PART XVI: DEDUCTION OF INTEREST AND EXPENSES

7932. Is interest expense deductible?

To be deductible, interest must be paid or accrued on "indebtedness" and the indebtedness must be that of the taxpayer. A taxpayer generally cannot deduct the interest he pays on the debt of another.[1] See also Q 7934.

However, certain interest expenses are not deductible: for example, interest paid on a loan used to buy or carry tax-exempt securities (see Q 7943); or interest on debt incurred or continued to buy or carry mutual funds to the extent that exempt-interest dividends are distributed to the shareholder (see Q 7859); and under certain circumstances, the interest on a loan used to buy or carry a life insurance policy or an endowment or annuity contract.[2]

The deduction of some interest expenses is deferred, such as the interest on borrowing incurred or continued to purchase or carry market discount bonds (Q 7945), Treasury bills, or short-term corporate obligations (Q 7944), and certain borrowing between related parties.[3] Cash basis taxpayers must allocate prepaid interest payments to the year or years in which payments represent a charge for the use of borrowed money and may take a deduction only for the amount properly allocable to the specific tax year.[4]

Special rules limit the deduction of personal interest (see Q 7933), qualified residence interest (see Q 7934), investment interest (see Q 7941), student loan interest (see Q 7947) and interest subject to the passive loss rules (see Q 7918, Q 7919). Proposed and temporary regulations provide complex and detailed rules for allocating interest expense for the purpose of applying these limits. See Q 7942 for an explanation of the interest tracing rules.

7933. What is personal interest? Is it deductible?

Personal interest is generally interest on debt incurred to buy consumer items (other than loans secured by a personal residence, as discussed in Q 7934), such as cars, televisions, etc. Personal interest is any interest *other than* interest allocable to passive activities (Q 7918), trade or business interest, investment interest (Q 7941), qualified residence interest (Q 7934), or interest payable under IRC Section 6601 on any unpaid portion of federal estate tax during the period there is an extension of time for payment in effect with respect to a reversionary or remainder interest.[5] Personal interest is not deductible.[6]

Personal interest includes interest on tax deficiencies. See *Robinson v. Comm.*,[7] where it was held (1) that Temporary Treasury Regulation Sections 1.163-8T and 1.163-9T(b)(2)(i)(A)

1. But see Treas. Reg. §1.163-1(b).
2. IRC Sec. 264.
3. IRC Sec. 267.
4. IRC Sec. 461(g).
5. IRC Sec. 163(h)(2).
6. IRC Sec. 163(h)(1).
7. 119 TC 44 (2002).

are valid, (2) that the interest on the underpayment of the taxpayer's income tax liability was nondeductible personal interest and (3) that *Redlark v. Comm.*[1] will no longer be followed.[2] Personal interest also includes otherwise deductible borrowing to buy personal life insurance.

Interest on *qualified higher education loans* (see Q 7947) is not personal interest.[3]

The allocation of debt to expenditures under temporary regulations is explained in Q 7942.

7934. Is interest on debt secured by a taxpayer's residence deductible?

Yes, within limits. Qualified residence interest is deductible, subject to certain definitions and limitations (see below and Q 7936). Qualified residence interest is interest paid or accrued during the taxable year on acquisition indebtedness or home equity indebtedness with respect to a qualified residence of the taxpayer.[4] Generally, it is deductible without regard to the expenditure to which it is allocated under the interest tracing rules. It is not taken into account in determining passive activity income or loss or the amount of investment interest.[5]

Interest paid by a taxpayer on a mortgage upon real estate of which he is the legal or equitable owner may be deducted as interest on indebtedness, even though the taxpayer is not directly liable on the mortgage obligation.[6] The Tax Court has held that a married couple was entitled to deduct amounts they paid on a construction loan taken by the builder as qualified residence interest although they were not personally obligated to repay the loan. The court concluded that the couple had a possessory and an equitable interest in the residence and could therefore deduct the applicable amounts.[7] The Tax Court has also held that married taxpayers could deduct interest they paid on a mortgage as qualified residence interest, even though the taxpayer's brother was the person directly liable on the mortgage obligation. The court found the taxpayers had held the benefits and burdens of ownership and thus were the equitable owners of the home and entitled to deduct qualified residence interest.[8]

The Tax Court denied a deduction for mortgage interest to individuals renting a home under a lease with an option to purchase the property; although the house was their principal residence, they did not have legal or equitable title to the home and the earnest money did not provide ownership status.[9] Similarly, the Tax Court held that because a taxpayer had an option agreement and not an agreement for the purchase and sale of property, the taxpayer could not deduct mortgage interest or real property taxes. According to the court, the taxpayer had not acquired sufficient benefits and burdens relating to the property to be deemed the equitable owner of the property.[10] An individual member of a homeowner's association was denied a

1. 106 TC 31 (1996), rev'd and remanded 141 F.3d 936 (9th Cir. 1998).
2. See also *Alfaro v. Comm.*, TC Memo 2002-309 (following *Robinson*, above), *aff'd*, 349 F. 2d 225 2003-2 USTC ¶50,715 (5th Cir. 2003); *Fitzmaurice v. U.S.*, 87 AFTR 2d 2001-1254, 2001-1 USTC ¶50,198 (S.D. Tex. 2001).
3. IRC Sec. 163(h)(2)(F).
4. IRC Sec. 163(h)(3)(A).
5. Temp. Treas. Reg. §1.163-8T(m)(3).
6. Treas. Reg. §1.163-1(b).
7. *Belden v. Comm.*, TC Memo 1995-360.
8. *Uslu v. Comm.*, TC Memo 1997-551.
9. *Blanche v. Comm.*, TC Memo 2001-63, *aff'd*, 2002 U.S. App. LEXIS (5th Cir. 2002).
10. *Jones v. Comm.*, TC Memo 2006-176.

deduction for interest paid by the association on a common building because the member was not the party primarily responsible for repaying the loan and the member's principal residence was not the specific security for the loan.[1] Assuming that the loan is otherwise a bona fide debt secured by the principal residence, a taxpayer may deduct interest paid on a mortgage loan from his qualified plan even where the amount by which the loan exceeded the $50,000 limit of IRC Section 72(p) is deemed to be a taxable distribution.[2]

Definitions

Acquisition indebtedness: The definition of acquisition indebtedness has three parts: (1) the debt must be incurred to acquire, construct, or substantially improve a residence; (2) the residence must be a "qualified residence"; and (3) the debt must be secured by the residence.[3] This definition is subject to the further definitions and limitations discussed below. Although all three parts must occur before the debt is acquisition indebtedness, they need not occur simultaneously. For example, a taxpayer may incur debt in 2014 to construct a residence and secure it by the residence. When the residence becomes a qualified residence in 2015, the debt would become acquisition indebtedness.

Home equity indebtedness: Home equity indebtedness means any indebtedness (1) that is secured by the qualified residence but is not acquisition indebtedness, (2) to the extent that it does not exceed the fair market value of the residence reduced by the amount of acquisition indebtedness. The aggregate amount that may be treated as home equity indebtedness (if incurred after October 13, 1987) is $100,000.[4] Limits with respect to debt incurred on or before October 13, 1987 are discussed below.

Incurred to acquire, construct, or substantially improve: There are two ways that the requirement that a debt be incurred to acquire, construct, or substantially improve a residence can be met. First, if the proceeds of a debt are used, within the meaning of the tracing rules found in Temporary Treasury Regulation Section 1.163-8T, to acquire, construct, or substantially improve the residence, the requirement is met. For example, a conventional, bank-financed consumer purchase of a principal residence will typically qualify under this provision because the loan proceeds will be traceable to the purchase of the residence. Alternatively, there is a 90-day rule (see below) under which debt may qualify. See Q 7942 for an explanation of the interest tracing rules. The limit on the amount of debt that may be treated as incurred to acquire, construct, or substantially improve a residence is the cost of the residence, including any improvements.

Qualified residence: A qualified residence is the taxpayer's principal residence and *one* other residence that the taxpayer (a) used for personal purposes during the year for more than the greater of 14 days or 10 percent of the number of days it was rented at a fair rental value, or (b) did not rent during the year.[5] The IRS has ruled that where a principal residence is destroyed and the taxpayer sells the remaining land or reconstructs the dwelling and reoccupies it as the

1. Let. Rul 200029018.
2. FSA 200047022.
3. IRC Sec. 163(h)(3)(B).
4. IRC Sec. 163(h)(3)(C).
5. IRC Sec. 163(h)(5)[(4)](A). See, e.g., FSA 200137033.

taxpayer's principal residence within a reasonable time period, the property will continue to be treated as a qualified residence for the period between the destruction and the sale or reconstruction and reoccupation of the land.[1]

Secured by: Temporary regulations provide generally that an instrument of debt such as a mortgage, deed of trust or land contract will meet the "secured by" requirement, while a security interest such as a mechanic's lien or judgment lien will not.[2] If indebtedness used to purchase a residence is secured by property other than the residence, the interest incurred on it is not residential interest but is personal interest.[3] Where a taxpayer uses an annuity contract as collateral to obtain or continue a mortgage loan, the allocable amount of interest is nondeductible to the extent the loan is collateralized by the annuity contract.[4] However, where loans from IRC Section 401(a) qualified plans were secured by the debtors' principal residences, the Service determined that the interest (which was otherwise deductible) was qualified residence interest.[5]

The Conference report for the Tax Reform Act of 1986 indicates that the security interest must be one perfected under local law.

