Effect of the New Investment Deduction Rules on Real Estate Transactions

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COMMENT

THE EFFECT OF THE NEW INVESTMENT DEDUCTION RULES ON REAL ESTATE TRANSACTIONS*

One of the major purposes of the Tax Reform Act of 1976 was to simplify and clarify some of the more complex provisions of the Internal Revenue Code.1 Apparently this goal was not foremost in the minds of the drafters of the Reform Act's version of subsection 163(d) of the Code. This subsection, which places a limitation on the amount of investment interest which an individual taxpayer can deduct as an itemized deduction, has been appreciatively described as "wonderfully complex"2 and as indicating "Congress' apparent desire to insure the full employment of accountants and tax advisers."3 The purpose of this article is to shed some light on the abstruse language of subsection 163(d) and to consider the impact the amended version might have on real estate investments.

The 1976 Tax Reform Act amendments to subsection 163(d),4 substantially increased its potential importance. Before the 1976 Act the deductibility of investment interest was subject to only a rather inconsequential limitation. An individual taxpayer could automatically deduct an amount of investment interest equal to the sum of the following: (1) $25,000,5 (2) net investment income, (3) the excess of so-called out-of-pocket expenses attributable to property subject to a net lease6

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1. STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 1 (Comm. Print 1976) [hereinafter cited as GENERAL EXPLANATION].


5. This base amount was $12,500 for married persons filing separate returns and zero for trusts.

6. Generally, a net lease is one in which the lessor does not assume the full risks and responsibility of owning and maintaining the property leased. The criteria for
over the rental income from such property and (4) the excess of net long-term capital gains over net short-term capital losses attributable to investment properties. In addition, a taxpayer could also deduct one half of any investment interest remaining after the application of the foregoing four-component formula.\(^7\) Relatively few real estate investors were threatened by this rather generous limitation on the deductibility of investment interest.

The Tax Reform Act of 1976, however, drastically reduced the amount of deductible investment interest. The $25,000 base amount in the formula was lowered to $10,000\(^8\) and the net long-term capital gain component was deleted. Furthermore, no interest in excess of the amount computed by the formula is deductible now after the 1976 Act.\(^9\) Thus, subsection 163(d) determining whether a particular lease constitutes a net lease will be discussed in detail later. See text accompanying notes 29-49 infra. The definition of net lease set forth in subsection 163(d) differs substantially from the generally accepted meaning of the term. In the real estate industry the phrase "net lease" is used to refer to any leasing arrangement in which the tenant agrees to pay one or more specified expenses relating to the rental property.


8. The base amount was lowered to $5,000 for married individuals filing separate returns and zero for trusts.

9. The legislative history behind the 1976 investment interest amendment was somewhat analogous to that of the 1969 amendment. The House Ways and Means Committee proposed amending the formula to include only three factors: (1) a $12,000 base amount, (2) net investment income and (3) capital gains. The Committee also recommended that the limitation formula apply to all nonbusiness interest, including interest paid on personal, as well as investment, loans. See H.R. Rep. No. 94-658, 94th
as presently enacted, limits the annual deduction of investment interest to an amount equal to the sum of the following components: (1) the $10,000 base amount, (2) net investment income and (3) the excess of out-of-pocket expenses attributable to net lease property over the rental income from such property.\(^\text{10}\)

The stricter investment interest limitation was intended "to reduce the possibility that this deduction could be used to shelter noninvestment types of income."\(^\text{11}\) It was also hoped that the new rules would encourage "taxpayers to focus on the economic viability of particular investments (rather than possible tax advantages resulting from investment deductions) before borrowing funds in order to make those investments."\(^\text{12}\).

I. WHEN TO APPLY SUBSECTION 163(d)

The limitation on deductibility in subsection 163(d) only applies to investment interest. Investment interest is defined as "interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment."\(^\text{13}\) Thus, whether or not the interest paid on any particular loan will be subject to subsection 163(d) depends upon whether the individual taxpayer took out the loan in order to purchase or maintain property held for investment. The method for determining whether particular parcels of real estate constitute investment property varies with the type of real estate involved.

