

Example 5. [Reserved]. See § 1.469-5(k) *Example 5* for this example.

Example 6. The facts are the same as in Example 5, except that D does not acquire any stock in the S corporation until 1994. Under paragraph (f)(1) of this section, D is not treated as participating in the activity for any taxable year prior to 1994 because D does not own an interest in the activity for any such taxable year. Accordingly, D materially participates in the activity for only one taxable year prior to 1995, and D is not treated under paragraph (a)(5) of this section as materially participating in the activity for 1995 or subsequent taxable years.

Example 7. (i) E, a married individual filing a separate return for the taxable year, is employed full-time as an attorney. E also owns an interest in a professional football team that is a trade or business activity (within the meaning of § 1.469-1T(e)(2)). E does no work in connection with this activity. E anticipates that, for the taxable year, E's deductions from the activity will exceed E's gross income from the activity and that, if E does not materially participate in the activity for the taxable year, part or all of F's passive activity loss for the taxable year will be disallowed under § 1.469-1T(a)(1)(i). Accordingly, E pays E's spouse to work as an office receptionist in connection with the activity for an average of 15 hours per week during the taxable year.

(ii) Under paragraph (f)(3) of this section any participation in the activity by E's spouse is treated as participation in the activity by E. However, under paragraph (f)(2)(i) of this section, the work done by E's spouse is not treated as participation in the activity because work as an office receptionist is not work of a type customarily done by an owner of a football team, and one of E's principal purposes for paying E's spouse to do this work is to avoid the disallowance under § 1.469-1T(a)(1)(i) of E's passive activity loss. Accordingly, E is not treated as participating in the activity for the taxable year.

Example 8. (i) F, an individual, owns an interest in a partnership that feeds and sells cattle. The general partner of the partnership periodically mails F a letter setting forth certain proposed actions and decisions with respect to the cattle-feeding operation. Such actions and decisions include, for example, what kind of feed to purchase, how much to purchase, and when to purchase it, how often to feed cattle, and when to sell cattle. The letters explain the proposed actions and decisions, emphasize that taking or not taking a particular action or decision is solely within the discretion of F and other partners, and ask F to indicate a decision with respect to each proposed action by answering certain questions. The general partner receives a fee that constitutes earned income (within the meaning of section 911

(d)(2)(A)) for managing the cattle-feeding operation. F is not treated as materially participating in the cattle-feeding operation under paragraph (a) (1) through (6) of this section.

(ii) F's only participation in the cattle-feeding operation is to make certain managerial decisions. Under paragraph (b)(2)(ii) of this section, such management services are not taken into account in determining whether the taxpayer is treated as materially participating in the activity for a taxable year under paragraph (a)(7) of this section, if any other person performs services in connection with the management of the activity and receives compensation described in section 911(d)(2)(A) for such services. Therefore, F is not treated as materially participating for the taxable year in the cattle-feeding operation.

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§ 1.469-6 Treatment of losses upon certain dispositions. [Reserved]

§ 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 pass-through 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 tax-

able 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 of 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×\$2,000). XY uses all of the proceeds received from RS as a passive activity. A's distributive share of interest expense attributable to the loan is \$1,000 (50 percent×\$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 × \$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 interest 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×\$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×\$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 tax-

able 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×\$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 interest 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×\$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 66⅔ 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 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 percent \times \$2,000). G's distributive share of interest expense attributable to the UTP-to-LTP loan is \$400 (80 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 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 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 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.

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