In the case of housing cooperatives, debt secured by stock held by the taxpayer as a tenant-stockholder is treated as secured by the residence the taxpayer is entitled to occupy as a tenant-stockholder.[6] Even though state or local law (or the cooperative agreement) may restrict the use of such stock as security, the stock may be treated as securing such debt if the taxpayer can satisfy the IRS that the debt was incurred to acquire the stock.[7] Also, if state homestead laws or other debtor protection laws (in effect on August 16, 1986) restrict the rights of secured parties with respect to certain types of residential mortgages, interest on the debt is not treated as nondeductible personal interest, as long as the lender has a perfected security interest and the interest on the debt is otherwise qualified residence interest.[8]

7935. What deduction is permitted for premiums paid by a taxpayer for qualified mortgage insurance?

Premiums paid by a taxpayer during the taxable year for qualified mortgage insurance in connection with acquisition indebtedness for the taxpayer's qualified residence will be treated as interest that is qualified residence interest.[9] But the amount otherwise treated as interest must be reduced (but not below zero) by 10 percent of the amount per each $1,000 or fraction thereof ($500 for married individuals filing separate returns) that the taxpayer's adjusted gross income exceeds $100,000 ($50,000 for married individuals filing separate returns) for the taxable year.[10] This favorable tax treatment does not apply to any mortgage insurance contracts issued

1. Rev. Rul. 96-32, 1996-1 CB 177.
2. Temp. Treas. Reg. §1.163-10T(o)(1).
3. Let. Ruls. 8742025, 8743063, 8906031.
4. Rev. Rul. 95-53, 1995-2 CB 30.
5. Let. Rul. 8935051.
6. IRC Sec. 163(h)(5)[(4)](B).
7. See Temp. Treas. Reg. §1.163-10T(q)(2).
8. IRC Sec. 163(h)(5)[(4)](C).
9. IRC Sec. 163(h)(3)(E)(i).
10. IRC Sec. 163(h)(3)(E)(ii).

before January 1, 2007, and does not apply to amounts paid or accrued *after* December 31, 2013 (or property allocable to any period after that date).[1]

Qualified mortgage insurance means (1) mortgage insurance provided by the Department of Veterans' Affairs, FHA, or Rural Housing Service, and (2) private mortgage insurance (as defined by Section 2 of the Homeowners Protection Act of 1998).[2] A special rule for prepaid qualified mortgage insurance requires that any amount prepaid by a taxpayer for qualified mortgage insurance, which is properly allocable to any mortgage the payment of which extends to periods that are after the close of the taxable year in which the amount is paid, will be treated as paid in those periods so allocated. No deduction is allowed for the unamortized balance of an account if the mortgage is satisfied before the end of its term. This does not, however, apply to amounts paid for qualified mortgage insurance provided by the Department of Veterans' Affairs or the Rural Housing Service.[3]

7936. What limitations apply to a taxpayer's ability to deduct mortgage interest?

There is a limitation of $1,000,000 on the amount of aggregate debt that may be treated as "acquisition indebtedness," but the amount of refinanced debt that may be treated as acquisition indebtedness is limited to the amount of debt being refinanced.[4] The deductibility of interest incurred on "home equity indebtedness" is limited to debt of $100,000, or the amount of equity (that is, the fair market value of the home less the acquisition indebtedness), whichever is less.[5]

The effect of this limitation is that for transactions after 1987, a homeowner who wishes to borrow against the equity in his home can deduct the interest only on $100,000 of such debt or on the amount that is equal to his equity, whichever is less. Interest on amounts over this limit does not qualify as "home equity indebtedness."

Indebtedness incurred on or before October 13, 1987 (and limited refinancing of it) that is secured by a qualified residence is considered acquisition indebtedness. This pre-October 14, 1987 indebtedness is not subject to the $1,000,000 aggregate limit, but is included in the aggregate limit as it applies to indebtedness incurred after October 13, 1987.[6]

In an October 14, 2010 revenue ruling,[7] the IRS allowed as a deduction interest paid on "home equity indebtedness" that would otherwise qualify as "acquisition indebtedness" and that exceeds the $1,000,000 "acquisition indebtedness" limitation. The ruling rejects the decisions in two earlier Tax Court cases that held that any debt incurred to "acquire, construct, or substantially improve" a residence did not meet the definition of "home equity indebtedness," and

1. IRC Secs. 163(h)(3)(E), as amended by MFDRA 2007 and ATRA.
2. IRC Sec. 163(h)(4)(E).
3. IRC Sec. 163(h)(4)(F). The Service provided guidance on allocating prepaid qualified mortgage insurance premiums for 2007. See Notice 2008-15, 2008-4 IRB 313.
4. IRC Sec. 163(h)(3)(B); Notice 88-74, 1988-2 CB 385.
5. IRC Sec. 163(h)(3)(C).
6. IRC Sec. 163(h)(3)(D).
7. Rev. Rul. 2010-25, 2010-44 IRB 571, 10/14/2010.

the interest on such debt was only deductible to the extent it qualified under the "acquisition indebtedness" deduction.

The holdings in the Tax Court cases resulted in a $1,000,000 limitation on the amount of home mortgage debt that qualified for interest deduction (taken out in order to buy or build a house). Under the revenue ruling, however, indebtedness incurred to "acquire, construct, or substantially improve a residence" can qualify as "home equity indebtedness" to the extent it exceeds $1,000,000. The effect of this new ruling is to allow a deduction for interest paid on up to $1,100,000 of mortgages taken to build or buy houses (the first $1,000,000 of "acquisition indebtedness" + the first $100,000 of "home equity indebtedness").

Qualified residence interest is not subject to the rules that apply to personal interest even if the amounts borrowed are used to buy consumer goods (see Q 7933).[1]

Planning Point: In an interesting case, the Tax Court found that two unmarried home co-owners could not each deduct interest on $1.1 million of personal residence indebtedness, because the debt limitations are residence-based, rather than taxpayer-based. Instead, both taxpayers could deduct only the interest incurred on a total of $1.1 million of debt ($1 million of acquisition indebtedness and $100,000 of home equity indebtedness), even if they owned two residences. *Sophy v. Comm.*, 138 TC 204 (2012).

90-day Rules

In order to be *incurred to acquire, construct, or substantially improve* a residence, a debt must (a) be traceable under the tracing rules of Temporary Treasury Regulation Section 1.163-8T to the purchase of a qualified residence, or (b) qualify under one of two 90-day rules.[2]

The 90-day rule with respect to *acquiring* a residence provides that expenditures to acquire the residence within 90 days before or after the date the debt is incurred can be treated as incurred to acquire the residence.

The 90-day rule with respect to *constructing* or *substantially improving* a residence is somewhat more complex. A debt incurred *before* the residence or improvement is complete may be treated as incurred to construct or substantially improve a residence to the extent of expenditures (to construct or improve the residence) made no more than 24 months prior to the date the debt is incurred. If the debt is incurred no later than 90 days *after* the residence is complete, it may be treated as incurred to construct or substantially improve a residence to the extent of expenditures (to construct or improve the residence) made during the following period: beginning 24 months before the residence or improvement is complete, and ending on the date the debt is incurred.

Guidelines state that a determination of whether a residence or an improvement is complete depends upon all the facts and circumstances.[3]

1. TD 8145, 1987-2 CB 47.
2. Notice 88-74, above.
3. Notice 88-74, above.

Date of Loan

The date a debt is incurred will be the date the loan proceeds are disbursed to or for the benefit of the taxpayer (typically the loan closing date). There is an exception to this rule, to the effect that taxpayers may (apparently if it is to their advantage) treat debt as incurred on the date that a written application is made to incur the debt. This may be done only to the extent that funds are actually disbursed within a reasonable time, which is described as 30 days. (A reasonable time is also provided, in the event the application is rejected, for the taxpayer to reapply for a loan.) This provision does not apply for purposes of determining whether debt is pre-October 13, 1987 indebtedness.[1]

7937. How does refinancing of a taxpayer's mortgage debt impact the taxpayer's mortgage interest deduction?

Refinancing of a debt that was incurred to acquire, construct, or substantially improve a residence will be treated in the same manner as the first debt, to the extent that the proceeds are used to refinance the first debt. (The tracing rules found in Temporary Treasury Regulation Section 1.163-8T are used to determine how the proceeds are used. See Q 7942.)

If a taxpayer uses part of the loan proceeds to refinance an existing debt and the remaining proceeds for other purposes, the debt may qualify as acquisition indebtedness to the extent of the refinancing. The remaining debt may qualify as home equity indebtedness, up to the applicable limits.

7938. Can a taxpayer deduct mortgage interest overcharges that are later reimbursed?

Taxpayers generally are not permitted a deduction for an interest payment made on a debt for which no liability exists or reasonably appears to exist. However, if a taxpayer in good faith makes an interest payment on an adjustable rate mortgage (ARM), and a portion of the interest is later determined to have been erroneously charged, the taxpayer is permitted under IRC Section 163(a) to deduct the interest overcharge in the year paid. The taxpayer's recovery of the overcharge is includable in the taxpayer's gross income in the year of recovery, but only to the extent that the prior deduction of the overcharge reduced the taxpayer's income tax in a prior tax year. This result is the same whether the lender refunds the overcharge or reduces the outstanding principal on the taxpayer's mortgage by the amount of the overcharge.[2]

7939. How is mortgage interest debt that is incurred to acquire the interest of a taxpayer's spouse or former spouse pursuant to a divorce treated?

Regulations will provide that a debt incurred to acquire the interest of a spouse or former spouse pursuant to a divorce or legal separation will be treated as debt incurred to acquire a residence (for purposes of the definition of acquisition indebtedness in IRC Section 163) without

1. Notice 88-74, above.
2. Rev. Rul. 92-91, 1992-2 CB 49.

regard to the treatment the transaction would otherwise receive under IRC Section 1041 (regarding transfers incident to divorce).[1]

7940. How are prepaid interest and points treated for tax purposes?

Cash basis taxpayers must generally allocate prepaid interest payments to the year or years in which payments represent a charge for the use of borrowed money and may take a deduction only for the amount properly allocable to the specific tax year. However, points paid on debt incurred to buy or improve (and secured by) the taxpayer's principal residence are generally excepted from the prepaid interest limitation if payment of points is an established business practice in the area and the amount does not exceed the amount generally charged in the area.[2]

The IRS has stated that points paid in connection with the acquisition of a principal residence will generally be deductible by a cash basis taxpayer in the year paid if all of the following requirements are satisfied: (1) the amount is clearly shown on the settlement statement as points charged for the mortgage; (2) the points are computed as a percentage of the principal amount of the debt; (3) the payment of points is an established business practice in the area, and the amount of points paid does not exceed the amount generally charged in that area; (4) the points are paid in connection with the acquisition of a principal residence, and the loan is secured by that residence; (5) the points do not exceed the sum of the funds provided at or before closing by the purchaser, plus any points paid by the seller, and such funds paid by the purchaser may not be borrowed from the lender or mortgage; and (6) the points may not be a substitute for amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, property taxes, etc.[3]

The fact that a full deduction was available for points in the year they were paid did not mean the taxpayers were required to claim it in that year, according to a private letter ruling. A couple for whom it was more advantageous to take the standard deduction in the year the mortgage was obtained was not precluded from amortizing the points over the life of the loan, starting in the following tax year.[4]

In the event that points are paid by the seller (or charged to the seller) in connection with a loan to the taxpayer, they can still be treated as paid directly by the taxpayer if all the tests above are met, and provided that the taxpayer subtracts the amount of any seller-paid points from the purchase price of the home in computing its basis. But such treatment is not available for the following: (a) the amount of points paid on acquisition and allocable to principal in excess of the amount that may be treated as acquisition indebtedness; (b) points paid for loans used to improve (as opposed to acquire) a principal residence; (c) points paid for loans used to purchase or improve a residence that is not the taxpayer's principal residence; and (d) points paid on a

1. Notice 88-74, above. See also Let. Rul. 8928010.
2. IRC Sec. 461(g).
3. See IRS Pub. 530.
4. See Let. Rul. 199905033.

refinancing loan, home equity loan, or line of credit.[1] Loan origination fees include points paid on FHA and VA loans if the points were paid during taxable years beginning after 1990.[2]

Refinancing. Points paid on refinancing a principal residence must generally be amortized over the life of the loan.[3] However, a taxpayer who was able to establish a direct link between acquisition of a residence and the necessity of refinancing to complete that step was permitted to take a current deduction for such points.[4]

In *Hurley v. Comm.*,[5] the Tax Court stated that IRC Section 461(g)(2) provides two instances where a taxpayer may deduct the entire amount of points paid to refinance a personal residence: (1) when the taxpayer refinances in order to purchase a new home; or (2) refinances in order to make improvements to the home. Consequently, the court stated, points paid when a taxpayer refinances a personal residence simply or only for the purpose of obtaining a lower payment are not deductible (citing *Kelly v. Comm.*[6]). The court further stated that IRC Section 461(g)(2) applies if a taxpayer pays points to refinance in connection with the improvement of his principal residence; and based on the intent of Congress, the Tax Court applies a broad interpretation of the phrase "in connection with." In *Hurley*, the Tax Court upheld the taxpayers' $4,400 deduction for points they paid to refinance their mortgage where the evidence (testimonial and otherwise) demonstrated to the court's satisfaction that the taxpayers had negotiated the refinancing of their personal residence in order to finance their home improvements (e.g., the home improvements started nine days after the refinancing). The court acknowledged that the taxpayers had saved money as a result of the refinancing, but also noted that the refinancing had financially enabled the taxpayers to complete the improvements to their principal residence. The court determined it was immaterial that the cost of the taxpayers' improvements ($18,735) exceeded their savings from the refinancing ($14,400) because the difference was not grossly disproportionate.