A. Undeveloped Real Estate

As of this writing there are no regulations interpreting subsection 163(d). However, during 1970 and 1971, when excess investment interest was a tax preference item subject to the minimum tax under section 57,\(^\text{14}\) the Treasury Department promulgated proposed regulations interpreting the section 57 defi-

\(^\text{10}\) I.R.C. § 163(d)(1).
\(^\text{11}\) GENERAL EXPLANATION, supra note 1, at 103.
\(^\text{12}\) Id.
\(^\text{13}\) I.R.C. § 163(d)(3)(D).
\(^\text{14}\) See note 7 supra.
nitions of the terms “investment interest” and “net lease.” These definitional provisions are essentially identical to the present definitions in subsection 163(d). Consequently, these regulations proposed for section 57 should be of assistance in ascertaining the intended meaning of the terms “investment interest” and “investment property” in the present subsection 163(d).

The proposed section 57 regulations provide that “[t]he determination whether property is held for investment must be made on the basis of the particular facts and circumstances.” The regulations set forth a two step test to determine whether a particular piece of property was held for investment. First, in order to constitute investment property under the proposed section 57 regulations, property has to be held for the production of “passive income, such as interest, rent, dividends, royalties, or capital gain.” Second, the property must not have been “actively used in the conduct of a trade or business.” The proposed regulations further explain that, except for property subject to a net lease, “property is not held for invest-

15. Prop. Treas. Reg. §§ 1.57-2, -3, 35 Fed. Reg. 19,757, at 19,766 (1970). Portions of treasury regulation § 1.57-2 were revised in 1971. 36 Fed. Reg. 12,020, at 12,023 (1971). In 1978 the Treasury Department adopted several of the regulations which were proposed at the same time as sections 1.57-2 and 1.57-3. However, the latter sections were not adopted, but were “left outstanding.” The Treasury Department indicated that “any necessary changes” in sections 1.57-2 and 1.57-3 would be made in a notice of proposed rulemaking issued under subsection 163(d). T.D. 7564, 1978-42 I.R.B. 5, at 7. Although sections 1.57-2 and 1.57-3 still probably constitute proposed regulations, they should not be accorded substantial independent significance. The division of the Internal Revenue Service now working on the revised regulations under subsection 163(d) is not the same division which drafted the original proposed regulations under section 57. Any new proposed regulations under subsection 163(d) will be issued no earlier than the fall of 1979. Consequently, the proposed section 57 regulations are all that is available to the private practitioner. The Internal Revenue Service is issuing rulings under subsection 163(d). Where the present proposed regulations do not follow clearly from the terms of the statute, it is recommended that a ruling be requested. Telephone conversations (January 30, 1979) with Robert Coplan and Jeffrey Tanning, Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service.

16. Compare the definition of investment interest expense in I.R.C. § 57(b)(2)(D) with the definition of investment interest in I.R.C. § 163(d)(3)(D) and the exclusion of construction interest in I.R.C. § 163(d)(4)(D). Also compare the definition of net leases in I.R.C. § 57(c) with the definition of “property subject to a net lease” in I.R.C. § 163(d)(4)(A).


18. Id.

19. Id.

20. The determination of whether property is subject to a net lease is considered at some length below. See text accompanying notes 29-49 infra.
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ment if the expenses paid or incurred by the taxpayer in connection with his use thereof are allowable as deductions under section 162."  

Section 162 provides for the deduction of "ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business." The use of section 162, which has been in existence for a relatively long period of time, as a limit on the scope of the phrase "investment property" should give tax advisors a fairly good touchstone in interpreting this phrase in subsection 163(d).

Under the two step test in the proposed section 57 regulations, unimproved real estate should generally be considered investment property if the taxpayer purchases such property with the intention of simply holding on to the property and selling it for a higher price in the future. First, the intended capital gain would be passive income. Second, it would be difficult to argue that the property was being actively used in the conduct of a trade or business.  

