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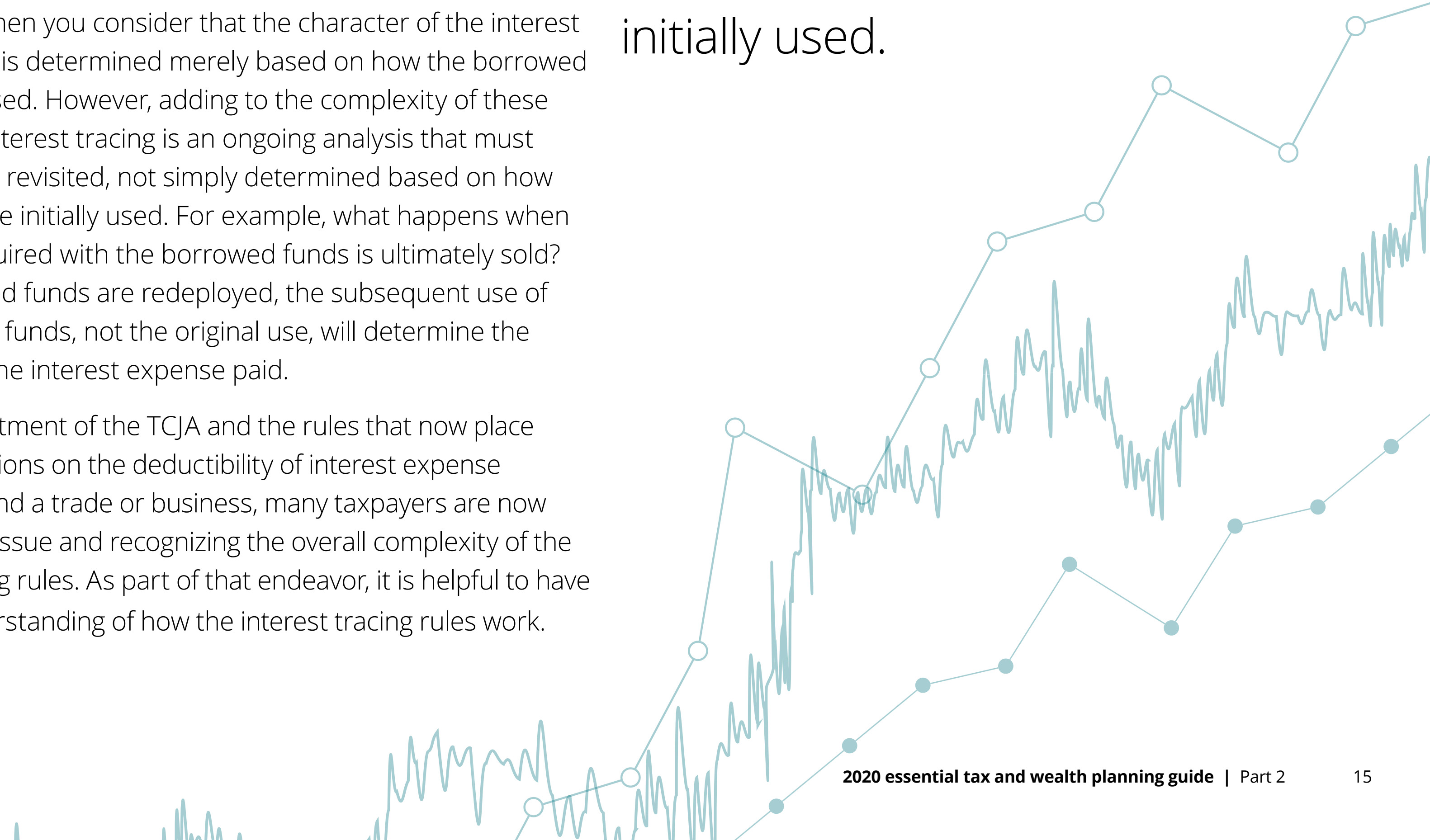
INTEREST TRACING

The complexity and flexibility of interest tracing

When a taxpayer borrows funds, a common misconception is that the deductibility of interest expense is determined by how the loan is collateralized. That is not the case. In fact, the deductibility of interest expense is determined based on how the loan proceeds are used, otherwise referred to as interest tracing. Over time, interest tracing has evolved into one of the more complex facets of the Internal Revenue Code. The rules for interest tracing appear rather elegant and simple in their application when you consider that the character of the interest expense paid is determined merely based on how the borrowed funds were used. However, adding to the complexity of these rules is that interest tracing is an ongoing analysis that must be continually revisited, not simply determined based on how the funds were initially used. For example, what happens when the asset acquired with the borrowed funds is ultimately sold? After borrowed funds are redeployed, the subsequent use of the borrowed funds, not the original use, will determine the character of the interest expense paid.

