

Internal Revenue Service

Department of the Treasury

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Date:

August 1, 2001

Legend

Subtrust1 =
Subtrust2 =
Subtrust3 =
Subtrust4 =

Master Trust =

Decedent =

Corporation =

x =

y =

z =

Dear

This letter responds to a letter dated July 14, 2000, and subsequent correspondence, written on behalf of Subtrust 1 requesting a ruling under section 469 of the Internal Revenue Code regarding the deductibility of certain interest expenses.

FACTS

The following facts are represented. Decedent was engaged in commercial and residential real estate development, property management, and leasing through Corporation. At the time of Decedent's death, Master Trust owned all of the shares in Corporation and a number of real estate parcels. After the payment of estate taxes and administration expenses, x commercial properties remained in Master Trust.

Under the terms of Master Trust, y percent of Decedent's estate is to pass outright to certain beneficiaries and z percent is to be held in identical Subtrusts, Subtrust1, Subtrust2, Subtrust3, and Subtrust4, for Decedent's minor children. The terms of the Master Trust instrument provide that the real estate parcels are to remain

in trust and are not to be disposed of or distributed to fund the outright transfers “at least for so long that it is not clearly imprudent to do so.” Instead, the trustees are given the power to borrow funds to make the outright transfers. The trustees of Master Trust are also the trustees of the Subtrusts.

The trustees, on behalf of the Subtrusts, propose to obtain a loan with commercially reasonable terms. The loan proceeds will then be used by the Subtrusts to acquire complete ownership of the x commercial properties from Master Trust and the trustees of Master Trust will, in turn, use the proceeds to fund the outright transfers. The Subtrusts, including Subtrust1, will use the real estate parcels in a passive rental activity for purposes of § 469. As a result of this transaction, Subtrusts, including Subtrust1, will incur interest expenses on the borrowed funds. Subtrust1 has requested a ruling as to whether it will be able to deduct the interest it accrued and paid with respect to the loan obtained.

LAW AND ANALYSIS

Section 469 disallows the passive activity loss for any taxable year of individuals, estates, trusts, and certain types of corporations.

In general, a taxpayer’s “passive activity loss” for a taxable year equals the amount by which the taxpayer’s aggregate losses from passive activities (passive activity deductions) exceed the taxpayer’s aggregate income from passive activities (passive activity gross income) for the taxable year. Section 469(d)(1) and § 1.469-2T(b). A passive activity is a trade or business activity in which the taxpayer does not materially participate or any rental activity. Section 469(c).

Section 163(d)(1) provides that in the case of a taxpayer other than a corporation, the amount allowed as a deduction for investment interest for any taxable year shall not exceed the net investment income of the taxpayer for the taxable year. Section 163(d)(3)(B)(ii) specifies that investment interest does not include interest which is taken into account under § 469 in computing income or loss from a passive activity of the taxpayer.

Section 1.469-2T(d)(2) indicates that passive activity deductions do not include interest expense (other than interest expense described in § 1.469-2T(d)(3)). Section 1.469-2T(d)(3) states that interest expense is taken into account as a passive activity deduction if and only if such interest expense is allocated under § 1.163-8T to a passive activity expenditure (within the meaning of § 1.163-8T(b)(4)), and is not qualified residence interest (within the meaning of § 1.163-10T), or capitalized pursuant to a capitalization provision (within the meaning of § 1.163-8T(m)(7)(i)).

Section 1.163-8T(b)(4) indicates that a “passive activity expenditure” means an expenditure that is taken into account under § 469 in computing income or loss from a passive activity of the taxpayer or an expenditure (including an expenditure properly

chargeable to capital account) that would be so taken into account if such expenditure were otherwise deductible. For purposes of this section, the term passive activity expenditure does not include any expenditure with respect to any low-income housing project in any taxable year in which any benefit is allowed with respect to such project under section 502 of the Tax Reform Act of 1986.

Section 1.163-8T(a)(3) provides that interest expense on a debt is generally allocated in the same manner as the debt to which such interest expense relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. According to the facts submitted, the real estate parcels acquired with the loan proceeds will be used by Subtrust1 in a passive activity, thus, amounts expended for their purchase will be considered passive activity expenditures within the meaning of § 1.163-8T(b)(4).

CONCLUSION

To the extent the debt proceeds are used to acquire property used in a passive activity, the interest expense attributable to that debt will constitute a passive activity deduction. The interest expense will be deductible by Subtrust1 in any year in which Subtrust1's gross passive activity income exceeds its gross passive activity deductions, including any passive interest expense deductions.

Except as expressly provided herein, no opinion is expressed or implied concerning the federal tax consequences of the transaction under any other provision of the Code. In particular, no opinion is expressed regarding the tax consequences to Master Trust of the proposed acquisitions of real estate by the Subtrusts. Furthermore, no opinion is expressed regarding the validity of the loan used to finance the transaction or any other tax consequences associated with such loan.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,
Donna M. Young
Acting Chief, Branch 3
Associate Chief Counsel
Passthroughs and Special Industries

Attachment:
Copy of this letter for § 6110 purposes