However, the fact that a taxpayer purchases property which is unimproved should not automatically preclude him from asserting that it is property to be actively used in his trade or business, and, therefore, not investment property. The Tax Court recently ruled that the intended use controls as to whether unimproved property is used in the taxpayer's trade or business. An individual in the business of renting real estate had purchased vacant property with the intention of developing and renting the property in the future. Holding that a loss on the sale of the property was ordinary, not capital, be-

22. I.R.C. § 162(a).
23. When property is owned by a taxpayer in association with other persons, such as in a partnership, a question arises as to whether it is the taxpayer's or the association's trade or business which is determinative of the property's classification as investment or trade or business property. For other purposes, the classification of particular items is made at the partnership level:  

Regulation 1.702-1(b) suggests the partnership as the level at which "character" is to be determined; it says: "For example, a partner's distributive share of gains in the sale of depreciable property used in the trade or business of the partnership shall be considered as gain from the sale of such depreciable property in the hands of the partner."

This example fixes the character of the item at the partnership level, without regard to the trade or business of each individual partner.

cause the property was used in the conduct of the taxpayer's trade or business, the court stated:

    The property does not have to be in actual use as rental property during the year of sale. . . . The phrase "used in the trade or business" means, as was said in Alamo Broadcasting Co., 15 T.C. 534, property that is "devoted to the trade or business" and includes property purchased with a view to its future use in the business even though this purpose is later thwarted by circumstances beyond the taxpayer's control."  

Thus, whether or not a particular piece of real estate is being actively used in the conduct of a trade or business for purposes of the second part of the section 57 test described above should depend upon whether the taxpayer intends to use the property in his trade or business in the future or to sell it for a capital gain.

B. Developed Real Estate

The same general rules explained above also apply in determining whether improved property which is not rented to others constitutes investment property. However, most real estate, for which the taxpayer is willing to incur interest on loans to pay for its purchase price and upkeep and which is not being rented to others, is actively used by the taxpayer himself. If so, either it is used for personal purposes and, thus, not held for the production of passive income or it is actively used in the taxpayer's trade or business. Consequently, most nonrental improved property is not investment property under the two part test of the section 57 regulations and the interest on a loan to pay for its purchase price and upkeep is not subject to the subsection 163(d) limitation.

Subsection 163(d) provides special rules for determining whether rental property constitutes investment property. Such property is treated as investment property if the rental agreement falls within the definition of a net lease set forth in subsection 163(d). Under this definition a rental agreement is

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25. Id. at 63-1148.
26. See text accompanying notes 18-23 supra.
27. The proposed section 57 regulations define a lease as, "any arrangement or agreement, formal or informal, written or oral, by which the owner of property (the "lessor") receives consideration in any form for the use of his property by another party." Prop. Treas. Reg. § 1.57-3(d), 35 Fed. Reg. at 19,769. Both an apartment building and a shopping center are used as examples. Id.
a net lease if it meets the requirements of either of two tests. The proposed section 57 regulations refer to these statutory net lease tests as the "expense test" and the "return test." The negative inference of this statutory provision is that rental property which is not subject to a net lease, because it does not fall within the parameters of either the expense test or the return test, should be considered trade or business property and not property held for investment. The proposed regulations explicitly state that, except with regard to net lease property, "real property held in the conduct of the business of renting real property is property actively used in the conduct of a trade or business."

1. The Expense Test

Under the expense test, rental property constitutes net lease and therefore investment property if the lessor's deductions for ordinary and necessary expenses under section 162 (excluding rents and expenses for which the taxpayer is reimbursed) are less than 15% of the rental income generated by the property. Rents and reimbursed expenses are excluded from the expense test because they do not involve the lessor's active assumption of the risks and duties of owning and managing rental property. Consequently, these expenses are not considered in qualifying property as trade or business property.

29. See Prop. Treas. Reg. §§ 1.57-3(b), -3(c); 35 Fed. Reg. at 19,768-69.
30. See also Fein, supra note 3, at 400; Josephs, Tuller & Greenberg, The Excess Investment Limitation: How it Works and How to Plan to Avoid it, 39 J. Tax. 214 (1973); Lewis, Investment Interest (Sec. 163(d)), 297 TAX MNGM'T (BNA) A-7 [hereinafter cited as Lewis].
32. I.R.C. § 163(d)(4)(A)(i). It is somewhat anomalous for a piece of property to be investment property subject to subsection 163(d) and for expenses of that property to be deductible under section 162, which provides the deduction of expenses relating to property used in the taxpayer's trade or business. Yet, this is the situation for net lease property for which the section 162 expenses total less than 15% of the annual rental income.
33. The Report of the House Committee, which originally proposed the exclusion of rents and reimbursed expenses from the expense test formula, stated:

