REPORT #573

TAX SECTION

New York State Bar Association

COMMITTEE ON PERSONAL INCOME

Report on Proposed Regulations Under Section 163
Dealing With the Allocation of Interest Expense

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Introduction

On July 1, 1987, the Internal Revenue Service, issued a notice of proposed rulemaking (LR-10-87) and temporary regulations (T.D.8145) on the allocation of interest expense among expenditures. The regulations deal with the allocation of interest expense among a taxpayer's expenditures in order to determine the deductibility of such interest expense under provisions added by the Tax Reform Act of 1986, in particular sections 469 and 163(h). This report sets forth comments on those regulations.

Summary

1. Tracing of Indebtedness. The regulations trace the use of borrowed funds to specific expenditures and determine the

[1/] This report was written by Steven C. Todrys and Michael L. Schler, Co-chairmen of the Committee on Personal Income. Helpful comments were received from William Brannen, William Burke, Herbert Camp, Arthur Feder, Simon Friedman, Irwin Goldstein, Michael Hirschfeld, Rhona Merkur, Donald Schapiro, Steven Shapiro, Lewis Steinberg, Donald Turlington and David Watts.

deductibility of the interest expense by reference to the nature of the expenditure. While the Committee believes that it is economically more accurate to allocate a taxpayer's indebtedness pro rata among all of his expenditures, we support the approach taken in the regulations on the ground of administrative convenience. In response to a request in the preamble to the regulations, the Committee makes some suggestions for possible modifications to the tracing regime in cases of perceived abuse.

2. Ordering Rules. The regulations provide that a taxpayer may treat any expenditure made from an account within 15 days after debt proceeds are deposited in such account as incurred with the proceeds of the debt. The Committee believes that this 15-day rule is too restrictive and unnecessarily favors separate accounts over commingled accounts. We suggest, at a minimum, that anything now permitted under the regulations by the use of multiple accounts be permitted by the use of a single account with book entries. Moreover, we suggest expansion of the 15-day rule to deal with cases in which debt is incurred after an expenditure. Finally, the Committee suggests other, more far-reaching approaches which could be considered.

3. Coordination with Other Interest Disallowance or Capitalization Provisions. The Committee suggests that the explanation of the coordination provisions be clarified.

4. Passthrough Entities. The regulations reserve the issue of the allocation of interest expense from passthrough entities. The Committee proposes a set of rules applicable to indebtedness incurred by a passthrough entity the proceeds of which are traced to distributions by the entity, and to indebtedness incurred to purchase an interest in the passthrough entity.

5. Transitional Rules. The Committee proposes some modifications to the transitional rules.

Discussion

1. Adoption of the Tracing Method.

The Committee recognizes that, because cash is fungible, the allocation of interest expense based upon a tracing of indebtedness to specific expenditures is not a proper reflection of the economic position of the taxpayer. A taxpayer's indebtedness carries all of his expenditures, including consumption expenses, because borrowing for one expenditure frees up cash for another expenditure. Thus, the Committee believes that an allocation of indebtedness among all of the taxpayer's expenditures, including consumption expenses, is the most accurate method for determining the nature of a taxpayer's interest expense.

However, the Committee has concluded that a pro rata allocation of indebtedness among a taxpayer's expenditures is not administratively feasible for at least two reasons. First, a pro rata allocation system would require a complete balance sheet of a taxpayer to be restated at least annually, listing all assets (including all personal assets) by either tax basis or value. The burden on the taxpayer of creating such a balance sheet would be compounded by the burden on the Internal Revenue Service in auditing the same. Second, a fair allocation system would also have to account for a taxpayer's consumption expenditures (i.e., expenditures for non-capital items) in determining the allocation of interest expense. The burden of record keeping and compliance with respect to consumption expenditures would be even greater than that with respect to capital expenditures.[2/]

The tracing approach adopted by the regulations, as complex as it may be, has the overwhelming virtue of simplicity as compared to the pro rata approach. On the other hand, its major shortcoming is that it is subject to an enormous amount of manipulation by sophisticated taxpayers, particularly those with substantial assets. These taxpayers will have the greatest opportunity to increase the deductibility of their interest expense by using cash to purchase personal items and borrowed funds to purchase investment, passive activity and business items. If they would normally have borrowed to buy personal items, they can easily, and legally, sell business or investment

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2/ See Blake D. Rubin, “Pro Rata Interest Allocation: The Path Not Chosen,” Tax Notes, July 20, 1987, p. 301.

assets and use the proceeds for personal expenses, and at the same time borrow to replace the business or investment assets. This raises an issue of whether the regulations result in unequal treatment for different taxpayers.

