

Section 469.— Passive Activity Losses and Credits Limited

26 CFR 1.469–7: Treatment of self-charged items of interest income and deduction.

T.D. 9013

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

Limitations on Passive Activity Losses and Credits— Treatment of Self-charged Items of Income and Expense

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: These regulations provide guidance on the treatment of self-charged items of income and expense under section 469. The regulations recharacterize a percentage of certain portfolio income and expense as passive income and expense (self-charged items) when a taxpayer engages in a lending transaction with a partnership or an S corporation (passthrough entity) in which the taxpayer owns a direct or indirect interest and the loan proceeds are used in a passive activity. Similar rules apply to lending transactions between two identically owned passthrough entities. These final regulations affect taxpayers subject to the limitations on passive activity losses and credits.

DATES: *Effective Date:* These regulations are effective August 21, 2002.

Applicability Date: For dates of applicability of these regulations, see § 1.469–11 of these regulations.

FOR FURTHER INFORMATION CONTACT: Danielle M. Grimm at (202) 622–3070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed

and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1244. Responses to this collection of information are required to obtain the benefit of self-charged treatment of income and expense under section 469.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent varies from 5 minutes to 15 minutes, depending on individual circumstances, with an estimated average of 6 minutes.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 469(a)(1)(A) of the Internal Revenue Code (Code) provides that if aggregate losses from passive activities exceed aggregate income from passive activities for the taxable year, the excess losses are not allowable for that taxable year. Under section 469(e)(1), passive activity income does not include income from interest, dividends, annuities, and royalties not derived in the ordinary course of a trade or business. However, under the rules of § 1.163–8T, if borrowed funds are used in a passive activity, the interest expense is treated as a passive activity deduction. Consequently, in certain lending transactions, a taxpayer may have interest income that is characterized as portfolio income under section 469(e)(1) and interest expense that is characterized as a passive activity deduction under § 1.163–8T. The legislative history of section 469 indicates that this result is in-

appropriate because the items of interest income and expense are essentially “self-charged” and thus lack economic significance.

On April 5, 1991, the IRS published in the **Federal Register** a notice of proposed rulemaking (PS–39–89, 1991–1 C.B. 983 [56 FR 14034]) proposing amendments to 26 CFR part 1 under section 469 of the Code relating to the treatment of self-charged items of income and expense for purposes of applying the limitations on passive activity losses and passive activity credits.

A number of public comments were received and a public hearing was held on September 6, 1991. Given the significant period of time that had elapsed since the former comment period, additional comments were solicited in Notice 2001–47 (2001–36 I.R.B. 212). After consideration of all of the comments received, the proposed regulations are adopted, as revised by this Treasury decision.

Explanation of Revisions and Summary of Comments

The proposed regulations provide self-charged treatment for items of interest income and interest expense in lending transactions between a taxpayer and a passthrough entity in which the taxpayer holds a direct or qualifying indirect interest. Several commentators suggested that the regulations should also apply to lending transactions between related passthrough entities such as brother-sister entities in which the taxpayer owns interests because such transactions also may result in mismatched income and expense for purposes of section 469. In response to the suggestions, the self-charged rules are extended to identically owned passthrough entities. This extension is limited to identically owned entities because of concerns regarding the difficulty of identifying self-charged items in transactions between less closely related or unrelated entities.

Certain commentators requested the removal of the qualifying indirect interest rule in the proposed regulations. The qualifying indirect interest rule provides that a taxpayer must have at least a 10-percent indirect interest in a passthrough entity to qualify for self-charged treatment. Commentators noted that a taxpayer that owns less than a 10 percent interest nevertheless may receive large amounts of self-

charged income and expense. This suggestion has been adopted. Accordingly, the regulations no longer contain the qualifying indirect interest rule.

Noting that Congress authorized the Secretary to identify other situations in which self-charged treatment is appropriate, several commentators suggested that self-charged treatment be extended to other transactions involving rental real estate activities, such as the payment of management fees and salaries. After publication of the proposed regulations, Congress considered the impact of section 469 on rental real estate transactions and enacted specific relief in section 469(c)(7) for certain real estate professionals for taxable years beginning after 1993. There was no indication in the legislative history of section 469(c)(7) that Congress considered additional relief for real estate transactions necessary or desirable. Moreover, there is less justification for the complexity of a self-charged rule in this area after the enactment of section 469(c)(7) because that change substantially reduced the number of real estate transactions that would benefit from a self-charged rule. Accordingly, the regulations do not extend the self-charged treatment to other transactions involving rental real estate. A number of comments suggested that the regulations clarify whether the self-charged rules apply to guaranteed payments to a partner for the use of capital. Section 1.469-2(e)(2)(ii) of the regulations treats these payments as interest income. Accordingly, the regulations clarify that lending transactions include guaranteed payments for the use of capital under section 707(c).