It has been suggested that the provisions of present law can be avoided where the lessor has a rental deduction which means that his deductions are very likely to exceed 15 percent. A rental deduction may be involved, for example, in the case of ground rent where the building is owned by the lessor. In this case the rent paid by the lessor does not provide any measure of his business activities in connection with the leased property. As a result, it seems inappropriate to permit these items to be taken into account to determine whether the 15-percent
penses which are deductible under sections other than section 162, such as depreciation, interest and taxes, are also not included in the formula. Thus, in order for a particular piece of rental property not to constitute investment property under the expense test, the expenses of managing and maintaining the property must total more than 15% of the rental income from the property.

Since the proposed section 57 regulations indicate that the expense test is to be applied each year, a particular parcel of real estate can constitute trade or business property one year and investment property the next. If in planning for the next year a taxpayer foresees the possibility that his section 162 deductions might fall below 15% of his rental receipts, he can apparently avoid the risk of failing to meet the expense test simply by hiring an independent party to manage and maintain the property for an amount fixed at 15% of the rental income.

A real estate lessor may also avoid having his property qualify as investment property under the expense test through the strategic use of two elections provided for in subsection 163(d)

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34. Depreciation is deductible under I.R.C. § 167.
35. Interest is deductible under I.R.C. § 163.
36. Taxes are deductible under I.R.C. § 164. For example, if an individual purchased a $500,000 sixteen-unit apartment building on January 1, 1978, and rented it for the entire year at $5,000 a month, or $60,000 per year, and had management and interest (at eight percent over twenty years payable annually) expenses of $20,000 and $40,000, respectively, the property would not be net lease, or investment property under the expense test. The $20,000 of ordinary and necessary section 162 expenses exceeds 15% of the annual rental income, or $9,000. Consequently, if the lease is not a net lease under the return test, the property would not constitute investment property and the entire $40,000 of interest would be deductible, notwithstanding subsection 163(d).
38. Id. § 1.57-3(b)(i), 35 Fed. Reg. at 19,768.
39. Temporary regulations have been promulgated by the Treasury explaining how and when the elections may be made. Temp. Treas. Reg. § 12.8, T.D. 7271, 1973-1 C.B. 37, at 38.
which apply exclusively to rental real estate.\textsuperscript{40} First, if a parcel of real estate is subdivided into two or more leased portions, the taxpayer may elect to treat all of the leased portions of the property as subject to a single lease.\textsuperscript{41} Therefore, if this election is properly exercised, an entire parcel of rental real estate may be considered trade or business property when several portions of the parcel, which are subject to independent lease agreements, would have constituted investment property if examined separately.

An owner of rental real estate may also elect to disregard the expense test entirely for property which has been in use for more than five years.\textsuperscript{42} The term "in use" is further explained in temporary regulations promulgated by the Treasury:

For this purpose, real property is in use only during the period that such property is both owned and used for commercial purposes by the taxpayer. If an improvement to the property was made during the time such property was owned by the taxpayer, and if, as a result of such an improvement, the adjusted basis of such property was increased by 50\% or more, use of such property for commercial purposes shall be deemed to have commenced for purposes of this paragraph as of the date such improvement was completed.\textsuperscript{43}

Thus, if the return test does not apply, all rental real estate should be considered trade or business property after the taxpayer has used it for five years without making substantial improvements.

2. The Return Test

Even if a particular piece of real estate does not qualify as investment property under the expense test, it may still qualify as net lease, and therefore investment property under the return test. Interest on loans to purchase or maintain property will qualify as investment interest if it is subject to the subsection 163(d) limitations, regardless of whether the property qualifies under the expense test or the return test.

Under the return test property qualifies as net lease property if "the lessor is either guaranteed a specified return or is

\begin{itemize}
  \item \textsuperscript{40} See I.R.C. § 163(d)(6).
  \item \textsuperscript{41} Id. § 163(d)(6)(A).
  \item \textsuperscript{42} Id. § 163(d)(6)(B).
\end{itemize}
guaranteed in whole or in part against loss of income."