If part of the refinancing proceeds are used to improve the taxpayer's principal residence, the portion of points allocable to the improvements may be deducted in the year paid.[7]

The IRS has stated that if a homeowner is refinancing a mortgage for a second time, a taxpayer may deduct all the not-yet-deducted points from the first refinancing when that loan is paid off.[8]

7941. Is interest on amounts borrowed in order to make or hold taxable investments deductible?

Yes, within limits. The Code permits a deduction for interest paid in the year on indebtedness properly allocable to property held for investment (investment interest).[9] See Q 7942 for an explanation of the interest tracing regulations.

1. See IRS Pub. 530.
2. Rev. Proc. 92-12, 1992-1 CB 664, as modified by Rev. Proc. 94-27, 1994-1 CB 613.
3. IR-2003-127 (Nov. 3, 2003).
4. *Huntsman v. Comm.*, *905 F.2d 1182*, 90-2 USTC ¶50,340 (8th Cir. 1990), *rev'g* 91 TC 917 (1988).
5. TC Sum. Op. 2005-125.
6. TC Memo 1991-605.
7. Rev. Rul. 87-22, 1987-1 CB 146.
8. IR-2003-127 (Nov. 3, 2003).
9. IRC Sec. 163(d).

However, there is a limit on otherwise allowable deductions that may be taken by an individual investor for investment interest.[1] (Interest not deductible for some other reason, such as interest on indebtedness to purchase or carry tax-exempt obligations, is not taken into consideration in determining the amount subject to this limit.) Deductible short sale expenses (Q 7529, Q 7530) are treated as interest subject to the limit.[2]

Generally, the investment interest deduction is limited to the amount of an investor's net investment income (see below). Any other investment interest expense is considered excess investment interest and is disallowed.[3]

"Net investment income" is investment income reduced by the deductible expenses–other than interest–that are directly connected with its production.[4] For purposes of this calculation, the 2 percent floor on miscellaneous itemized deductions is applied before investment income is reduced by investment expenses; thus, only those investment expenses that are allowable as a deduction after application of the 2 percent floor operate to reduce investment income.[5] See Q 7948 for an explanation of the deduction for investment expenses.

"Investment income" means the sum of: (1) gross income from property held for investment (other than net gain attributable to dispositions of such property); (2) the excess, if any, of (i) "net gain" attributable to the disposition of property held for investment over (ii) the "net capital gain" determined by taking into account gains and losses from dispositions of property held for investment; and (3) any net capital gain (or, if less, the net gain amount described in (2)), with respect to which a special election is made (see below).[6] In other words, investment income, for purposes of computing the investment interest deduction, generally does not include net capital gain from the disposition of investment property, unless the election described below is made.[7]

The Tax Court held that net gain for purposes of IRC Section 163(d)(4)(B)(ii) means the excess (if any) of total gains over total losses, including capital loss carryovers, from the disposition of property held for investment. The court further held that net gain required inclusion of the taxpayers' capital losses and capital loss carryovers for purposes of calculating the IRC Section 163(d)(1) limit on the investment interest expense deduction.[8]

Investment income includes qualified dividend income (see Q 608) only to the extent the taxpayer elects to treat such income as investment income.[9] See also IRC Section 1(h)(11)(D)(i) (qualified dividend income does not include any amount the taxpayer takes into account as investment income under IRC Section 163(d)(4)(B)).

1. IRC Sec. 163(d).
2. IRC Sec. 163(d)(3)(C).
3. IRC Sec. 163(d)(1).
4. See IRC Sec. 163(d)(4)(A).
5. Conference Agreement for TRA '86 at pp. 153-154.
6. IRC Sec. 163(d)(4)(B).
7. House Committee Report, OBRA '93.
8. *Gorkes v. Comm.*, TC Sum. Op. 2003-160.
9. IRC Sec. 163(d)(4)(B) (flush sentence); see Treas. Reg. §1.163(d)-1(a).

Special elections are available that allow taxpayers to elect in any year to include all or a portion of net capital gain or qualified dividend income attributable to dispositions of property held for investment, as investment income. If the elections are made, any net capital gain or qualified dividend income treated as investment income will be subject to the taxpayer's ordinary income tax rates.[1] The advantage of making the elections is that a taxpayer may increase the amount of his investment income against which investment interest is deducted, thus receiving the full benefit of the deduction.[2]

The elections for net capital gain and qualified dividend income must be made on or before the due date (including extensions) of the income tax return for the taxable year in which the net capital gain is recognized, or the qualified dividend income is received, respectively.[3] (But compare Let. Rul. 200033020, in which a taxpayer was permitted to make a late election to treat capital gains as investment income based on the Service's conclusion that the taxpayer had acted reasonably and in good faith, and that granting the extension would not prejudice the interests of the government.)[4]

The elections are made on Form 4952, "Investment Interest Expense Deduction" and may not be revoked for that year, except with IRS permission.[5] See, e.g., Let. Rul. 200146018 (where the Service ruled that the taxpayers' correct status as securities traders would have entitled them to treat such gains as investment income anyway; thus, allowing them to revoke their prior election did not prejudice the interest of the government or cause undue administrative burdens). However, making the election in one year does not bind the taxpayer for any other year.[6]

In an unpublished private letter ruling, the taxpayer (whose former tax return preparer had recently died) prepared his return for Year 1 using commercial software. The return involved significant securities transactions, including net long-term capital gains. The return also reflected investment interest expense, some of which was disallowed due to lack of net investment income. The taxpayer was not aware that he could have made an election to include in investment income all or part of the net capital gain; the necessity for making the election; nor how it could impact his return or the provisions for amending the return until the taxpayer subsequently sought help from a tax professional in the summer of Year 3. Upon review of Year 1 and Year 2, the tax professional noted the item and explained the situation to the taxpayer. The taxpayer requested consent to revoke the default election made inadvertently when the taxpayer filed the return, and to permit him to make an informed election by filing an amended return. The Service granted the taxpayer an extension of time for making the election, requiring the taxpayer to file a revised Form 4952 and Schedule D and to include a copy of the ruling with an amended return for Year 1. The Service also granted consent to revoke the first election made on the Year 1 return.[7]

1. Treas. Reg. §1.163(d)-1(a).
2. See IRC Sec. 163(d)(4).
3. Treas. Reg. §1.163(d)-1(b).
4. See also Let. Rul. 200303013.
5. Treas. Regs. §§1.163(d)-1(b), 1.163(d)-1(c).
6. See Treas. Reg. §1.163(d)-1(c).
7. Let. Rul. 161402-04, *unpublished* (March 22, 2005).

The Service privately ruled that: (1) the term "property" (under IRC Section 163(d)(5)(A)(i)) included interest-free loans (which are deemed to yield gross income as a result of interest imputed under IRC Section 7872) to a tax-exempt foundation; (2) any imputed interest income deemed received by the taxpayer on the potential loan from the line of credit to the foundation would be investment income (under IRC Section 163(d)(4)(B)(i)); and (3) any interest paid by the taxpayer on the line of credit used to make the potential loan to the foundation would be investment interest (under IRC Section 163(d)(3)(A)).[1]

The IRS has determined that capital loss carryovers that reduce taxable gain for income tax purposes in the year to which carried as a result of the election should also reduce investment income to the same extent for purposes of the investment expense limitation.[2]

Investment interest expense disallowed because of the investment income limitation will be treated as investment interest paid or accrued in the succeeding tax year.[3] The IRS will not limit the carryover of a taxpayer's disallowed investment interest to a succeeding taxable year to the taxpayer's taxable income for the taxable year in which the interest is paid or accrued.[4] Prior to the issuance of Revenue Ruling 95-16, several federal courts had held that no taxable income limitation existed on the amount of disallowed investment interest that could be carried over.[5]

Investment interest expense and investment income and expenses do not include items from a trade or business in which the taxpayer materially participates. The IRS has determined that interest on a loan incurred to purchase stock in a C corporation was investment interest (where the purchaser was not a dealer or trader in stock or securities), even though the purchaser acquired the stock to protect his employment with the C corporation.[6] In a decision citing Revenue Ruling 93-68, the Tax Court held that interest on indebtedness incurred to purchase a taxpayer's share of stock in a family-owned mortuary business was subject to the investment interest limitation, despite the fact that the taxpayer purchased the stock to conduct business full time and the fact that no dividends had been paid on the stock.[7]

The investment interest limitation is coordinated with the passive loss rules (see Q 7918 to Q 7929), so that interest and income subject to the passive loss rules are not taken into consideration under the investment interest limitation.[8] Interest expense incurred to purchase an interest in a passive activity is allocated to that passive activity and is not investment interest.[9] (Very generally, a passive activity is any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate and any rental activity).[10] However, portfolio

1. Let. Rul. 200503004.
2. TAM 9549002.
3. IRC Sec. 163(d)(2).
4. Rev. Rul. 95-16, 1995-1 CB 9.
5. See *Sharp v. U.S.*, 14 F. 3d 583, 94-1 USTC ¶50,001 (Fed.Cir. 1993); *Beyer v. Comm.*,916 F. 2d 153, 90-2 USTC ¶50,536 (4th Cir. 1990); *Haas v. U.S.*, 861 F. Supp. 43 (W.D. Mich. 1994); *Richardson v. U.S.*, 94-1 USTC ¶50,111 (W.D. Okla. 1994); *Lenz v. Comm.*, 101 TC 260 (1993); *Flood v. U.S.*, 845 F. Supp. 1367, 94-1 USTC ¶50,259 (D. Alaska 1993).
6. Rev. Rul. 93-68, 1993-2 CB 72.
7. *Russon v. Comm.*, 107 TC 263 (1996).
8. IRC Secs. 163(d), 469.
9. Temp. Treas. Reg. §1.163-8T(a)(4)(B).
10. IRC Sec. 469.

income of a passive activity and expense (including interest expense) allocable to it is considered investment income and expense, not passive income and expense.[1]

Temporary regulations provide that, for purposes of the investment interest and passive loss rules, interest expense is generally allocated on the basis of the use of the proceeds of the underlying debt (see Q 7942).

