

# Publication 925

## Passive Activity and At-Risk Rules

For use in preparing  
**2022** Returns

Volume 1 of 2



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## Future Developments

For the latest developments related to Pub. 925, such as legislation enacted after it was published, go to [IRS.gov/Pub925](https://www.irs.gov/pub925).

## Reminders

**Excess business loss limitation.** If you are a noncorporate taxpayer and have allowable business losses after taking into account first the at-risk limitations and then the passive loss limitations (Form 8582), your losses may be subject to the excess business loss limitation. After taking into account all the other loss limitations, complete Form 461, Limitation on Business Losses, to figure the amount of your excess business loss. See Form 461 and its instructions for details on the excess business loss limitation.

**Commercial revitalization deduction (CRD).** The 120-month deduction period for rental real estate placed in service by December 31, 2009, has expired. See Form 8582 and its instructions for reporting requirements for unused CRDs.

**Changes in rules on grouping and definition of real property trade or business.** T.D. 9943 revised certain rules in the Regulations under section 469.

- **Applicable date.** The new rules apply to tax years beginning on or after March 22, 2021, but you may chose to adopt these rules earlier. See Regulations section 1.469-11(a)(1) and (4) for additional information on applicability dates and early adoption. If you are a calendar year taxpayer, the new provision applies to you in calendar year 2022.
- **Grouping rules.** T.D. 9943 added Regulations section 1.469-4(d)(6), which prohibits grouping of trading activities described in Temporary Regulations section 1.469-1T(e)(6) subject to section 163(d)(5) (A)(ii) involving a non-passive trade or business in which the taxpayer does

not materially participate with any other activity or activities including other trading activities. See Regulations section 1.469-4(d)(6) for more details.

- **Definition of real property trade or business.** T.D. 9905 and 9943 expanded Regulations section 1.469-9(b)(2)(i) to define several terms used in determining whether a trade or business is a real property trade or business for purposes of section 469(c)(7)(C). T.D. 9905 added Regulations sections 1.469-9(b)(2)(ii)(H) and (I) defining real property operations and real property management. T.D. 9943 added Regulations sections 1.469-9(b)(2)(ii)(A) and (B) defining real property development and real property redevelopment.

## **Regrouping due to Net Investment**

**Income Tax.** You may be able to regroup your activities if you're subject to the Net Investment Income Tax. See *Regrouping Due to Net Investment Income Tax* under *Grouping Your Activities*, later, for more information.

**At-risk amounts.** The following rules apply to amounts borrowed after May 3, 2004.

- You must file Form 6198, At-Risk Limitations, if you're engaged in an activity included in (6) under *Activities Covered by the At-Risk Rules* and you have borrowed certain amounts described in *Certain borrowed amounts excluded* under *At-Risk Amounts* in this publication.
- You may be considered at risk for certain amounts described in *Certain borrowed amounts excluded* under *At-Risk Amounts* secured by real property used in the activity of holding real



property (other than mineral property) that, if nonrecourse, would be qualified nonrecourse financing.

**Photographs of missing children.** The Internal Revenue Service is a proud partner with the *National Center for Missing & Exploited Children® (NCMEC)*. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 800-THE-LOST (800-843-5678) if you recognize a child.

## Introduction

This publication discusses two sets of rules that may limit the amount of your deductible loss from a trade, business, rental, or other income-producing activity. The first part of the publication discusses the passive activity rules. The second part discusses the at-risk rules. However, when you figure your

allowable losses from any activity, you must apply the at-risk rules before the passive activity rules.

**Comments and suggestions.** We welcome your comments about this publication and suggestions for future editions.

You can send us comments through [IRS.gov/FormComments](https://www.irs.gov/FormComments). Or, you can write to the Internal Revenue Service, Tax Forms and Publications, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224.

Although we can't respond individually to each comment received, we do appreciate your feedback and will consider your comments and suggestions as we revise our tax forms, instructions, and publications.

**Don't** send tax questions, tax returns, or payments to the above address.

***Getting answers to your tax questions.*** If you have a tax question not answered by this publication or the *How To Get Tax Help*

section at the end of this publication, go to the IRS Interactive Tax Assistant page at [IRS.gov/ Help/ITA](https://www.irs.gov/Help/ITA) where you can find topics by using the search feature or viewing the categories listed.

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## **Useful Items**

You may want to see:

## Publication

- ☐ **527** Residential Rental Property  
(Including Rental of Vacation Homes)
- ☐ **541** Partnerships

## Form (and Instructions)

- ☐ **4952** Investment Interest Expense Deduction
- ☐ **6198** At-Risk Limitations
- ☐ **8582** Passive Activity Loss Limitations
- ☐ **8582-CR** Passive Activity Credit Limitations
- ☐ **8810** Corporate Passive Activity Loss and Credit Limitations
- ☐ **8949** Sales and Other Dispositions of Capital Assets

See *How To Get Tax Help* at the end of this publication for information about getting these publications and forms.

# **Passive Activity Limits**

## **Who Must Use These Rules?**

The passive activity rules apply to:

- Individuals,
- Estates,
- Trusts (other than grantor trusts),
- Personal service corporations, and •  
Closely held corporations.

Even though the rules don't apply to grantor trusts, partnerships, and S corporations directly, they do apply to the owners of these entities.

For information about personal service corporations and closely held corporations, including definitions and how the passive activity rules apply to these corporations, see Form 8810 and its instructions.



*Before applying the passive activity limits, you must first determine the amount of the deductions disallowed under the basis or at-risk rules. See Passive Activity Deductions, later.*

## **Passive Activity Loss**

Generally, the passive activity loss for the tax year isn't allowed. However, there is a special allowance under which some or all of your passive activity loss may be allowed. See Special \$25,000 allowance, later.

### **Definition of passive activity loss.**

Generally, your passive activity loss for the tax year is the excess of your passive activity deductions over your passive activity gross income. See Passive Activity Income and Deductions, later.