Thus, under the return test property will be considered investment property and not trade or business property if the lessor is assured by the lessee that he will either receive a specified return on the lease or at least will not suffer a loss.

Unlike the expense test, the "return test is not based on a year by year analysis" but instead depends upon an "analysis of the leasing arrangement as a whole." A rental agreement in which the lessee guarantees that the rental payments will either equal or exceed the expenses by a fixed amount would be considered a net lease under the return test. Similarly, a rental agreement in which the lessee promises to pay all of the expenses attributable to the property and to continue to pay rent, or a lump sum equivalent, in the event that the property is destroyed would also be a net lease under the return test.

However, not all rental agreements with escalator clauses protecting the lessor to some extent against increases in expenses would be considered net leases. The proposed section 57 regulations state that an escalator clause will not in and of itself cast the entire agreement as a net lease under the return test. Thus, a lease provision allowing the rent to be raised when expenses, such as taxes or utilities, increase would not automatically qualify the property as investment property.

Although the reach of subsection 163(d)'s net lease definition appears to be quite broad, most taxpayers with rental real estate should be able to structure their rental agreements so as to avoid having the property classified as net lease and therefore investment property. A taxpayer can avoid having property qualify as net lease property under the return test simply by not requiring the tenant or tenants to guarantee him a specified return after expenses on his investment in the property. Furthermore, a taxpayer will often be able to avoid having the property qualify under the expense test if he agrees to pay for the expenses connected with the management and maintenance of the property, such as heat and other utilities, insurance, lawn care and repairs. It is submitted that these expenses.

46. Id. § 1.57-3(c)(2). Since all of the expenses would be reimbursed under such an arrangement, the agreement would also constitute a net lease under the expense test. See text accompanying note 33 supra.
should exceed 15% of the rental income in most cases. Furthermore, the taxpayer can always hire an independent party to manage and maintain the building for 15% of the rental income. Finally, after five years a taxpayer can elect to disregard the expense test.

C. Property under Construction

The application of the subsection 163(d) deductibility limitation to interest on real estate construction loans differs markedly from the treatment of interest on the loans discussed above, which was for the purchase and maintenance of unimproved real estate and property which has already been developed. In addition to the general investment interest deductibility limitation in subsection 163(d), section 189 contains special rules requiring the capitalization of "real property construction period interest" in many cases. Instead of being immediately deductible, interest incurred in the construction of real property which is subject to section 189 must be treated as a capital acquisition and must be amortized over a period which in 1987 will be ten years for all types of real property. Consequently, in 1987 only ten percent of construction interest can be deducted in any given year during the amortization period, beginning with the year of its incurrence. The application of subsection 163(d) to construction interest varies depending on whether or not section 189 is applicable. If section 189 does

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48. This conclusion is based on conversations with Mr. James Injeski, a tax manager of the Milwaukee office of the accounting firm of Arthur Young & Co., and Mr. William Griffiths, president of the Milwaukee real estate investment consulting firm of Inter-Design Investments, Inc. But cf. Lewis, supra note 30, at A-8 (concluding that these expenses will not exceed 15% of the rental income for most rental buildings).

49. Section 189 also requires the capitalization of construction period taxes in some cases. See I.R.C. § 189. Section 189 was first enacted in 1976 along with the subsection 163(d) amendments. It too was intended to discourage the use of real estate investments as tax shelters. The basic reason for requiring the taxpayer to capitalize construction period interest under section 189 as opposed to allowing the taxpayer to take a deduction in the year that the interest is paid, as the law formerly provided, is that this prevents the taxpayer from realizing large losses in the initial years of a building project which can be used to shelter other sources of income such as a salary. The capitalization of interest which is amortized over a ten year period forces the taxpayer to act in accord with the fundamental accounting principle of matching income and expenses. See General Explanation, supra note 1, at 25-29.

50. In the interim, section 189 provides for more lenient transitional rules for the deductibility of interest incurred in the construction of the various types of real property. See I.R.C. § 189(b).