With the enactment of the TCJA and the rules that now place further limitations on the deductibility of interest expense incurred to fund a trade or business, many taxpayers are now revisiting this issue and recognizing the overall complexity of the interest tracing rules. As part of that endeavor, it is helpful to have a better understanding of how the interest tracing rules work.

Interest tracing is an ongoing analysis that must be continually revisited, not simply determined based on how the borrowed funds were initially used.



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A brief history

Prior to the Tax Reform Act of 1986 (1986 TRA), interest expense, regardless of type, was generally deductible. The 1986 TRA made personal interest, other than qualified residence interest, nondeductible and limited deductions for other types of interest expense. Shortly thereafter, guidance was issued that introduced interest tracing. As mentioned above, the interest tracing rules determine the character of interest expense by tracing the use of the loan proceeds to specific asset acquisitions or expenditures. These rules place the emphasis on the loan's use, rather than on the underlying asset used to collateralize the loan. The various categories of interest expense are as follows:

Personal interest	Investment interest	Residential interest	Passive interest	Trade or business interest
Related to credit card debt, auto loans, and other household borrowing	Related to property held for investment (for example, stocks, mutual funds, land, and other investments); however, interest incurred to produce tax-exempt income is not deductible	Mortgage interest on a primary and/or secondary home	Includes interest on debt for business or other income-producing activities in which the taxpayer does not materially participate	Includes interest on debt for activities in which the taxpayer materially participates

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Applying the rules

With that as background, how would you apply the interest tracing rules? As an example, assume a taxpayer borrowed from a bank and used the loan proceeds to purchase a boat. Assume that the loan was secured by an investment account held with the bank. It may feel intuitive to determine the deductibility of the interest expense based on how the loan is secured. Under that approach, the interest expense would be characterized as investment interest expense due to the loan being secured by investment assets. However, as we learned earlier, the interest tracing rules stipulate that, to determine the character of the interest expense, a taxpayer must trace how the loan proceeds were used. Since the loan proceeds were used to purchase a boat, which in this case is a personal asset, the interest expense should be categorized as personal, and therefore nondeductible.

Next, consider what happens when the proceeds are redeployed. Assume that at some time in the future the taxpayer decides to sell the boat and then use the proceeds from the sale of the boat to purchase inventory for their sole proprietorship. The interest expense on the loan is now subsequently traced to a business expense and thus the character of the interest expense changes from personal to trade or business. Note that this does not retroactively affect the interest expense incurred while the proceeds were traced to the acquisition of the boat. As such, the taxpayer has personal interest expense until the boat is sold and business interest expense once the proceeds from the sale of the boat are used for the taxpayer's business.

Let's now take a step back and add some more complexity to our scenario. Assume that before our taxpayer purchased their boat, the loan proceeds were first deposited into an investment bank account rather than being immediately disbursed to purchase the boat. How would our result change? The interest tracing rules determine that a deposit of loan proceeds into an account is treated as an investment expenditure and amounts held in an account (whether or not the account is interest-bearing) are treated as property held for investment. What that tells us is that upon the deposit of the loan proceeds into our taxpayer's bank account, the interest expense incurred would be characterized as investment interest expense. Recall that the interest tracing rules require the debt to be reallocated whenever the proceeds are used for another expenditure. Therefore, our taxpayer would have investment interest expense upon the deposit of the loan proceeds into their bank account, which would be recharacterized as personal interest expense upon the use of the loan proceeds to purchase their boat, then further recharacterized as trade or business interest expense upon using the sales proceeds from the boat to purchase inventory for their sole proprietorship.

