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An Overview of Prop. Reg. Section 1.163-14 and its Impact on Passthrough Entities Including Partners and Shareholders

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On July 28, 2020, the Treasury Department (Treasury) and the IRS released a highly anticipated Proposed Regulations¹ (Proposed Regulations) that responds to long-awaited guidance regarding interest expenses associated with debt proceeds of partnerships and S corporations including, (1) where debt is used to fund certain distributions and, (2) where debt proceeds of partners or shareholders are allocated to the acquisition of an interest in a partnership or S corporation.² This article provides an overview and analysis of this Proposed Regulations (i.e., Prop. Reg. §1.163-14), and examines the impact of the same on passthrough entities and their partners and shareholders.

OVERVIEW

The guidance released concerns the limitation on the deduction for business interest expense following the amendment of the I.R.C. by the provisions commonly referred to as the Tax Cuts and Jobs Act of 2017³ (TCJA).⁴ Prior to the release of the Proposed Regulations, pass-through entities and their owners were required to follow the debt tracing and interest allocation rules set forth in Reg. §1.163-8T. With the

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¹ Prop. Reg. §1.163-14, REG-107911-18, 16-17 (July 28, 2020). Concurrently with the publication of the Proposed Regulations, the Treasury and the IRS also published (RIN 1545-BO73) final regulations (the "Final Regulations") under §163(j). All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

² Prop. Reg. §1.163-14.

³ Pub. L. No. 115-97.

⁴ Prop. Reg. §1.163-14.

release of the Proposed Regulations, Treasury and the IRS have apparently determined that Reg. §1.163-8T does not adequately provide for debt proceeds by a pass-through entities and their owners under §163(j), and specifically, in circumstances where a partnership or S corporation used debt proceeds to make owner distributions.

Prior to the release of the Proposed Regulations, the debt tracing guidance that could be relied upon pass-through entities and their owners was that found in a temporary regulation released in 1987 that speaks to the allocation of interest expense and debt, and a trio of Notices that were released following this temporary regulation that provided discrete, but far from comprehensive, guidance on how pass-through entities and their owners should allocate distributed debt proceeds to debt financed distributions including, where an interest is acquired in a pass-through entity.

BACKGROUND

Reg. Section 1.163-8T

Reg. §1.163-8T, a temporary regulation released by Treasury on July 1, 1987, provided rules regarding the allocation of interest expense⁵ for purposes of applying the passive loss activity limitation in §469, the investment interest limitation in §163(d), and the personal interest limitation in §163(h) that apply to tax years after 1986.⁶ Under Reg. §1.163-8T, debt generally is allocated by tracing disbursement of the debt proceeds to specific expenditures and interest expense associated with debt is allocated for Reg. §1.163-8T purpose in the same manner⁷ in which the interest expense relates.⁸ When debt proceeds are deposited into the borrower's account, and the account also contains unborrowed funds, Reg. §1.163-8T(c) provides that the debt generally is allocated to expenditures from the account as made first from the debt proceeds (and to the extent of the same).⁹ Reg. §1.163-8T also provide that if the proceeds of two or more debts are deposited into the borrower's account, the proceeds are treated as expended in the order in which they were deposited. Also, Reg. §1.163-8T provides specific rules that address the reallocation of debt, repayments and refinancing.¹⁰

⁵ Prop. Reg. §1.163-14(a)(1).

⁶ Prop. Reg. §1.163-14(a)(1).

⁷ Prop. Reg. §1.163-14(b)(1)(i)-§1.163-14(b)(1)(vi).

⁸ Prop. Reg. §1.163-14(b)(1)(i)-§1.163-14(b)(1)(vi).

⁹ Prop. Reg. §1.163-14(b)(1)(i)-§1.163-14(b)(1)(vi).

¹⁰ Prop. Reg. §1.163-14(b)(1)(i)-§1.163-14(b)(1)(vi).

The preamble¹¹ to Reg. §1.163-8T provides that, “interest expense of partnerships and S corporations, and of partners and S corporation shareholders, is generally allocated in the same manner as the interest expense of other taxpayers.”¹² Although the preamble acknowledged a lack of specific guidance within Reg. §1.163-8T for partnerships and S corporations, the need for special rules addressing debt financed distributions to owners of partnerships and S corporations, and what effect for those cases in which taxpayers incur debt to acquire or increase their capital interest in passthrough entities, it reserved any comments on these circumstances and instead, invited public comments.¹³ While authoritative guidance addressing these questions was not released until the Proposed Regulations, the IRS did publish three key Notices following the release of Reg. §1.163-8T that each offer key insight regarding these issues for pass-through entities and their owners.

