Notice 89-35, 1989-1 CB 675

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.

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

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

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

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

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

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.

FSA 200011025 (excerpt) – Is Notice 89-35 still in effect?

ISSUES

1. Was Section VI of Notice 89-35, 1989-1 C.B. 675, which modified the “single account” and “15-day rules” of Temp. Treas. Reg. section 1.163-8T(c)(4)(iii)(B) still in effect during 1994?

2. Under the “any account of the taxpayer” rule set out in Notice 89-35, can the taxpayer's loan be allocated to the subsidiary's expenditure, and must that subsidiary be members of taxpayer's consolidated group?

3. Do the “any account” and “30-day rules” of Notice 89-35 apply to debt refinancing as defined at Treas. Reg. section 1.163-8T(e)?

4. Is an intercompany loan an “investment expenditure . . . properly chargeable to capital account” for purposes of the debt allocation rules of Treas. Reg. section 1.163-8T?

CONCLUSIONS

1. Yes

2. Under Section VI of Notice 89-35 it would not be appropriate to treat the account of a subsidiary (even if the member of the same consolidated group) as an account of the taxpayer for purposes of the “same account” rule.

3. The “any account” and “30 day” rule would apply to debt refinancing proceeds only to the extent that the proceeds are not allocable to the repayment of the preexisting debt.

4. Treas. Reg. section 1.163-8T(j)(1)(iii) applies in a very narrow context and does not provide any authority for a broad treatment of intercompany loans.

FACTS

A is a limited liability company taxable as a partnership and subject to TEFRA procedures. A was formed on or about Date 1 by B, as #1 percent partner, and D, as #5 percent partner. B and D contributed their interests in E to A on or about Date 2.

On or about Date 3, F, transferred stock in G, a State 1 corporation which owned a power plant in Country 1, to A for a partnership interest. On that same date, C transferred the stock of H, a Country 2 company which in turn owned the stock of I and J, both Country 2 companies operating power plants in the Country 2, to A for a partnership interest.

All partners are affiliated with K and may or may not join in the K consolidated return. B, F and C will be referred to as Intermediate Subsidiaries. It is not clear that F and C were the historic owners of the lower-tier subsidiaries; B in particular, acquired its lower-tier subsidiary recently from K.

It appears that C and F subsequently contributed their respective interests in A to B. B was then owned in the following percentages: #2 percent K, #3 percent C, #4 percent F, and #5 percent D. A assumed $1 of B's liabilities. It is our understanding that the Intermediate Subsidiaries assumed the liabilities in connection with either their acquisition or their development of the lower-tier subsidiaries. These liabilities originally were assumed by F, C and B from K.

The assumption agreements provide as follows: The assumption agreement dated Date1, between K, A, and B provides that whereas K assigned to B, and B in turn, assigned to A #6 shares of E, and K issued $2 of commercial paper allocated to those shares, that B assumed the liability in connection with the transfer of shares to A, and A then assumed the liability for the indebtedness.

The assumption agreement dated Date 4 between F and A provides that whereas F assumed $3 in indebtedness of commercial paper issued by K and F has transferred to A #9 shares of G, that A assumed the liability for the $3 million indebtedness, the refinancing of the existing debt.

The assumption agreement dated Date 3 between K, C and A provides that whereas C assumed $4 of indebtedness of commercial paper issued by K, and C has transferred to A #7 shares of H, that A assumed the liability for the $4 million indebtedness, the refinancing of the existing debt.

At all times, however, K remained the sole obligor of the commercial paper obligations.

A and B participated in an initial public offering (IPO) of approximately #8 percent of A's partnership interests on or about Date5. The IPO was structured so that B was offering shares that it currently held and A was offering shares in itself. B apparently received $5 for the shares that it sold and A received $6 for the shares that it offered. A used $1 of the proceeds to retire the commercial paper liabilities that it had assumed and used the remainder of the proceeds to redeem D's partnership interest. A authorized a distribution of $7 to B on or about Date 5.