Some comments requested clarification on the types of interest eligible for self-charged treatment. The comments noted that the examples in the regulations may be interpreted as precluding certain types of interest because the introductory language states that the lending transactions described in the examples do not result in foregone interest (within the meaning of section 7872(e)(2)), original issue discount (within the meaning of section 1273), or total unstated interest (within the meaning of section 483(b)). Accordingly, the regulations clarify that the examples assume, solely for purposes of simplifying the presentation, that the lending transactions do not involve foregone interest, original issue discount, or total unstated interest.

A few comments responded to the notice of proposed rulemaking's solicitation for suggestions on the proper treatment of items recognized in different taxable years. One comment suggested the use of a suspense account. Under this suggestion, in the year in which the taxpayer identifies the corresponding item of self-charged income or expense, that item would be netted against the self-charged item in the suspense account. Another comment suggested that where the recognition of passive interest expense precedes the recognition of passive income, the taxpayer could elect to treat the income as passive when ultimately recognized. Another suggestion was to allow the taxpayer to recharacterize interest income or expense equal to the amount calculated on a cumulative basis. The commentators recognize that to implement the above methods would require more complex regulations.

After consideration of these comments, the final regulations adopt the rule of the proposed regulations that the self-charged rules apply only to self-charged items recognized in the same taxable year. This rule is consistent with the legislative history and avoids the complexity of the other suggested methods. For similar reasons, comments suggesting special rules for capitalized expenses are not adopted.

Certain commentators requested that the regulations be extended to apply to transactions between taxpayers and their trusts, estates, REMICs and housing cooperatives. The regulations address the transactions identified by Congress involving S corporations and partnerships (including entities classified as partnerships for federal tax purposes). Application of the self-charged rules to other types of entities would require a significant expansion of the scope of these regulations to address broader issues concerning the manner in which section 469 applies to those entities.

The applicability date of the final regulations is consistent with the applicability date as proposed. However, certain clarifications have been made to the transition rule. In the transition period, a taxpayer may use any reasonable method to offset items of interest income and interest expense from lending transactions.

Effective Date

These regulations are applicable for taxable years beginning after December 31,

1986. However, for taxable years beginning before June 4, 1991, a taxpayer that owns an interest in a passthrough entity is not required to apply these provisions and may use any reasonable method to offset items of interest income and interest expense from lending transactions between the passthrough entity and its owners or between certain passthrough entities. Items from nonlending transactions cannot be offset under the self-charged rules.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12886. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Danielle M. Grimm, Office of the Associate Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.469-7 also issued under 26 U.S.C. 469(l). * * *

Par. 2. Section 1.469-0 is amended by: 1. Revising the entry for § 1.469-7.

2. Adding entries for § 1.469–7(a) through (h).

3. Revising the entries for § 1.469–11(c)(1) and (c)(1)(i).

4. Adding an entry for § 1.469–11, paragraph (c)(1)(iii).

The additions and revisions read as follows:

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* * * * *

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* * * * *

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(1) Application of certain income recharacterization rules and self-charged rules.

(i) Certain recharacterization rules inapplicable in 1987.

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(iii) Self-charged rules.

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Par. 3. Section 1.469–7 is amended by:

(3) Revising the section heading.

(4) Adding paragraphs (a) through (h).

The revision and additions read as follows:

§ 1.469–7 Treatment of self-charged items of interest income and deduction.

(a) *In general*—(1) *Applicability and effect of rules.* This section sets forth rules that apply, for purposes of section 469 and the regulations thereunder, in the case of a lending transaction (including guaranteed payments for the use of capital under section 707(c)) between a taxpayer and a passthrough entity in which the taxpayer owns a direct or indirect interest, or between certain passthrough entities. The rules apply only to items of interest income and interest expense that are recognized in the same taxable year. The rules—

(i) Treat certain interest income resulting from these lending transactions as passive activity gross income;

(ii) Treat certain deductions for interest expense that is properly allocable to the interest income as passive activity deductions; and

(iii) Allocate the passive activity gross income and passive activity deductions resulting from this treatment among the taxpayer's activities. (2) *Priority of rules in this section.* The character of amounts treated under the rules of this section as passive activity gross income and passive activity deductions and the activities to which these amounts are allocated are determined under the rules of this section and not under the rules of §§ 1.163–8T, 1.469–2(c) and (d), and 1.469–2T(c) and (d).