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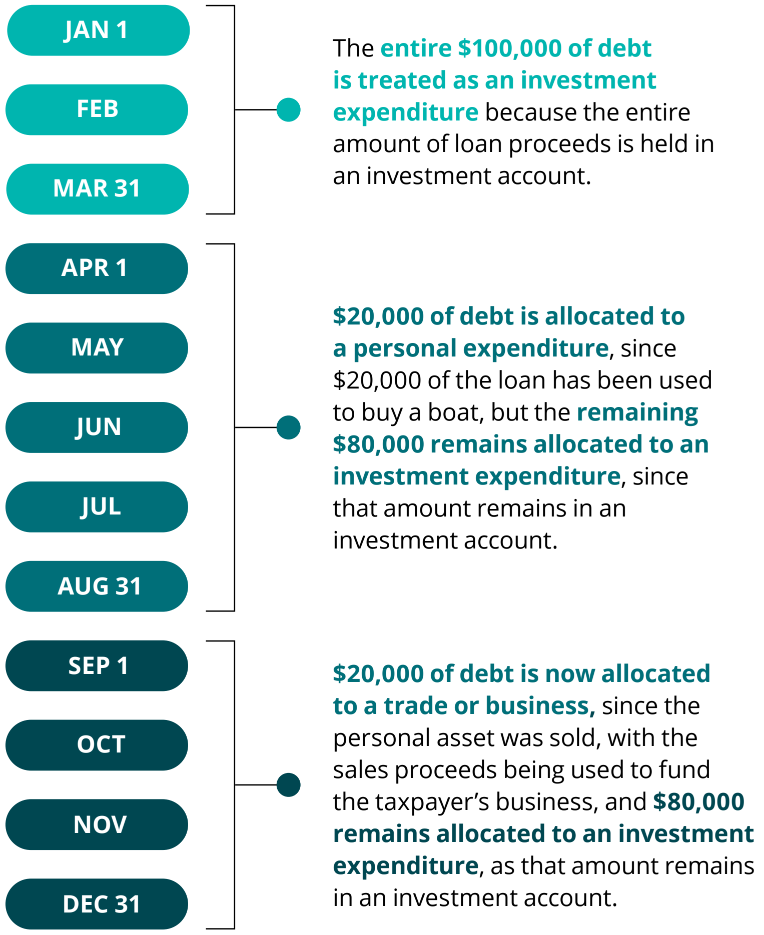
A basic example

Let's explore interest tracing further with another example. Assume a taxpayer borrows $100,000 on January 1 and immediately uses the proceeds to open a non-interest-bearing checking account. No other amounts are deposited in the account during the year, and no portion of the principal amount of the debt is repaid during the year. On April 1, the taxpayer uses $20,000 of the debt proceeds held in the account to purchase a boat. On September 1, the taxpayer sells the boat and uses the $20,000 of proceeds from the sale of the boat to purchase inventory for their business. The result of this activity is shown to the left.



The **entire $100,000 of debt is treated as an investment expenditure** because the entire amount of loan proceeds is held in an investment account.

$20,000 of debt is allocated to a personal expenditure, since $20,000 of the loan has been used to buy a boat, but the **remaining $80,000 remains allocated to an investment expenditure**, since that amount remains in an investment account.

$20,000 of debt is now allocated to a trade or business, since the personal asset was sold, with the sales proceeds being used to fund the taxpayer's business, and **$80,000 remains allocated to an investment expenditure**, as that amount remains in an investment account.

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With flexibility, timing is key

Another factor in the interest tracing rules is that a taxpayer may treat any expenditure made from an account within 30 days before or 30 days after debt proceeds are deposited in that account as being made from those loan proceeds. As an example, suppose a taxpayer spends $10,000 from an account to acquire a publicly traded stock investment. Ten days later, the taxpayer deposits loan proceeds into the same account. This rule allows the taxpayer to treat the acquisition of their stock investment as being made from the loan proceeds and thus trace the interest expense as investment interest expense. The 30-day rule provides flexibility to taxpayers to analyze the impact of the interest tracing rules; timing is the key.

While we have only reviewed a few scenarios, we hope it is apparent that the interest tracing rules, while quite complex in their application, also provide significant flexibility that can be beneficial to taxpayers. This flexibility provides an opportunity for planning. By anticipating borrowing needs and identifying asset acquisitions or expenses that can yield an interest expense deduction if funded with loan proceeds, a taxpayer can determine what steps they need to take to improve their tax posture.