51. The determination of when section 189 applies is outside the scope of this article.
not apply, subsection 163(d) specifically provides that, "interest paid or accrued on indebtedness incurred or continued in the construction of property to be used in a trade or business shall not be treated as investment interest."52 The negative inference of this provision is that interest on construction loans for property which is not to be used in a trade or business will be considered investment interest and will still be subject to the subsection 163(d) limitation on its deductibility during construction.53

The rule requires the taxpayer to predict the future use of property upon which a building is being constructed in order to determine whether subsection 163(d) applies. The proposed section 57 regulations stress that the intent of the taxpayer during the construction period is determinative.54 This intent can, in part, be ascertained by examining the taxpayer's past course of conduct. For example, the fact that a taxpayer has constructed several net lease buildings in the past should be considered in determining the taxpayer's intended use for a building presently under construction.55

However, under the proposed section 57 regulations the taxpayer is not required to predict the future use of the property with complete accuracy. "In determining the taxpayer's intent . . . the fact that the property is leased (regardless of when the lease is executed) under an arrangement which is subsequently considered to be a net lease . . . will not be considered."56 Therefore, if a taxpayer intends to use a building under construction in his trade or business but later decides to rent the building under a net lease, the interest deducted in prior years does not change in character and become subject to subsection 163(d). Naturally, the interest paid after the net lease agreement has been established will be investment interest subject to the subsection 163(d) limitation on deductibility.57

If section 189 does apply, interest paid on a construction

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52. I.R.C. § 163(d)(4)(D).
53. The same rules for determining what is considered trade or business property that were discussed above with respect to developed real estate would also apply here. See text accompanying notes 29-49 supra.
55. Id.
56. Id.
57. As discussed earlier, however, a taxpayer may elect to disregard the expense test after the building has been in use for five years. See text accompanying notes 42-43 supra.
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loan cannot be immediately deducted in the year in which it is incurred, but must be amortized over a period of up to ten years. In such a case the Internal Revenue Code is unclear as to whether the subsection 163(d) deductibility limitation still applies, and if so, whether it should be applied in the year in which the interest is incurred or in the subsequent year when the interest is amortized.

In discussing the amended subsection 163(d) the Joint Committee on Taxation noted: "Generally, construction period interest is not treated as investment interest for purposes of the limitation on investment interest . . . ." However, recognizing that interest on construction loans would constitute investment interest in some cases, the Joint Committee stated:

[W]here construction period interest is also investment interest, (i.e. where the exception under sec. 163(d)(4)(D) for construction period interest [on loans for property to be used in a trade or business] does not apply), the construction period interest rules are to be applied first. Amounts allowable under the construction period rules for a taxable year are thus not to be subject to the investment interest provision until that year; if disallowed for that year under the investment interest provision, these amounts can be deducted in succeeding years in accordance with the carryover rules of the investment interest provision.59

Therefore, the Joint Committee clearly intended for both section 189 and subsection 163(d) to limit the deductibility of interest on investment property construction loans. Furthermore, subsection 163(d) is to be applied in the year in which the interest is eligible to be amortized under section 189 and not the year in which it would have been deductible but for the new section 189 capitalization requirement. Consequently, where a taxpayer originally intends to use improved real estate in his trade or business, but later decides to rent the property under a net lease, only part of the interest will constitute investment interest. The interest amortized before the decision

58. GENERAL EXPLANATION, supra note 1, at 25.
59. Id. at 27 n.5. This Joint Committee explanation appears to be in conflict with subsection 189(e) which defines construction period interest to include only such interest "to the extent such interest . . . would be allowable as a deduction under this chapter for the taxable year in which paid or accrued (determined without regard to this section)." The latter provision certainly seems to imply that subsection 163(d) should be applied first.
to net lease the property would constitute trade or business interest.

II. How to Apply Subsection 163(d)

If a particular piece of real estate does constitute investment property, then the interest on loans procured to purchase or maintain the property is deductible only to the extent it does not exceed the amount determined under the limitation formula in subsection 163(d). As mentioned previously, the present formula contains three components: (1) a $10,000 base amount, (2) the taxpayer's net investment income and (3) the excess of out-of-pocket expenses over rental income for net lease property. Any investment interest in excess of the amount computed by the formula may be carried over to the next year.