One approach to the perceived unfairness of the tracing method would be to require a pro rata allocation of interest expense for persons perceived as “wealthy.” Even assuming that the administrative complexities of a pro rata allocation system are justified in this case, the difficulty in this approach is defining those taxpayers who are wealthy. If net worth is the standard, the benefit of avoiding valuation of a taxpayer's assets has been, to some extent, lost since valuation will be required to determine whether the taxpayer is subject to the allocation regime. Alternatively, wealthy taxpayers could be determined with reference to their adjusted gross income, perhaps using the break points for the phase out of the personal exemption or the 15% bracket. If adjusted gross income were to be used as a break point, the Committee believes that the allocation regime should not be imposed unless the taxpayer's interest expense (not including deductible mortgage interest expense) also exceeds a certain amount, such as a percentage of adjusted gross income.

If certain taxpayers are required to adopt a pro rata allocation of indebtedness, the Committee suggests that the allocation be limited to identifiable assets, excluding consumption expenditures. In addition, we would suggest the use of adjusted tax basis, rather than fair market value, for allocation purposes.[3/] The Committee recognizes that the elimination of consumption expenditures will have the effect of shifting the taxpayer's allocation towards investment, passive activity and business assets and, in some instances, the allocation method might result in the taxpayer being entitled to deduct more interest than he would have been able to deduct under the tracing method. Given this imprecision in the pro rata method, the tracing method could appropriately be used as a cap on interest deductions.

A second approach to dealing with the perceived unfairness of the tracing regime would be to require each taxpayer to treat a minimum amount of interest as personal interest, with the minimum determined either as a percentage of all interest expense or a percentage of adjusted gross income before interest expense (not in excess of total interest expense). The Committee is concerned, however, that disallowing a portion of a taxpayer's interest expense as personal interest would be unfair and may not be authorized by the statute, at least if the taxpayer can prove that under both the tracing and pro rata methods a lesser amount of interest was allocable to personal expenditures. Thus, the Committee believes that it would only be appropriate to treat a minimum amount of interest as personal interest if the taxpayer is otherwise given the alternative of choosing the pro rata allocation system. Under this approach, a taxpayer would first be required to allocate interest under the tracing method. If the amount of personal

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[3/] Alternatively, the allocation could be based on the original cost of a taxpayer's assets or on tax basis as computed for earnings and profits purposes (see section 453C(b)(2)). In any case, personal assets would not be depreciated.

interest under the tracing method was less than the specified minimum amount, the taxpayer would be allowed either to adopt the pro rata allocation method or to increase the amount of non-deductible interest to the specified minimum amount. The reduction in deductible interest expense would be allocated pro rata among the types of interest expense incurred by the taxpayer determined under the tracing method.[4/]

In sum, the Committee supports the tracing method of the regulations for the reason of administrative convenience, and would apply that method to the interest expense of all taxpayers. If there is a perceived unfairness in allowing sophisticated taxpayers to arrange their affairs to maximize the amount of deductible interest, a limited pro rata allocation method could be adopted for those taxpayers or, if that is deemed to be too cumbersome, such taxpayers could be given the choice of either treating a minimum amount of interest as personal interest or else using the pro rata allocation method.

2. Ordering Rules.

The regulations, in adopting a tracing rule, provide a series of rules to determine the origin of funds expended out of a particular account. Reg. §1.163-8T(c)(4)(ii). With one exception, funds withdrawn from a specific account are treated as coming out of the balance then in the account, and (1) any withdrawals from the account are treated as first consisting of all debt proceeds previously deposited in the account and not previously treated as withdrawn, and only after all such debt

[4/] A discussion of anti-abuse rules for “wealthy” taxpayers brings to mind the issue whether some rule of convenience should be adopted for low-income taxpayers. Perhaps a low-income taxpayer could be exempted from the tracing system if he agreed to treat some minimum amount of his interest expense as personal interest.

proceeds are treated as withdrawn are other funds (not consisting of deposited debt proceeds) treated as accessible for withdrawal, and (2) earlier-deposited debt proceeds are treated as withdrawn before later-deposited debt proceeds. The exception allows a taxpayer withdrawing money from an account within 15 days of depositing borrowed funds into the account to treat the withdrawal as having been made from the debt proceeds, even though the general rule might have treated interim withdrawals during the 15-day period as using up all or part of the debt proceeds.