IRS Guidance Released After Reg. Section 1.163-8T: Notice 88-20, Notice 88-37, and Notice 89-35

In a series of Notices published after the issuance of Reg. §1.163-8T, the Treasury and the IRS provided further guidance regarding the allocation of interest expense with respect to certain transactions involving partnerships, partners, S corporations, and S corporation shareholders. Study of these Notices and in particular Notice 89-35, is central to the understanding the application of the Proposed Regulations on partnerships and S corporations, especially as much of the Proposed Regulations are drawn from the lack of concrete guidance in Notice 89-35 applicable to pass-through entities.

Notice 88-20

In Notice 88-20, the IRS announced an intention to issue further Proposed Regulations that, for debt proceeds deposited into an account on or before December 31, 1987, taxpayers could treat any expenditure made from any account of the taxpayer or from cash within 30 days before or after cash proceeds are deposited in that account or any other account of the taxpayer as made from such proceeds. The Notice also provides that forthcoming Proposed Regulations would also allow, for debt proceeds received in cash on or before December 31, 1987, that taxpayers may treat any expenditure made from any account of the taxpayer or from cash within 30 days before or after the debt proceeds are deposited in any account of the

taxpayer or received in cash as made from such proceeds. Notice 89-35 supplanted Notice 88-20.

Notice 88-37

Notice 88-37 provides guidance with respect to reporting of interest expense with respect to debt-financed acquisitions and debt-financed distributions involving partnerships and S corporations for taxable years beginning after December 31, 1986. Per Notice 88-37, interest expense allocated to a trade or business expenditure (within the meaning of Reg. §1.163-8T(b)(7)) of a passthrough entity should be reported in Part II of Schedule E. After interest expense is allocated for the pass-through, the expense is reported in the appropriate places on the Form 1040, *U.S. Individual Tax Return*. Applying Notice 88-37 would, for example, result in a partner reporting interest expense allocable to a passive activity on Form 8582.

Notice 89-35

Notice 89-35 provides that interest expense of the owner of a passthrough entity (for Reg. §1.163-8T purposes), is allocated amount the assets of the entity using any reasonable method. One example of such a reasonable method includes allocating the debt among all of the assets of the passthrough entity based either the fair market value, the book value, or the adjusted basis of the assets, reduced by the amount of any debt of the entity or the amount of any debt that the owner of the entity allocated to such assets.¹⁴ Notice 89-35 also provides that interest expense of debt proceeds allocated to a contribution to the capital of a passthrough entity shall be allocated using any reasonable method for purposes of Reg. §1.163-8T. An example of such reasonable method here would be allocating the debt among the assets of the passthrough entity or tracing the debt proceeds to the expenses of the passthrough entity.¹⁵

Where a distribution is debt-financed, Notice 89-35 provides both a general allocation rule as well as an optional allocation rule.¹⁶ The general allocation rule applies the principles of Reg. §1.163-8T to interest allocation associated with any distribution that is debt-financed through application of a tracing paradigm to determine the character of that interest expense for purposes of Reg. §1.163-8T.¹⁷ Here, the debt proceeds and the corollary interest expense related to the distribution that is debt-financed are allocated under Reg. §1.163-8T in accordance with the use of the distributed debt proceeds by the distributed owner of the

¹¹ T.D. 8145, 52 Fed. Reg. 24,996 (July 2, 1987).

¹² T.D. 8145, 52 Fed. Reg. 24,996 (July 2, 1987).

¹³ T.D. 8145, 52 Fed. Reg. 24,996 (July 2, 1987).

¹⁴ Notice 89-35.

¹⁵ Notice 89-35.

¹⁶ Notice 89-35.

¹⁷ Notice 89-35.

passthrough entity.¹⁸ In the case where an owner's share of a passthrough entity's interest expense related to a debt-financed distribution exceeds the entity's interest expense on the portion of debt proceeds distributed to that particular owner, Notice 89-35 provides that the passthrough entity may allocate such excess interest expense using any reasonable method.