For a closely held corporation, the passive activity loss is the excess of passive activity deductions over the sum of passive activity gross income and net active income. For

details on net active income, see the Instructions for Form 8810. For the definition of passive activity gross income, see Passive Activity Income, later. For the definition of passive activity deductions, see Passive Activity Deductions, later.

## **Identification of Disallowed Passive Activity Deductions**

If all or a part of your passive activity loss is disallowed for the tax year, you may need to allocate the disallowed passive activity loss among different passive activities and among different deductions within a passive activity.

**Allocation of disallowed passive activity loss among activities.** If all or any part of your passive activity loss is disallowed for the tax year, a ratable portion of the loss (if any) from each of your passive activities is disallowed. The ratable portion of a loss from an activity is computed by multiplying the

passive activity loss that's disallowed for the tax year by the fraction obtained by dividing:

1. The loss from the activity for the tax year; by
2. The sum of the losses for the tax year from all activities having losses for the tax year.

Use Part VII of Form 8582 to figure the ratable portion of the loss from each activity that's disallowed.

***Loss from an activity.*** The term "loss from an activity" means:

1. The amount by which the passive activity deductions (defined later) from the activity for the tax year exceed the passive activity gross income (defined later) from the activity for the tax year; reduced by



2. Any part of such amount that's allowed under the Special \$25,000 allowance, later.

If your passive activity gross income from significant participation passive activities (defined later) for the tax year is more than your passive activity deductions from those activities for the tax year, those activities shall be treated, solely for purposes of figuring your loss from the activity, as a single activity that doesn't have a loss for such taxable year. See Significant Participation Passive Activities, later.

**Example.** Terry holds interests in three passive activities, A, B, and C. The gross income and deductions from these activities for the taxable year are as follows.

	<u><b>A</b></u>	<u><b>B</b></u>	<u><b>C</b></u>	<u><b>Total</b></u>
Gross income	\$7,000	\$4,000	\$12,000	\$23,000

Deduc				
tions	<u>(16,000)</u>	<u>(20,000)</u>	<u>(8,000)</u>	<u>(44,000)</u>
Net				
income				
(loss)	<u>(\$9,000)</u>	<u>(\$16,000)</u>	<u>\$4,000</u>	<u>(\$21,000)</u>

Terry's \$21,000 passive activity loss for the taxable year is disallowed. Therefore, a ratable portion of the losses from activities A and B is disallowed. The disallowed portion of each loss is as follows.

A: $\$21,000 \times \$9,000/\$25,000$	\$7,560
B: $\$21,000 \times \$16,000/\$25,000$	<u>13,440</u>
Total	<u>\$21,000</u>

**Allocation within loss activities.** If all or any part of your loss from an activity is disallowed under Allocation of disallowed passive activity loss among activities for the tax year, a ratable portion of each of your

passive activity deductions (defined later), other than an excluded deduction (defined below) from such activity is disallowed. The ratable portion of a passive activity deduction is the amount of the disallowed portion of the loss from the activity for the tax year multiplied by the fraction obtained by dividing:

1. The amount of such deduction; by
2. The sum of all of your passive activity deductions (other than excluded deductions) from that activity from the tax year.

***Excluded deductions.*** “Excluded deduction” means any passive activity deduction that’s taken into account in computing your net income from an item of property for a taxable year in which an amount of the taxpayer's gross income from such item of property is treated as not from a passive activity. See *Recharacterization of Passive Income*, later.

***Separately identified deductions.*** In identifying the deductions from an activity that are disallowed, you don't need to account separately for a deduction unless such deduction may, if separately taken into account, result in an income tax liability for any tax year different from that which would result were such deduction not taken into account separately.

Use Form 8582, Part IX, for any activity if you have passive activity deductions for that activity that must be separately identified.

Deductions that must be accounted for separately include (but aren't limited to) the following deductions.

- Deductions that arise in a rental real estate activity in tax years in which you actively participate in such activity. See Active participation, later.
- Deductions that arise in a rental real estate activity in tax years in which

you don't actively participate in such activity. See Active participation, later.

- Losses from sales or exchanges of capital assets.
- Section 1231 losses. See *Section 1231 Gains and Losses* in Pub. 544, *Sales and Other Dispositions of Assets*, for more information.

## **Carryover of Disallowed Deductions**

In the case of an activity with respect to which any deductions or credits are disallowed for a taxable year (the loss activity), the disallowed deductions are allocated among your activities for the next tax year in a manner that reasonably reflects the extent to which each activity continues the loss activity. The disallowed deductions or credits allocated to an activity under the preceding sentence are treated as deductions or credits from the activity for the next tax

year. For more information, see Regulations section 1.469-1(f)(4).

## **Passive Activity Credit**

Generally, the passive activity credit for the tax year is disallowed.

The passive activity credit is the amount by which the sum of all your credits subject to the passive activity rules exceed your regular tax liability allocable to all passive activities for the tax year. Credits that are included in figuring the general business credit are subject to the passive activity rules.

See the Instructions for Form 8582-CR for more information.

## **Publicly Traded Partnership**

You must apply the rules in this part separately to your income or loss from a passive activity held through a publicly traded partnership (PTP). You must also apply the limit on passive activity credits separately to

your credits from a passive activity held through a PTP.

You can offset deductions from passive activities of a PTP only against income or gain from passive activities of the same PTP.

Likewise, you can offset credits from passive activities of a PTP only against the tax on the net passive income from the same PTP. This separate treatment rule also applies to a regulated investment company holding an interest in a PTP for the items attributable to that interest.

For more information on how to apply the passive activity loss rules to PTPs, and on how to apply the limit on passive activity credits to PTPs, see *Publicly Traded Partnerships (PTPs)* in the instructions for Forms 8582 and 8582-CR, respectively.

# Passive Activities

There are two kinds of passive activities.

- Trade or business activities in which you don't materially participate during the year.
- Rental activities, even if you do materially participate in them, unless you're a real estate professional.

Material participation in a trade or business is discussed, later, under Activities That Aren't Passive Activities.

**Treatment of former passive activities.** A former passive activity is an activity that was a passive activity in any earlier tax year, but isn't a passive activity in the current tax year. You can deduct a prior-year unallowed loss from the activity up to the amount of your current-year net income from the activity. Treat any remaining prior-year unallowed loss like you treat any other passive loss.