In any given year a taxpayer can deduct only investment interest in excess of the $10,000 base amount if he has net investment income or his out-of-pocket expenses attributable to net lease property exceed the rental income from that property. The statute defines net investment income as "the excess of investment income over investment expenses." The term "investment income," in turn, is defined to include all of the taxpayer's interest, dividends, rents, royalties, net short-term capital gains and recaptured depreciation which are not derived from his trade or business. Thus, this definition encompasses essentially all passive income generated by investment property.

Investment expenses are netted against investment income to arrive at net investment income. The statute specifies the deductible expenses which will constitute investment expenses when they are "directly connected with the production of investment income." These specified deductions include those for ordinary and necessary trade or business expenses, state

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60. See text accompanying notes 8-10 supra.
63. Id. § 163(d)(3)(B).
64. Id. § 163(d)(3)(C).
65. Ordinary and necessary trade or business expenses are deductible under I.R.C.
and local taxes,66 bad debts,67 depreciation,68 amortizable bond premiums,69 ordinary and necessary nontrade or nonbusiness expenses70 and depletion.71

In determining investment expenses straight line depreciation may be used, even if the taxpayer uses an accelerated method for determining his actual deduction for depreciation.72 In the initial years of a real estate investment, when accelerated depreciation exceeds straight line depreciation and when the greater portion of the interest expense is incurred, this provision serves to increase the amount of interest deductible, because it allows the taxpayer to increase the amount of net investment income attributable to the property by decreasing the investment expense of depreciation.

In addition to $10,000 plus the amount of net investment income, a taxpayer may deduct the excess of his out-of-pocket expenses attributable to net lease property over the rental income derived from the property.73 Thus, a taxpayer, who in renting a particular parcel of real estate incurs substantial cash expenses which are not offset by the rents received, will be able to deduct a larger amount of interest in the present taxable year. The expenses which are considered to be out-of-pocket are interest expenses (without regard to the subsection 163(d) limitation), ordinary and necessary trade or business expenses, ordinary and necessary nontrade or nonbusiness expenses and state and local taxes.74 Depreciation, a noncash expense, is not included. Since this third factor is defined as the excess of out-of-pocket expenses over net lease income, it equals zero in any case where the rental income from net lease property is greater than the out-of-pocket expenses attributable to it.

Applying the formula to a particular fact situation will illustrate how subsection 163(d) limits the amount of interest

§ 162. For an explanation of how a taxpayer can have trade or business expenses in connection with investment property, see text accompanying note 33 supra.
66. State and local property taxes are deductible under I.R.C. §§ 164(a)(1) & 164(a)(2).
67. Bad debts are deductible under I.R.C. § 166.
68. Depreciation is deductible under I.R.C. § 167.
69. Bond premiums are amortizable under I.R.C. § 171.
70. Individual contracts or nonbusiness expenses are deductible under I.R.C. § 212.
71. Depletion allowances are deductible under I.R.C. § 611.
72. Similarly, depletion may be determined without regard to percentage depletion. See I.R.C. § 163(d)(3)(C).
74. Id.
deductible. The example will include a taxpayer who purchased a $500,000 sixteen-unit apartment building on January 1, 1978, and rented it for the entire year of 1978 for $5,000 a month, or $60,000. It will be assumed that the apartment units had been renovated immediately before the purchase and that the taxpayer managed the property himself, and that, consequently, the ordinary and necessary trade or business expenses amounted to only $6,000 during the first year. The taxpayer’s interest on a twenty year mortgage for the purchase price at eight percent payable annually would amount to $40,000 in the first year and straight line depreciation over a twenty year useful life would be $25,000.

Since the ordinary and necessary trade or business expenses equal only ten percent of the taxpayer’s rental income, the property would constitute net lease, and therefore investment property under the expense test. Consequently, the deductibility of the interest paid on the indebtedness would be subject to the subsection 163(d) limitation. Assuming that the taxpayer has no other investment income or investment expenses, the amount of deductible investment interest would be computed as follows:

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\text{\$10,000 base amount} & \quad \text{\$10,000} \\
\text{Investment income} & \quad \text{\$60,000} \\
\text{Less: Investment expenses} & \\
\text{Depreciation (straight line)} & \quad \text{\$25,000} \\
\text{Management} & \quad \text{6,000} \quad \text{31,000} \\
\text{Net investment income} & \quad \text{29,000} \\
\text{Out-of-pocket expenses} & \\
\text{Interest} & \quad \text{\$40,000} \\
\text{Management} & \quad \text{6,000} \quad \text{\$46,000} \\
\text{Less: Rental income} & \quad \text{60,000} \\
\text{Excess} & \quad \text{($14,000)} \quad \text{- 0 -} \\
\text{Investment interest} & \\
\text{deduction limitation} & \quad \text{\$39,000}
\end{align*}
\]

Thus, all but $1,000 of the $40,000 of investment interest would be deductible in this hypothetical example.

The result would be different if, as is likely, the taxpayer

75. For an example of where the management expenses are high enough such that the property does not qualify as net lease or investment property under the expense test, see note 37 supra.
had other types of investment income, such as dividends or investment expenses. Similarly, the result would be substantially different if the taxpayer decided to invest in a second net lease property, because there is only one $10,000 base amount.

However, all interest paid in excess of net out-of-pocket rental income is deductible, since it increases the out-of-pocket component of the limitation formula dollar for dollar. For example, in the situation above all interest in excess of the $54,000 of net out-of-pocket rental income (rental income of $60,000 less management expense of $6,000) would be deductible. Furthermore, any investment interest which is not deductible in the present year because of the subsection 163(d) limitation is carried over to the next taxable year, in which it is deductible, along with investment interest paid or accrued during that year, subject again to the subsection 163(d) limitation.

It is also possible to increase the limitation in the present year by as much as $15,000 by channeling investments through a partnership or a corporation. The $10,000 base amount is increased (up to $25,000) by the amount of interest paid or accrued by the taxpayer on a loan used to acquire an ownership interest in a corporation or partnership in which the taxpayer, his spouse or his children own fifty percent or more of the ownership interests.

Thus, in the example above, if instead of purchasing $500,000 of real estate outright the taxpayer invested the same amount of money in a real estate partnership, all of the interest paid could have been deductible. If there were two taxpayers in the situation described above and they formed a partnership with each contributing $500,000 to acquire a fifty percent interest, the partnership could purchase $1,000,000 of investment property, consisting of, perhaps, one thirty-two unit or two sixteen-unit apartment buildings. Assuming that the pro rata portion of expenses and income on each partner's $500,000 investment was the same as it would have been had each partner invested $500,000 individually, the subsection 163(d) investment interest limitation would be computed for both taxpayers as follows:

76. See I.R.C. § 163(d)(7).
$10,000 base amount  
Plus: Additional base amount  
New base amount  
Investment income  
Less: Investment expenses  
Depreciation (straight line)  
Management  
Net investment income  
(passed through from partnership)  
Out-of-pocket expenses for  
net lease property:  
Interest  
Management  
Less: Rental income  
Excess  
Investment interest deduction limitation  

Thus, the entire $40,000 of investment interest incurred by each partner would be deductible.  

III. Conclusion  
The purpose of this article was to explore the potential impact of the new subsection 163(d) investment interest deduction rules upon real estate investments. In the majority of cases interest on money borrowed to invest in rental real estate will be entirely deductible. Most taxpayers purchasing improved rental real estate should be able to enter rental agreements which do not constitute net leases, and thus their real estate will be trade or business property, the interest related to which is not subject to subsection 163(d). Similarly, most taxpayers constructing rental real estate should be able to show that the property, when completed, will constitute trade or business property not subject to subsection 163(d). However, taxpayers purchasing unimproved property must show that it will be ac-
tively used in the taxpayer's trade or business in the future in order to avoid the application of subsection 163(d).

However, even if real estate does constitute investment property, the interest on money borrowed to purchase the property will still be deductible up to $10,000 plus net investment income and excess out-of-pocket expenses. Furthermore, the amount deductible can be increased by as much as $15,000 by investing through a partnership or corporation in which the taxpayer owns a fifty percent or greater interest. Finally, any interest disallowed under subsection 163(d) in one year can be carried over into succeeding years. Thus, subsection 163(d) should not have a prohibitive impact on the vast majority of real estate investments.