

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-106244-99/CC:DOM:P&SI:B3

Attn:

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Year Involved:
Date of Conference:

LEGEND:

A =

B =

C =

D =

E =

X =

Y =

XY =

a =

b =

c =d =e =f =g =h =i =j =k =

Date =

ISSUE:

Should the portion of XY's interest expense that is allocated to XY's accounts receivable and cash bank accounts be treated as investment interest expense subject to the limitation rules of § 163(d)?

CONCLUSION:

XY's accounts receivable are not "property held for investment" under § 163(d)(5). Accordingly, the portion of XY's interest expense that is allocable to XY's accounts receivable will not be subject to the limitation rules of § 163(d). However, XY's cash bank accounts are "property held for investment" and the interest expense allocable to the cash bank accounts will be subject to the limitation rules of § 163(d).

FACTS:

XY is a limited liability company that is taxable as a partnership. Prior to the formation of XY, the business was run through X, an S corporation, and Y, a partnership. A, B, C, D, and E were the shareholders of X, and C and E were the partners of Y. X and Y decided that the business should be run through a single entity. Through a series of simultaneous transactions, A and B each received \$a for their shares, and X and Y contributed properties to XY, with X becoming a b% member in XY, and Y becoming a c% member in XY. As a result of these transactions, the ownership interests of C, D, and E in X increased from d% to

e% each. XY also entered into a debt restructuring arrangement with a bank and assumed the existing business debts of X, including the debt obligation associated with the \$f received by A and B for their shares.

For the period ending Date, XY incurred and deducted \$g in business interest expenses, h% of which (\$i) were directly traceable to the purchase of the shares of A and B. The balance sheet of XY for the period ending Date indicates that accounts receivable and cash bank deposits constitute approximately j% of XY's total assets.

As part of its business practice, XY allows its customers a certain number of days to pay their accounts. Although XY's invoices have a stated interest, as a matter of company policy and industry practice, XY does not charge "interest" on delinquent accounts receivable. Instead, XY bills its customers "late charges" for accounts not paid in full by the due dates.

LAW AND ANALYSIS:

Section 163 limits the deduction of investment interest for noncorporate taxpayers to an amount that does not exceed the taxpayer's net investment income for the taxable year. Section 163(d)(3) defines "investment interest" as any interest allowable as a deduction which is paid or accrued on indebtedness properly allocable to property held for investment.

Section 163(d)(5) provides that "property held for investment" includes:
(i) any property which produces income of a type described in § 469(e)(1), and
(ii) any interest held by a taxpayer in an activity involving the conduct of a trade or business which is not a passive activity and with respect to which the taxpayer does not materially participate.

Section 469(e)(1) provides that gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business is not taken into account in determining the income or loss from a passive activity.

Section 1.469-2T(c)(3)(i) provides that passive activity income does not include portfolio income. Portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business (within the meaning of paragraph (c)(3)(ii)) that is attributable to, among other things, interest, dividends, annuities, and royalties.

Section 1.469-2T(c)(3)(ii)(B) provides that for purposes of § 1.469-2T(c)(3)(i), gross income derived in the ordinary course of a trade or business includes interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business.

Notice 89-35, 1989-1 C.B. 675 provides rules for the allocation of interest expense in connection with certain transactions involving partnerships and S

corporations. In the instant case, XY agrees that the debts it assumed from X are subject to the provisions of Notice 89-35 and that the debt proceeds and associated interest expense ($f\%$ of $\$e$, or $\$g$) must be allocated among all of the assets of XY. However, XY believes that its cash bank accounts and accounts receivable are trade or business assets and not “property held for investment.”

Because XY customarily offers credit to its customers, we agree with XY that its accounts receivable are not “property held for investment” as defined in § 163(d)(5). Accordingly, interest expense allocable to the accounts receivable will not be treated as investment interest expense subject to the limitation rules of § 163(d). However, the cash bank accounts produce interest income not derived in the ordinary course of a trade or business. Therefore, the cash bank accounts are “property held for investment” as defined in § 163(d)(5). Accordingly, interest expense allocable to the cash bank accounts will be treated as investment interest expense subject to the limitation rules of § 163(d)(5).

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.