In addition, any prior-year unallowed passive activity credits from a former passive activity offset the allocable part of your current-year tax liability. The allocable part of your current-year tax liability is that part of this year's tax liability that's allocable to the current-year net income from the former passive activity. You figure this after you reduce your net income from the activity by any prior-year unallowed loss from that activity (but not below zero).

## **Trade or Business Activities**

A trade or business activity is an activity that:

- Involves the conduct of a trade or business (that is, deductions would be allowable under section 162 of the Internal Revenue Code if other limitations, such as the passive activity rules, didn't apply);
- Is conducted in anticipation of starting a trade or business; or

- Involves research or experimental expenditures that are deductible under Internal Revenue Code section 174 (or that would be deductible if you chose to deduct rather than capitalize them).

A trade or business activity doesn't include a rental activity or the rental of property that's incidental to an activity of holding the property for investment.

You generally report trade or business activities on Schedule C, F, or in Part II or III of Schedule E.

## **Rental Activities**

A rental activity is a passive activity even if you materially participated in that activity, unless you materially participated as a real estate professional. See *Real Estate Professional* under *Activities That Aren't Passive Activities*, later. An activity is a rental activity if tangible property (real or personal) is used by customers or held for use by

customers, and the gross income (or expected gross income) from the activity represents amounts paid (or to be paid) mainly for the use of the property. It doesn't matter whether the use is under a lease, a service contract, or some other arrangement.

**Exceptions.** Your activity isn't a rental activity if any of the following apply.

1. The average period of customer use of the property is 7 days or less. You figure the average period of customer use by dividing the total number of days in all rental periods by the number of rentals during the tax year. If the activity involves renting more than one class of property, multiply the average period of customer use of each class by a fraction. The numerator of the fraction is the gross rental income from that class of property and the denominator is the activity's total gross rental income.

The activity's average period of customer use will equal the sum of the amounts for each class.

2. The average period of customer use of the property, as figured in (1) above, is 30 days or less and you provide significant personal services with the rentals. Significant personal services include only services performed by individuals. To determine if personal services are significant, all relevant facts and circumstances are taken into consideration, including the frequency of the services, the type and amount of labor required to perform the services, and the value of the services relative to the amount charged for use of the property. Significant personal services don't include the following.
  - a. Services needed to permit the lawful use of the property;

- b. Services to repair or improve property that would extend its useful life for a period substantially longer than the average rental; and
  - c. Services that are similar to those commonly provided with long-term rentals of real estate, such as cleaning and maintenance of common areas or routine repairs.
- 3. You provide extraordinary personal services in making the rental property available for customer use. Services are extraordinary personal services if they're performed by individuals and the customers' use of the property is incidental to their receipt of the services.
- 4. The rental is incidental to a nonrental activity. The rental of property is incidental to an activity of holding property for investment if the main

purpose of holding the property is to realize a gain from its appreciation and the gross rental income from the property is less than 2% of the smaller of the property's unadjusted basis or fair market value. The unadjusted basis of property is its cost not reduced by depreciation or any other basis adjustment. The rental of property is incidental to a trade or business activity if all of the following apply.

- a. You own an interest in the trade or business activity during the year.
- b. The rental property was used mainly in that trade or business activity during the current year, or during at least 2 of the 5 preceding tax years.
- c. Your gross rental income from the property is less than 2% of

the smaller of its unadjusted basis or fair market value.

Lodging provided to an employee or the employee's spouse or dependents is incidental to the activity or activities in which the employee performs services if the lodging is furnished for the employer's convenience.

5. You customarily make the rental property available during defined business hours for nonexclusive use by various customers.
6. You provide the property for use in a nonrental activity in your capacity as an owner of an interest in the partnership, S corporation, or joint venture conducting that activity.



*If you meet any of the exceptions listed above, see the Instructions for Form 8582 for information about how to report any income or loss from the activity.*

**Special \$25,000 allowance.** If you or your spouse actively participated in a passive rental real estate activity, the amount of the passive activity loss that's disallowed is decreased and you therefore can deduct up to \$25,000 of loss from the activity from your nonpassive income. This special allowance is an exception to the general rule disallowing the passive activity loss. Similarly, you can offset credits from the activity against the tax on up to \$25,000 of nonpassive income after taking into account any losses allowed under this exception.

If you're married, filing a separate return, and lived apart from your spouse for the entire tax year, your special allowance can't be more than \$12,500. If you lived with your spouse at any time during the year and are filing a separate return, you can't use the special allowance to reduce your nonpassive income or tax on nonpassive income.



The maximum special allowance is reduced if your modified adjusted gross income exceeds certain amounts. See Phaseout rule, later.

**Example.** You are a single taxpayer. You have \$70,000 in wages, \$15,000 income from a limited partnership, a \$26,000 loss from rental real estate activities in which you actively participated, and you aren't subject to the modified adjusted gross income phaseout rule. You can use \$15,000 of your \$26,000 loss to offset your \$15,000 passive income from the partnership. You actively participated in your rental real estate activities, so you can use the remaining \$11,000 rental real estate loss to offset \$11,000 of your nonpassive income (wages).

**Active participation.** Active participation isn't the same as material participation (defined later). Active participation is a less stringent standard than material participation. For example, you may be treated as actively participating if you make management

decisions in a significant and bona fide sense. Management decisions that count as active participation include approving new tenants, deciding on rental terms, approving expenditures, and similar decisions.

Only individuals can actively participate in rental real estate activities. However, a decedent's estate is treated as actively participating for its tax years ending less than 2 years after the decedent's death, if the decedent would have satisfied the active participation requirement for the activity for the tax year the decedent died.

A decedent's qualified revocable trust can also be treated as actively participating if both the trustee and the executor (if any) of the estate choose to treat the trust as part of the estate. The choice applies to tax years ending after the decedent's death and before:

- 2 years after the decedent's death if no estate tax return is required, or

- 6 months after the estate tax liability is finally determined if an estate tax return is required.