The optional allocation rule applicable to any distribution that is debt-financed allows a passthrough entity to 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.¹⁹ Under the optional allocation rule, distributed debt proceeds are traced to the owner's use of the borrowed funds to the extent that the distributed debt proceeds exceed the entity's expenditures, not including distributions, for the tax year to which the debt proceeds are not otherwise allocated.²⁰

The 2018 Proposed Regulations

On December 28, 2018, Treasury and the IRS published Proposed Regulations²¹ under §163(j), as amended by the TCJA, in a notice of proposed rulemaking (2018 Proposed Regulations). Interestingly, these 2018 Proposed Regulations did not include rules to further address how §1.163-8T would apply to passthrough entities.

Following the publication of the 2018 Proposed Regulations, a public hearing occurred on February 27, 2019. In conjunction with this public hearing, Treasury and the IRS also received written comments indicating that, for purposes of §163(j), a tracing rule based on how a passthrough entity owner uses the proceeds of a debt-financed distribution would not comport with §163(j)(4).²² Section 163(j)(4) provides that §163(j) "shall be applied to at the partnership level." Thus, in conjunction with making final portions of the 2018 Proposed Regulations, Treasury and the IRS published new proposed rules, specific to partnerships and partners, and S corporations and shareholders, which seek to clarify how the rules under Reg. §1.163-8T work when applied both to these entities and their owners, and in light of the entity-level limitation contained in §163(j)(4).

Proposed Treasury Regulation Section 1.163-14

While the preamble to Reg. §1.163-8T provided that this guidance would generally apply to partnerships, S corporations, and their respective owners, however, the Proposed Regulations (i.e., Prop. Reg. §1.163-14) provide additional rules for the purposes of applying the Reg. §1.163-8T rules to passthrough entities.²³ The Proposed Regulations provide that interest expense on a debt incurred by a passthrough entity is allocated in the same manner as the debt to which such interest relates is allocated, and that debt is generally allocated by tracing disbursements of the debt proceeds to specific expenditures.²⁴ In publishing this new Proposed Regulations, the Treasury and the IRS announced that Reg. §1.163-8T did not fully address one specific use of debt by a passthrough entity; namely, to make distributions to its owners.²⁵ Accordingly, and to better account for the types of expenditures made by passthrough entities (including, distributions), the new Proposed Regulations aim to both address the circumstances applicable to passthrough entities and to provide a framework for these entities to determine how much of its interest expense is allocable to a trade or business for purposes of applying §163(j).²⁶ Notably, the Proposed Regulations would apply *before* a passthrough entity applies any of the rules in §163(j) including, Reg. §1.163(j)-10, which provides special rules for allocating various tax items.

In application, a passthrough entity would continue to apply the operative rules in Reg. §1.163-8T to allocate debt and the interest expense associated with such debt.²⁷ However, instead of generally tracing debt proceeds to the types of expenditures described under Reg. §1.163-8T(b) and treating any interest expense associated with such debt proceeds in the manner described under Reg. §1.163-8T(a)(4), a passthrough entity would now trace debt proceeds to the types of expenditures described under proposed Prop. Reg. §1.163-14(b)(2) and treat any interest expense associated with such debt proceeds in the manner that is described under Prop. Reg. §1.163-14(b)(1).²⁸

DEBT FINANCED DISTRIBUTIONS

Before the TCJA, partners in a partnership were responsible for determining the applicability of any

¹⁸ Notice 89-35.

¹⁹ Notice 89-35.

²⁰ Notice 89-35.

²¹ Prop. Reg. §1.163(j)-2, REG-106089-18, 83 Fed. Reg. 67,490 (Dec. 28, 2018).

²² Reg. §1.163-8T.

²³ Prop. Reg. §1.163-14, REG-107911-18 (July 28, 2020).

²⁴ Prop. Reg. §1.163-14.

²⁵ Prop. Reg. §1.163-14.

²⁶ Prop. Reg. §1.163-14.

²⁷ Prop. Reg. §1.163-14.