We strongly object to these rules. They are completely arbitrary, and in many if not most cases they will not reflect economic reality. Moreover, the well-advised taxpayer with adequate liquid assets can easily avoid the rules (if it is to his advantage to do so) by simply creating multiple accounts. A separate account can be set up for deposits of each borrowing, and one more account used for deposits of nonborrowed funds. The taxpayer could then freely decide out of which account any particular expenditure of funds should be made.

a. <u>Multiple subaccounts</u>

We see no reason the regulations should give such tax benefits to well-advised taxpayers engaging in such noneconomic activities as creating multiple bank accounts. At a minimum, we urge that the regulations permit taxpayers to reach the same result without requiring multiple accounts. To achieve this result, taxpayers should be allowed to designate, at their sole option, which funds (borrowed or nonborrowed) in an account at any particular time are then being withdrawn for any particular purpose. In other words, instead of being forced to physically create multiple accounts, a taxpayer would be allowed to create, solely in his own records, multiple subaccounts of one actual account, and make deposits to (and withdrawals from) those subaccounts. Anything that could actually be done with multiple accounts (e.g., transfers between accounts) would be allowed to be done on the taxpayer's own records with respect to subaccounts of a single account. For example, if on January 1, an account held $1,000 in borrowed funds and $1,000 in nonborrowed funds, a taxpayer subsequently spending $1,000 on a car and $1,000 on investments over the course of the year could always allocate the investment expense to the borrowed funds and the car expense to the nonborrowed funds, without regard to the original sequence of the deposits or sequence of the withdrawals and without regard to the time interval between deposit and withdrawal.

While this rule might initially seem like a vast liberalization of the present regulations, this is not the case at all. It only permits to be done on paper what the regulations now permit to be done with multiple accounts. We see no reason why the former should be prohibited and the latter allowed. Any revenue loss from the proposal would be from those unwilling (or not aware of the need) to create multiple accounts, and we see no justification for raising revenue solely from this group of taxpayers.

Taxpayers might be required to keep contemporaneous records showing hypothetical deposits and withdrawals from subaccounts of every one of their actual accounts. However, in general, on such records personal expenses will always first be allocated to nonborrowed funds, and investment expenses will first be allocated to borrowed funds. We believe it is unlikely that taxpayers would gain any undue benefit by the ability to retroactively construct the subaccount records for a single account at the time they file their tax return for the taxable year in question. The benefits of hindsight would be relatively small. Thus, we recommend that a taxpayer simply be required to attach to his tax return his own method of tracing money into and out of each subaccount during the year, with no need for contemporaneous recordkeeping.

There is a precedent in the regulations for this approach. If debt is used for both personal and nonpersonal purposes, repayments of part of the debt are first allocated to personal expenses. Reg. §1.163-8T(d)(l). This will generally be the most advantageous to taxpayers. We see no reason taxpayers should not likewise be allowed to allocate <u>expenditures</u> of funds in the most advantageous manner.

If the foregoing subaccount approach is adopted, there will still be a need for a rule for taxpayers who do not create the appropriate records. We would strongly support an automatic rule that investment expenses are first deemed to come out of borrowed funds in an account, and personal expenses are first deemed to come out of nonborrowed funds in the account. A taxpayer would presumably always have made this allocation were he well-advised, and we see no reason to penalize taxpayers who could have reported in this way had they been aware of the need to do so.

