

Part I

Section 702.—Income and Credits of a Partner

26 CFR: (None)
(Also: 62, 163)

Rev. Rul. 2008-38

ISSUES

(1) In the case of an individual, is interest paid or accrued on indebtedness allocable to property described in § 163(d)(5)(A)(ii) of the Internal Revenue Code deductible (after the application of the § 163(d)(1) limitation) in determining the taxpayer's adjusted gross income or does the interest (after the application of the § 163(d)(1) limitation) instead constitute an itemized deduction?

(2) If an individual has both investment interest expense attributable to indebtedness allocable to property described in § 163(d)(5)(A)(ii) and investment interest expense attributable to indebtedness allocable to property described in § 163(d)(5)(A)(i) and the individual's aggregate investment interest expense is greater than the individual's net investment income, how does the individual determine the portion of the allowed

investment interest deduction that is deductible in determining the taxpayer's adjusted gross income and the portion that constitutes an itemized deduction?

FACTS

Situation 1

PRS is a partnership that is engaged solely in the trade or business of trading securities for its own account and not for customers. LP, an individual, owns an interest in PRS as a limited partner. LP does not materially participate (as that term is used in § 469) in the activity in which PRS is engaged. The taxable year for PRS and LP is the calendar year.

PRS incurs indebtedness in its trade or business of trading securities. In Year 1, LP's distributive share of PRS' income, gain, loss, deduction, and credit includes \$200x of interest expense incurred by PRS with respect to its indebtedness. LP's net investment income, as defined in § 163(d)(4), for Year 1 is equal to \$150x. During Year 1, LP's distributive share of PRS' interest expense is the only interest paid or accrued by LP (either directly or through any flow-through entity) on indebtedness properly allocable to property held for investment (as defined in § 163(d)(5)(A)). LP's distributive share of PRS' interest expense is not subject to any limitation under § 465 or 704(d).

Situation 2

The facts are the same as in Situation 1 except that during Year 1 LP also pays \$100x of interest expense on indebtedness properly allocable to stocks and bonds held by LP for investment (within the meaning of § 163(d)(5)(A)(i)). None of the \$100x of interest expense is described in § 265(a).

LAW AND ANALYSIS

Section 62(a) provides that the term “adjusted gross income” means, in the case of an individual taxpayer, gross income minus the deductions specified in § 62(a)(1) through (21).

Section 62(a)(1) provides that deductions allowed by chapter 1 of subtitle A, other than by part VII of subchapter B, which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee, are taken into account in determining the adjusted gross income of the taxpayer.

Section 63(d) defines the term “itemized deductions” as including all deductions allowable under chapter 1 of subtitle A other than deductions allowable in arriving at adjusted gross income and the deduction for personal exemptions provided in § 151.

Section 163(d)(1) provides that, in the case of a noncorporate taxpayer, the amount allowed as a deduction under chapter 1 of subtitle A for investment interest for any taxable year shall not exceed the amount of the taxpayer’s net investment income for the taxable year. Section 163(d)(2) provides that any amount not allowed as a deduction for a given taxable year by reason of § 163(d)(1) shall be treated as investment interest paid or accrued by the taxpayer in the next succeeding taxable year.

Section 163(d)(3)(A) provides that the term “investment interest” means any interest allowable as a deduction under chapter 1 of subtitle A (determined without regard to paragraph (1) of § 163(d)) which is paid or accrued on indebtedness properly allocable to property held for investment.

Section 702(a)(8) provides that, in determining the partner's income tax, each partner shall take into account the partner's distributive share of the partnership's taxable income or loss, exclusive of the items requiring separate computation under § 702(a)(1) through (7). Section 702(a)(1) through (6) lists specific items of income, gain, loss, deduction or credit that must be separately stated by a partnership. Section 702(a)(7) provides that other items of income, gain, loss, deduction or credit also must be separately stated if required by regulations prescribed by the Secretary.

Section 702(b) provides that the character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of § 702(a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Section § 1.702-1(a)(8)(ii) of the Income Tax Regulations provides that each partner must take into account separately the partner's distributive share of any partnership item that, if separately taken into account by the partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately.

Section 706(a) provides that, in computing the taxable income of a partner for a taxable year, the inclusions required by § 702 and § 707(c) with respect to a partnership shall be based on the income, gain, loss, deduction, or credit of the partnership for any taxable year of the partnership ending within or with the taxable year of the partner.

Revenue Ruling 2008-12, 2008-10 IRB 520, holds that, by virtue of the definition of the term “property held for investment” in § 163(d)(5)(A)(ii), a noncorporate limited partner’s distributive share of interest expense on indebtedness allocable to a partnership’s trade or business of trading securities for its own account constitutes investment interest described in § 163(d)(3) and is therefore subject to the limitation on the deduction of investment interest in § 163(d)(1), provided that the limited partner does not materially participate (as that term is used in § 469) in the trading activity. The ruling further holds that a partnership that engages in the trade or business of trading securities for its own account must separately state the amount of interest paid or accrued on indebtedness properly allocable to its trading activity because the degree of participation by each noncorporate partner of the partnership could limit the deductibility of such interest by the partner on his or her individual tax return.