(b) *Definitions.* The following definitions set forth the meaning of certain terms for purposes of this section:

(1) *Passthrough entity.* The term *passthrough entity* means a partnership or an S corporation.

(2) *Taxpayer's share.* A *taxpayer's share* of an item of income or deduction of a passthrough entity is the amount treated as an item of income or deduction of the taxpayer for the taxable year under section 702 (relating to the treatment of distributive shares of partnership items as items of partners) or section 1366 (relating to the treatment of pro rata shares of S corporation items as items of shareholders).

(3) *Taxpayer's indirect interest.* The taxpayer has an indirect interest in an entity if the interest is held through one or more passthrough entities.

(4) *Entity taxable year.* In applying this section for a taxable year of a taxpayer, the term *entity taxable year* means the taxable year of the passthrough entity for which the entity reports items that are taken into account under section 702 or section 1366 for the taxpayer's taxable year.

(5) *Deductions for a taxable year.* The term *deductions for a taxable year* means deductions that would be allowable for the taxable year if the taxpayer's taxable income for all taxable years were determined without regard to sections 163(d), 170(b), 469, 613A(d), and 1211.

(c) *Taxpayer loans to passthrough entity*—(1) *Applicability.* Except as provided in paragraph (g) of this section, this paragraph (c) applies with respect to a taxpayer's interest in a passthrough entity (borrowing entity) for a taxable year if—

(i) The borrowing entity has deductions for the entity taxable year for interest charged to the borrowing entity by persons that own direct or indirect interests in the borrowing entity at any time during the entity taxable year (the borrowing entity's self-charged interest deductions);

(ii) The taxpayer owns a direct or an indirect interest in the borrowing entity at any time during the entity taxable year and has gross income for the taxable year from interest charged to the borrowing entity by the taxpayer or a passthrough entity through which the taxpayer holds an interest in the borrowing entity (the taxpayer's income from interest charged to the borrowing entity); and

(iii) The taxpayer's share of the borrowing entity's self-charged interest deductions includes passive activity deductions.

(2) *General rule.* If any of the borrowing entity's self-charged interest deductions are allocable to an activity for a taxable year in which this paragraph (c) applies, the passive activity gross income and passive activity deductions from that activity are determined under the following rules—

(i) The applicable percentage of each item of the taxpayer's income for the taxable year from interest charged to the borrowing entity is treated as passive activity gross income from the activity; and

(ii) The applicable percentage of each deduction for the taxable year for interest expense that is properly allocable (within the meaning of paragraph (f) of this section) to the taxpayer's income from the interest charged to the borrowing entity is treated as a passive activity deduction from the activity.

(3) *Applicable percentage.* In applying this paragraph (c) with respect to a taxpayer's interest in a borrowing entity, the applicable percentage is separately determined for each of the taxpayer's activities. The percentage applicable to an activity for a taxable year is obtained by dividing—

(i) The taxpayer's share for the taxable year of the borrowing entity's self-charged interest deductions that are treated as passive activity deductions from the activity by

(ii) The greater of—

(A) The taxpayer's share for the taxable year of the borrowing entity's aggregate self-charged interest deductions for all activities (regardless of whether these deductions are treated as passive activity deductions); or

(B) The taxpayer's aggregate income for the taxable year from interest charged to the borrowing entity for all activities of the borrowing entity.

(d) *Passthrough entity loans to taxpayer*—(1) *Applicability.* Except as provided in paragraph (g) of this section, this paragraph (d) applies with respect to a taxpayer's interest in a passthrough entity (lending entity) for a taxable year if—

(i) The lending entity has gross income for the entity taxable year from interest charged by the lending entity to persons that own direct or indirect interests in the lending entity at any time during the entity taxable year (the lending entity's self-charged interest income);

(ii) The taxpayer owns a direct or an indirect interest in the lending entity at any time during the entity taxable year and has deductions for the taxable year for interest charged by the lending entity to the taxpayer or a passthrough entity through which the taxpayer holds an interest in the lending entity (the taxpayer's deductions for interest charged by the lending entity); and(iii) The taxpayer's deductions for interest charged by the lending entity include passive activity deductions.

(2) *General rule.* If any of the taxpayer's deductions for interest charged by the

lending entity are allocable to an activity for a taxable year in which this paragraph (d) applies, the passive activity gross income and passive activity deductions from that activity are determined under the following rules—

(i) The applicable percentage of the taxpayer's share for the taxable year of each item of the lending entity's self-charged interest income is treated as passive activity gross income from the activity.