²⁸ Preamble to Prop. Reg. §1.163-14, REG-107911-18, 16-17 (July 28, 2020).

limitations on the use of proceeds from debt because limitations on interest expense deductibility were determined at the partner level.²⁹ The TCJA amended §163(j) such that the partnership is required to calculate irrespective of if a limitation applies to the partnership related to trade or business interest expenses.³⁰ Prop. Reg. §1.163-14 provide guidance for partners and partnerships as to the methods that should be used to allocate interest expense in cases where a partner receives a distribution that is financed from debt.³¹

In Prop. Reg. §1.163-14, when debt proceeds of a passthrough entity are allocated under Reg. §1.163-8T to distributions to the owners of the entity, the debt proceeds distributed to any owner and the associated interest expense are to be allocated under the procedures set forth in Prop. Reg. §1.163-14(d).³² The Proposed Regulations require that partnerships allocate the interest expense of the partners not receiving a debt-financed distribution first.³³ This interest expense is allocated to trade or business expense to the extent of the partnership's expenses.³⁴ The character of any remaining interest expense is determined based on the the partnership's asset basis.³⁵ Then, the Proposed Regulations allocate the interest expense of the partner receiving the debt-financed distribution. If there is any remaining business expense that was not used by the other partners, it is used first to allocate the interest expense. Then the partner receiving the debt-financed distribution looks to the use of the proceeds of the distribution to determine the character of any additional interest expense.³⁶

In general, Prop. Reg. §1.163-14(d) adopts a rule that is substantially similar to that in Notice 89-35, with certain modifications. Included among these modifications are that instead of providing that passthrough entities may use the optional allocation rule, the Prop. Reg. §1.163-14(d) would require passthrough entities to apply a rule that is similar to the optional allocation rule.³⁷ Also among these modifications is that instead of providing that passthrough entity may allocate excess business interest expense using any reasonable method, Prop. Reg. §1.163-14(d) generally provides that the passthrough entity must al-

locate excess business interest expense based on the adjusted tax basis of the passthrough entity's assets.³⁸

Prop. Reg. §1.163-14(d)(1) provides a rule based in principle on the optimal allocation rule in Notice 89-35. Under this rule, distributed debt proceeds (debt proceeds of a passthrough entity allocated under Reg. §1.163-8T to distributions to owners of the entity) would first be allocated under Prop. Reg. §1.163-14(d)(1)(i) to the passthrough entity's available expenditures.³⁹ Available expenditures are defined as those expenditures of a passthrough entity made in the same taxable year as the distribution, but only to the extent that debt proceeds (including other distributed debt proceeds) are not otherwise allocated to such expenditures.⁴⁰ This approach is consistent with the idea that money is fungible (a passthrough entity may be fairly treated as distribution non-debt proceeds other than debt proceeds and using debt proceeds rather than non-debt proceeds to finance its non-distribution expenditures) and seeks to coordinate the interest allocation rules with the entity-level approach to passthroughs adopted in §163(j).⁴¹ Where the distributed debt proceeds exceed the passthrough entities available expenditures, the excess amount of distributed debt proceeds would be allocated to distributions to owners of the passthrough entity (debt financed distributions) under Prop. Reg. §1.163-14(d)(1)(ii).⁴²

After determining the amount of its distributed debt proceeds allocated to available expenditures and debt financed distributions, a passthrough entity would use this information to determine the tax treatment of each owner's allocable interest expense (i.e., an owner's share of interest expense associated with the distributed debt proceeds otherwise distributed under §704(b) or §1366(a)).⁴³ To assist the passthrough entity and owner in determining the tax treatment of each owner's allocable interest expense, Prop. Reg. §1.163-14(d)(2) provide rules for determining the portion of each owner's allocation interest expense that is: (1) debt-financed distribution interest, (2) expenditure interest expense, and (3) excess interest expense.⁴⁴ These three categories of allocable interest expense are mutually exclusive. A specific dollar of allocable interest expense cannot simultaneously be both debt-financed distribution interest expense and expenditure interest expense.⁴⁵

Once a passthrough entity categorizes each owner's allocable interest expense in this manner, it would

²⁹ Preamble to Prop. Reg. §1.163-14, REG-107911-18, 16-17.

³⁰ Preamble to Prop. Reg. §1.163-14, REG-107911-18, 16-17.

³¹ Preamble to Prop. Reg. §1.163-14, REG-107911-18, 16-17.

³² Prop. Reg. §1.163-14(d).

³³ Prop. Reg. §1.163-14(d)(1).

³⁴ Prop. Reg. §1.163-14(d)(1).

³⁵ Prop. Reg. §1.163-14(d)(1).

³⁶ Prop. Reg. §1.163-14(d)(1).

³⁷ Prop. Reg. §1.163-14(d)(1).

³⁸ Prop. Reg. §1.163-14(d)(1).

³⁹ Prop. Reg. §1.163-14(d)(1).