Future regulations will clarify the treatment of interest on a debt incurred to purchase a partnership or S corporation interest. IRS guidance generally requires that such interest expense be allocated among all the assets of the entity using any reasonable method.[2] Regulations will also clarify the treatment of interest on debt of passthrough entities allocated to distributions to the owners of the entity. If the debt of a passthrough entity is allocable under the interest tracing rules to distributions to owners of the entity, then the interest tracing rules will govern allocation of the owner's share of the entity's interest based on the owner's use of the debt proceeds. An optional allocation rule permits passthrough entities to allocate their interest expense to expenditures during the taxable year other than distributions, if certain requirements are met. The special rules for passthrough entities will not apply to taxpayers who use such entities to avoid or circumvent the interest tracing rules.[3]

7942. How is interest traced to personal, investment, and passive activity expenditures?

Generally, the interest tracing rules allocate debt and the interest on it to expenditures according to the use of the debt proceeds. The deductibility of the interest is generally determined by the expenditure to which it is allocated. The allocation of interest under these rules is unaffected by the use of any asset or property to secure the debt; for example, interest on a debt traced to the purchase of an automobile will be personal interest even though the debt may be secured by shares of stock.[4]

Specific Ordering Rules

The tracing of debt proceeds is accomplished by specific rules that determine the order in which amounts borrowed are used. The allocation of debt under these specific ordering rules depends on the manner in which the debt proceeds are distributed to and held by the borrower. The following alternatives and results are described in regulations:

(1) *Proceeds are deposited in borrower's account that also contains unborrowed funds*: The first expenditures made from the account (with two exceptions) will be treated as made from the debt proceeds to the extent thereof. If proceeds from more than one debt are deposited, the funds will be considered expended in the order in which they were deposited. If they were deposited simultaneously, they will be treated as deposited in the order in which the debts were incurred.[5]

1. IRC Sec. 469(e)(1).
2. Notice 89-35, 1989-1 CB 675; see also Let. Rul. 9215013.
3. Notice 89-35, above.
4. Temp. Treas. Reg. §1.163-8T(c).
5. Temp. Treas. Reg. §1.163-8T(c)(4)(ii).

Exceptions to this rule are: (a) any expenditure made from an account within the 30 days before or after the debt proceeds are deposited may be treated as made from the debt proceeds (to the extent thereof); and (b) if an account consists solely of debt proceeds and interest income on those proceeds, any expenditures from the account may be treated as first from the interest income, to the extent thereof at the time of the expenditure.[1]

> *Example*: Gladys purchases a certificate of deposit on May 1 for $3,000. On May 8 she borrows $5,000 and deposits it into her checking account, which also contains $5,000 of unborrowed funds. On May 21 she makes a down payment of $5,000 on a new car. On May 23 she invests $2,000 in stocks. Under rule (1), above, the debt proceeds (and interest thereon) would be traced to the car and characterized as personal interest; however, exception (a) permits Gladys to designate any expenditures during the 30 days before or after deposit as coming from the debt proceeds. Thus, Gladys may trace the debt to the purchase of the certificate of deposit and the stock, and thus determine the deductibility of her interest expense under the rules for investment interest.

(2) *Proceeds are disbursed to a third party*: Expenditures directly to a person selling property or providing services to the borrower are treated as expenditures from the debt proceeds.[2]

(3) *No disbursement is made*: If the debt does not involve any cash disbursements (for example, the borrower is assuming a loan, or the seller is financing the purchase) the debt is treated as if the borrower had made an expenditure for the purpose to which the debt relates.[3]

(4) *Proceeds are disbursed to the borrower in cash*: Any expenditure made within 30 days before or after the debt proceeds are received in cash may be treated as made from the debt proceeds. Otherwise, the debt will be treated as used for personal expenditures. If the proceeds are deposited into the borrower's account and an expenditure is made from those proceeds (under the ordering rules described above) in the form of a cash withdrawal, the proceeds will be considered received in cash.[4]

(5) *Proceeds are held in an account*: Debt proceeds are treated as held for investment purposes while held in an account, even if the account does not bear interest. When an expenditure is made, the debt is reallocated as described above. The taxpayer may either reallocate the debt on the date of the expenditure or on the first day of the month (or the date of deposit, if later than the first day of the month) so long as all expenditures from the account are treated similarly.[5]

Repayments and Refinancings

When a debt is allocable to more than one type of expenditure, repayments are applied in a manner that maximizes the deductibility of the remaining interest. Thus, for example, if a debt is allocated to personal, investment, and passive activity expenditures, repayment would be applied first against the portion attributable to the personal expenditure.[6] If a debt (including interest on it or borrowing charges other than interest) is repaid with the proceeds of a second

1. Notice 89-35, 1989-1 CB 675.
2. Temp. Treas. Reg. §1.163-8T(c)(3)(i).
3. Temp. Treas. Reg. §1.163-8T(c)(3)(ii).
4. Notice 89-35, 1989-1 CB 675.
5. Temp. Treas. Reg. §1.163-8T(c)(4)(i).
6. Temp. Treas. Reg. §1.163-8T(d)(1).

debt, the second debt will be allocated to the same expenditures as the repaid debt.[1] If, however, the amount of the second debt exceeds the amount of repayment, the excess will be allocated according to the normal allocation rules described above.

Reallocation of Debt

Debt that is allocated to an expenditure properly chargeable to a capital account with respect to an asset must be reallocated when the asset is sold or the nature of its use changes. For example, debt (and the interest on it) allocated to a computer purchased for business use must be reallocated to a personal expenditure if the computer is converted to personal use.[2]

Coordination with Other Provisions

Generally, any Internal Revenue Code provision that disallows, defers, or capitalizes an interest expense will be applied without regard to the expenditure to which the debt is allocated under these regulations, except that interest expense allocated to a personal expenditure is not capitalized.[3] For example, an interest expense on debt incurred or continued to purchase or carry tax-exempt obligations is not deductible regardless of the expenditure to which the debt is allocated under the regulations.[4] Interest expense that is not deductible because of a deferral provision is taken into account as allocated, but is deferred to the year in which it becomes deductible. Thus, for example, interest on an amount borrowed by an accrual method taxpayer from a related cash basis taxpayer is deferred even though allocated to a passive activity expenditure. When the expense becomes deductible it will be allocated to the passive activity regardless of how it is allocated when it is no longer deferred.[5]

7943. Is interest on indebtedness incurred to purchase or carry tax-exempt obligations deductible?

No deduction is allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is tax-exempt.[6] (Where the obligation offers tax-exempt income other than interest, see Q 7949.) Whether debt was incurred to purchase or carry obligations on which interest is tax-exempt depends on the individual taxpayer's purpose for borrowing.[7] Where the necessary purpose to use borrowed funds to buy or carry tax-exempt interest obligations is shown, the interest deduction will be denied, even though no tax-exempt interest is currently being received.[8] Furthermore, the deduction is denied even though the taxpayer's motives are not tax avoidance but to realize a taxable profit from sale instead of interest.[9]

1. Temp. Treas. Reg. §1.163-8T(e).
2. Temp. Treas. Reg. §1.163-8T(j).
3. Temp. Treas. Reg. §1.163-8T(m)(2)(ii).
4. Temp. Treas. Reg. §1.163-8T(m)(2)(i).
5. Temp. Treas. Reg. §1.163-8T(m)(6), Ex.(2).
6. IRC Sec. 265(a)(2).
7. Rev. Proc. 72-18, 1972-1 CB 740, as clarified by Rev. Proc. 74-8, 1974-1 CB 419, and as modified by Rev. Proc. 87-53, 1987-2 CB 669.
8. *Clyde C. Pierce Corp. v. Comm.*, 120 F.2d 206 (5th Cir. 1941); *Illinois Terminal R.R. Co. v. U.S.*, 375 F.2d 1016 (Ct. Cl. 1967).
9. *Denman v. Slayton*, 282 U.S. 514 (1931).

The taxpayer's purpose in borrowing requires an examination of all the facts and circumstances involved.[1] Purpose can be established by direct or by circumstantial evidence. According to IRS guidelines, if the loan proceeds can be directly traced to the purchase, there is direct evidence of a purpose to purchase. Nonetheless, this evidence is not conclusive, as the IRS acknowledges in pointing out that the deduction is not denied where proceeds of bona fide business borrowing are temporarily invested in tax-exempt interest obligations.[2]

Use of tax-exempt interest obligations as collateral for debt is direct evidence of a purpose to carry the obligations.[3] The Tax Court has determined that the use of tax-exempt municipal bonds as collateral did not, of itself, establish the necessary purpose to carry the bonds.[4] However, in a later Tax Court decision, the use of tax-exempt municipal bonds as collateral did establish a direct relationship between the carrying of the bonds and the borrowing, even though the loan proceeds were used for an investment purpose.[5]

Lacking direct evidence, if the facts and circumstances support a reasonable inference that the purpose of the borrowing was to purchase or carry tax-exempt interest obligations, the deduction will be denied. However, a deduction will not be denied merely because the investor also holds such tax-exempt obligations.[6] Generally, the interest deduction will not be disallowed if borrowing is for a personal purpose (and the interest would otherwise be deductible). Thus, an individual who holds tax-exempt municipal bonds and takes out a mortgage to buy a residence is not required to sell his municipal bonds to finance the purchase.[7]

Similarly, the deduction will not generally be denied if the indebtedness is incurred or continued in connection with the active conduct of a trade or business (other than as a dealer in tax-exempt obligations) and the loan is not in excess of business needs. Nonetheless, if the business need could reasonably have been foreseen when the tax-exempt obligations were bought, a rebuttable presumption arises that there was a purpose to carry the tax-exempt obligations by means of borrowing.[8]

On the other hand, where there is outstanding indebtedness not directly connected with personal expenditures and not incurred or continued in connection with the active conduct of a business, and the individual owns tax-exempt obligations, a purpose to carry the tax-exempt obligations will be inferred, but may be rebutted. The inference will be made even though the debt is ostensibly incurred or continued to purchase or carry other portfolio investments not connected with the active conduct of trade or business. Thus, deduction of interest on a margin account by an individual holding tax-exempt obligations was disallowed, even though only taxable securities were purchased in that account.[9] (The management of one's personal investments

1. *Indian Trail Trading Post, Inc. v. Comm.*, 60 TC 497 (1973), *aff'd* per curiam 503 F.2d 102 (6th Cir. 1974).
2. Rev. Rul. 55-389, 1955-1 CB 276.
3. *Wisconsin Cheesemen, Inc. v. U.S.*, 388 F.2d 420 (7th Cir. 1968); Rev. Proc. 72-18, above.
4. See *Lang v. Comm.*, TC Memo 1983-318.
5. See *Rifkin v. Comm.*, TC Memo 1988-255.
6. *Ball v. Comm.*, 54 TC 1200 (1970), nonacq. at 1972 AOD LEXIS 89 (IRS Jan. 14, 1972).
7. Rev. Proc. 72-18, Sec. 4.02, above.
8. *Wisconsin Cheesemen, Inc. v. U.S.*, above; Rev. Proc. 72-18, Sec. 4.03, above.
9. *McDonough v. Comm.*, 577 F.2d 234 (4th Cir. 1978).

is not considered a trade or business.)[1] A limited partnership interest is generally considered a passive activity.[2] If the taxpayer borrows to buy such an interest while holding tax-exempts, it is possible that the IRS will infer an intent to carry tax-exempt obligations and will disallow the interest deduction.