(ii) The applicable percentage of the taxpayer's share for the taxable year of each deduction for interest expense that is properly allocable (within the meaning of paragraph (f) of this section) to the lending entity's self-charged interest income is treated as a passive activity deduction from the activity.

(3) *Applicable percentage.* In applying this paragraph (d) with respect to a taxpayer's interest in a lending entity, the applicable percentage is separately determined for each of the taxpayer's activities. The percentage applicable to an activity for a taxable year is obtained by dividing—

(i) The taxpayer's deductions for the taxable year for interest charged by the lending entity, to the extent treated as passive activity deductions from the activity; by

(ii) The greater of—

(A) The taxpayer's aggregate deductions for all activities for the taxable year for interest charged by the lending entity (regardless of whether these deductions are treated as passive activity deductions); or

(B) The taxpayer's aggregate share for the taxable year of the lending entity's self-charged interest income for all activities of the lending entity.

(e) *Identically-owned passthrough entities*—(1) *Applicability.* Except as provided in paragraph (g) of this section, this paragraph (e) applies with respect to lending transactions between passthrough entities if each owner of the borrowing entity has the same proportionate ownership interest in the lending entity.

(2) *General rule.* To the extent an owner shares in interest income from a loan between passthrough entities described in paragraph (e)(1) of this section, the owner is treated as having made the loan to the borrowing passthrough entity and paragraph (c) of this section applies to determine the applicable percentage of portfolio income or properly allocable interest expense that is recharacterized as passive.

(3) *Example.* The following example illustrates the application of this paragraph (e):

Example. (i) A and B, both calendar year taxpayers, each own a 50-percent interest in the capital and profits of partnerships RS and XY, both calendar year partnerships. Under the partnership agreements of RS and XY, A and B are each entitled to a 50-percent distributive share of each partnership's income, gain, loss, deduction, or credit. RS makes a \$20,000 loan to XY and XY pays RS \$2,000 of interest for the taxable year. A's distributive share of interest income attributable to this loan is \$1,000 (50 percent x \$2,000). XY uses all of the proceeds received from RS in a passive activity. A's distributive share of interest expense attributable to the loan is \$1,000 (50 percent x \$2,000).

(ii) This paragraph (e) applies in determining A's passive activity gross income because RS and XY are identically-owned passthrough entities as described in paragraph (e)(1) of this section. Under paragraph (e)(2) of this section, the RS-to-XY loan is treated as if A made the loan to XY. Therefore, A must apply paragraph (c) of this section to determine the applicable percentage of portfolio income that is recharacterized as passive income.

(iii) Paragraph (c) of this section applies in determining A's passive activity gross income because: XY has deductions for interest charged to XY by RS for the taxable year (XY's self-charged interest deductions); A owns an interest in XY during XY's taxable year and has gross income for the taxable year from interest charged to XY by RS; and A's share of XY's self-charged interest deductions includes passive activity deductions. See paragraph (c)(1) of this section.

(iv) Under paragraph (c)(2)(i) of this section, the applicable percentage of A's interest income is recharacterized as passive activity gross income from the activity. Paragraph (c)(3) of this section provides that the applicable percentage is obtained by dividing A's share for the taxable year of XY's self-charged interest deductions that are treated as passive activity deductions from the activity (\$1,000) by the greater of A's share for the taxable year of XY's self-charged interest deductions (\$1,000), or A's income for the year from interest charged to XY (\$1,000). Thus, A's applicable percentage is 100 percent (\$1,000/\$1,000), and \$1,000 (100 percent x \$1,000) of A's income from interest charged to XY is treated as passive activity gross income from the passive activity.

(f) *Identification of properly allocable deductions.* For purposes of this section, interest expense is properly allocable to an item of interest income if the interest expense is allocated under §1.163-8T to an expenditure that—

(1) Is properly chargeable to capital account with respect to the investment producing the item of interest income; or

(2) May reasonably be taken into account as a cost of producing the item of interest income.

(g) *Election to avoid application of the rules of this section*—(1) *In general.* Paragraphs (c),(d) and (e) of this section shall not apply with respect to any taxpayer's in-

terest in a passthrough entity for a taxable year if the passthrough entity has made, under this paragraph (g), an election that applies to the entity's taxable year.

(2) *Form of election.* A passthrough entity makes an election under this paragraph (g) by attaching to its return (or amended return) a written statement that includes the name, address, and taxpayer identification number of the passthrough entity and a declaration that an election is being made under this paragraph (g).

(3) *Period for which election applies.* An election under this paragraph (g) made with a return (or amended return) for a taxable year applies to that taxable year and all subsequent taxable years that end before the date on which the election is revoked.