⁴⁰ Prop. Reg. §1.163-14(d)(1).

⁴¹ Prop. Reg. §1.163-14(d)(1).

⁴² Prop. Reg. §1.163-14(d)(1).

⁴³ Prop. Reg. §1.163-14(d)(1).

⁴⁴ Prop. Reg. §1.163-14(d)(2).

⁴⁵ Prop. Reg. §1.163-14(d)(2).

next apply Prop. Reg. §1.163-14(d)(3) to determine the tax treatment of that interest expense.⁴⁶ The manner in which the tax treatment of allocable interest expense is determined depends on how the allocable interest expense was categorized under Prop. Reg. §1.163-14(d)(2). At base, each of the three categories of allocable interest expense, along with the the tax treatment of interest expense in each of these categories is addressed in Notice 89-35.⁴⁷ Debt-financed distribution interest expense is referred to in Notice 89-35 as an owner's share of a passthrough entity's interest expense on debt proceeds allocated to each owner.⁴⁸ Similar to what is contained in Notice 89-35, Prop. Reg. §1.163-14(d)(3)(i) would generally provide that such interest expense is allocated under Reg. §1.163-8T in accordance with the owner's use of the debt proceeds.⁴⁹

Notably, under Notice 89-35, which generally allows any reasonable method for determining the tax treatment of excess interest expense, Prop. Reg. §1.163-14(d)(3)(iii) would generally provide that the tax treatment excess interest expense is determined by allocating the distributed debt proceeds among all the assets of the passthrough entity, pro-rata, based on the adjusted basis of these assets.⁵⁰

Prop. Reg. §1.163-14(d)(4) also provides rules addressing the tax treatment of the interest expense of the transferee owner where the transferor had previously been allocated debt-financed distribution interest expense. In the case of a transfer of an interest in a passthrough entity, any debt-financed distribution interest expense of the transferor generally shall be treated as excess interrelation expense by the transferee.⁵¹ However, in the case of a transfer of an interest in a passthrough entity to a person who is related to the transferor, any debt-financed distribution interest expense of the transferor shall continue to be treated as debt-financed distribution interest exposed by the related party transferee, and the tax treatment of such debt-financed distribution expense shall be the same to the related party transferee as it was to the transferor.⁵² A related party for these purposes is the same as the meaning under §267(b) or §707(b)(1).

Prop. Reg. §1.163-14 also includes several operational rules that clarify the application of some of the provisions in Reg. §1.163-8T as they apply to pass-

through entities.⁵³ As an example, Prop. Reg. §1.163-14(e) would provide an ordering rule applicable to the repayment of debt by passthrough entities similar to the rules in Reg. §1.163-8T(d)(1).

DEBT FINANCED ACQUISITIONS

Prop. Reg. §1.163-14(f) adopts a rule providing that the tax treatment of an owner's interest expense associated with a debt financed acquisition (either by purchase or contribution) will be determined by allocating the debt proceeds among the adjusted tax basis of the entity's assets.⁵⁴ The owner would allocate the debt proceeds in proportion to the relative adjusted tax basis of the entity's assets reduced by any assets in accordance with the rules in Reg. §1.163(j)-10(c)(5)(i) reduced by any debt allocated to such assets.⁵⁵ Once the pass-through entity's owner chooses a method for allocating the debt proceeds for this purpose, the owner must consistently apply the same method in all subsequent tax years.⁵⁶ With respect to tax return reporting, a pass-through owner will report interest expense paid or incurred in connection with debt-financed acquisitions on her Form 1040 in accordance with the asset to which the interest expense is allocated, which harkens to the nature of reporting prescribed under Notice 88-37.

Treasury and the IRS have requested comments regarding whether asset basis (either adjusted tax basis or adjusted tax basis based on the rules in Reg. §1.163(j)-10(c)(5)(i) less the amount of debt allocated to assets under Prop. Reg. §1.163-14 and Reg. §1.163-8T is appropriate as the sole method for allocating interest expense.

Change in Pass-through Entity Ownership

The Proposed Regulations also provide guidance regarding the change in pass-through entity ownership.⁵⁷ If the transfer is between unrelated parties,⁵⁸ any transfer of an ownership interest will not be a reallocation event under Reg. §1.163-8T, except where Prop. Reg. §1.163-14(d)(4) applies. In this case, a debt-financed distribution interest expense is treated as excess debt-financed distribution interest expense by the transferee. The transferee then must determine the tax treatment of the interest expense by allocating the associated debt proceeds among the assets of the

⁴⁶ Prop. Reg. §1.163-14(d)(2).