According to IRS guidelines, there will generally be a direct connection between borrowing and purchasing or carrying existing tax-exempt interest obligations if the debt is incurred to finance new portfolio investments. This presumption can be rebutted, the IRS says, by showing the taxpayer could not have sold his holdings of tax-exempt interest obligations. But it cannot be overcome by showing the tax-exempts could have been sold only with difficulty or at a loss, or that the investor owned other investment amounts that could have been liquidated, or that an investment adviser recommended that a prudent investor should maintain a particular percentage of assets in tax-exempt obligations.[3]

If a fractional part of the indebtedness is directly traceable to holding tax-exempt interest obligations, the same fractional part of interest paid will be disallowed. In any other case, where the interest deduction is to be disallowed, an allocable portion of the interest is disallowed. The portion is determined by multiplying the total interest on the debt by a fraction: the numerator is the average amount during the tax year of the taxpayer's tax-exempt obligations (valued at adjusted basis), and the denominator is the average amount during the tax year of the taxpayer's total assets (valued at adjusted basis) minus the amount of any indebtedness the interest on which is not subject to disallowance under IRC Section 265(a)(2).[4]

If a partnership incurs debt or holds tax-exempt obligations, the partners are treated as incurring or holding their partnership share of each such debt or tax-exempt obligation. The purposes of the partnership in borrowing are attributed to the general partners.[5]

However, if an individual's investment in tax-exempt obligations is insubstantial, the requisite purpose will generally not be inferred in the absence of direct evidence. Investment will generally be considered insubstantial if the average amount of tax-exempt obligations (valued at their adjusted basis) is not more than 2 percent of the average adjusted basis of his portfolio investments and any assets held in the active conduct of a trade or business.[6]

The IRS has ruled that the interest deduction will be disallowed on a joint return if indebtedness that was incurred by one spouse is allocable to the acquisition of tax-exempt securities by the other.[7]

If the proceeds of a short sale are used (as determined under the foregoing rules) to purchase or carry tax-exempt obligations, certain expenses of that short sale (see Q 7529, Q 7530) may not be deducted.[8]

1. *Higgins v. Comm.*, 312 U.S. 212 (1941).
2. Ann. 87-4, 1987-3 IRB 17.
3. Rev. Proc. 72-18, Sec. 4.04, above.
4. Rev. Proc. 72-18, Secs. 7.01, 7.02, above. See also *McDonough v. Comm.*, TC Memo 1982-236.
5. Rev. Proc. 72-18, Sec. 4.05, above.
6. Rev. Proc. 72-18, Sec. 3.05, above.
7. Rev. Rul. 79-272, 1979-2 CB 124.
8. IRC Sec. 265(a)(5).

See Q 7941 for the limit on allowable investment interest deductions and Q 7942 for rules relating to the allocation of interest expense for purposes of the limit. See also Q 7949 for limits on the deduction of expenses incurred in producing tax-exempt income other than interest.

7944. Is interest paid on amounts borrowed to purchase or carry Treasury bills or short-term taxable corporate obligations deductible?

Where indebtedness is incurred or continued by a cash basis investor to purchase or carry Treasury bills, other short-term taxable government obligations, or taxable corporate short-term obligations (i.e., obligations with a fixed maturity date not more than one year from the date of issue), the current deductibility of interest expenses will be subject to limitation and deferral. However, if the taxpayer is required to or elects to include interest and acquisition discount or original issue discount as it accrues (as discussed in Q 7612, Q 7614), the otherwise allowable deduction of interest will not be limited or deferred except by any limit on deductibility applicable under the interest tracing rules (see Q 7942).[1]

If the taxpayer does not include discount and interest as it accrues, the deductibility of interest expense incurred to purchase or carry the obligation is subject to certain limitations. Such interest will be deductible to the extent of includable interest income from the obligation. Interest expenses in excess of that amount will be deductible only to the extent that the interest expense exceeds the total amount of discount and interest accrued (but not includable) while the taxpayer held the bond during the year.[2] Thus, the excess interest expense that is equal to the discount and interest accruing in the year (but is not currently includable in income) is not currently deductible. The deduction is deferred to a later year when includable interest income on the obligation exceeds interest expense for the year, or to the year of disposition.[3]

In the case of short sales of securities, expenses that are not required to be capitalized (see Q 7529, Q 7530) are treated as interest expenses subject to these limitation and deferral rules if the proceeds of the short sale are used to purchase or carry Treasury bills or other taxable short-term government or corporate obligations.[4]

Whether amounts are borrowed or are loans continued to purchase or carry short-term obligations depends on the taxpayer's purpose for borrowing. In determining the individual's purpose, the IRS will, apparently, apply the same principles applied in determining if indebtedness is incurred or continued to purchase or carry tax-exempt bonds (see Q 7943).

7945. Is interest paid on amounts borrowed to purchase or carry market discount bonds deductible for bonds issued after July 18, 1984, and bonds issued before July 19, 1984 and acquired after April 30, 1993?

If amounts are borrowed or indebtedness is continued in order to purchase or carry a bond issued *after* July 18, 1984 at a market discount, or a bond issued *before* July 19, 1984 and

1. IRC Secs. 1281, 1282.
2. IRC Sec. 1282(a).
3. IRC Secs. 1282, 1277(b).
4. IRC Secs. 1282(c), 1277(c).

purchased on the market at a discount after April 30, 1993, the interest expense is deductible to the extent that stated interest (or original issue discount) paid or accrued on it is includable in income for the year. (For the income tax treatment of market discount upon disposition of such bonds, see Q 7630 to Q 7633.) If interest expense exceeds that amount, it will be deductible to the extent that it exceeds the market discount allocable to the days on which the bond was held during the tax year. Interest expense that is allocable to the market discount accruing in the year is not currently deductible; the deduction is deferred.[1]

Amounts so disallowed in one year may be deductible in a later year in which includable interest on the obligation is greater than the interest expense for that year. Generally, the taxpayer may elect, on a bond by bond basis, to deduct an amount of previously disallowed interest expense up to the difference.[2]

Any deferred interest expense not previously deducted under that election becomes deductible in the year in which the bond is sold or redeemed. If the bond is disposed of in a transaction in which part or all of the gain is not recognized (e.g., a gift), the deferred interest is allowed as a deduction at that time only to the extent that gain is recognized. (See, e.g., Q 7631 with respect to gain that is recognized on a gift.) To the extent deferred interest expense is not allowed as a deduction upon the disposition of the bond in such a nonrecognition transaction, the disallowed interest expense will be treated as disallowed interest expense of the transferee of transferred basis property, or the transferor who receives exchanged basis property in the transaction.[3] (Transferred basis property is property having a basis determined in whole or in part by the basis of the transferor.[4] Exchanged basis property is property having a basis determined in whole or in part by other property held at any time by the person for whom the basis is being determined.)[5] Thus, in the case of a market discount bond that is transferred basis property (a gift, for example), the transferee will be entitled to deduct the previously disallowed interest expense as if it were his own.

On the other hand, interest expense allocable to market discount is currently deductible, not deferred, if the taxpayer has elected to treat the market discount as current income as it accrues under either the straight line or constant interest rate method.[6] This election is discussed in Q 7629. Unless the interest expense on borrowing is greater than the sum of (1) interest income on the bond that would be includable in gross income in the absence of the election plus (2) the amount of market discount accruing over the days the bond was held in the year, the election will merely result in a wash; in other words, the deduction and the included interest will offset each other.

Whether amounts are borrowed or loans continued in order to purchase or carry market discount bonds depends on the taxpayer's purpose for borrowing. In determining the individual's

1. IRC Sec. 1277.
2. IRC Sec. 1277(b)(1)(A).
3. IRC Sec. 1277(b)(2).
4. IRC Sec. 7701(a)(43).
5. IRC Sec. 7701(a)(44).
6. IRC Sec. 1278(b).

purpose, the IRS will, presumably, apply the same principles applied in determining if indebtedness is incurred or continued to purchase or carry tax-exempt bonds (see Q 7943).

Noncapitalized expenses incurred in short sales of securities are treated as interest expenses subject to the deferred deduction rules if the proceeds of the short sales are used to purchase or carry a market discount bond.[1]

During the time the deduction of interest is deferred because it is on indebtedness incurred or continued to purchase or carry market discount bonds (or is an expense of a short sale the proceeds of which are used to purchase or carry market discount bonds), the interest (or short sale) expense is not counted as interest expense for other purposes (for example, in disallowing interest on amounts borrowed to buy tax-exempt bonds).

7946. Is interest paid on amounts borrowed to purchase or carry market discount bonds deductible for bonds issued before July 19, 1984 and acquired before May 1, 1993?

If a market discount bond was issued before July 19, 1984 and acquired on the market after that date but before May 1, 1993, the taxpayer generally will not be required to treat any part of the gain on disposition that is attributable to market discount as interest income (see Q 7630). However, if deferred interest expense on such a bond is deducted on disposition, an equal amount of any gain on the disposition must be treated as interest income.[2] Similarly, if the bond is disposed of in a nonrecognition transaction, an interest characterization rule will apply at the time gain is recognized and the deferred interest expense is deducted by the transferee.[3]

If amounts are borrowed or indebtedness is continued to purchase or carry bonds that were issued and acquired on or before July 18, 1984 at a market discount, the interest expense paid in the year is not disallowed simply because market discount is not recognized until disposition of the bond. Furthermore, when gain attributable to the market discount is recognized it is treated as capital gain (see Q 608 for the treatment of capital gain).