(4) *Revocation.* An election under this paragraph (g) may be revoked only with the consent of the Commissioner.

(h) *Examples.* The following examples illustrate the principles of this section. The examples assume for purposes of simplifying the presentation, that the lending transactions described do not result in foregone interest (within the meaning of section 7872(e)(2)), original issue discount (within the meaning of section 1273), or total unstated interest (within the meaning of section 483(b)).

Example 1. (i) A and B, two calendar year individuals, each own 50-percent interests in the capital, profits and losses of AB, a calendar year partnership. AB is engaged in a single rental activity within the meaning of § 1.469-1T(e)(3). AB borrows \$50,000 from A and uses the loan proceeds in the rental activity. AB pays \$5,000 of interest to A for the taxable year. A and B each incur \$2,500 of interest expense as their distributive share of AB's interest expense.

(ii) AB has self-charged interest deductions for the taxable year (*i.e.*, the deductions for interest charged to AB by A); A owns a direct interest in AB during AB's taxable year and has income for A's taxable year from interest charged to AB; and A's share of AB's self-charged interest deductions includes passive activity deductions. Accordingly, paragraph (c) of this section applies in determining A's passive activity gross income. See paragraph (c)(1) of this section.

(iii) Under paragraph (c)(2)(i) of this section, the applicable percentage of A's interest income is recharacterized as passive activity gross income from AB's rental activity. Paragraph (c)(3) of this section provides that the applicable percentage is obtained by dividing A's share for the taxable year of AB's self-charged interest deductions that are treated as passive activity deductions from the activity (\$2,500) by the greater of A's share for the taxable year of AB's self-charged interest deductions (\$2,500), or A's income for the taxable year from interest charged to AB (\$5,000). Thus, A's applicable percentage is 50 percent (\$2,500/\$5,000), and \$2,500 (50 percent x \$5,000) of A's income from interest charged to AB is treated

as passive activity gross income from the passive activity A conducts through AB.

(iv) Because B does not have any gross income for the year from interest charged to AB, this section does not apply to B. See paragraph (c)(1)(ii) of this section.

Example 2. (i) C and D, two calendar year taxpayers, each own 50-percent interests in the capital and profits of CD, a calendar year partnership. CD is engaged in a single rental activity, within the meaning of § 1.469-1T(e)(3). C obtains a \$10,000 loan from a third-party lender, and pays the lender \$900 in interest for the taxable year. C lends the \$10,000 to CD, and receives \$1,000 of interest income from CD for the taxable year. D lends \$20,000 to CD and receives \$2,000 of interest income from CD for the taxable year. CD uses all of the proceeds in the rental activity. C and D are each allocated \$1,500 (50 percent x \$3,000) of interest expense as their distributive share of CD's interest expense for the taxable year.

(ii) CD has self-charged interest deductions for the taxable year (*i.e.*, deductions for interest charged to CD by C and D); C and D each own direct interests in CD during CD's taxable year and have gross income for the taxable year from interest charged to CD; and both C's and D's shares of CD's self-charged interest deductions include passive activity deductions. Accordingly, paragraph (c) of this section applies in determining C's and D's passive activity gross income. See paragraph (c)(1) of this section.

(iii) Under paragraph (c)(2)(i) of this section, the applicable percentage of each partner's interest income is recharacterized as passive activity gross income from CD's rental activity. Paragraph (c)(3) of this section provides that C's applicable percentage is obtained by dividing C's share for the taxable year of CD's self-charged interest deductions that are treated as passive activity deductions from the activity (\$1,500) by the greater of C's share for the taxable year of CD's self-charged interest deductions (\$1,500), or C's income for the taxable year from interest charged to CD (\$1,000). Thus, C's applicable percentage is 100 percent (\$1,500/\$1,500), and all of C's income from interest charged to CD (\$1,000) is treated as passive activity gross income from the passive activity C conducts through CD. Similarly, D's applicable percentage is obtained by dividing D's share for the taxable year of CD's self-charged interest deductions that are treated as passive activity deductions from the activity (\$1,500) by the greater of D's share for the taxable year of CD's self-charged interest deductions (\$1,500), or D's income for the taxable year from interest charged to CD (\$2,000). Thus, D's applicable percentage is 75 percent (\$1,500/\$2,000), and \$1,500 (75 percent x \$2,000) of D's income from interest charged to CD is treated as passive activity gross income from the rental activity.