⁴⁷ Prop. Reg. §1.163-14(d)(2).

⁴⁸ Prop. Reg. §1.163-14(d)(2).

⁴⁹ Prop. Reg. §1.163-14(d)(2).

⁵⁰ Prop. Reg. §1.163-14(d)(2).

⁵¹ Prop. Reg. §1.163-14(d)(4).

⁵² Prop. Reg. §1.163-14(d)(4).

⁵³ Prop. Reg. §1.163-14(d)(4).

⁵⁴ Prop. Reg. §1.163-14(f).

⁵⁵ Prop. Reg. §1.163-14(f).

⁵⁶ Prop. Reg. §1.163-14(f).

⁵⁷ Prop. Reg. §1.163-14(g).

⁵⁸ Defined per §267(b) and §707(b).

pass-through entity. Related taxpayers may assume and continue the interest tax treatment of the transferee.⁵⁹

Prop. Reg. Section 1.163-14: Example & Explanation

Prop. Reg. §1.163-14 offers seven examples,⁶⁰ which all address debt financed distributions. In the simplest of these examples, the Proposed Regulations explain how the pass-through entity and its owners would treat and report interest expense related to a debt financed distribution.

In one example (where the total distributed debt proceeds does not exceed available expenditures), two individuals are partners in a partnership (AB) AB conducts two businesses: a manufacturing business, which is a trade or business for purposes of §163,⁶¹ and a separate commercial real estate leasing business, which is an activity described under §469.⁶² In Year 1, AB borrows \$100,000 from an unrelated third party lender and executes a note in favor of the same. This loan is the only outstanding liability on AB's balance sheet. Also, during Year 1, AB incurs: (1) \$80,000 in manufacturing expenses; (2) \$120,000 in leasing expenses. AB makes a distribution of \$100,000 to A in Year 1, which A uses to buy herself a new speedboat. AB pays \$10,000 in interest expense on the third-party loan, and allocates this interest expense in accordance with §704(b) equally to A and B (\$10,000/2). As a result, A and B each have \$5,000 of allocable interest expense under Prop. Reg. §1.163-14(d)(5)(i).

AB will treat the proceeds of the third-party loan as being distributed to A.⁶³ Starting with Prop. Reg. §1.163-14(d)(1)(i), and to the extent that AB has available expenditures, AB must allocate any distributed debt proceeds to those available expenditures. As an illustration, in Year 1, AB will have \$200,000 of available expenditures under Prop. Reg. §1.163-14(d)(5)(ii) (\$80,000 in manufacturing expenses plus \$120,000 in leasing expenses) and \$100,000 of distributed debt proceeds under Prop. Reg. §1.163-

14(d)(5)(iii). Accordingly, AB will allocate all \$100,000 of the distributed debt proceeds to available expenditures as follows: \$40,000 to manufacturing expenses ($\$100,000 \times (\$80,000/\$200,000)$), and \$60,000 to leasing expenses ($\$100,000 \times (\$120,000/\$200,000)$). Since the total amount of AB's distributed debt proceeds (\$100,000) is less than its available expenditures (\$200,000), none of the \$100,000 of distributed debt proceeds will be allocable to debt financed distributions as required under Prop. Reg. §1.163-14(d)(1)(ii).

Since all of AB's distributed debt proceeds (\$100,000) are allocable to available expenditures (\$200,000), A and B may treat all \$5,000 of each's interest expense as expenditure interest expense. Under Prop. Reg. §1.163-14(d)(3), A and B will then treat their respective interest expense in the same manner as the distributed debt proceeds (\$100,000) that were allocated to available expenditures. For A, the result is that her \$5,000 interest expense deduction is allocated as follows: \$2,000 is business interest expense ($\$5,000 \times (\$40,000^{64}/\$100,000)$), and \$3,000 of interest expense allocated to rental expenditures ($\$5,000 \times (\$60,000^{65}/\$100,000)$). B's \$5,000 of expenditure interest expense is allocated in an identical way as to A. In sum, \$4,000 (A and B each have \$2,000 of expenditure interest expense treated as business interest expense) of interest expense associated with the distributed debt proceeds (\$100,000) is business interest expense of AB, which is subject to §163(j) at the partnership (AB) level.