7947. Is student loan interest deductible?

An above-the-line deduction (see Q 619) is available to middle income taxpayers for interest paid on a qualified education loan (i.e., college loans – see below) subject to certain limitations.[4]

The amount of the deduction is limited to a maximum of $2,500.[5] The deduction is phased out ratably for taxpayers with modified adjusted gross income (MAGI–see below) between $100,000 and $130,000 (married filing jointly) or $50,000 and $65,000 (single).[6] The $50,000

1. IRC Sec. 1277(c). See General Explanation–TRA '84, p. 98.
2. IRC Sec. 1277(d), prior to repeal by OBRA '93.
3. See General Explanation–TRA '84, p. 98.
4. IRC Sec. 221(a).
5. IRC Sec. 221(b)(1); Treas. Reg. §1.221-1(c).
6. IRC Sec. 221(b)(2); Treas. Reg. §1.221-1(d)(1).

and the $100,000 amounts are adjusted for inflation (as rounded to the next lowest multiple of $5,000).[1] In 2014, the indexed levels are: $130,000 - $160,000 (married filing jointly); $65,000 - $80,000 (single).[2] The phaseout is accomplished by reducing the otherwise deductible amount by the ratio that the taxpayer's MAGI over the applicable limit bears to $15,000 ($30,000 for a couple filing married filing jointly)(the deduction cannot be reduced below zero).

> *Example*: In 2014, Mr. and Mrs. Green paid $900 in interest on a student loan that otherwise qualifies for the deduction under the statutory requirements described below. The Greens' MAGI in 2-14 was $140,000. The ratio that their MAGI in excess of $130,000 [$140,000 - $130,000 = $10,000] bears to $30,000 is one to three; consequently, the amount otherwise deductible is reduced by one-third, to $600 [$900 - (⅓ x $900) = $600].

Modified adjusted gross income is the taxpayer's adjusted gross income as determined *before* the deduction for qualified tuition and related expenses[3] (see Q 7952) and the exclusions for income derived from certain foreign sources or sources within United States possessions,[4] and *after* the inclusion of any taxable Social Security benefits,[5] any deductible IRA contributions,[6] adjustments for passive activity losses or credits[7] (see Q 7918), the exclusion for savings bond interest used for education expenses[8] (see Q 7666), and the exclusion for certain adoption expenses.[9]

Eligibility. The individual claiming the deduction must be legally obligated to make the interest payments under the terms of the loan.[10] But if a third party who is not legally obligated to make a payment of interest on a qualified education loan makes an interest payment on behalf of a taxpayer who is legally obligated to make the payment, then the taxpayer is treated as receiving the payment from the third party and, in turn, paying the interest.[11] See, e.g., Treasury Regulation Section 1.221-1(b)(4)(ii), Example 1 (payment by employer) and Example 2 (payment by parent).

The deduction may not be taken: (1) by an individual who may be claimed as a dependent on another's tax return; (2) if the expense can be claimed as a deduction elsewhere on the return; or (3) by married taxpayers filing separate returns.[12]

A *qualified education loan* is any indebtedness incurred by the taxpayer solely to pay qualified higher education expenses (see below) that are: (1) incurred on behalf of the taxpayer, his spouse, or a dependent at the time the indebtedness was incurred; (2) paid or incurred within a reasonable period of time (see below) before or after the indebtedness was incurred, and (3) attributable to education furnished in an academic period during which the recipient was an eligible student (see below).[13]

1. IRC Sec. 221(f); Treas. Reg. §1.221-1(d)(3).
2. Rev. Proc. 2013-35, 2013-47 IRB 537.
3. IRC Sec. 222.
4. IRC Secs. 911, 931, 933.
5. IRC Sec. 86.
6. IRC Sec. 219.
7. IRC Sec. 469.
8. IRC Sec. 135.
9. IRC Sec. 137. IRC Sec. 221(b)(2)(C); Treas. Reg. §1.221-1(d)(2).
10. Treas. Reg. §1.221-1(b)(1).
11. Treas. Reg. §1.221-1(b)(4)(i).
12. IRC Secs. 221(e), 221(c); Treas. Regs. §§1.221-1(b)(2), 1.221-1(b)(3); 1.221-1(g)(2).
13. IRC Sec. 221(d)(1); Treas. Reg. §1.221-1(e)(3)(i).

The determination of whether qualified higher education expenses are paid or incurred within a "reasonable period of time" generally is made based on all the relevant facts and circumstances. However, qualified higher education expenses are treated as paid or incurred within a reasonable period of time before or after the taxpayer incurs the indebtedness if: (1) the expenses are paid with the proceeds of education loans that are part of a federal postsecondary education loan program; or (2) the expenses relate to a particular academic period and the loan proceeds used to pay the expenses are disbursed within a period that begins 90 days prior to the start of the academic period and ends 90 days after the end of that academic period.[1]

The term qualified education loan does not include indebtedness owed to certain related persons. In addition, a loan from a qualified plan – including an IRC Section 403(b) plan or from a life insurance or annuity contract held by such a plan – is not a qualified education loan.[2]

A loan does not have to be issued or guaranteed under a federal postsecondary education loan program to be a qualified education loan.[3]

A qualified education loan includes indebtedness incurred solely to refinance a qualified education loan. A qualified education loan includes a single, consolidated indebtedness incurred solely to refinance two or more qualified education loans of a borrower.[4]

Qualified higher education expenses means the cost of attendance at an eligible education institution (see below) reduced by the sum of: (1) the amounts excluded from gross income under IRC Section 127 (employer educational assistance programs), IRC Section 135 (income from U.S. Savings bonds used to pay for higher education expenses – see Q 7666), IRC Section 529 (distributions from qualified tuition programs – see Q 597), or IRC Section 530 (distributions from a Coverdell Education Savings Account, formerly known as an Education IRA – see Q 592) by reason of such expenses; (2) the amount of any excludable scholarship, allowance or payments (other than a gift, bequest, devise or inheritance) received by an individual for expenses attributable to enrollment; and (3) certain educational assistance allowances provided to veterans or members of the armed forces.[5]

An *eligible education institution* generally includes any accredited postsecondary institution (i.e., college, university, or vocational school) offering an educational program for which it awards a bachelor's degree or a 2-year degree, as well as those that conduct an internship or residency program leading to a degree or certificate awarded by an institute of higher learning, a hospital, or a health care facility that offers postgraduate training. The term also includes those institutions offering at least a 1-year program that trains students for gainful employment in a recognized profession.[6]

1. Treas. Reg. §1.221-1(e)(3)(ii).
2. IRC Sec. 221(d)(1); Treas. Reg. §1.221-1(e)(3)(iii).
3. Treas. Reg. §1.221-1(e)(3)(iv).
4. Treas. Reg. §1.221-1(e)(3)(v).
5. IRC Sec. 221(d)(2); Treas. Reg. §1.221-1(e)(2).
6. IRC Secs. 221(d)(2), 25A(f)(2); Treas. Reg. §1.221-1(e)(1).

An *eligible student* means any student who is enrolled in a degree, certificate, or other program leading to a recognized credential at an eligible education institution, and who is carrying at least half of a normal full-time work load in the course of study.[1]

Interest. Amounts paid on a qualified education loan are deductible if the amounts are interest for federal income tax purposes. Interest includes qualified stated interest and original issue discount, which generally includes capitalized interest (i.e., any accrued and unpaid interest on a qualified education loan that, in accordance with the terms of the loan, is added by the lender to the outstanding principal balance of the loan).[2]

The Preamble to the final regulations states: "generally, fees such as loan origination fees or late fees are interest if the fees represent a charge for the use or forbearance of money. Therefore, if the fees represent compensation to the lender for the cost of specific services performed in connection with the borrower's account, the fees are not interest for federal income tax purposes.[3] The Tax Court found that certain fees, including insurance fees, were similar to payments for services rendered and not deductible as interest."[4]

In general, a payment is treated first as a payment of interest to the extent of the interest that has accrued and remains unpaid as of the date the payment is due, and second as a payment of principal.[5]

The 60-month limit on the student loan interest deduction was permanently repealed under PPA 2006.

Reporting requirements. Certain reporting requirements must be met by a payee who receives interest totaling $600 or more with respect to a single payor on one or more covered student loans. Generally, the payee must file Form 1098-E (Student Loan Interest Statement) with respect to that interest, and provide the payor with the same information. For the final regulations relating to the information reporting requirements for payments of interest on qualified education loans (including the filing of information returns in an electronic format in lieu of a paper format), see Treasury Regulation Sections 1.6050S-3, 1.6050S-4.[6]

7948. What expenses paid in connection with the production of investment income are deductible?

The IRC allows individuals a deduction for ordinary and necessary expenses paid in the year for the production or collection of income, or paid for the management, conservation, or maintenance of property held for the production of income, whether or not, in either case, they are business expenses.[7] Personal management of one's investments is not the conduct of a trade

1. IRC Secs. 221(d)(3), 25A(b)(3).
2. Treas. Reg. §1.221-1(f)(1).
3. See Rev. Rul. 69-188, 1969-1 CB 54, amplified by Rev. Rul. 69-582, 1969-2 CB 29; see also, e.g., *Trivett v. Comm.*, TC Memo 1977-161, *aff'd* on other grounds 611 F.2d 655 (6th Circ. 1979).
4. Preamble, TD 9125, 68 Fed. Reg. 25489, 25490 (5-7-2004).
5. Treas. Reg. §1.221-1(f)(3).
6. See Treas. Reg. §§1.6050S-3, 1.6050S-4.
7. IRC Sec. 212.

or business.[1] This is so without regard to the amount of time spent managing the investments or to the size of the portfolio.[2]

The deduction applies to expenses in connection with both income and gain from sales. The deduction is taken by a cash method taxpayer in the year the expense is paid. This deduction is limited to expenses related to the production of income that is subject to federal income tax.[3] However, it may be income realized in a prior year or anticipated in a subsequent year (as, for example, defaulted bonds bought with the expectation of gain on resale). The expenses are deductible even if no income is realized in the year.[4] Expenses not for the production of income or the management, conservation, or maintenance of property held for the production of income, but paid in connection with activities carried on primarily as a sport or hobby may be limited (see Q 7931).[5] Whether a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production of income rather than primarily as a sport or hobby or recreation depends on the facts and circumstances involved (see Q 7931).

To be deductible, expenses must be reasonable in amount and bear a reasonable and proximate relation to the production or collection of taxable income or the management, conservation, or maintenance of property held for the production of income.[6]

Expenses that enter into the determination of income or loss of a passive activity are subject to the limitations of the passive loss rule and are not deducted as investment expenses. In general, a passive activity is any activity involving the conduct of a trade or business in which the taxpayer does not materially participate and any rental activity.[7] Generally, an individual may deduct aggregate losses for the year from a passive activity only to the extent that they do not exceed aggregate income from passive activities in that year. The passive loss rules are explained in Q 7918 to Q 7929.