The Commissioner issued an FPAA to A on Date 6 attacking the transaction under a disguised sale theory. The primary theory was that certain liabilities of K did not constitute “qualified liabilities” within the meaning of section 1.707-5(a)(6)(i)(C). The taxpayer concedes that it was a disguised sale but disputes that the liabilities were not “qualified liabilities.”

A's tax matters partner, B, filed a Petition for Redetermination on Date 7 in the Tax Court.

LAW AND ANALYSIS

ISSUE 1

Treas. Reg. section 1.707-5(a)(6)(i)(C) indicates that for purposes of the disguised sale analysis, a liability that is assumed or taken subject to by a partnership in connection with a transfer of property to the partnership is a qualified liability if the liability is allocable under the rules of Treas. Reg. section 1.163-8T to capital expenditures with respect to the contributed property. A qualified liability has preferential tax treatment to an ordinary liability. Under the facts of the present case, the Intermediate Subsidiaries have contributed stock in corporate subsidiaries to A. Taxpayer has raised the argument that the liability represented by the commercial paper is allocable to capital expenditures within the lower-tier subsidiaries contributed to A.

Treas. Reg. section 1.163-8T,of the temporary regulations provides rules for determining the character of interest expense for purposes of sections 163(d), 163(h) and 469. Treas. Reg. section 1.163-8T(c)(1) provides that debt is allocated to expenditures in accordance with the use of the debt proceeds. Treas. Reg. section 1.163-8T(c)(4)(iii)(B) 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. Treas. Reg. section 1.163-8T(c)(5)(i) provides a similar rule with respect to debt proceeds received in cash.

Section VI of Notice 89-35, 1989-1 C.B. 675, (which expands the guidance contained in Notice 88-20, 1988-1 C.B. 487, and Notice 88-37, 1988-1 C.B. 522) modified the single account and 15-day rules to provide that 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. Section III of Notice 89-35 provides that taxpayers may rely on the guidance 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. To date, no further guidance under Treas. Reg. section 1.163-8T has been published. Therefore, Section VI of Notice 89-35 was still in effect during 1994.

ISSUE 2

It does not appear to be appropriate to allocate a liability of a taxpayer to a subsidiary's expenditure under the "any account of the taxpayer" rule. Specifically, the debt of the corporate parent should not be allocated to expenditures paid out of a subsidiary's bank account. Section VI of Notice 89-35 provides considerable freedom to taxpayers in determining the proper tracing of debt proceeds. In particular, Notice 89-35 modifies the general rule of Temp. Treas. Reg. section 1.163-8T(c)(4)(ii)(B) to provide that the debt proceeds may be allocated to an expenditure out of any account of the taxpayer made within 30 days before or after the proceeds are deposited in an account of the taxpayer. However, this freedom does not extend to permit the loan proceeds of one taxpayer (K) to be allocated to the expenditures of other taxpayers (the Intermediate Subsidiaries).

The taxpayer has apparently represented that the proceeds of the commercial paper were either lent or contributed to the Intermediate Subsidiaries by K. Therefore, the only expenditure that the proceeds of the commercial paper may be traced to under Treas. Reg. section 1.163-8T and Notice 89-35 would be the use that K made of the proceeds. That is, the proceeds of the loans may be traced to either intra-company loans or capital contributions to Intermediate Subsidiaries.

To the extent that K lent the proceeds to the Intermediate Subsidiaries, the Intermediate Subsidiaries would have obtained debt proceeds that could conceivably be traced to capital contributions to the lower-tier subsidiaries. In such a case, the Intermediate Subsidiaries could presumably refinance their obligation to K by assuming K's obligation under the original commercial paper. If A then assumed the Intermediate Subsidiaries' obligations under the commercial paper when it received the contributions of the interests in the lower-tier subsidiaries, then it is theoretically possible that the assumed liability under the commercial paper could be traced to capital expenditures with respect to the contributed property. Assuming, the Intermediate Subsidiaries did not contribute the original loan proceeds to the lower-tier subsidiaries, but rather loaned the money to the subsidiaries, such intercompany loans would not be considered capital expenditures.