Implications of Prop. Reg. Section 1.163-14 for Partnerships and S Corporations

Arguably, Notice 89-35, along with the 2018 Proposed Regulations, did not fully address pass-through entities and their owners with respect to the application of Reg. §1.163-8T. Notice 89-35 provided guidance on debt financed distributions, providing that taxpayers may employ a general and optional allocation rule to address the same. With respect to debt-financed acquisitions of pass-through interests, Notice 89-35 provided that interest expense of the pass-through owner of should be allocated among the assets of the entity using any reasonable method. With respect to Reg. §1.163-8T, the list of expenditures contained in this guidance did not account for use of debt proceeds.

The Proposed Regulations would render Notice 89-35 obsolete, and provide long-awaited guidance

⁵⁹ Prop. Reg. §1.163-14(d)(4).

⁶⁰ Prop. Reg. §1.163-14(h). There are seven examples in the Proposed Regulations with variations on these facts for where the pass-through entity has no rental expenditures, where the pass-through entity makes non pro-rata distributions, where the partner receiving the loan proceeds distribution sells her partnership interest to an unrelated third-party, where the partner receiving the loan proceeds distribution sells her partnership interest to a related third-party (per §267(b) or §707(b)(1)), and where the pass-through entity is an S corporation with equal shareholders.

⁶¹ Specifically, a business defined in Reg. §1.163(j)-1(b)(44).

⁶² Reg. §1.469-4(b)(2).

⁶³ Reg. §1.163-8T.

⁶⁴ This represents A's share of AB's manufacturing expenses.

⁶⁵ This represents A's share of AB's leasing expenses.

specifically applicable to pass-through entities and owners as to how they determine the allocations for distributed debt proceeds. Prop. Reg. §1.163-14 imposes new allocation requirements to categorize interest expense associated with a debt-financed distribution into a number of categories, and allows for allocation trade or business, investment, and personal expense, which could result in significant benefit to partners and owners.

As example of how the allocation paradigm of the Proposed Regulations differs from that of Reg. §1.163-8T is illustrated in the example described above (which is based on Prop. Reg. §1.163-14(h)(1)). Under Reg. §1.163-8T, if the loan proceeds were used for personal expenditures (e.g., a A's speedboat), the related interest expense would not be deductible. The allocation method under Reg. §1.163-8T focuses on the use of the proceeds by the owners who receive the debt-financed distributions, and prohibited deduction where the owner used the funds for a personal expenditure. Conversely, if the loan proceeds were used in income-producing activities or investments, the related interest expense would be deductible. Moreover, and under Reg. §1.163-8T, any deduction for interest expense is limited to net investment income, although the excess investment interest expense may be carried forward.

Prior to the release of the Proposed Regulations, Notice 89-35 provided the means for pass-through entities and their owners to utilize an optional allocation method. Through this optional allocation method, to the extent a pass-through entity has not already allocated other debt to specific operating expenditures, the entity would be permitted to allocate the debt actually used for distributions to those expenditures, without consideration of when those expenses were

incurred. This method bifurcates the connection of the debt proceeds to operational expenditures of the entity, which may allow a favorable treatment for the pass-through entity. This method also removes the need for the owners to make a determination separately based on their use of the funds, and allows the interest to be characterized as a deductible component of "ordinary income" on Schedules K-1. Accordingly, while the Proposed Regulations would render Notice 89-35 obsolete, they would also not subject pass-through owners to the arguably more restrictive paradigm of Reg. §1.163-8T.

The Proposed Regulations provide clarity and, potentially, opportunity for pass-through entities and their owners in contrast to the debt tracing guidance under Reg. §1.163-8T by expanding upon the optional allocation model in Notice 89-35. Although the allocation 'waterfall' rules under Prop. Reg. §1.163-14 are not devoid of complexity, they might provide more favorable interest expense deductibility for owners under certain circumstances. As one such circumstance, if interest rates continue to make refinancing attractive for pass-through entities that own and develop real estate, the Proposed Regulations could allow allocation of a portion of the debt proceeds distribution derived from refinancing in the vein of Notice 89-35 (and without the subsequent limitations found under Reg. §1.163-8T). Key for real estate entities may be to the extent the entity has available expenditures including, rental expenditures.

Treasury and the IRS have invited public comments and written requests for hearings on these Proposed Regulations; however, no period has been set by publication as of publication the time this article was published.