Expenses of a passive activity that are allocable to income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business are not treated as passive activity expenses, but rather are treated under the general rules applicable to other investment expenses.[8]

Investment expenses are generally treated as miscellaneous itemized deductions (which also include certain non-investment expenses–see Q 631). These expenses are, therefore, deductible from adjusted gross income only to the extent that the aggregate of all miscellaneous itemized deductions for the taxable year exceeds 2 percent of adjusted gross income.[9] Only those investment expenses that are deductible (i.e., those remaining after the 2 percent floor has been applied)

1. *Higgins v. Comm.*, 312 U.S. 212 (1941).
2. *Moller v. U.S.*, 721 F 2d 810, 83-2 USTC ¶9698 (Fed. Cir. 1983).
3. IRC Sec. 265(a)(1).
4. Treas. Reg. §1.212-1(b).
5. IRC Sec. 183(b)(2); Treas. Regs. §§1.183-1, 1.212-1(c).
6. Treas. Reg. §1.212-1(d); *Bingham's Trust v. Comm.*, 325 U.S. 365 (1945).
7. IRC Sec. 469(c).
8. IRC Sec. 469(e)(1).
9. IRC Sec. 67.

are considered in the calculation of net investment income. (See Q 7941.) For purposes of this calculation, the 2 percent floor is applied against all other miscellaneous itemized deductions before it is applied against investment expenses.[1]

The more common expenses, provided they have the required relationship to the production of income (and deductible only to the extent that they exceed the 2 percent floor) include: (a) rental expense of a safe deposit box used to store taxable securities; (b) subscriptions to investment advisory services; (c) investment counsel fees; (d) custodian's fees; (e) services charged in connection with a dividend reinvestment plan; (f) service, custodian, and guarantee fees charged by the issuer of mortgage-backed securities (Q 7671 and Q 7673);[2] (g) bookkeeping services; (h) office expenses in connection with investment activities, such as rent, water, telephone, stamps, stationery, etc.;[3] and (i) premiums paid for indemnity bonds required for issuance of new stock certificates to replace certificates mislaid, lost, stolen, or destroyed.[4]

The Tax Court has denied a deduction for mutual fund shareholders' pro rata share of the annual operating expenses incurred by the mutual funds in which they owned shares. Because publicly offered mutual funds pass through income to shareholders on a net basis (i.e., gross income minus expenses), the Tax Court concluded that the shareholders had already received the benefit of a reduction in income for these costs and, therefore, were not entitled to deduct the operating expenses as investment expenses.[5]

Partners in an investment club partnership formed solely to invest in securities and whose income is derived solely from taxable dividends, interest, and gains from security sales may deduct their distributive shares of the partnership's reasonable operating expenses incurred in its tax year that are proximately related to the partnership's investment activities. Operating expenses include postage, stationery, safe deposit box rentals, bank charges, fees for accounting and investment services, rent, and utility charges. Investment partnerships are not engaged in business because management of activities with respect to one's own account is not a trade or business.[6]

The Tax Court has held that fees withheld from a trust beneficiary's distribution to repay, under a court order, expenses incurred by the trustee and other beneficiaries in dealing with her frivolous objections to the trust's accounting were deductible under IRC Section 212. Citing *Ostrom v. Comm.*,[7] the court reasoned that if the origin and character of the claim arise out of a taxpayer's position as a seeker after profit (which in this case was the motivation underlying her objections to the accounting), then it did not matter that the taxpayer's expenditures were made because of the imposition of a court sanction to compensate the victims of the taxpayer's improper actions.[8]

1. Conference Report (TRA '86) at pp. 153-154.
2. See *Loew v. Comm.*, 7 TC 363 (1946).
3. See *Scott v. Comm.*, TC Memo 1979-109.
4. See Rev. Rul. 62-21, 1962-1 CB 37.
5. *Tokh v. Comm.*, TC Memo 2001-45.
6. Rev. Rul. 75-523, 1975-2 CB 257.
7. 77 TC 608 (1991).
8. *Di Leonardo v. Comm.*, TC Memo 2000-120.

Expenses may be nondeductible because they are personal in nature, or because they are not ordinary and necessary. Examples of such expenses would include: newspaper and magazine costs, where it is not clear that the publications were used principally for investment activities rather than personal activities;[1] travel to attend shareholders' meetings;[2] fees paid for maintenance of interest paying checking accounts where the fee is charged for the privilege of writing checks instead of maintaining the interest bearing account and the checks written are personal;[3] travel expenses going to watch a broker's ticker tape regularly but not directly related to any particular transactions entered into for profit;[4] maintenance of an art collection where personal pleasure, not investment, was the most important purpose for the collection;[5] and expenses of maintaining a personal residence.[6] An expense not otherwise deductible that is paid in contesting a liability against an individual does not become deductible simply because property held for production of income might have to be used or sold to satisfy the liability.[7]

Expenses may be nondeductible because of other Internal Revenue Code sections. For example, expenses that are capital in nature are not deductible, such as broker's commissions and fees incurred in connection with acquiring property.[8] These types of expenses are instead added to the basis of property. Similarly, selling expenses are offset against the selling price used in determining capital gains and losses, not deducted as expenses.[9] A safe purchased to store property used in the production of income was ruled to be a capital expenditure.[10] Expenses to defend, acquire, or perfect title to property are capital in nature.[11] Legal expenses incurred to recover taxable interest and dividends are deductible, but portions allocable to the recovery of a capital asset (e.g., stock) are not deductible, but rather are capitalized.[12] No deduction is allowed for expenses allocable to attending a convention, seminar, or similar meeting unless the expenses are ordinary and necessary expenses of carrying on a trade or business.[13]

The Service has determined that a flat fee (representing a specified percentage of the market value of the assets in a taxpayer's account) that is paid to a stockbroker for investment services is not a carrying charge (under IRC Section 266) and, thus, cannot be capitalized. Instead, the Service stated, a flat fee is better viewed as a currently deductible investment expense.[14]

A federal district court has held that payments made to discharge a preexisting lien on property (e.g., stock) are part of the purchase price of the property and, as such, must be capitalized. The court further held that the attorney's fees incurred in connection with discharging

1. *Tokh v. Comm.*, TC Memo 2001-45.
2. Rev. Rul. 56-511, 1956-2 CB 170.
3. Rev. Rul. 82-59, 1982-1 CB 47.
4. *Walters v. Comm.*, TC Memo 1969-5.
5. *Wrightsman v. U.S.*, 428 F.2d 1316 (Ct. Cl. 1970).
6. Treas. Reg. §1.212-1(h).
7. Treas. Reg. §1.212-1(m).
8. *Vestal v. U.S.*, 498 F.2d 487 (8th Cir. 1947).
9. *Milner v. Comm.*, 1 TCM 513 (1943).
10. Let. Rul. 8218037.
11. Treas. Reg. §1.212-1(k); *Kelly v. Comm.*, 23 TC 682 (1955), *aff'd* 228 F.2d 512 (7th Cir. 1956); *Collins v. Comm.*, 54 TC 1656 (1970).
12. Treas. Reg. §1.212-1(k); *Nickell v. Comm.*, 831 F.2d 1265 (6th Cir. 1987).
13. IRC Sec. 274(h)(7).
14. See IRS CCA 200721015.

the lien should also be included in the purchaser's basis under IRC Section 1012, again as costs of acquiring the stock.[1]

Where purchasers of a hotel incurred legal fees maintaining a lawsuit to recover damages from the seller for misrepresentations that caused the taxpayers to pay an inflated price for the property, the Tax Court held that the litigation arose out of, was incurred in connection with, and was directly related to the acquisition of the property; accordingly, the legal fees were required to be capitalized.[2]

With regard to deduction of loan premiums and amounts equal to cash dividends to cover short sales, see Q 7529 and Q 7530.

Deduction of interest in connection with investments may be limited to the amount of net investment income (Q 7941), or otherwise limited if the purpose of borrowing is to acquire or keep tax-exempt obligations (Q 7943), market discount bonds (Q 7945), or taxable short-term obligations (Q 7944).

7949. Are expenses paid for the production of tax-exempt income deductible?

Any expense that would otherwise be deductible under any Internal Revenue Code section is not deductible if it is allocable to tax-exempt income other than tax-exempt interest.[3] Expenses allocable to tax-exempt interest may be deductible if they are trade or business expenses, taxes, or depreciation, but the same expenses allocable to tax-exempt income other than interest are not deductible.

If an expense is allocable to both nonexempt income and exempt income, a reasonable proportion, determined in the light of all the facts and circumstances, is allocated to each.[4] Legal fees incurred to collect Social Security benefits have been held deductible only to the extent that they were allocable to the portion of benefits that were includable in the taxpayer's gross income.[5] In the absence of evidence showing a more reasonable basis for allocation, the expense has been allocated between taxable and tax-exempt income in the proportion that each bears to the total taxable and nontaxable income in the year.[6]

7950. Are expenses relating to tax questions deductible?

Yes. The IRC permits a deduction for ordinary and necessary expenses paid in the year in connection with the determination, collection, or refund of any tax.[7] This includes expenses

1. *Lobato v. U.S.*, 2002-1 USTC ¶50,332 (N.D. Okla. 2002).
2. *Winter v. Comm.*, TC Memo 2002-173.
3. IRC Sec. 265(a)(1).
4. Treas. Reg. §1.265-1(c).
5. Rev. Rul. 87-102, 1987-2 CB 78.
6. *Jamison v. Comm.*, 8 TC 173 (1947); *Ellis v. Comm.*, 6 TCM 662 (1947); *Mallinckrodt v. Comm.*, 2 TC 1128 (1943), acq.; Rev. Rul. 59-32, 1959-1 CB 245, as clarified by Rev. Rul. 63-27, 1963-1 CB 57.
7. IRC Sec. 212(3).

for: the preparation of income tax returns;[1] the cost of tax books used in preparing tax returns;[2] accountant's tax advice;[3] legal fees for obtaining a letter ruling;[4] legal or accounting fees contesting a tax deficiency, whether or not successfully;[5] or claiming a refund;[6] and appraisal fees necessary to establish a charitable deduction.[7] The Tax Court held that miles driven (165.5) by a taxpayer, for the purpose of copying and filing his personal federal income tax return, constituted an ordinary and necessary expense paid by him in connection with the determination of his federal income taxes; accordingly, the mileage was held to be properly deductible as a miscellaneous itemized deduction.[8]

"The requirement that the expenses be 'ordinary and necessary' implies that they must be reasonable in amount and must bear a reasonable and proximate relation" to the determination, collection or refund of taxes.[9]

The expenses may relate to income, estate, gift, property, or any other tax, whether federal, state, or municipal.[10]

The burden of proof is on the taxpayer to establish the extent to which expenses are allocable to tax advice rather than to nondeductible personal expenditures (e.g., will preparation, estate planning). In the absence of an itemization or other evidence supporting a claimed deduction, only that portion that the IRS deems reasonably allocable to the tax advice will be deductible.[11]

The deduction may be deferred or disallowed in whole or in part if the taxpayer has tax-exempt income (Q 7949), or if the expense is taken into account in determining income or loss of a passive activity (Q 7918), or is treated as an investment expense (Q 7948).