The choice is irrevocable and can't be made later than the due date for the estate's first income tax return (including any extensions).

Except as provided in regulations, limited partners aren't treated as actively participating in a partnership's rental real estate activities.

You aren't treated as actively participating in a rental real estate activity unless your interest in the activity (including your spouse's interest) was at least 10% (by value) of all interests in the activity throughout the year.

Active participation isn't required to take the low-income housing credit or the rehabilitation investment credit from rental real estate activities.

**Example.** Stacey, a single taxpayer, had the following income and loss during the tax year.

Salary . . . . .	\$42,300
Dividends . . . . .	300
Interest . . . . .	1,400
Rental loss . . . . .	(4,000)

The rental loss came from a house Stacey owned. Stacey advertised and rented the house to the current tenant. Stacey also collected the rents and did the repairs or hired someone to do them.

Even though the rental loss is a loss from a passive activity, Stacey can use the entire \$4,000 loss to offset other income because Stacey actively participated.

**Phaseout rule.** The maximum special allowance of \$25,000 (\$12,500 for married individuals filing separate returns and living

apart at all times during the year) is reduced by 50% of the amount of your modified adjusted gross income that's more than \$100,000 (\$50,000 if you're married filing separately). If your modified adjusted gross income is \$150,000 or more (\$75,000 or more if you're married filing separately), you generally can't use the special allowance. This is because the special allowance is reduced to \$0 since the modified adjusted gross income is over the \$100,000 amount.

Modified adjusted gross income for this purpose is your adjusted gross income figured without the following.

- Taxable social security and Tier 1 railroad retirement benefits.
- Deductible contributions to individual retirement accounts (IRAs) and section 501(c)(18) pension plans.
- The exclusion from income of interest from qualified U.S. savings bonds used

to pay qualified higher education expenses.

- The exclusion from income of amounts received from an employer's adoption assistance program.
- Passive activity income or loss included on Form 8582.
- Any rental real estate loss allowed because you materially participated in the rental activity as a Real Estate Professional (as discussed, later, under *Activities That Aren't Passive Activities*).
- Any overall loss from a publicly traded partnership (see *Publicly Traded Partnerships (PTPs)* in the instructions for Form 8582).
- The deduction allowed for the deductible part of self-employment tax.

- Foreign-derived intangible income and global intangible low-taxed income.
- The deduction allowed for interest on student loans.

**Example.** During 2022, you were unmarried and weren't a real estate professional. For 2022, you had \$120,000 in salary and a \$31,000 loss from your rental real estate activities in which you actively participated. Your modified adjusted gross income is \$120,000. When you file your 2022 return, you can deduct only \$15,000 of your passive activity loss. You must carry over the remaining \$16,000 passive activity loss to 2023. You figure your deduction and carryover as follows.

Adjusted gross income, modified	
as required . . . . .	\$120,000

Minus amount not subject to phaseout . . . .	<u>-100,000</u>
Amount subject to phaseout rule .	\$20,000
Multiply by 50% . . . . .	<u>× 50%</u>
Required reduction to special allowance . . . . .	<u>\$10,000</u>
Maximum special allowance . . . .	\$25,000
Minus required reduction (see above) . . . .	<u>-10,000</u>
Adjusted special allowance . . . . .	<u>\$15,000</u>
Passive loss from rental real estate . . . . .	\$31,000
Deduction allowable/Adjusted special allowance (see above)	<u>-15,000</u>



Amount that must be carried  
forward . . . . . \$16,000

***Exceptions to the phaseout rules.*** A higher phaseout range applies to rehabilitation investment credits from rental real estate activities. For those credits, the phaseout of the \$25,000 special allowance starts when your modified adjusted gross income exceeds \$200,000 (\$100,000 if you're a married individual filing a separate return and living apart at all times during the year).

There is no phaseout of the \$25,000 special allowance for low-income housing credits.

***Ordering rules.*** If you have more than one of the exceptions to the phaseout rules in the same tax year, you must apply the \$25,000 phaseout against your passive activity losses and credits in the following order.

1. Passive activity losses.

2. The portion of passive activity credits attributable to credits other than the rehabilitation and low-income housing credits.
3. The portion of passive activity credits attributable to the rehabilitation credit.
4. The portion of passive activity credits attributable to the low-income housing credit.

## **Activities That Aren't Passive Activities**

The following aren't passive activities.

1. Trade or business activities in which you materially participated for the tax year.
2. A working interest in an oil or gas well that you hold directly or through an entity that doesn't limit your liability (such as a general partner interest in a

partnership). It doesn't matter whether you materially participated in the activity for the tax year. However, if your liability was limited for part of the year (for example, you converted your general partner interest to a limited partner interest during the year) and you had a net loss from the well for the year, some of your income and deductions from the working interest may be treated as passive activity gross income and passive activity deductions. See Temporary Regulations section 1.469-1T(e)(4)(ii).

3. The rental of a dwelling unit that you also used for personal purposes during the year for more than the greater of 14 days or 10% of the number of days during the year that the home was rented at a fair rental.
4. An activity of trading personal property for the account of those who

own interests in the activity. See Temporary Regulations section 1.469-1T(e)(6).

5. Rental real estate activities in which you materially participated as a real estate professional. See Real Estate Professional, later.



*You shouldn't enter income and losses from these activities on Form 8582, as they are not passive activities.*

*Instead, enter them on the forms or schedules you would normally use.*

## **Material Participation**

A trade or business activity isn't a passive activity if you materially participated in the activity.

**Material participation tests.** You materially participated in a trade or business activity for a tax year if you satisfy any of the following tests.

1. You participated in the activity for more than 500 hours.
2. Your participation was substantially all the participation in the activity of all individuals for the tax year, including the participation of individuals who didn't own any interest in the activity.
3. You participated in the activity for more than 100 hours during the tax year, and you participated at least as much as any other individual (including individuals who didn't own any interest in the activity) for the year.
4. The activity is a significant participation activity, and you participated in all significant participation activities for more than 500 hours. A significant participation activity is any trade or business activity in which you participated for more than 100 hours during the year

and in which you didn't materially participate under any of the material participation tests, other than this test. See Significant Participation Passive Activities under *Recharacterization of Passive Income*, later.