Our proposed ordering rule would eliminate the need for the 15-day rule of the regulations since taxpayers can associate expenditures out of an account with any cash in that account at the time of the expenditure, whether or not borrowed. If the regulations retain the ordering rule that, in general, debt proceeds are treated as expended from an account prior to nonborrowed funds, we would urge an expansion of the 15-day rule in two respects. First, taxpayers should be allowed to allocate debt proceeds to any specified expenditure made from an account during at least a 60-day period after the deposit of the debt proceeds. Second, a similar designation rule should apply to nonborrowed funds deposited in an account. For example, if debt proceeds and nonborrowed funds are deposited in the same account, the taxpayer should be entitled to designate expenditures within 60 days after a deposit of the nonborrowed funds as being derived from the nonborrowed funds, rather than being subject to the general rule that debt proceeds are expended first.

b. <u>Subsequently incurred debt</u>.

Because the 15-day rule (and our suggested expansion above) looks only to expenditures incurred <u>after</u> the borrowing, the regulations provide no relief for a taxpayer who uses nonborrowed funds for an investment, passive activity or business expenditure in anticipation of a subsequent borrowing to replace those funds. The interest expense with respect to a subsequent borrowing will be characterized with reference to expenditures subsequently incurred by the taxpayer, rather than the expenditure which was the reason for the borrowing. The Committee believes that this result is inconsistent with economic reality. Investment decisions must often be made prior to the availability of borrowed funds and it is common for taxpayers to use nonborrowed funds to “bridge” the period between investment and borrowing.

> Example: On September 1 taxpayer has $10,000 in nonborrowed funds which I s intended to be used for a personal expenditure. On September 5 taxpayer is offered a favorable opportunity to invest in real estate but cash must be available by September 15. Taxpayer borrows funds for the real estate investment, but they are not available until September 17. As a result, the taxpayer uses the nonborrowed funds to purchase the real estate. When the proceeds of the borrowing are available, they are deposited in the taxpayer's account and subsequently used to pay for a personal expenditure.

The Committee suggests that a rule be developed allowing a taxpayer to attribute indebtedness to previously incurred expenditures. We would support a rule which would allow a taxpayer to associate expenditures with subsequently deposited debt proceeds, if application for the loan was made within 15 days after the expenditure. If this proposal is not adopted, the taxpayer should have the right to show, on a subjective basis that, at the time the expenditure was incurred from nonborrowed funds, the taxpayer intended to replace the funds with borrowed funds.

c. Other approaches

The multiple subaccount approach suggested above is a limited expansion of the account rule proposed in the regulations. The Committee has considered a number of other approaches for applying the tracing method, all of which, in effect, “deem” a taxpayer to have taken advantage of tax planning opportunities already available under the regulations.

i. Master account approach

The regulations and the multiple subaccount approach both look to the cash available in the account at the time of the expenditure to determine whether it was derived from borrowed or nonborrowed funds. Thus, a taxpayer who makes a personal expenditure out of an account containing only borrowed funds would not be allowed an interest deduction, even though he also had mother account with sufficient nonborrowed funds to cover the expenditure. Likewise, no interest deduction would be allowed where debt proceeds are disbursed directly by the lender in payment of a personal expenditure, even though the taxpayer had nonborrowed funds available to cover the expenditure.

In both cases, had the taxpayer been properly advised he would have used nonborrowed funds for the personal expenditure.[5/] This need for tax planning, even for everyday transactions, could be eliminated by treating all of a taxpayer's cash or cash equivalents on hand at any particular time as included in a single “master account” and allowing the taxpayer to designate,

[5/] In the latter case, a well-advised taxpayer would have requested the lender to deposit the loan proceeds in an account and would have paid for the personal expenditure from the nonborrowed funds, rather than by direct disbursement.

as under the multiple subaccount approach, which funds on hand at the time were used for the expenditure.

> Example: On September 1, taxpayer has $10,000 in nonborrowed funds. On September 15, taxpayer purchases a car for $8,000, incurring an indebtedness in that amount which is disbursed directly to the dealer.

Under the master account approach, the taxpayer could treat the car as having been purchased with the nonborrowed funds, and the borrowed funds would be treated as deposited in the account for future use. As with the multiple subaccount approach, described above, this approach does not permit any benefit that could not have otherwise been obtained through relatively simple tax planning.

ii. Noncash assets

One purpose of the rule disallowing the deduction of personal interest expense may be to limit the benefit to a taxpayer from borrowing against appreciated assets without recognition of gain. On the other hand, a taxpayer who incurred indebtedness for a personal expenditure could correct his mistake, without tax cost, by disposing of a nonappreciated investment asset, using the sale proceeds to repay the debt and borrowing again to replace the investment asset.