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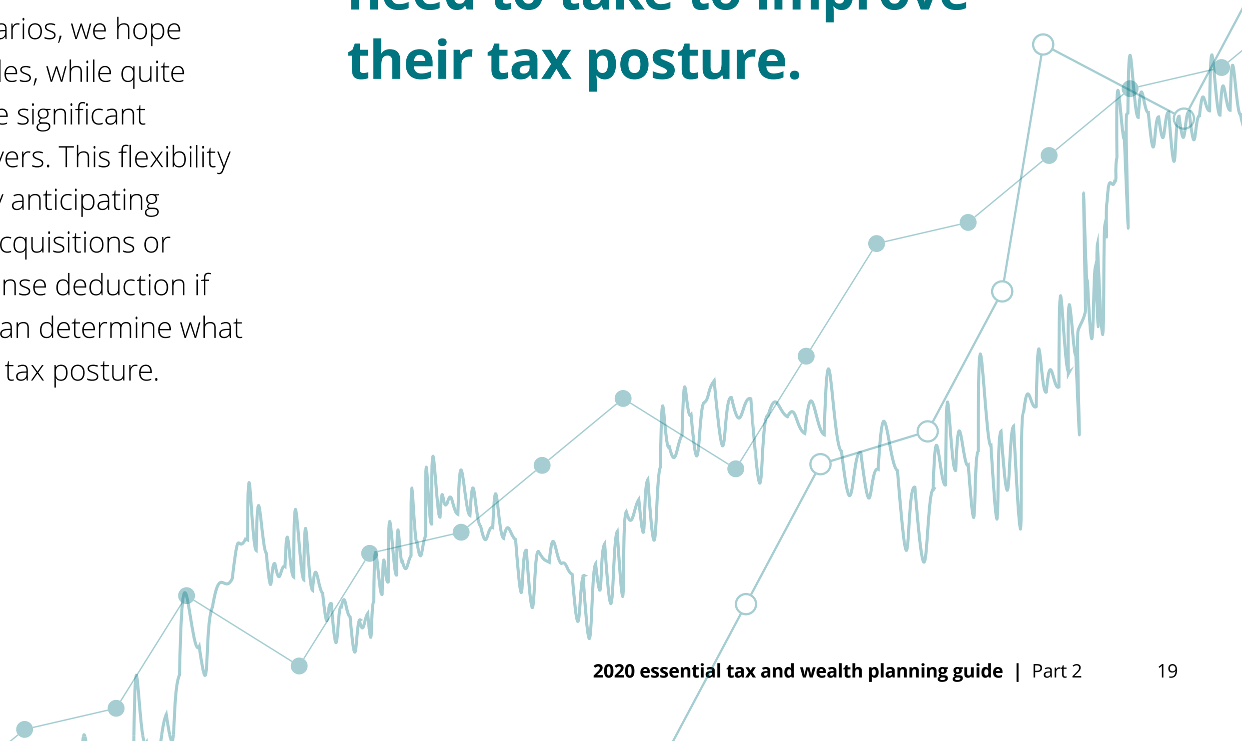

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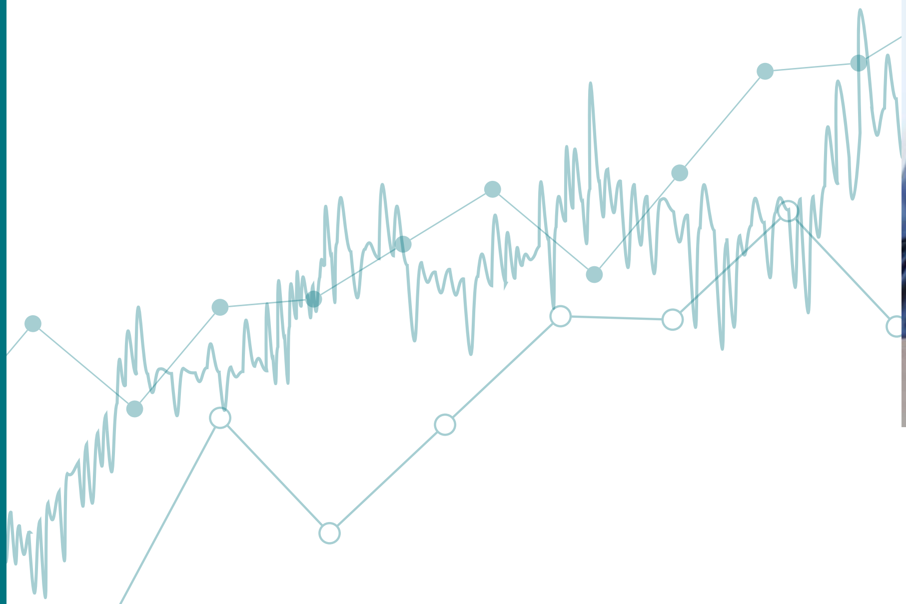
With flexibility, timing is key

It is important to note that debt incurred by a taxpayer to acquire an interest in a passthrough entity or debt incurred by a passthrough entity to fund distributions to its owners adds an additional layer of complexity that is beyond the scope of this article. If these facts are a part of your analysis, reach out to your tax adviser to determine how the interest tracing rules will affect you.