(iv) The \$900 of interest expense that C pays to the third-party lender is allocated under § 1.163-8T(c)(1) to an expenditure that is properly chargeable to capital account with respect to the loan to CD. Thus, the expense is properly allocable to the interest income C receives from CD (see paragraph (f) of this section). Under paragraph (c)(2)(ii) of this section, the applicable percentage of C's deductions for the taxable year for interest expense that is properly allocable to C's income from interest charged to CD is recharacterized as a passive activity deduction from CD's rental activity. Accordingly, all of C's \$900 in-

terest deduction is treated as a passive activity deduction from the rental activity.

Example 3. (i) E and F, calendar year taxpayers, each own 50 percent of the stock of X, a calendar year S corporation. E borrows \$30,000 from X, and pays X \$3,000 of interest for the taxable year. E uses \$15,000 of the loan proceeds to make a personal expenditure (as defined in § 1.163-8T(b)(5)), and uses \$15,000 of loan proceeds to purchase a trade or business activity in which E does not materially participate (within the meaning of § 1.469-5T) for the taxable year. E and F each receive \$1,500 as their *pro rata* share of X's interest income from the loan for the taxable year.

(ii) X has gross income for X's taxable year from interest charged to E (X's self-charged interest income); E owns a direct interest in X during X's taxable year and has deductions for the taxable year for interest charged by X; and E's deductions for interest charged by X include passive activity deductions. Accordingly, paragraph (d) of this section applies in determining E's passive activity gross income. See paragraph (d)(1) of this section.

(iii) Under the rules in paragraph (d)(2)(i) of this section, the applicable percentage of E's share of X's self-charged interest income is recharacterized as passive activity gross income from the activity. Paragraph (d)(3) of this section provides that the applicable percentage is obtained by dividing E's deductions for the taxable year for interest charged by X, to the extent treated as passive activity deductions from the activity (\$1,500), by the greater of E's deductions for the taxable year for interest charged by X, regardless of whether those deductions are treated as passive activity deductions (\$3,000), or E's share for the taxable year of X's self-charged interest income (\$1,500). Thus, E's applicable percentage is 50 percent (\$1,500/\$3,000), and \$750 (50 percent x \$1,500) of E's share of X's self-charged interest income is treated as passive activity gross income.

(iv) Because F does not have any deductions for the taxable year for interest charged by X, this section does not apply to F. See paragraph (d)(1)(ii) of this section.

Example 4. (i) This Example 4 illustrates the application of this section to a partner that has a different taxable year from the partnership. The facts are the same as in Example 1 except as follows: Partnership AB has properly adopted a fiscal year ending June 30 for federal tax purposes; AB borrows the \$50,000 from A on October 1, 1990; and under the terms of the loan, AB must pay A \$5,000 in interest annually, in quarterly installments, for a term of 2 years.

(ii) For A's taxable years from 1990 through 1993 and AB's corresponding entity taxable years (as defined in paragraph (b)(4) of this section) A's interest income and AB's interest deductions from the loan are as follows:

	A's Interest Income	AB's Interest Deductions
1990	\$1,250	0
1991	\$5,000	\$3,750
1992	\$3,750	\$5,000
1993	0	\$1,250

(iii) For A's taxable year ending December 31, 1990, the corresponding entity taxable year is AB's taxable year ending June 30, 1990. Because AB does not have any deductions for the entity taxable year for

interest charged to AB by A, paragraph (c) of this section does not apply in determining A's passive activity gross income for 1990 (see paragraph (c)(1)(i) of this section). Accordingly, A reports \$1,250 of portfolio income on A's 1990 income tax return.

(iv) For A's taxable year ending December 31, 1991, the corresponding entity taxable year ends on June 30, 1991. AB has \$3,750 of deductions for the entity taxable year for interest charged to AB by A (AB's self-charged interest deductions); A owns a direct interest in AB during the entity taxable year and has \$5,000 of interest income for A's taxable year from interest charged to AB; and A's share of AB's self-charged interest deductions includes passive activity deductions. Accordingly, paragraph (c) of this section applies in determining A's passive activity gross income.

(v) Under paragraph (c)(2)(i) of this section, the applicable percentage of A's 1991 interest income is recharacterized as passive activity gross income from the activity. Paragraph (c)(3) of this section provides that the applicable percentage is obtained by dividing A's share for A's 1991 taxable year of AB's self-charged interest deductions that are treated as passive activity deductions from the activity ($50 \text{ percent} \times \$3,750 = \$1,875$) by the greater of A's share for A's taxable year of AB's self-charged interest deductions (\$1,875), or A's income for A's taxable year from interest charged to AB (\$5,000). Thus, A's applicable percentage is 37.5 percent ($\$1,875/\$5,000$), and \$1,875 ($37.5 \text{ percent} \times \$5,000$) of A's income from interest charged to AB is treated as passive activity gross income from the passive activity A conducts through AB.