> Example: Taxpayer incurs an indebtedness of $1,000 for a personal expenditure at a time when he owns stock (acquired with nonborrowed funds) in ABC Corporation with a basis and fair market value of $1,000. Taxpayer sells the stock, uses the proceeds to repay the debt and borrows $1,000 to repurchase the stock.

Rather than require the transaction costs associated with converting personal debt to investment debt and consistent with the purpose of limiting borrowing against appreciated assets, the master account rule could be expanded to include all of a taxpayer's cash assets and nonappreciated noncash marketable assets (such as marketable securities). In the above example, the taxpayer could treat the indebtedness as having been incurred to purchase the ABC Corporation stock which he already owns and the personal expenditure as having been incurred with nonborrowed funds.

iii. Year-end allocation

With the exception of our suggestion for subsequently-incurred debt, the regulations and the proposals discussed in this report allow a taxpayer to trace his expenditures only based upon cash (or assets) on hand at the time the expenditure is incurred. Another approach would be to allow a taxpayer to allocate his indebtedness incurred during the taxable year as of the end of the year to expenditures incurred during the year without regard to the timing of the borrowing or the expenditure.

> Example: On January 1, taxpayer, a sole proprietor, borrows $1,000 for personal expenditures. During the taxable year, the proprietor earns $1,000 income which is used to pay business expenses and acquire business assets.

Under the year-end allocation approach, the taxpayer would be permitted to allocate his indebtedness to the business expenses and business assets (as if he had used the business profits to pay down the personal loan, and borrowed another $1,000 for use in the business).[6/] The same result would arise if $1,000 of business expenses were paid with non borrowed funds in January and $1,000 was borrowed in December for personal expenses

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[6/] Some special rule might be necessary to deal with the interim period between the initial borrowing and the subsequent expenditures, although, under this approach, such distortion may be accepted as de minimis.

(as if the taxpayer borrowed to pay the business expenses and saved the cash on hand for the personal expenses).

iv. Reallocation approach

The broadest expansion of the regulations would be a system which allows a taxpayer to reallocate his indebtedness as of the end of each taxable year to the extent of the cost basis of his assets on hand at the end of each year.

> Example: At the end of Year 1, taxpayer has indebtedness of $5,000, investment assets with a cost of $4,000 and personal assets with a cost of $3,000. At the end of Year 2, the taxpayer's cost of investment assets increases to $5,000.

Under the reallocation approach, the taxpayer could allocate $4,000 of indebtedness to investment assets in Year 1 and $5,000 to investment assets in Year 2 (as if the taxpayer had sold whatever investment assets were necessary to repay the personal portion of the indebtedness and borrowed to repurchase the investment assets). Under this approach, it might be appropriate to require gain recognition on the assets that would otherwise have had to have been sold to achieve the same result.

3. Coordination

Reg. §1.163-8T(m) attempts to set forth rules for coordinating the tracing rules of the regulations with other limitations on interest deductions. As we understand the rules, (1) all interest is first allocated into categories under the tracing rules of the regulations (i.e., business, investment, passive, personal), (2) certain general interest disallowance rules, such as section 265, are then applied regardless of the result of tracing, (3) if an interest deduction is deferred, such as under section 267 or 465, its tracing category is “frozen” in the year it would otherwise be deductible, but it is taken into account as an interest expense in that category when the deduction is actually allowed under the deferral rule, (4) if an interest expense is capitalized, such as under section 266, it is permanently removed from the tracing categories, with the exception that if the interest expense had been traced to the personal category, it remains in that category and cannot be capitalized, and (5) qualified residence interest is deductible (subject to limitations such as section 265) without regard to tracing category. If these are the intended rules, we believe they could be stated more clearly and with more examples.

One purpose of the coordination rules is to deal with interest expense allocated in one manner under the tracing rules of the regulations and in another manner under other provisions of the Code, in particular, section 265(a)(2). The regulations do not clearly state, however, the class of interest expense which is reduced when section 265(a)(2) is applicable. Example (1) of Reg. §1.163-8T(m)(6) suggests that interest on the indebtedness identified under section 265(a)(2) as incurred or continued to purchase or carry tax-exempt obligations is simply recharacterized until the tax-exempt obligations are disposed of. Another approach would be to reduce each class of the taxpayer's interest expense proportionately.

