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Father’s treatment of partnership interest expense does not bind son

The son, who inherited and received as gifts the interests in real estate partnerships, could treat nonrecourse debt as acquisition indebtedness, the Tax Court holds.

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The Tax Court held that, after a father transferred partnership interests to his son as gifts and bequests, the son properly reported interest expense that passed through to him from the partnerships as allocable to real estate assets held by the partnerships and not as investment interest. The court found no support for the IRS's position that the interest, properly reported by the father as investment interest, retained that character when passed through to the son.

Facts: Maurice Lipnick owned interests in four real estate partnerships. Between 2009 and 2012, the partnerships borrowed money and made debt-financed distributions of the proceeds to the partners. All debt was secured by partnership assets, and neither Maurice nor any other partner was personally liable. Maurice used his share of the distributions to purchase assets he held for investment. Thereafter, the partnerships incurred interest expense on the debts, and Maurice deducted his distributive share as investment interest on Schedule A, *Itemized Deductions*, of his individual tax returns.

In 2011, Maurice gifted half of his ownership interests in three partnerships to William Lipnick, his son. On his individual tax return for that year, Maurice treated the nonrecourse partnership liabilities of which he was relieved as taxable capital gains. In 2013, Maurice died, and his will bequeathed his interest in a fourth partnership to William, who did not assume personal liability for any of the four partnerships' debts.

On his 2013 and 2014 individual tax returns, William treated his distributive share of interest expense passed through by the partnerships as indebtedness allocable to the partnerships' real estate assets. He therefore deducted it on Schedule E, *Supplemental Income and Loss*, against his share of the partnerships' real estate income. In 2017, the IRS issued William a notice of deficiency for 2013 and 2014, claiming that he should have reported the partnerships' interest expense as investment interest on Schedule A. But because William did not have enough investment income in those years against which to deduct the interest, the IRS disallowed the deductions and assessed accuracy-related penalties.

Issues: For taxpayers other than corporations, Sec. 163(d)(1) limits the amount allowed as a deduction for investment interest to the taxpayer's net investment income for the year. Sec. 163(d)(3)(A) defines investment interest as interest that is paid or accrued on indebtedness properly allocable to property held for investment. Temp. Regs. Sec. 1.163-8T(a)(3) states that debt is allocated by tracing disbursements to specific expenditures. Notice 89-35 provides that if a partnership uses debt proceeds to make a distribution to partners — a debt-financed distribution — each partner's use of the proceeds determines whether the interest passed through by the partnership constitutes investment interest.

Because Maurice purchased investments with the debt-financed distributions he received from the partnerships, the interest passed through to him was properly treated as investment interest. William, however, neither received debt-financed distributions from the partnerships nor acquired investments with any distributions. The question before the court, therefore, was whether William was bound to treat the interest expense passed through to him by the partnerships in the same manner as Maurice had.

The IRS argued that because the debt was nonrecourse to William, the liens held by the lenders applied to the partnerships' real estate assets, not against William's partnership interests. Therefore, William had not assumed a debt or taken property subject to a debt. Alternatively, the IRS asserted that because William acquired the partnership interests by gift and inheritance, he effectively stepped into his father's shoes, and the interest expense incurred by the partnerships remained investment interest to William.

Holding: The Tax Court found that the interest expense passed through to William by the partnerships was not investment interest under Sec. 163(d). William did not receive, directly or indirectly, any portion of the debt-financed distributions that the partnerships made to Maurice. Additionally, William did not use distributions from the partnerships to acquire investments. The facts that caused the passed-through interest to be investment interest to Maurice did not apply to William. With regard to the IRS's step-in-the-shoes argument for treating the interest as investment interest, the court stated that it found "no support for this theory in the statute, the regulations, or the decided cases."

Instead, the Tax Court concluded that William acquired his partnership interests subject to the debts that were then on the partnerships' books, despite the fact that the debts were nonrecourse to him. According to the court, the fact that a partner is not personally liable for a partnership's debt does not mean that his or her partnership interest is not "subject to a debt" for purposes of Subchapter K. Thus, having taken the partnership interest subject to the debts, under Temp. Regs. Sec. 1.163-8T(c)(1) and Notice 89-35, William was treated as having made a debt-financed acquisition of the partnership interests. Both the debt proceeds and the corresponding interest were therefore allocable among the partnerships' real estate assets. Since those assets were actively managed operating assets and not investment property, the interest paid on the partnership debts was not investment interest.

- *Lipnick*, 153 T.C. No. 1 (2019)

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