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My Liabilities Are My Greatest Assets: Tax Court Decision in *Lipnick v. Commissioner*

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The characterization of interest expense as "business interest," "investment interest," or "personal interest" can have important tax consequences. However, many taxpayers are blissfully unaware of the tax treatment of interest expense if they use real estate refinancing proceeds to buy yachts or to make other personal expenses. A recent opinion issued by the U.S. Tax Court clarifies how the interest characterization rules work in the context of partnerships that have made debt-financed distributions to their partners.

Under Section 163 of the Internal Revenue Code, the deductibility of interest expense varies depending on how it is characterized. Interest allocable to a trade or business is generally deductible (subject to the limitations of new Section 163(j)). However, investment interest is deductible only to the extent of the taxpayer's investment income, and personal interest is generally not deductible at all. The characterization of interest expense is generally determined by tracing how the taxpayer used the proceeds of the underlying debt.

If a partnership incurs debt and distributes the proceeds to its partners, IRS guidance provides that the characterization of a partner's share of the partnership's interest expense is determined based on how the partner used the debt proceeds that were distributed to him.

In *Lipnick v. Commissioner*, 153 T.C. No. 1 (Aug. 28, 2019), the petitioner's father, Maurice Lipnick, was a partner in various real estate partnerships. Each of the various partnerships had incurred nonrecourse debt secured by its property and had distributed the excess debt proceeds to its partners. Lipnick's share of the proceeds was deposited in a personal bank account, and he then used the cash to invest in money market funds and other investment assets. In the years following the financings, the partnerships incurred interest expense on the loans, and reported to Lipnick his share of the interest expense on Forms K-1. Because he had used his share of the financing proceeds to acquire investment assets, Lipnick reported his share of the interest expense as "investment interest."

Lipnick later made a gift of a portion of his partnership interests to his son William Lipnick, and, when Maurice died, he bequeathed a portion of his remaining partnership interests to William. Subsequently, when the partnerships reported to William his share of the partnerships' interest expense, he reported it on his tax return as interest allocable to a trade or business.

The IRS had argued that, because William Lipnick received the partnership interests as a gift or bequest from his father, he "stepped into the shoes" of his father and was required to report his share of the partnerships' interest expense as investment interest. Because William Lipnick had little investment income, the interest would not have been deductible.

The court found no statutory or regulatory support for the IRS's argument, and instead cited a regulation that provides that if a taxpayer takes property subject to debt, and no debt proceeds are disbursed to the taxpayer, the taxpayer is treated as if it used the proceeds to make an expenditure with respect to the property. According to the court, when William Lipnick received the partnership interests by gift and bequest from his father, he took them subject to the underlying debt on the properties. He was therefore treated as having acquired the partnership interests in part for his share of the partnerships' debt, which allowed him to treat his share of the interest expense as allocable to a trade or business.

This case serves as a reminder that, if a partnership makes a debt-financed distribution, the characterization of a partner's share of the partnership's interest expense depends on how the partner used his share of the debt proceeds. This result may seem counterintuitive, and many taxpayers incorrectly assume that a partner's share of interest on debt secured by a partnership's real estate is always allocable to the real estate business.

In light of recent statutory changes, the consequences of the characterization of interest expense have become more

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complicated. Under pre-2017 law, taxpayers generally had a clear preference to have their interest expense treated as allocable to a trade or business (which was generally deductible) rather than as investment interest (which could only offset investment income). However, as part of the tax reform legislation enacted in 2017, new Section 163(j) of the Code generally limits business interest deductions to the taxpayer's business interest income plus 30% of the taxpayer's taxable income (with certain adjustments).

Although many businesses may qualify for exceptions to Section 163(j), new Section 461(l) imposes further restrictions. Under Section 461(l), individuals may use deductions attributable to trades or businesses to offset only income attributable to trades or business plus $250,000 of other income (or $500,000 in the case of a married couple filing a joint tax return). Therefore, if a taxpayer has a large amount of investment income and has interest deductions attributable to a trade or business, such deductions may not be able to offset the investment income. In such case, the taxpayer would be better off if the interest expense were treated as investment interest. Thus, the preferred characterization of interest expense is heavily dependent on a taxpayer's individual circumstances.

Although the reasoning of *Lipnick v. Commissioner* is sound, because of recent statutory changes, the characterization of interest expense as allocable to a trade or business may not always be favorable to the taxpayer.