(vi) For A's taxable year ending December 31, 1992, the corresponding entity taxable year ends on June 30, 1992. AB has \$5,000 of deductions for the entity taxable year for interest charged to AB by A (AB's self-charged interest deductions); A owns a direct interest in AB during the entity taxable year and has \$3,750 of gross income for A's taxable year from interest charged to AB; and A's share of AB's self-charged interest deductions includes passive activity deductions. Accordingly, paragraph (c) of this section applies in determining A's passive activity gross income.

(vii) The applicable percentage for 1992 is obtained by dividing A's share for A's 1992 taxable year of AB's self-charged interest deductions that are treated as passive activity deductions from the activity (\$2,500) by the greater of A's share for A's taxable year of AB's self-charged interest deductions (\$2,500), or A's income for A's taxable year from interest charged to AB (\$3,750). Thus, A's applicable percentage is 66 2/3 percent ($\$2,500/\$3,750$), and \$2,500 ($66 \frac{2}{3} \text{ percent} \times \$3,750$) of A's income from interest charged to AB is treated as passive activity gross income from the passive activity A conducts through AB.

(viii) Paragraph (c) of this section does not apply in determining A's passive activity gross income for the taxable year ending December 31, 1993, because A has no gross income for the taxable year from interest charged to AB (see paragraph (c)(1)(ii) of this section). A's share of AB's self-charged interest deductions for the entity taxable year ending June 30, 1993 (\$625) is taken into account as a passive activity deduction on A's 1993 income tax return.

(ix) Because B does not have any gross income from interest charged to AB for any of the taxable

years, this section does not apply to B. See paragraph (c)(1)(ii) of this section.

Example 5. (i) This *Example 5* illustrates the application of the rules of this section in the case of a taxpayer who has an indirect interest in a partnership. G, a calendar year taxpayer, is an 80-percent partner in partnership UTP. UTP owns a 25-percent interest in the capital and profits of partnership LTP. UTP and LTP are both calendar year partnerships. The partners of LTP conduct a single passive activity through LTP. UTP obtains a \$10,000 loan from a bank, and pays the bank \$1,000 of interest per year. G's distributive share of the interest paid to the bank is \$800 ($80 \text{ percent} \times \$1,000$). UTP uses the \$10,000 debt proceeds and another \$10,000 of cash to make a loan to LTP, and LTP pays UTP \$2,000 of interest for the taxable year. G's distributive share of interest income attributable to the UTP-to-LTP loan is \$1,600 ($80 \text{ percent} \times \$2,000$). LTP uses all of the proceeds received from UTP in the passive activity. UTP's distributive share of interest expense attributable to the UTP-to-LTP loan is \$500 ($25 \text{ percent} \times \$2,000$). G's distributive share of interest expense attributable to the UTP-to-LTP loan is \$400 ($80 \text{ percent} \times \500).

(ii) LTP has deductions for interest charged to LTP by UTP for the taxable year (LTP's self-charged interest deductions); G owns an indirect interest in LTP during LTP's taxable year and has gross income for the taxable year from interest charged to LTP by a passthrough entity (UTP) through which G owns an interest in LTP; and G's share of LTP's self-charged interest deductions includes passive activity deductions. Accordingly, paragraph (c) of this section applies in determining G's passive activity gross income. See paragraph (c)(1) of this section.

(iii) Under paragraph (c)(2)(i) of this section, the applicable percentage of G's interest income is recharacterized as passive activity gross income from the activity. Paragraph (c)(3) of this section provides that the applicable percentage is obtained by dividing G's share for the taxable year of LTP's self-charged interest deductions that are treated as passive activity deductions from the activity (\$400) by the greater of G's share for the taxable year of LTP's self-charged interest deductions (\$400), or G's income for the year from interest charged to LTP (\$1,600). Thus, G's applicable percentage is 25 percent ($\$400/\$1,600$), and \$400 ($25 \text{ percent} \times \$1,600$) of G's income from interest charged to LTP is treated as passive activity gross income from the passive activity that G conducts through UTP and LTP.

(iv) G's \$800 distributive share of the interest expense that UTP pays to the third-party lender is allocated under § 1.163-8T(c)(1) to an expenditure that is properly chargeable to capital account with respect to the loan to LTP. Thus, the expense is a deduction properly allocable to the interest income that G receives as a result of the UTP-to-LTP loan (see paragraph (f) of this section). Under paragraph (c)(2)(ii) of this section, the applicable percentage of G's deductions for the taxable year for interest expense that is properly allocable to G's income from interest charged by UTP to LTP is recharacterized as a passive activity deduction from LTP's passive activity. Accordingly, \$200 ($25 \text{ percent} \times \800) of G's interest deduction is treated as a passive activity deduction from LTP's activity.