7951. How are business expenses reported for income tax purposes?

The amount of the deduction for expenses incurred in carrying on a trade or business depends upon whether the individual is an independent contractor or an employee. Independent contractors may deduct all allowable business expenses from gross income (generally on Schedule C) to arrive at adjusted gross income.[12] The business expenses of an employee are deductible from adjusted gross income if he itemizes, but only to the extent that they exceed 2 percent of adjusted gross income when aggregated with other miscellaneous itemized deductions (described in Q 631).

1. *Loew v. Comm.*, 7 TC 363 (1946); Treas. Reg. §1.212-1(l).
2. *Contini v. Comm.*, 76 TC 447 (1981), acq. 1981-2 CB 1.
3. *Collins v. Comm.*, 54 TC 1656 (1970).
4. *Kaufmann v. U.S.*, 227 F. Supp. 807 (W.D. Mo. 1963).
5. *Bingham's Trust v. Comm.*, 325 U.S. 365 (1945).
6. *Cammack v. Comm.*, 5 TC 467 (1945); *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945).
7. Rev. Rul. 67-461, 1967-2 CB 125.
8. *Stussy v. Comm.*, TC Memo 2003-232.
9. *Bingham's Trust v. Comm.*, above.
10. Treas. Reg. §1.212-1(l).
11. *Wong v. Comm.*, TC Memo 1989-683.
12. IRC Sec. 62(a)(1).

A full-time life insurance salesperson will not be treated as an "employee" for purposes of IRC Sections 62 and 67 merely because he is a "statutory employee" for Social Security tax purposes.[1] The IRS has frequently challenged insurance agents' claims of independent contractor status; however, its position has been struck down by at least two circuit courts of appeals, both of which held that the fact that an insurance agent received certain employee benefits did not preclude his being considered an independent contractor based on all the other facts and circumstances of the case.[2] The IRS has instructed its attorneys to discontinue the practice of challenging certain independent contractor status claims of insurance agents who were treated as statutory employees by the companies for whom they worked.[3] However, industrial agents (or "debit agents") are treated as employees for tax purposes.[4] Thus, as in the case of any employee, a debit agent can deduct transportation and away-from-home traveling expenses from adjusted gross income if he itemizes, only to the extent that the aggregate of these and other miscellaneous itemized deductions exceeds 2 percent of adjusted gross income.[5]

Self-employed taxpayers are permitted a deduction equal to one-half of their self-employment (i.e., Social Security) taxes for the taxable year. This deduction is treated as attributable to a trade or business that does not consist of the performance of services by the taxpayer as an employee; thus it is taken "above-the line."[6]

In a legal memorandum concerning the deductibility of medical insurance costs, the Service ruled as follows:

(1) A sole proprietor who purchases health insurance in his individual name has established a plan providing medical care coverage with respect to his trade or business, and therefore may deduct the medical care insurance costs for himself, his spouse, and dependents under IRC Section 162(l), but only to the extent the cost of the insurance does not exceed the earned income derived by the sole proprietor from the specific trade or business with respect to which the insurance was purchased.

(2) A self-employed individual may deduct the medical care insurance costs for himself and his spouse and dependents under a health insurance plan established for his trade or business up to the net earnings of the specific trade or business with respect to which the plan is established, but a self-employed individual may not add the net profits from all his trades and businesses for purposes of determining the deduction limit under IRC Section 162(l)(2)(A). However, if a self-employed individual has more than one trade or business, he may deduct the medical care insurance costs of the self-employed individual and his spouse and dependents under each specific health insurance plan established under each specific business up to the net earnings of that specific trade or business.[7]

1. Rev. Rul. 90-93, 1990-2 CB 33.
2. *Ware v. U.S.*, 67 F.3d 574 (6th Cir. 1995); *Butts v. Comm.*, TC Memo 1993-478, aff'd 49 F.3d 713 (11th Cir. 1995).
3. Notice N(35)000-141 (Doc. 96-31376).
4. Rev. Rul. 58-175, 1958-1 CB 28.
5. IRC Sec. 67.
6. IRC Sec. 164(f).
7. CCA 200524001.

Later, with respect to the same taxpayer, the Service ruled that a self-employed individual cannot deduct the costs of health insurance on Schedule C; instead, the deduction under IRC section 162(l) must be claimed as an adjustment to gross income on the front of Form 1040.[1]

The Service has provided rules under which a 2 percent shareholder-employee in an S corporation is entitled to the deduction (under IRC Section 162(l)) for health insurance premiums that are paid or reimbursed by the S corporation and included in the 2 percent shareholder-employee's gross income.[2]

The Tax Court has held that a taxpayer could deduct his expenses ($15,745) incurred in earning a master's degree in business administration to the extent those expenses were substantiated and education-related. The court based its decision on the fact that the taxpayer's MBA did not satisfy a minimum education requirement of his employer, nor did the MBA qualify the taxpayer to perform a new trade or business.[3]

Expenses for business meals and entertainment must meet one of two tests, as defined in regulations, in order to be deductible. The meal must be: (1) directly related to the active conduct of the trade or business, or (2) associated with the trade or business. Generally, the deduction for business meal and entertainment expenses is limited to 50 percent of allowable expenses.[4] The 50 percent otherwise allowed as a deduction is then subject to the 2 percent floor which applies to miscellaneous itemized deductions.[5] The taxpayer or his employee generally must be present for meal expenses to be deductible, and expenses that are lavish or extravagant may be disallowed. Substantiation is required for lodging expenses and for most expenditures of $75 or more.[6] An employee must generally provide an adequate accounting of reimbursed expenses to his employer.[7]

7952. Are expenses relating to higher education deductible?

For taxable years beginning after 2001 and before 2014, an above-the-line deduction (see Q 619) is available for qualified tuition and related expenses (see below) paid by the taxpayer during the taxable year, subject to certain limitations.[8]

In 2004 through 2013, a deduction of $4,000 is available for taxpayers with adjusted gross income (see Q 619) that does not exceed the following limits: single, $65,000; married filing jointly, $130,000. A more limited deduction of $2,000 is available for taxpayers with adjusted gross income that falls within the following limits: married filing jointly, $130,000 - $160,000; single, $65,000 - $80,000. Taxpayers with adjusted gross income above these limits are not entitled to a deduction.[9] (Note that these amounts are not adjusted for inflation). As a practical

1. CCA 200623001.
2. Notice 2008-1, 2008-2 IRB 251.
3. *Allemeier v. Commissioner*, TC Memo 2005-207.
4. IRC Sec. 274(n)(1).
5. Temp. Treas. Reg. §1.67-1T(a)(2).
6. IRC Sec. 274; Treas. Reg. §1.274-5(c)(2)(iii).
7. Treas. Reg. §1.274-5(f)(4).
8. IRC Secs. 222(a), 222(e), as amended by ATRA.
9. IRC Secs. 222(b)(2)(A), 222(b)(2)(B).

matter, this deduction can be used by taxpayers whose income is too high to utilize the Hope Scholarship (American Opportunity) or Lifetime Learning Credit.

Adjusted gross income (see Q 619) for this purpose is determined *before* the exclusions for income derived from certain foreign sources or sources within United States possessions and *after* the inclusion of any taxable Social Security benefits, the exclusion for savings bond interest used for education expenses, the exclusion for certain adoption expenses, any deductible IRA contributions, interest on education loans, and adjustments for passive activity losses or credits.[1]

Qualified tuition and related expenses are tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer (for whom he is allowed a dependency exemption) at an eligible educational institution (defined in Q 646). Qualified tuition and related expenses do not include nonacademic fees such as room and board, medical expenses, transportation, student activity fees, athletic fees, insurance expenses, personal, living, family, or other expenses unrelated to a student's academic course of instruction. Additionally, qualified tuition and related expenses do not include expenses for a course involving sports, games, or hobbies, unless it is part of the student's degree program.[2]

7953. What limitations apply to a taxpayer's ability to deduct higher education expenses?

Coordination with other provisions. The deduction for qualified tuition and related expenses is not allowed for any expenses for which there is a deduction available.[3] Taxpayers are not eligible to claim the deduction for qualified higher education expenses and an American Opportunity, Hope, or Lifetime Learning Credit in the same year with respect to the same student.[4]

The amount of qualified tuition and related expenses is limited by the sum of the amounts paid for the benefit of the student, such as scholarships, education assistance advances, and payments (other than a gift, bequest, devise, or inheritance) received by an individual for educational expenses attributable to enrollment.[5]

The total amount of qualified tuition and related expenses for the deduction has to be reduced by the amount of such expenses taken into account in determining the following exclusions: (1) interest from U.S. Savings bonds used to pay for higher education expenses;[6] (2) distributions from qualified tuition programs;[7] and (3) distributions from a Coverdell Education Savings Account.[8] For these purposes, the excludable amount under IRC Section 529 does not include that portion of the distribution that represents a return of contributions to the plan.[9]

1. IRC Sec. 222(b)(2)(C).
2. IRC Sec. 222(d)(1), 25A(f)(1).
3. IRC Sec. 222(c)(1).
4. IRC Sec. 222(c)(2)(A).
5. IRC Secs. 25A(g)(2), 222(d)(1).
6. IRC Sec. 135.
7. IRC Sec. 529.
8. IRC Sec. 530.
9. IRC Sec. 222(c)(2)(B).

Eligibility. If the student is claimed as a dependent on another individual's tax return (e.g., parents), he cannot claim the deduction for himself.[1] The deduction is not available to married taxpayers filing separately.[2]

Identification. For the deduction to be permitted, the taxpayer has to provide the name and the taxpayer identification (i.e., Social Security) number of the student for whom the credit is claimed.[3]

Timing. A deduction is permitted for any taxable year only to the extent that the qualified tuition and related expenses are connected with enrollment at an institution of higher education during the taxable year.[4] However, this does not apply to expenses paid during a taxable year if those expenses are connected with an academic term beginning during the taxable year, or during the first three months of the next taxable year.[5]

The Secretary may provide regulations necessary and appropriate to carry out these provisions, including recordkeeping and information reporting regulations.[6]

1. IRC Sec. 222(c)(3).
2. IRC Sec. 222(d)(4).
3. IRC Sec. 222(d)(2).
4. IRC Sec. 222(d)(3)(A).
5. IRC Sec. 222(d)(3)(B).
6. IRC Sec. 222(d)(6).