Situation 1

LP’s only investment interest (as defined in § 163(d)(3)) for Year 1 is LP’s \$200x distributive share of PRS’ interest expense in Year 1. This investment interest is subject to the limitation on investment interest in § 163(d)(1). Section 163(d)(1) limits LP’s deduction for investment interest in Year 1 to \$150x, the amount of LP’s net investment income (as defined in § 163(d)(4)) for that year. Accordingly, in Year 1, LP may deduct \$150x of LP’s \$200x distributive share of the interest expense of PRS. Pursuant to § 163(d)(2), the \$50x of interest expense not allowed as a deduction for Year 1 is treated as investment interest paid or accrued in Year 2.

LP's distributive share of PRS' Year 1 interest expense that is allowed under § 163(d)(1) is deductible in arriving at LP's adjusted gross income pursuant to § 62(a)(1). Section 702(b) provides that the character of any item of deduction included in a partner's distributive share under § 702(a) shall generally be determined as if such item were incurred in the same manner as incurred by the partnership. Because the interest expense of PRS is attributable to the carrying on of its trade or business of trading securities, LP's share of that expense is described in § 62(a)(1). While LP's distributive share of PRS' interest expense is subject to the investment interest limitation in § 163(d)(1), the investment interest limitation does not affect the character of the interest expense for other purposes of the Code. Thus, except for purposes of applying the investment interest limitation, LP's distributive share of PRS' interest expense deductions are characterized under § 702(b).

Accordingly, \$150x of LP's distributive share of the Year 1 interest expense of PRS is deductible in arriving at LP's adjusted gross income. Therefore, such amount does not constitute an itemized deduction (as defined in § 63(d)).

Situation 2

In Situation 2, in addition to LP's \$200x distributive share of PRS' Year 1 interest expense, LP also pays \$100x of interest expense on indebtedness properly allocable to stocks and bonds held by LP for investment (within the meaning of § 163(d)(5)(A)(i)). Accordingly, LP's total investment interest expense for Year 1 is \$300x. Pursuant to § 163(d)(1), LP is allowed to deduct only \$150x of this investment interest expense in Year 1.

To the extent that LP's \$150x of allowed investment interest deduction is attributable to indebtedness incurred in PRS' trade or business of trading securities, the deduction is taken into account in arriving at LP's adjusted gross income. To the extent the \$150x of allowed investment interest deduction is attributable to the indebtedness attributable to the stock and bonds held for investment, the deduction is not taken into account in arriving at LP's adjusted gross income and is instead reported as an itemized deduction.

When an individual has both investment interest expense attributable to property described in § 163(d)(5)(A)(i) and investment interest expense attributable to property described in § 163(d)(5)(A)(ii) and the individual's aggregate investment interest expense is greater than the individual's net investment income, the individual must allocate the taxpayer's net investment income to the two categories of investment interest expenses using a reasonable method of allocation. One reasonable method is to allocate the net investment income to the two categories of investment interest in the same proportion that the amount of investment interest in each category bears to the total amount of investment interest (the pro rata method). In Situation 2, two-thirds ($\$200x/\$300x$) of LP's aggregate investment interest expense is attributable to LP's interest in the trade or business of trading securities of PRS (property described in § 163(d)(5)(A)(ii)), and one-third ($\$100x/\$300x$) is attributable to stocks and bonds held by LP for investment (property described in § 163(d)(5)(A)(i)). Accordingly, using a pro rata method, two-thirds of LP's \$150x of net investment income is allocated to LP's distributive share of the interest expense of PRS, while one-third of LP's \$150x of net

investment income is allocated to LP's other investment interest expense. Therefore, using this method of allocation, of LP's allowed \$150x investment interest deduction in Year 1 under § 163(d)(1), \$100x is taken into account in arriving at LP's adjusted gross income under § 62(a), while the remaining \$50x constitutes an itemized deduction under § 63(d). The \$150x of investment interest that is not allowed as a deduction under § 163(d)(1) in Year 1 is treated as investment interest paid or accrued in Year 2 pursuant to § 163(d)(2). The \$150x of investment interest that is not allowed as a deduction under § 163(d)(1) in Year 1 is comprised of \$100x of investment interest attributable to LP's interest in PRS' trade or business (an interest described in § 163(d)(5)(A)(ii)) and \$50x of investment interest expense attributable to stocks and bonds held for investment (within the meaning of § 163(d)(5)(A)(i)).

HOLDINGS

Issue 1: In the case of an individual, interest paid or accrued on indebtedness allocable to property held for investment described in § 163(d)(5)(A)(ii) is (after the application of the § 163(d)(1) limitation) a deduction described in § 62(a)(1) and is therefore taken into account in determining the individual's adjusted gross income.

Issue 2: If an individual has both investment interest expense attributable to indebtedness allocable to property described in § 163(d)(5)(A)(i) and investment interest expense attributable to indebtedness allocable to property described in § 163(d)(5)(A)(ii) and the individual's aggregate investment interest expense is greater than the individual's net investment income, the individual must allocate the individual's net investment income between the two categories of investment interest expense using a

reasonable method of allocation. One reasonable method of allocation is to allocate the individual's net investment income to the two categories of investment interest in proportion to the relative amounts of interest expense within each category.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 2008-12 is amplified.

DRAFTING INFORMATION

The principal author of this revenue ruling is Faith P. Colson of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue ruling, contact Faith P. Colson at (202) 622-3060 (not a toll-free call).