Next, we will discuss changes to the deductibility of business interest expense. In the past, business interest expense was often viewed as providing the most benefit for interest expense deduction purposes. While that may still be the case, given the changes discussed next, taxpayers may be surprised to find that something other than business interest expense provides a more tax-efficient result. As such, thoughtful planning in this area is critical.



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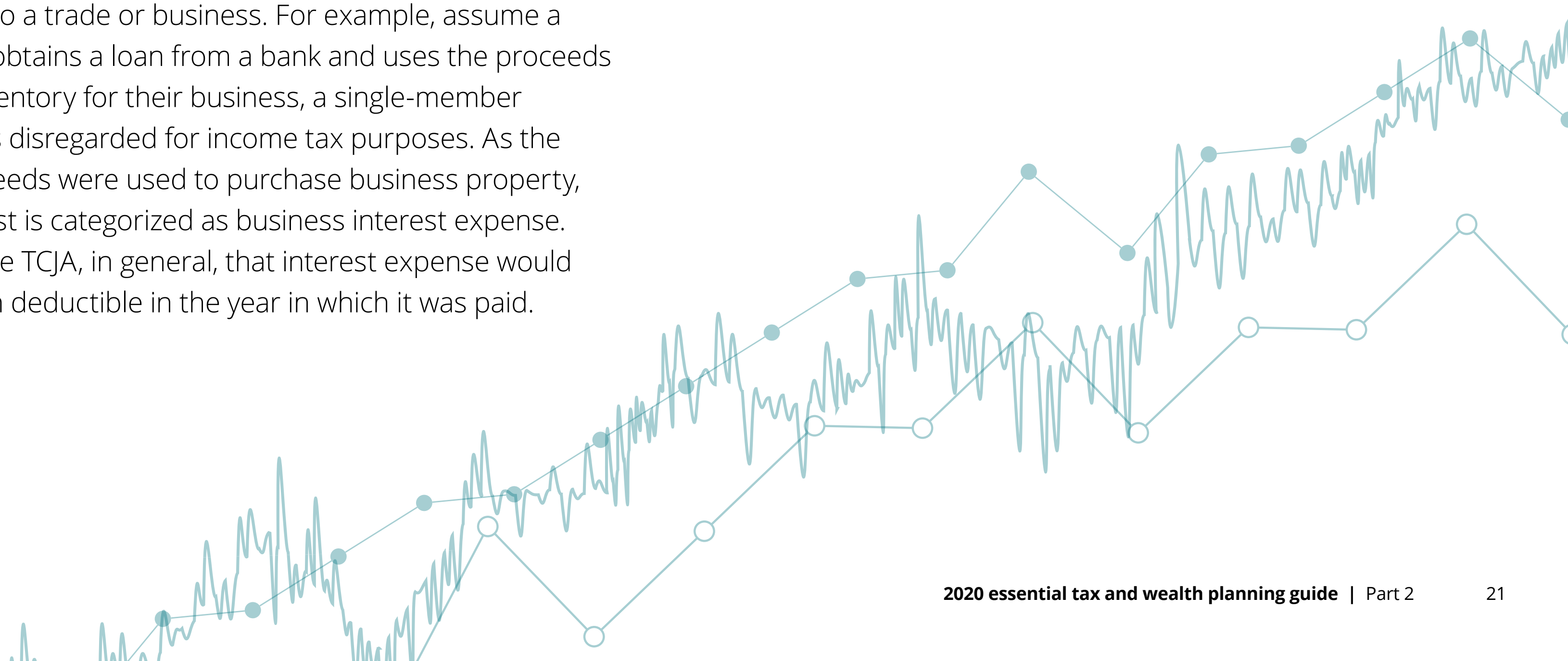
New business interest expense implications

The TCJA ushered in several fundamental changes that generally place limitations on the deductibility of business interest expense. These rules are highly complex and are applied differently depending on how a taxpayer's business is structured. For many taxpayers, this new limitation on the deductibility of trade or business interest expense places a renewed focus on the interest tracing rules since, as we learned earlier, interest expense is characterized based on how the loan proceeds are used. The following is a high-level discussion of the business interest expense limitations applied at the individual taxpayer level.