4. Passthrough Entities.

The preamble to the regulations invites comment on the rules applicable to the allocation of indebtedness in connection with passthrough entities. Such indebtedness would include debt incurred to purchase an interest in the entity and debt incurred by the entity.

Passthrough entities present an interest allocation problem when they own different classes of assets (*i.e.*, passive, business, investment or personal) to which indebtedness may be allocated. The intention expressed in the legislative history of the Tax Reform Act of 1986 to treat income earned on working capital as portfolio income means that most operating entities will have at least two classes of assets. The other major issue presented by passthrough entities is the treatment of interest expense on indebtedness incurred to fund distributions.

a. Indebtedness incurred to purchase an interest in a partnership.[7/]

A partner may incur indebtedness to acquire a partnership interest either by purchase from an existing partner or by contribution to the partnership on initial formation or after the partnership has commenced operations. The first step in allocating the indebtedness should be to apply the general tracing rules to attribute the indebtedness to the purchase of the partnership interest.

[7/] For convenience, this report refers only to partnerships, although its suggestions are equally applicable to S corporations.

Assuming that the indebtedness has been properly attributed to the partnership interest, the second step in determining the character of the partner's interest expense is to allocate the indebtedness/interest expense to the assets/income of the partnership.

i. Allocation based on assets

> Example: A borrows $20 and contributes another $30 of nonborrowed funds to acquire a 50% interest in newly formed Partnership AB. AB buys $75 of business assets and $25 portfolio securities. During the taxable year, the business assets generate $6 of income and the portfolio securities generate $4 of income.

An allocation of interest expense based on partnership assets is consistent with an aggregate theory of partnerships. In the example, A should be treated as owning 50% of each of the partnership's assets and, barring a rule which allows A to allocate his debt between those assets as he chooses,[8] A would allocate his indebtedness $15 to business assets and $5 to portfolio assets. Fluctuations in the value of the assets would not result in subsequent adjustments in the allocation. Dispositions of assets by the partnership and a reinvestment or distribution of the proceeds would result in a reallocation of the indebtedness in the same manner as debt is reallocated when

[8] The Committee considered, but rejected, a rule which would allow a purchasing partner to allocate his indebtedness among partnership assets as he chose. In the example, one could argue that A should be entitled to attribute his debt in full to his share of the business assets of the partnership since he could have done so had he operated the business as a sole proprietor and purchased the portfolio securities in his individual capacity.

an individual disposes of an asset and reinvests the proceeds rather than repaying the debt (i.e., the debt is reallocated to the new asset).

> Example: Partnership AB sells its portfolio assets for $50 and invests the proceeds in business assets. A's debt previously allocated to the portfolio assets ($5) would be allocated to the business assets.

While the asset allocation approach seems simple enough to apply upon the initial formation of a partnership, problems arise where a partnership interest is purchased or where a new partner is admitted after the partnership's assets have changed in value.

> Example: The business assets of Partnership AB increase in value to $150 and the portfolio assets decline in value to $10. B sells his interest in the partnership to C for $80, the full amount of which is borrowed by C.

An asset allocation rule should require the partnership to value its assets at the time of C'S purchase, resulting in an allocation of C's indebtedness $75 to business assets and $5 to portfolio assets.[9/] While valuation may not be difficult where there are only two classes of assets and one class is marketable securities,[10/] valuation would be difficult where, for example, the partnership owns an active business and other assets which are not traded. Nonetheless, valuation may be required anyway under section 754 where there is a purchase of a partnership interest, and under section 704(c) and the regulations under section 704(b) where there is a contribution to the partnership.

9/ Similar rules would apply to indebtedness incurred by C to acquire his partnership interest by contribution to capital.

10/ This assumes that aggregation of classes of assets is permitted.

One way to avoid the valuation problem would be to allow C to allocate his indebtedness in accordance with the basis of the property of the partnership. Such an allocation would result in economic distortion,[11] but could be allowed as a matter of administrative convenience subject to the power of the Commissioner to reallocate based upon fair market value in clearly abusive cases.