5. You materially participated in the activity (other than by meeting this fifth test) for any 5 (whether or not consecutive) of the 10 immediately preceding tax years.
6. The activity is a personal service activity in which you materially participated for any 3 (whether or not consecutive) preceding tax years. An activity is a personal service activity if it involves the performance of personal services in the fields of health (including veterinary services), law, engineering, architecture, accounting, actuarial science, performing arts,

consulting, or any other trade or business in which capital isn't a material income-producing factor.

7. Based on all the facts and circumstances, you participated in the activity on a regular, continuous, and substantial basis during the year.

You didn't materially participate in the activity under test (7) if you participated in the activity for 100 hours or less during the year. Your participation in managing the activity doesn't count in determining whether you materially participated under this test if:

- Any person other than you received compensation for managing the activity, or
- Any individual spent more hours during the tax year managing the activity than you did (regardless of whether the individual was

compensated for the management services).

**Participation.** In general, any work you do in connection with an activity in which you own an interest is treated as participation in the activity.

***Work not usually performed by owners.***

You don't treat the work you do in connection with an activity as participation in the activity if both of the following are true.

- The work isn't work that's customarily done by the owner of that type of activity.
- One of your main reasons for doing the work is to avoid the disallowance of any loss or credit from the activity under the passive activity rules.

***Participation as an investor.*** You don't treat the work you do in your capacity as an investor in an activity as participation unless you're directly involved in the day-to-day



management or operations of the activity.

Work you do as an investor includes:

- Studying and reviewing financial statements or reports on operations of the activity,
- Preparing or compiling summaries or analyses of the finances or operations of the activity for your own use, and
- Monitoring the finances or operations of the activity in a nonmanagerial capacity.

**Spouse's participation.** Your participation in an activity includes your spouse's participation. This applies even if your spouse didn't own any interest in the activity and you and your spouse don't file a joint return for the year.



**Proof of participation.** You can use any reasonable method to prove your participation in an activity for the year. You don't have to keep

contemporaneous daily time reports, logs, or similar documents if you can establish your participation in some other way. For example, you can show the services you performed and the approximate number of hours spent by using an appointment book, calendar, or narrative summary.

**Limited partners.** If you owned an activity as a limited partner, you generally aren't treated as materially participating in the activity. However, you're treated as materially participating in the activity if you met test (1), (5), or (6) under Material participation tests, discussed earlier, for the tax year.

You aren't treated as a limited partner, however, if you were also a general partner in the partnership at all times during the partnership's tax year ending with or within your tax year (or, if shorter, during that part of the partnership's tax year in which you directly or indirectly owned your limited partner interest).

**Retired or disabled farmer and surviving spouse of a farmer.** If you're a retired or disabled farmer, you're treated as materially participating in a farming activity if you materially participated for 5 or more of the 8 years before your retirement or disability. Similarly, if you're a surviving spouse of a farmer, you're treated as materially participating in a farming activity if the real property used in the activity meets the estate tax rules for special valuation of farm property passed from a qualifying decedent, and you actively manage the farm.

**Corporations.** A closely held corporation or a personal service corporation is treated as materially participating in an activity only if one or more shareholders holding more than 50% by value of the outstanding stock of the corporation materially participate in the activity.

A closely held corporation can also satisfy the material participation standard by meeting

the first two requirements for the qualifying business exception from the at-risk limits. See *Special exception for qualified corporations* under *Activities Covered by the At-Risk Rules*, later.

## **Real Estate Professional**

Generally, rental activities are passive activities even if you materially participated in them. However, if you qualified as a real estate professional, rental real estate activities in which you materially participated aren't passive activities. For this purpose, each interest you have in a rental real estate activity is a separate activity, unless you choose to treat all interests in rental real estate activities as one activity. See the Instructions for Schedule E (Form 1040), Supplemental Income and Loss, for information about making this choice.

If you qualified as a real estate professional for 2022, report income or losses from rental real estate activities in which you materially participated as nonpassive income or losses, and complete line 43 of Schedule E (Form 1040). If you also have an unallowed loss from these activities from an earlier year when you didn't qualify, see *Treatment of former passive activities* under *Passive Activities*, earlier.

**Qualifications.** You qualified as a real estate professional for the year if you met both of the following requirements.

- More than half of the personal services you performed in all trades or businesses during the tax year were performed in real property trades or businesses in which you materially participated.
- You performed more than 750 hours of services during the tax year in real

property trades or businesses in which you materially participated.

Don't count personal services you performed as an employee in real property trades or businesses unless you were a 5% owner of your employer. You were a 5% owner if you owned (or are considered to have owned) more than 5% of your employer's outstanding stock, outstanding voting stock, or capital or profits interest.

If you file a joint return, don't count your spouse's personal services to determine whether you met the preceding requirements. However, you can count your spouse's participation in an activity in determining if you materially participated.

***Real property trades or businesses.*** A real property trade or business is a trade or business that does any of the following with real property.

- Develops or redevelops it.

- Constructs or reconstructs it.
- Acquires it.
- Converts it.
- Rents or leases it.
- Operates or manages it.
- Brokers it.

***Real property development.*** Real property development is a trade or business that includes the maintenance and improvement of raw land to make it suitable for subdivision, further development, or construction of residential or commercial buildings. Also included in real property development is the establishment, cultivation, maintenance, or improvement of timberlands.

***Real property redevelopment.*** Real property redevelopment is a trade or business that includes demolition, deconstruction, separation, and removal of existing buildings, landscaping, and infrastructure on a parcel of

land to return the land to a raw condition or otherwise prepare the land for new development or construction, or for establishment, cultivation, maintenance, or improvement of timberlands.

***Real property operations.*** Real property operations involve handling the day-to-day operations of a trade or business relating to the maintenance and occupancy of the real property affecting its availability or functionality by a direct or indirect owner. The real property must be used, or held for use, by customers and payments received must be principally for the customer's use of the property and not for the provision of other significant or extraordinary personal services.