In general, taxpayers can deduct business interest expense, which is interest paid or accrued on indebtedness properly allocable to a trade or business. For example, assume a taxpayer obtains a loan from a bank and uses the proceeds to buy inventory for their business, a single-member LLC that is disregarded for income tax purposes. As the loan proceeds were used to purchase business property, the interest is categorized as business interest expense. Prior to the TCJA, in general, that interest expense would have been deductible in the year in which it was paid.

However, for business interest expense paid in tax years beginning after 2017, the deduction may be limited. The highly complex calculation applied to determine what portion of business interest expense can be currently deducted versus what portion is to be disallowed is beyond the scope of this article other than to note that (1) business interest expense that is disallowed can be carried forward indefinitely and (2) an exception to the business interest expense limitation is available for certain small-business taxpayers. Assuming our hypothetical taxpayer who bought inventory does not meet the small-business exception, the taxpayer may not receive a current deduction for the interest expense incurred.



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New business interest expense implications

Now consider the treatment of business interest expense in comparison to the treatment of investment interest expense. In general, investment interest expense is currently deductible by an individual taxpayer as an itemized deduction, but only to the extent the taxpayer has net investment income, with any excess investment interest expense being carried forward to future years. Assume the same hypothetical individual taxpayer above, but instead of using the proceeds to purchase inventory, the taxpayer used the proceeds to purchase a publicly traded stock portfolio. As before, we begin the analysis with interest tracing. Since the debt proceeds were used to purchase a portfolio of stocks, the interest expense paid will be investment interest expense. Next, the taxpayer must determine the taxpayer's net investment income (generally, interest, dividends, and capital gains) and whether that amount exceeds the investment interest expense paid. Prior to the TCJA, net investment income was reduced by miscellaneous itemized deductions (that is, 2% deductions, such as investment advisory fees and tax preparation fees) before determining the deductibility of investment interest expense. However, as the TCJA suspended the deduction for such expenses for tax years 2018–2025, miscellaneous itemized deductions do not affect the calculation of net investment income for these years. Taxpayers are no longer be able to claim such expenses as itemized deductions, but they may benefit from the resulting increase in net investment income, which provides the ability to deduct additional investment interest expense—whether that be investment interest expense paid currently or excess investment interest expense carried forward from a prior year.

To summarize, prior to the TCJA, business interest expense generally resulted in a current deduction, but now is subject to additional hurdles that may create a current-year disallowance. While the TCJA did not directly change the deductibility of investment interest expense, as a result of changes to the deductibility of miscellaneous itemized deductions, taxpayers may be able to currently deduct additional investment interest expense. Given these changes, is business interest expense still the "best" type of interest expense? It may or may not be, depending on a taxpayer's individual situation. But as we learned earlier, the interest tracing rules provide flexibility to analyze the impact based on their personal tax situation. With planning, it is possible for a taxpayer to identify what character of interest expense may yield a favorable result.

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Assess your situation to arrive at a favorable result

Let's consider a final example. Assume that in a prior year, an individual taxpayer borrowed funds to acquire a new asset for their business, operated as a sole proprietorship, and thus has business interest expense. While reviewing their most recent tax return, the taxpayer notices that they are limited on the current deductibility of their business interest expense, and they expect this limitation may continue to apply for years to come. For this taxpayer, business interest expense may not be a favorable result, as they do not foresee being able to receive a current deduction for the business interest expense they incur. However, the taxpayer also has a significant amount of net investment income that would allow for deductibility of investment interest expense. Through proper planning, the taxpayer could repay the loan traced to the business asset and then, at a later date, the taxpayer could establish a new loan using those proceeds to acquire investment assets. Thus, the interest expense would be investment interest expense. This example illustrates not only the flexibility and complexity inherent in these rules, but also that with thoughtful planning and an understanding of the potential outcomes, a taxpayer can use the interest tracing rules to yield a favorable result.