The asset allocation rule is further complicated when the partnership has incurred indebtedness to purchase its assets. Assuming, as discussed below, that the partnership's indebtedness is allocated among its assets in the same manner as an individual allocates indebtedness, a partner who purchases an interest in the partnership with borrowed funds should allocate his debt in accordance with the net value of the partnership's assets. However, if the partnership's assets to which debt was allocated have declined in value below the principal amount of such debt, a reallocation of the partnership debt for the purchasing partner would be appropriate.

> Example: Partnership AB borrowed $20 to purchase its portfolio assets which declined in value to $10. C purchases his partnership interest for $70.

All of C's debt should be allocated to the partnership's business assets, but unless $5 of the debt allocable to C's share of the

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[11] In particular, where the partnership business involves substantial goodwill, which has no basis, a new partner would be unlikely to adopt a basis allocation approach, since the effect would be to shift the allocation to portfolio or passive assets.

portfolio assets is reallocated to the business assets, the asset allocation approach is inaccurate.

If an asset allocation approach is adopted, the Committee suggests that some *de minimis* rule also be adopted. For example, if more than 85% of the assets of the partnership relate to a single class of assets (*e.g.*, business assets), all indebtedness incurred to acquire the partnership interest could be allocated to the business activity. The Committee recognizes that this rule would undermine the treatment of working capital as portfolio assets for this purpose. In addition, the Committee believes that partnerships should be allowed to aggregate classes of assets, rather than requiring allocation on an asset-by-asset basis. Otherwise, every asset of the partnership would have to be valued individually to determine the allocation of a partner's indebtedness.

ii. *Allocation based on income*

Allocating indebtedness based upon the income of the partnership is consistent with an entity theory of partnerships. In at least one situation this method of allocation is necessary. If all income of publicly-traded and widely-held partnerships is treated as portfolio income, debt incurred to purchase a partnership interest would be treated as allocated to portfolio assets, i.e., the character of interest expense would be determined by reference to the income of the partnership to the partner.

Allocation of interest expense based on partnership income could be extended to all partnerships and may be simpler to administer, though less accurate, than an asset allocation approach. Each partner would allocate his interest expense on indebtedness incurred to purchase a partnership interest pro rata in accordance with his share of the classes of income generated by the partnership during the year. Since partnerships will be required to separate different categories of income in reporting to their partners, the additional administrative burden of this approach would be small.

If the income approach is adopted, the Committee does not believe that net income is an appropriate measure for allocating interest expense. Instead, we would suggest that interest expense be allocated in accordance with the gross income of each class of activity of the partnership, reduced by partnership interest expense allocated to such activity under the tracing rules.

> Example: Partnership AB has $10 of gross income and $4 of interest expense with respect to its business activity and$6 of gross income and $2 of interest expense related to its portfolio assets. A's interest expense would be treated 60% as business interest and 40% as portfolio interest.

Of course, by varying from the aggregate theory, this system has flaws which can be used to a taxpayer's advantage.

Example: Partnership AB's portfolio assets produce no gross income and were purchased by the partnership to take advantage of the income allocation rule. As a result, A's interest expense is treated solely as business interest.

Nevertheless, its relative simplicity makes the income allocation approach worthy of consideration.

b. Partnership borrowing.

The Committee believes that borrowings by a partnership should be allocated among the partnership's assets in the same manner as an individual's borrowings are allocated. Once debt has been allocated, the Committee believes that it should not be reallocated as a result of fluctuation in asset values, even upon admission of a new partner, although the Committee recognizes that the failure to reallocate debt in the case of admission of a new partner may be a distortion of the asset allocation approach.

For purposes of allocating indebtedness, a partnership should be allowed to group assets by classes, rather than allocating on an asset-by-asset basis. The sale of assets within any such category should be ignored as long as proceeds are reinvested in assets of the same class. If proceeds of the sale of assets are invested in assets of a different class or distributed, the partnership should be deemed to have sold an undivided interest in the assets of the class with a net fair market value equal to the sales proceeds which were not reinvested in that category of assets. The proceeds deemed realized by the partnership should then be traced by the partnership and, if distributed, by each partner.

i. Distributions

A partnership should have a separate, additional category to which borrowings may be attributed -- a distribution account. Interest expense on amounts borrowed to fund distributions should be required to be separately stated by the partnership and allocated by each partner in accordance with his individual use of the distribution proceeds.[12/] A purchaser of an interest in a partnership that is maintaining a distribution account would treat his share of the distribution account as he would personal debt incurred to purchase his partnership interest, allocated in accordance with the rules discussed above.