***Real property management.*** Real property management involves handling the day-to-day operations of a trade or business relating to the maintenance and occupancy of the real property affecting its availability or functionality by a professional manager. The



real property must be used, or held for use, by customers and payments received must be principally for the customer's use of the property and not for the provision of other significant or extraordinary personal services. A professional manager is a person who is not a direct or indirect owner of the real property or properties and who is responsible for, on a full-time basis, management and oversight of the real property or properties.

***Closely held corporations.*** A closely held corporation can qualify as a real estate professional if more than 50% of the gross receipts for its tax year came from real property trades or businesses in which it materially participated.

## **Passive Activity Income and Deductions**

In figuring your net income or loss from a passive activity, take into account only

passive activity income and passive activity deductions.

**Self-charged interest.** Certain self-charged interest income or deductions may be treated as passive activity gross income or passive activity deductions if the loan proceeds are used in a passive activity.

Generally, self-charged interest income and deductions result from loans between you and a partnership or S corporation in which you had a direct or indirect ownership interest. This includes both loans you made to the partnership or S corporation and loans the partnership or S corporation made to you.

It also includes loans from one partnership or S corporation to another partnership or S corporation if each owner in the borrowing entity has the same proportional ownership interest in the lending entity.

***Exception.*** The self-charged interest rules don't apply to your interest in a partnership or S corporation if the entity made an election under Regulations section 1.469-7(g) to avoid the application of these rules. For more details on the self-charged interest rules, see Regulations section 1.469-7.

## **Passive Activity Income**

Passive activity income includes all income from passive activities and generally includes gain from disposition of an interest in a passive activity or property used in a passive activity.

Passive activity income doesn't include the following items.

- Income from an activity that isn't a passive activity. These activities are discussed under *Activities That Aren't Passive Activities*, earlier.
- Portfolio income. This includes interest, dividends, annuities, and

royalties not derived in the ordinary course of a trade or business. It includes gain or loss from the disposition of property that produces these types of income or that's held for investment. The exclusion for portfolio income doesn't apply to self-charged interest treated as passive activity income. For more information on self-charged interest, see *Self-charged interest*, earlier.

- Personal service income. This includes salaries, wages, commissions, self-employment income from trade or business activities in which you materially participated, deferred compensation, taxable social security and other retirement benefits, and payments from partnerships to partners for personal services.
- Income from positive section 481 adjustments allocated to activities

other than passive activities. (Section 481 adjustments are adjustments that must be made due to changes in your accounting method.)

- Income or gain from investments of working capital.
- Income from an oil or gas property if you treated any loss from a working interest in the property for any tax year beginning after 1986 as a nonpassive loss, as discussed in item (2) under Activities That Aren't Passive Activities, earlier. This also applies to income from other oil and gas property, the basis of which is determined wholly or partly by the basis of the property in the preceding sentence.
- Any income from intangible property, such as a patent, copyright, or literary, musical, or artistic composition, if your personal efforts significantly

contributed to the creation of the property.

- Any other income that must be treated as nonpassive income. See *Recharacterization of Passive Income*, later.
- Overall gain from any interest in a publicly traded partnership. See *Publicly Traded Partnerships (PTPs)* in the instructions for Form 8582.
- State, local, and foreign income tax refunds.
- Income from a covenant not to compete.
- Reimbursement of a casualty or theft loss included in gross income to recover all or part of a prior-year loss deduction, if the loss deduction wasn't a passive activity deduction.
- Alaska Permanent Fund dividends.

- Cancellation of debt income, if at the time the debt is discharged the debt isn't allocated to passive activities under the interest expense allocation rules. See chapter 4 of Pub. 535, Business Expenses, for information about the rules for allocating interest.

**Disposition of property interests.** Gain on the disposition of an interest in property is generally passive activity income if, at the time of the disposition, the property was used in an activity that was a passive activity in the year of disposition. The gain generally isn't passive activity income if, at the time of disposition, the property was used in an activity that wasn't a passive activity in the year of disposition. An exception to this general rule may apply if you previously used the property in a different activity.

***Exception for more than one use in the preceding 12 months.*** If you used the property in more than one activity during the 12-month period before its disposition, you must allocate the gain between the activities on a basis that reasonably reflects the property's use during that period. Any gain allocated to a passive activity is passive activity income.

For this purpose, an allocation of the gain solely to the activity in which the property was mainly used during that period reasonably reflects the property's use if the fair market value of your interest in the property isn't more than the lesser of:

- \$10,000, or
- 10% of the total of the fair market value of your interest in the property and the fair market value of all other property used in that activity immediately before the disposition.



***Exception for substantially appreciated property.*** The gain is passive activity income if the fair market value of the property at disposition was more than 120% of its adjusted basis and either of the following conditions applies.

- You used the property in a passive activity for 20% of the time you held your interest in the property.
- You used the property in a passive activity for the entire 24-month period before its disposition.

If neither condition applies, the gain isn't passive activity income. However, it's treated as portfolio income only if you held the property for investment for more than half of the time you held it in nonpassive activities.

For this purpose, treat property you held through a corporation (other than an S corporation) or other entity whose owners receive only portfolio income as property held

in a nonpassive activity and as property held for investment. Also, treat the date you agree to transfer your interest for a fixed or determinable amount as the disposition date.

If you used the property in more than one activity during the 12-month period before its disposition, this exception applies only to the part of the gain allocated to a passive activity under the rules described in the preceding discussion.

**Disposition of property converted to inventory.** If you disposed of property that you had converted to inventory from its use in another activity (for example, you sold condominium units you previously held for use in a rental activity), a special rule may apply. Under this rule, you disregard the property's use as inventory and treat it as if it were still used in that other activity at the time of disposition. This rule applies only if you meet all of the following conditions.

- At the time of disposition, you held your interest in the property in a dealing activity (an activity that involves holding the property or similar property mainly for sale to customers in the ordinary course of a trade or business).
- Your other activities included a nondealing activity (an activity that doesn't involve holding similar property for sale to customers in the ordinary course of a trade or business) in which you used the property for more than 80% of the period you held it.
- You didn't acquire or hold your interest in the property for the main purpose of selling it to customers in the ordinary course of a trade or business.