ISSUE 3

District Counsel essentially asks whether a new debt can be traced to the repayment of an old debt so that the refinancing rules apply. The "any account" and "30-day rules" of Notice 89-35 apply to debt refinancing as defined in Treas. Reg. section 1.163- 8T(e) in a limited manner.

Treas. Reg. section 1.163-8T(e)(1) specifically indicates that to the extent proceeds of any debt (the "replacement debt") are used to repay any portion of a debt, the replacement debt is allocated to the expenditures to which the repaid debt was allocated. The amount of replacement debt allocated to any such expenditure is equal to the amount of debt allocated to such expenditures that was repaid with proceeds of the replacement debt. To the extent proceeds of the replacement debt are used for expenditures other than repayment of a debt, the replacement debt is allocated to expenditures in accordance with the rules of this section. These provisions indicate that a taxpayer only has flexibility to allocate the amount of the replacement debt that is not used to repay the original debt. Treas. Reg. section 1.163-8T(e)(1) does not permit any flexibility in the allocation of the portion of the replacement debt that is used to repay the original debt; that portion must be allocated to the expenditures that the original debt was allocated to.

An additional issue has arisen as to whether a debt incurred within 30 days of the repayment of a preexisting debt may be treated as a refinancing within the meaning of Treas. Reg. section 1.163-8T(e) of the original debt. Assuming the proper tracing can be shown, it appears appropriate to treat the new debt as a refinancing of the original debt. There is no indication in Treas. Reg. section 1.163-8T(e) that a refinancing for tracing purposes must be a formal refinancing (that is an arrangement where proceeds of a replacement debt are conveyed directly to retire a pre-existing debt). Treas. Reg. section 1-163-8T(e)(1) merely states that:

> To the extent proceeds of any debt (the "replacement debt") are used to repay any portion of a debt, the replacement debt is allocated to the expenditures to which the repaid debt was allocated.

This general statement only requires that the taxpayer be able to trace the proceeds of the replacement debt to an expenditure to repay the original debt. In the absence of any indication to the contrary, it should be presumed that the normal rules of Treas. Reg. section 1.163-8T (as augmented by Notice 89-35) would be used to determine whether the proceeds of the replacement debt can be traced to a repayment of the original debt. Therefore, a taxpayer could treat replacement debt as a refinancing of an original debt if the proceeds of the replacement debt could be traced to a repayment within 30 days (out of any account) of the original debt.

ISSUES 4, 5, AND 6

Advice has been requested on the proper interpretation of Treas. Reg. section 1.163-8T(j)(1)(iii). That section indicates, in part, that:

> [A]n 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.

Because Treas. Reg. section 1.707-5(a)(6)(i)(C) refers to a liability that is allocable to capital expenditures, the theory has been advanced that Treas. Reg. section 1.163-8T(j)(1)(iii) mandates that intercompany loans be treated as capital expenditures. This does not appear to be the proper interpretation of Treas. Reg. section 1.163-8T(j)(1)(iii). Treas. Reg. section 1.163-8T(j)(1) addresses the reallocation of debt when the debt had been allocated to a capital expenditure. In particular, when an asset is sold, any debt that had been allocated to that asset must be reallocated when the proceeds of the disposition are used for another expenditure. The language of Treas. Reg. section 1.163-8T(j)(1)(iii) must be viewed in this context, that is debt proceeds that are in turn used to make a loan must be reallocated when the loan is repaid. Treas. Reg. section 1.163-8T(j)(1)(iii) cannot be relied upon for any broader authority as to the nature of intercompany loans.

Intercompany loans to a subsidiary should not constitute capital expenditures “with respect to the property transferred” under Treas. Reg. section 1.707-5(a)(6)(i)(C). However, the partners in this disguised sale are F, C and B and it is not apparent that they loaned money to their lower-tier subsidiaries. The origin of the funds with K, does not change this analysis.

Capital expenditures of the subsidiary incurred and paid by the subsidiary constitute capital expenditures “with respect to the property transferred” under Treas. Reg. section 1.707-5(6)(i)(C), but only if the capital expenditure can be traced to a contribution by the subsidiary's parent. If the expenditure has no relation and cannot be traced to the liability of the parent which is assumed, then the liability is not a qualified liability.