The interest tracing rules provide flexibility based on personal tax situations.

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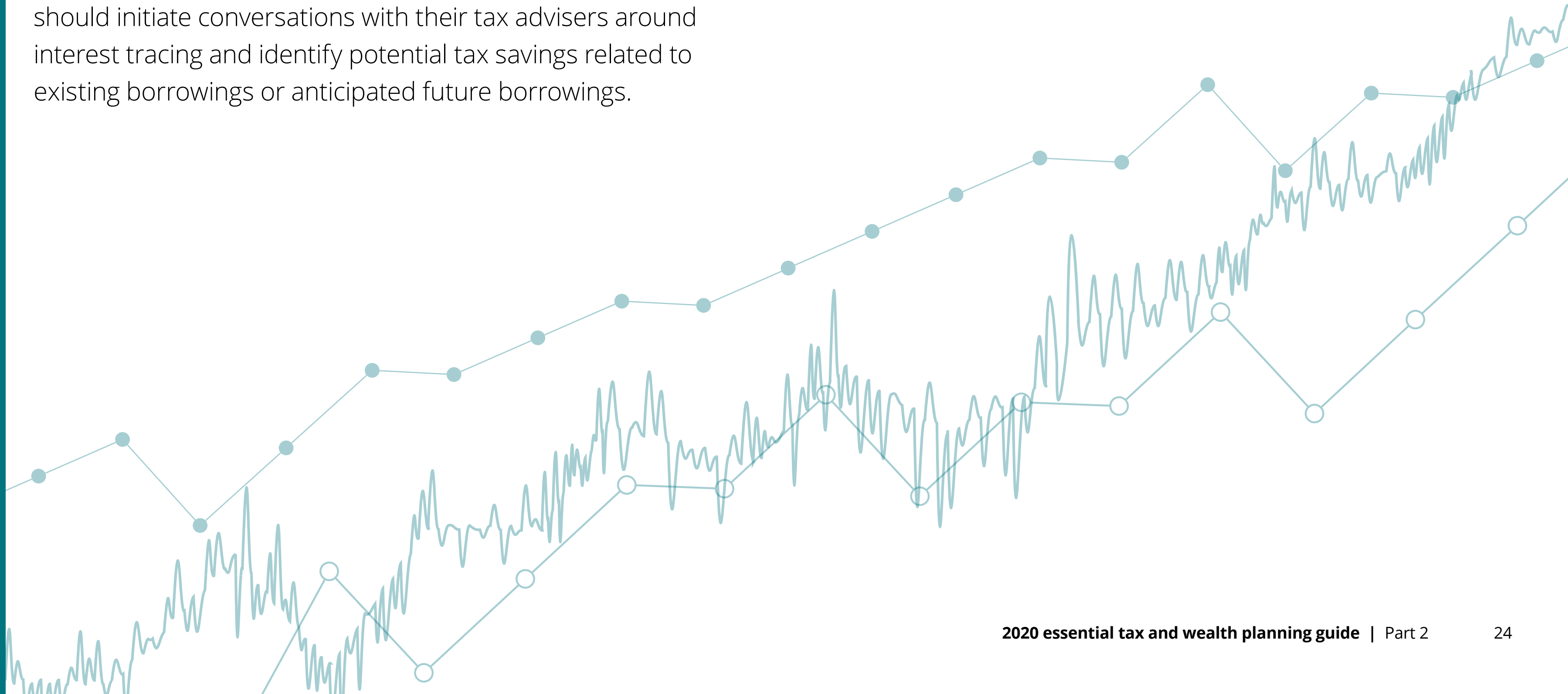
Assess your situation to arrive at a favorable result

Some taxpayers may not have been aware of the complexity inherent in the interest tracing rules and how they should be applied to the interest expense incurred each year, while others may have been aware of and applied the interest tracing rules at the time they borrowed the funds, but have not revisited their analysis since. Regardless, the recent changes to the deductibility of business interest expense provide a good reason to revisit this analysis and determine whether the result of interest tracing is providing a favorable tax result and, if not, whether the flexibility of the interest tracing rules provides an opportunity for planning. Taxpayers should initiate conversations with their tax advisers around interest tracing and identify potential tax savings related to existing borrowings or anticipated future borrowings.

With thoughtful planning and an understanding of the potential outcomes, a taxpayer can **use the interest tracing rules to yield a favorable result.**



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