## **Passive Activity Deductions**

Generally, a deduction is a passive activity deduction for a taxable year if and only if such deduction either:

1. Arises in connection with the conduct of an activity that's a passive activity for the tax year, or
2. Is treated as a deduction from an activity for the tax year because it was disallowed by the passive activity rules in the preceding year and carried forward to the tax year.

For purposes of item (1) above, an item of deduction arises in the taxable year in which the item would be allowable as a deduction under the taxpayer's method of accounting if taxable income for all taxable years were determined without regard to the passive activity rules and without regard to the basis and at-risk limits. See Coordination with other

limitations on deductions that apply before the passive activity rules, later.

Passive activity deductions generally include any loss from a disposition of property used in a passive activity at the time of the disposition and any loss from a disposition of less than your entire interest in a passive activity.

**Exceptions.** Passive activity deductions don't include the following items.

- Deductions for expenses (other than interest expense) that are clearly and directly allocable to portfolio income.
- Qualified home mortgage interest, capitalized interest expenses, and other interest expenses (other than self-charged interest) properly allocable to passive activities. For more information on self-charged interest, see Self-charged interest

under *Passive Activity Income and Deductions*, earlier.

- Losses from dispositions of property that produce portfolio income or property held for investment.
- State, local, and foreign income taxes.
- Miscellaneous itemized deductions that may be disallowed because of the 2%-of-adjusted-gross-income limit (expired for 2018 through 2025).
- Charitable contribution deductions.
- Net operating loss deductions.
- Percentage depletion carryovers for oil and gas wells.
- Capital loss carrybacks and carryovers.
- Items of deduction from a passive activity that are disallowed under the limits on deductions that apply before the passive activity rules. See

Coordination with other limitations on deductions that apply before the passive activity rules, later.

- Deductions and losses that would have been allowed for tax years beginning before 1987 but for basis or at-risk limits.
- Net negative section 481 adjustments allocated to activities other than passive activities. (Section 481 adjustments are adjustments required due to changes in accounting methods.)
- Casualty and theft losses, unless losses similar in cause and severity recur regularly in the activity.
- The deduction allowed for the deductible part of self-employment tax.

**Coordination with other limitations on deductions that apply before the passive activity rules.** An item of deduction from a passive activity that's disallowed for a tax year under the basis or at-risk limitations isn't a passive activity deduction for the tax year. The following sections provide rules for figuring the extent to which items of deduction from a passive activity are disallowed for a tax year under the basis or at-risk limitations.

***Proration of deductions disallowed under basis limitations.*** If any amount of your distributive share of a partnership's loss for the tax year is disallowed under the basis limitation, a ratable portion of your distributive share of each item of deduction or loss of the partnership is disallowed for the tax year. For this purpose, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing:



1. The amount of your distributive share of partnership loss that's disallowed for the taxable year, by
2. The sum of your distributive shares of all items of deduction and loss of the partnership for the tax year.

If any amount of your pro rata share of an S corporation's loss for the tax year is disallowed under the basis limitation, a ratable portion of your pro rata share of each item of deduction or loss of the S corporation is disallowed for the tax year. For this purpose, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing:

1. The amount of your share of S corporation loss that's disallowed for the tax year, by

2. The sum of your pro rata shares of all items of deduction and loss of the corporation for the tax year.

***Proration of deductions disallowed under at-risk limitation.*** If any amount of your loss from an activity (as defined in Activities Covered by the At-Risk Rules, later) is disallowed under the at-risk rules for the tax year, a ratable portion of each item of deduction or loss from the activity is disallowed for the tax year. For this purpose, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing:

1. The amount of the loss from the activity that's disallowed for the tax year, by
2. The sum of all deductions from the activity for the taxable year.

***Separately identified items of deduction and loss.*** In identifying the items of deduction and loss from an activity that aren't disallowed under the basis and at-risk limitations (and that therefore may be treated as passive activity deductions), you needn't account separately for any item of deduction or loss unless such item may, if separately taken into account, result in an income tax liability different from that which would result were such item of deduction or loss taken into account separately.

Items of deduction or loss that must be accounted for separately include (but aren't limited to) items of deduction or loss that:

1. Are attributable to separate activities. See *Grouping Your Activities*, later.
2. Arise in a rental real estate activity in tax years in which you actively participate in such activity.

3. Arise in a rental real estate activity in taxable years in which you don't actively participate in such activity.
4. Arose in a taxable year beginning before 1987 and weren't allowed for such taxable year under the basis or at-risk limitations.
5. Are taken into account under section 613A(d) (relating to limitations on certain depletion deductions).
6. Are taken into account under section 1211 (relating to the limitation on capital losses).
7. Are taken into account under section 1231 (relating to property used in a trade or business and involuntary conversions). See *Section 1231 Gains and Losses* in Pub. 544 for more information.

8. Are attributable to pre-enactment interests in activities. See Regulations section 1.469-11T(c).

***Excess business loss limitation that applies after the passive activity rules.*** If you are a noncorporate taxpayer and have allowable business losses after considering first the at-risk limitations and then the passive loss limitations (Form 8582), your losses may be subject to the excess business loss limitation. After considering all the other loss limitations, complete Form 461, Limitation on Business Losses, to figure the amount of your excess business loss. See Form 461 and its instructions for details on the excess business loss limitation.

## **Grouping Your Activities**

You can treat one or more trade or business activities, or rental activities, as a single activity if those activities form an appropriate

economic unit for measuring gain or loss under the passive activity rules.

Grouping is important for a number of reasons. If you group two activities into one larger activity, you need only show material participation in the activity as a whole. But if the two activities are separate, you must show material participation in each one. On the other hand, if you group two activities into one larger activity and you dispose of one of the two, then you have disposed of only part of your entire interest in the activity. But if the two activities are separate and you dispose of one of them, then you have disposed of your entire interest in that activity.