> Example: Partnership AB borrows $50 and distributes the proceeds $25 to each partner. C purchases A's partnership interest. $25 of the partnership's distribution borrowing is treated as incurred by C to purchase his interest in the partnership.

[12/] The regulations must deal with disproportionate distributions of debt proceeds -- distributions in which some partners do not participate and, as a result, increase their interests in the partnership and distributions of cash to some partners and property to others. Disproportionate distributions should be recharacterized as transactions between the partners and the partnership so that, for example, a partner increasing his interest in the partnership will be treated as incurring his share of partnership indebtedness to acquire his increased interest.

In an operating partnership, if indebtedness is allocable to distributions under the usual tracing rules, we recommend that it be reallocated to business expenses and the acquisition of business assets, at least to the extent that distributions out of borrowed funds for a taxable year do not exceed the taxable income of the partnership.

ii. Contributions of encumbered property

Under our proposed rules, the contribution of encumbered property has a potential for changing the character of a partner's interest deduction.

> Example: D owns unencumbered real estate valued at $100. D borrows $50 secured by the real estate and uses the proceeds for a personal expenditure. D and E then form an equal partnership to which D contributes the property, subject to the debt and E contributes $50 cash used in the real estate activity.

In the hands of the partnership, the debt is related to the real estate activity and E's share of the debt should clearly be allocated to the activity since E, in essence, purchased one-half of the real estate activity for $50 cash.

D's interest expense can either be treated as converted to the real estate activity or can retain its character as personal interest. The Committee supports a rule which characterizes D's share of the partnership interest expense as relating to the real estate activity. As justification for this treatment, the transaction can be viewed as a distribution by the partnership of cash to D (sections 731 and 752(b)) which D used to repay his personal debt, and a new partnership borrowing to fund its acquisition of the property from D. The result would be the same under the tracing rules if the partnership had in fact engaged in these transactions.

We recognize that an anti-abuse rule may be appropriate. For example, a taxpayer with any personal indebtedness secured by business real estate could always convert the debt into non-personal debt by contributing the property to a partnership in which he was a 99% partner.[13/] Perhaps an exception to the general rule could be made where a partner contributing encumbered property retains a significant interest in the partnership (e.g., 25% or 50%), in which case the interest expense would retain its former character in his hands.

5. Transitional Rules.

The regulations contain a rule which allows individuals to attribute indebtedness outstanding on December 31, 1986 to a business or rental activity (regardless whether the debt would be allocable under the regulations to other expenditures) if the taxpayer consistently deducted interest expense on such indebtedness in computing income or loss from such activity on Schedule C, E or F of Form 1040. The Committee is not opposed to the transitional rule (although it is not required by the statute) but questions why it is limited to business or rental activities. A taxpayer who borrowed in an investment activity prior to December 31, 1986 (but used the proceeds for personal expenditures) is similarly prejudiced by the regulations. If a concern is the difficulty of policing whether debt was properly associated with an investment activity, the taxpayer could be required to show, for example, that the debt was incurred in his

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13/ Of course, an individual could convert personal debt by satisfying the debt from nonborrowed funds and, then, borrowing to invest in an investment, passive or business activity.

margin account or that he properly reported the interest expense as investment interest on Form 4952.

The Committee would also support an expansion of the transitional rule applicable to the allocation of debt with respect to expenditures made on or before August 3, 1987. The regulations extend the normal 15-day designation rule, discussed above, to 90 days in the case of expenditures incurred prior to August 3, 1987. However, the regulations fail to provide transitional relief for debt incurred in 1987 but more than 90 days before the issuance of the regulations. For example, a taxpayer who incurred indebtedness on January 1, 1987 and made an expenditure intended to be out of the debt proceeds more than 90 days thereafter obtains no relief. If the committee's proposed modification of the ordering rules is adopted, this issue would become moot but, if not adopted, we believe that taxpayers should be allowed to designate expenditures as being derived from indebtedness incurred prior to the issuance of the regulations without any time limit.