Example 6. (i) This *Example 6* illustrates the application of the rules of this section in the case of a taxpayer who conducts two passive activities through

a passthrough entity. J, a calendar year taxpayer, is the 100-percent shareholder of Y, a calendar year S corporation. J conducts two passive activities through Y: a rental activity and a trade or business activity in which J does not materially participate. Y borrows \$80,000 from J, and uses \$60,000 of the loan proceeds in the rental activity and \$20,000 of the loan proceeds in the passive trade or business activity. Y pays \$8,000 of interest to J for the taxable year, and J incurs \$8,000 of interest expense as J's distributive share of Y's interest expense.

(ii) Y has self-charged interest deductions for the taxable year (*i.e.*, the deductions for interest charged to Y by J); J owns a direct interest in Y during Y's taxable year and has gross income for J's taxable year from interest charged to Y; and J's share of Y's self-charged interest deductions includes passive activity deductions. Accordingly, paragraph (c) of this section applies in determining J's passive activity gross income. See paragraph (c)(1) of this section.

(iii) Under paragraph (c)(2)(i) of this section, the applicable percentage of J's interest income is recharacterized as passive activity gross income attributable to the rental activity. Paragraph (c)(3) of this section provides that the applicable percentage is obtained by dividing J's share for the taxable year of Y's self-charged interest deductions that are treated as passive activity deductions from the rental activity (\$6,000) by the greater of J's share for the taxable year of Y's self-charged interest deductions (\$8,000), or J's income for the taxable year from interest charged to Y (\$8,000). Thus, J's applicable percentage is 75 percent ($\$6,000/\$8,000$), and \$6,000 ($75 \text{ percent} \times \$8,000$) of J's income from interest charged to Y is treated as passive activity gross income from the rental activity J conducts through Y.

(iv) Under paragraph (c)(2)(i) of this section, the applicable percentage of J's interest income is recharacterized as passive activity gross income attributable to the passive trade or business activity. Paragraph (c)(3) of this section provides that the applicable percentage is obtained by dividing J's share for the taxable year of Y's self-charged interest deductions that are treated as passive activity deductions from the passive trade or business activity (\$2,000) by the greater of J's share for the taxable year of Y's self-charged interest deductions (\$8,000), or J's income for the taxable year from interest charged to Y (\$8,000). Thus, J's applicable percentage is 25 percent ($\$2,000/\$8,000$), and \$2,000 of J's income from interest charged to Y is treated as passive activity gross income from the passive trade or business activity J conducts through Y.

Par. 4. Section 1.469-11 is amended as follows:

1. Paragraph (a)(3) is amended by removing the language "and" at the end of the paragraph.

2. Paragraph (a)(4) is redesignated as paragraph (a)(5) and a new paragraph (a)(4) is added.

3. The paragraph headings for (c)(1) and (c)(1)(i) are revised.

4. Paragraph (c)(1)(iii) is added.

5. The added and revised provisions read as follows:

§ 1.469–11 Effective date and transition rules.

(a) * * *

(4) The rules contained in § 1.469–7 apply for taxable years ending after December 31, 1986; and

* * * * *

(c) * * *

(1) *Application of certain income re-characterization rules and self-charged rules—(i) Certain recharacterization rules inapplicable in 1987.* * * *

* * * * *

(iii) *Self-charged rules.* For taxable years beginning before June 4, 1991—

(1) A taxpayer is not required to apply the rules in § 1.469–7 in computing the taxpayer’s passive activity loss and passive activity credit; and

(2) A taxpayer that owns an interest in a passthrough entity may use any reasonable method of offsetting items of interest income and interest expense from lending transactions between the passthrough entity and its owners or between identically-owned passthrough entities (as defined in § 1.469–7(e)) to compute the taxpayer’s passive activity loss and passive activity credit. Items from non-lending transactions cannot be offset under the self-charged rules.

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 5. The authority citation for the part 602 continues to read:

Authority: 26 U.S.C. 7805.

Par. 6. In § 602.101, paragraph (b) is amended by adding the following entry in numerical order to the table to read as follows:

§ 602.101 OMB Control Numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control number
* * * * *	
1.469–7	1545–1244

* * * * *

Robert E Wenzel,
Deputy Commissioner
of Internal Revenue.

Approved July 31, 2002.

Pamela F. Olson,
Acting Assistant Secretary
of the Treasury.