Grouping can also be important in determining whether you meet the 10% ownership requirement for actively participating in a rental real estate activity.

## **Appropriate Economic Units**

Generally, to determine if activities form an appropriate economic unit, you must consider all the relevant facts and circumstances. You can use any reasonable method of applying the relevant facts and circumstances in grouping activities. The following factors have the greatest weight in determining whether activities form an appropriate economic unit. All of the factors don't have to apply to treat more than one activity as a single activity. The factors that you should consider are:

1. The similarities and differences in the types of trades or businesses;
2. The extent of common control;
3. The extent of common ownership;
4. The geographical location; and
5. The interdependencies between or among activities, which may include the extent to which the activities:

- a. Buy or sell goods between or among themselves,
- b. Involve products or services that are generally provided together,
- c. Have the same customers,
- d. Have the same employees, or
- e. Use a single set of books and records to account for the activities.

**Example 1.** Jackie owns a bakery and a movie theater at a shopping mall in Baltimore and a bakery and movie theater in Philadelphia. Based on all the relevant facts and circumstances, there may be more than one reasonable method for grouping Jackie's activities. For example, Jackie may be able to group the movie theaters and the bakeries into:

- One activity,



- A movie theater activity and a bakery activity,
- A Baltimore activity and a Philadelphia activity, or
- Four separate activities.

**Example 2.** Pat is a partner in ABC partnership, which sells nonfood items to grocery stores. Pat is also a partner in DEF (a trucking business). ABC and DEF are under common control. The main part of DEF's business is transporting goods for ABC. DEF is the only trucking business in which Pat is involved. Based on the rules of this section, Pat treats ABC's wholesale activity and DEF's trucking activity as a single activity.

**Consistency and disclosure requirement.**

Generally, when you group activities into appropriate economic units, you may not regroup those activities in a later tax year. You must meet any disclosure requirements of the IRS when you first group your activities

and when you add or dispose of any activities in your groupings.

However, if the original grouping is clearly inappropriate or there is a material change in the facts and circumstances that makes the original grouping clearly inappropriate, you must regroup the activities and comply with any disclosure requirements of the IRS.

See *Disclosure Requirement*, later.

**Regrouping by the IRS.** If any of the activities resulting from your grouping isn't an appropriate economic unit and one of the primary purposes of your grouping (or failure to regroup) is to avoid the passive activity rules, the IRS may regroup your activities.

**Rental activities.** In general, you can't group a rental activity with a trade or business activity. However, you can group them together if the activities form an appropriate economic unit and:

- The rental activity is insubstantial in relation to the trade or business activity;
- The trade or business activity is insubstantial in relation to the rental activity; or
- Each owner of the trade or business activity has the same ownership interest in the rental activity, in which case the part of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.

**Example.** Finley and Taylor are married and file a joint return. Healthy Food, an S corporation, is a grocery store business. Finley is Healthy Food's only shareholder. Plum Tower, an S corporation, owns and rents out the building. Taylor is Plum Tower's only shareholder. Plum Tower rents part of its building to Healthy Food. Plum Tower's

grocery store rental business and Healthy Food's grocery business aren't insubstantial in relation to each other.

Finley and Taylor file a joint return, so they're treated as one taxpayer for purposes of the passive activity rules. The same owner (Finley and Taylor) owns both Healthy Food and Plum Tower with the same ownership interest (100% in each). If the grouping forms an appropriate economic unit, as discussed earlier, Finley and Taylor can group Plum Tower's grocery store rental and Healthy Food's grocery business into a single trade or business activity.

***Grouping of real and personal property rentals.*** In general, you can't treat an activity involving the rental of real property and an activity involving the rental of personal property as a single activity. However, you can treat them as a single activity if you provide the personal property in connection with the real property or the

real property in connection with the personal property.

**Certain activities may not be grouped: limited partnerships and limited**

**entrepreneurs.** In general, if you own an interest as a limited partner or a limited entrepreneur in one of the following activities, you may not group that activity with any other activity in another type of business.

- Holding, producing, or distributing motion picture films or video tapes.
- Farming.
- Leasing any section 1245 property (as defined in section 1245(a)(3) of the Internal Revenue Code). For a list of section 1245 property, see Section 1245 property under *Activities Covered by the At-Risk Rules*, later.
- Exploring for, or exploiting, oil and gas resources.

- Exploring for, or exploiting, geothermal deposits.

If you own an interest as a limited partner or a limited entrepreneur in an activity described in the list above, you may group that activity with another activity in the same type of business if the grouping forms an appropriate economic unit as discussed earlier.

***Limited entrepreneur.*** A limited entrepreneur is a person who:

- Has an interest in an enterprise other than as a limited partner, and
- Doesn't actively participate in the management of the enterprise.

***Certain activities may not be grouped:***

***trading activities.*** A trading activity of trading personal property is not a passive activity. Personal property is any personal property that is actively traded, (for example, financial securities). A taxpayer who does not materially participate in a trading activity is

prohibited from grouping the activity with any other activity including any other trading activity. The prohibition on grouping is effective for taxable years beginning on or after March 22, 2021. If you are a calendar year taxpayer, the new provisions apply to you in calendar year 2022.

**Activities conducted through another entity.** A personal service corporation, closely held corporation, partnership, or S corporation must group its activities using the rules discussed in this section. Once the entity groups its activities, you, as the partner or shareholder of the entity, may group those activities (following the rules of this section):

- With each other,
- With activities conducted directly by you, or
- With activities conducted through other entities.



*You may not treat activities grouped together by the entity as separate activities.*

***Personal service and closely held corporations.*** You may group an activity conducted through a personal service or closely held corporation with your other activities only to determine whether you materially or significantly participated in those other activities. See Material Participation, earlier, and Significant Participation Passive Activities, later.

***Publicly traded partnership (PTP).*** You may not group activities conducted through a PTP with any other activity, including an activity conducted through another PTP.

***Partial dispositions.*** If you dispose of substantially all of an activity during your tax year, you may treat the part disposed of as a separate activity. However, you can do this only if you can show with reasonable certainty: