entity may allocate distributed debt proceeds and the associated interest expense to one or more expenditures (other than distributions) of the entity that are made during the same taxable year of the entity as the distribution, to the extent that debt proceeds (including other distributed debt proceeds) are not otherwise allocated to such expenditures. However, distributed debt proceeds must be allocated under the general allocation rule to distributions to owners of the entity to the extent that such distributed debt proceeds exceed the entity's expenditures (other than distributions) for the taxable year to which debt proceeds are not otherwise allocated. Once debt proceeds are allocated under this section V.B., the debt proceeds shall be reallocated, when necessary, under the rules of section 1.163-8T.

.C. Coordination with Repayment Rule

.C. Paragraph (d) of section 1.163-8T provides rules governing the treatment of debt repayments. Any repayment of debt of a passthrough entity allocated to distributions to owners of the entity and to one or more other expenditures may, at the option of the passthrough entity, be treated first as a repayment of the portion of the debt allocated to such distributions.

.D. Reporting Rules

1. Reporting Under the General Allocation Rule To the extent that debt proceeds of a passthrough entity are allocated to distributions to owners of the entity, the portion of an owner's share of the entity's interest expense on debt proceeds allocated to distributions to owners that does not exceed the entity's interest expense on the portion of the debt proceeds distributed to such owner should be included on the line on Schedule K-1 for other deductions. This interest expense should be identified on an attached schedule as "Interest expense allocated to debt-financed distributions." The manner in which the owner should report such interest expense depends on the types of expenditures that the owner makes with the distributed debt proceeds. For example, if the owner uses the debt proceeds to make a personal expenditure (within the meaning of section 1.163-8T(b)(5)), the owner should report the interest expense as personal interest on Schedule A. To the extent that an owner's share of a passthrough entity's interest expense on debt proceeds allocated to distributions to owners exceeds the entity's interest expense on the portion of the debt proceeds distributed to such owner, the excess interest expense should be reported on Schedule K-1 in a manner consistent with the allocation of such interest expense by such entity.

2. Reporting Under the Optional Allocation Rule If the passthrough entity uses the optional rule to allocate distributed debt proceeds and associated interest expense, the entity's interest expense on debt proceeds allocated to such other expenditures should be reported on Schedule K-1 in a manner consistent with the allocation of the debt proceeds. For example, if the passthrough entity allocates distributed debt and the associated interest expense to an expenditure in connection with a rental activity, the entity should take the interest expense on the debt into account in computing the income or loss from the rental activity that is reported to the owner on Schedule K-1. Notice 88-37 provides additional guidance on the reporting of interest expense in connection with debt-financed distributions.

VI. EXTENSION OF MODIFICATION OF SINGLE ACCOUNT AND 15-DAY RULES

Paragraph (c)(4)(iii)(B) of section 1.163-8T provides, among other things, that a 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. Paragraph (c)(5)(i) of section 1.163-8T provides a similar rule with respect to debt proceeds received in cash. In the case of debt proceeds deposited in an account, taxpayers may treat any expenditure made from any account of the taxpayer, or from cash, within 30 days before or 30 days after debt proceeds are deposited in any account of the taxpayer as made from such proceeds to the extent thereof. Similarly, in the case of debt proceeds received in cash, taxpayers may treat any expenditure made from any account of the taxpayer, or from cash, within 30 days before or 30 days after debt proceeds are received in cash as made from such proceeds to the extent thereof.

VII. ADMINISTRATIVE PRONOUNCEMENT

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure.