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U.S. Tax Court: Taxpayer properly offset interest expenses against real estate income

The U.S. Tax Court today issued an opinion finding that the taxpayer husband and wife had properly offset interest expenses in full against the real estate income reported on Schedule E and rejecting the IRS contention that the interest expenses should have been reported on Schedule A as itemized deductions (and thus subject to the limitations imposed by section 163(d) on investment interest).

The case is: *Lipnick v. Commissioner,* 158 T.C. No. 1 (August 28, 2019). Read the Tax Court's **opinion** [PDF 86 KB]

Summary

The Tax Court provided the following summary of the case:

- The taxpayer's father owned interests in partnerships that made debt-financed distributions to the partners.
- The father used the proceeds of those distributions to purchase assets that he held for investment.
- The father treated the interest paid by the partnerships on those debts and passed through to him as "investment interest" subject to the limitation on deductibility imposed by section 163(d).
- In 2011 and 2013, the father transferred interests in the partnerships to the taxpayer by gift and bequest.
- The partnerships continued to incur interest expense on the debts, which was passed through to the taxpayer as a new partner.

- The taxpayer treated the debts as properly allocable to the partnerships' real estate assets and reported the interest expense on his 2013 and 2014 Schedules E, *Supplemental Income and Loss*, as offsetting the passed-through real estate income.

- The IRS, however, for tax years 2013 and 2014 characterized the interest passed through to the taxpayer as "investment interest." In turn, because the taxpayers had insufficient investment income for these years, the IRS disallowed 100% of the deductions for interest expense under section 163(d).

The Tax Court held that:

- The taxpayer (unlike his father) did not receive the proceeds of any debt-financed distributions and did not use partnership distributions to acquire property held for investment. Rather, the taxpayer was deemed to have made a debt-financed acquisition of the partnership interests he acquired by gift and bequest, and the associated interest expense was allocated among the assets of the partnerships.

- Because the assets owned by the partnerships were not property held for investment, none of the interest expense passed through to the taxpayer was "investment interest" subject to limited deductibility under section 163(d).

- The interest expense passed through to the taxpayer could not be characterized as "investment interest" on the theory that he stepped into his father's shoes.

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