

Passive Activities – Source: IRS Publication 925 “Passive Activity and At-Risk Rules

There are two kinds of passive activities.

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

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, did not 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 *does not* include a rental activity or the rental of property that is incidental to an activity of holding the property for investment.

Material Participation

A trade or business activity is not 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 did not 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 did not 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 did not 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 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 is not 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 did not 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 does not 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 do not treat the work you do in connection with an activity as participation in the activity if both of the following are true:

- The work is not work that is 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 do not treat the work you do in your capacity as an investor in an activity as participation unless you are 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 did not own any interest in the activity and you and your spouse do not 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 do not 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 are not treated as materially participating in the activity. However, you are 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.

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.

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 are not 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.

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.