Publication 925

Passive Activity and At-Risk Rules

For use in preparing

2023 Returns

Volume 2 of 3

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Publication 925 (Rev 2023) Catalog Number 39328F
Department of the Treasury **Internal Revenue Service** www.irs.gov

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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 tax 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 tax year in which the item would be allowable as a deduction under the taxpayer's method of accounting if taxable income for all tax 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 tax 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 tax 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 not 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 tax years in which you don’t actively participate in such activity.

4. Arose in a tax year beginning before 1987 and weren’t allowed for such tax 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 Temporary 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 tax years beginning on or after March 22, 2021. If you are a calendar year taxpayer, the new provisions apply to you beginning 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:

- The amount of deductions and credits disallowed in prior years under the passive activity rules that's allocable to the part of the activity disposed of, and
- The amount of gross income and any other deductions and credits for the current tax year that are allocable to the part of the activity disposed of.

Regrouping Due to Net Investment Income Tax

You may be able to regroup your activities, as described below, if you're subject to the Net Investment Income Tax (NIIT) for the first time. For detailed information, see Regulations section 1.469-11(b)(3)(iv).

Regrouping on an original return. Under the NIIT "fresh start" election, you may regroup for the first tax year you are subject to the NIIT (without regard to the effect of regrouping). You may regroup only once under this election and that regrouping will

apply to the tax year for which you regroup and all future tax years. You are eligible to regroup if:

1. You were not previously subject to the NIIT;
2. The amount you would have entered on Form 8960, line 12, without the regrouping, would have been greater than zero; and
3. The amount you would have entered on Form 8960, line 13, without the regrouping, would have been greater than the amount you would have entered on Form 8960, line 14, without the regrouping.

Regrouping on an amended return. You may regroup your activities on an amended tax return, but only if you were not subject to the NIIT on your original return (or previously amended return). You are eligible if:

1. You were not previously subject to the NIIT for the tax year for which you are filing an amended return or any prior tax year;
2. The changes on the amended return cause you to be subject to the NIIT for the first time beginning in the tax year for which you are amending the return;
3. The limitation period for assessments under Code section 6501 hasn't ended;
4. The changes on your amended return cause the amount on Form 8960, line 12, of your amended return to be greater than zero; and
5. The changes on your amended return cause the amount on Form 8960, line 13, of your amended return to be greater than the amount entered on Form 8960, line 14.

This rule applies equally to changes to modified adjusted gross income or net investment income upon an IRS examination.

Manner of regrouping. If you regroup your activities under this rule, you must attach to your original or amended return, as applicable, a statement that satisfies the requirements described in *Regrouping* under *Disclosure Requirement*, later.

Disclosure Requirement

For tax years beginning after January 24, 2010, the following disclosure requirements for groupings apply. You're required to report certain changes to your groupings that occur during the tax year to the IRS. If you fail to report these changes, each trade or business activity or rental activity will be treated as a separate activity. You will be considered to have made a timely disclosure if you filed all affected income tax returns consistent with the claimed grouping and make the required disclosure on the income tax return for the

year in which you first discovered the failure to disclose. If the IRS discovered the failure to disclose, you must have reasonable cause for not making the required disclosure.

New grouping. You must file a written statement with your original income tax return for the first tax year in which two or more activities are originally grouped into a single activity. The statement must provide the names, addresses, and employer identification numbers (EINs), if applicable, for the activities being grouped as a single activity. In addition, the statement must contain a declaration that the grouped activities make up an appropriate economic unit for the measurement of gain or loss under the passive activity rules.

Addition to an existing grouping. You must file a written statement with your original income tax return for the tax year in which you add a new activity to an existing group. The statement must provide the name,

address, and EIN, if applicable, for the activity that’s being added and for the activities in the existing group. In addition, the statement must contain a declaration that the activities make up an appropriate economic unit for the measurement of gain or loss under the passive activity rules.

Regrouping. You must file a written statement with your original income tax return for the tax year in which you regroup the activities. The statement must provide the names, addresses, and EINs, if applicable, for the activities that are being regrouped. If two or more activities are being regrouped into a single activity, the statement must contain a declaration that the regrouped activities make up an appropriate economic unit for the measurement of gain or loss under the passive activity rules. In addition, the statement must contain an explanation of the material change in the facts and

circumstances that made the original grouping clearly inappropriate.

Groupings by partnerships and S corporations. Partnerships and S corporations aren’t subject to the rules for new grouping, addition to an existing grouping, or regrouping. Instead, they must comply with the disclosure instructions for grouping activities provided in their Form 1065, U.S. Return of Partnership Income, or Form 1120-S, U.S. Income Tax Return for an S Corporation, whichever is applicable.

The partner or shareholder isn’t required to make a separate disclosure of the groupings disclosed by the entity unless the partner or shareholder:

- Groups together any of the activities that the entity doesn’t group together,
- Groups the entity's activities with activities conducted directly by the partner or shareholder, or

- Groups an entity's activities with activities conducted through another entity.

A partner or shareholder may not treat activities grouped together by the entity as separate activities.

Recharacterization of Passive Income

Net income from the following passive activities may have to be recharacterized and excluded from passive activity income.

- Significant participation passive activities,
- Rental of property when less than 30% of the unadjusted basis of the property is subject to depreciation,
- Equity-financed lending activities,
- Rental of property incidental to development activities,
- Rental of property to nonpassive activities, and

- Licensing of intangible property by pass-through entities.

If you're engaged in or have an interest in one of these activities during the tax year (either directly or through a partnership or an S corporation), combine the income and losses from the activity to determine if you have a net loss or net income from that activity.

If the result is a net loss, treat the income and losses the same as any other income or losses from that type of passive activity (trade or business activity or rental activity).

If the result is net income, don't enter any of the income or losses from the activity or property on Form 8582 or its separate parts, as they are recharacterized as nonpassive. Instead, enter income or losses on the form and schedules you normally use. However, see *Significant*

Participation Passive Activities, later, if the activity is a significant participation passive activity and you also have a net loss from a different significant participation passive activity.

Limit on recharacterized passive income. The total amount that you treat as nonpassive income under the rules described later in this discussion for significant participation passive activities, rental of nondepreciable property, and equity-financed lending activities can't exceed the greatest amount that you treat as nonpassive income under any one of these rules.

Investment income and investment expense. To figure your investment interest expense limitation on Form 4952, treat as investment income any net passive income recharacterized as nonpassive income from rental of nondepreciable property, equity-financed lending activity, or licensing of intangible property by a pass-through entity.

Significant Participation Passive Activities

A significant participation passive activity is any trade or business activity in which you participated for more than 100 hours during the tax year but didn’t materially participate.

If your gross income from all significant participation passive activities is more than your deductions from those activities, a part of your net income from each significant participation passive activity is treated as nonpassive income.

Corporations. An activity of a personal service corporation or closely held corporation is a significant participation passive activity if both of the following statements are true.

- The corporation isn’t treated as materially participating in the activity for the year.
- One or more individuals, each of whom is treated as significantly participating in the activity, directly or indirectly, hold (in

total) more than 50% (by value) of the corporation's outstanding stock.

Worksheet A. Complete Worksheet A. Significant Participation Passive Activities if you have income or losses from any significant participation activity. Begin by entering the name of each activity in the left column.

Column (a). Enter the number of hours you participated in each activity and total the column.

If the total is more than 500, don’t complete Worksheet A or B. None of the activities are passive activities because you satisfy test 4 for material participation. (See *Material participation tests*, earlier.) Report all the income and losses from these activities on the forms and schedules you normally use. Don’t include the income and losses on Form 8582.

Column (b). Enter the net loss, if any, from the activity.

Net loss from an activity means either:

- The activity's current-year net loss (if any) plus prior-year unallowed losses (if any), or
- The excess of prior-year unallowed losses over the current-year net income (if any). Enter -0- here if the prior-year unallowed loss is the same as the current-year net income.

Column (c). Enter net income (if any) from the activity. Net income means the excess of the current-year net income from the activity over any prior-year unallowed losses from the activity.

Worksheet A. **Significant Participation Passive Activities**

Keep for Your Records

Name of activity	(a) Hours of participation	(b) Net loss	(c) Net income	(d) Combine totals of cols. (b) and (c)
		( )		
		( )		
		( )		
		( )		
		( )		
		( )		
		( )		
Totals		( )		

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Column (d). Combine amounts in the *Totals* row for columns (b) and (c) and enter the total net income or net loss in the *Totals* row of column (d). If column (d) is a net loss, skip Worksheet B. Significant Participation Activities With Net Income. Include the income and losses in Part V of Form 8582 (or Worksheet 2 in the Instructions for Form 8810).

Worksheet B. On Worksheet B. Significant Participation Activities With Net Income, list only the significant participation passive activities that have net income as shown in column (c) of Worksheet A.

Column (a). Enter the net income of each activity from column (c) of Worksheet A.

Column (b). Divide each of the individual net income amounts in column (a) by the total of column (a). The result is a ratio. In column (b), enter the ratio for each activity as a decimal (rounded to at least three places). The total of these ratios must equal 1.000.

Column (c). Multiply the amount in the *Totals* row of column (d) of Worksheet A by each of the ratios in column (b). Enter the results in column (c).

Column (d). Subtract column (c) from column (a). To this figure, add the amount of prior-year unallowed losses (if any) that reduced the current-year net income. Enter the result in column (d). Enter these amounts on Part V of Form 8582 or Worksheet 2 in the Instructions for Form 8810. (See also *Limit on recharacterized passive income*, earlier.)

Rental of Nondepreciable Property

If you have net passive income (including prior-year unallowed losses) from renting property in a rental activity, and less than 30% of the unadjusted basis of the property is subject to depreciation, you treat the net passive income as nonpassive income.

Worksheet B. **Significant Participation Activities With Net Income**

Keep for Your Records

Name of activity with net income	(a) Net income	(b) Ratio (see instructions)	(c) Nonpassive income (see instructions)	(d) Passive income (subtract col. (c) from col. (a))
Totals		1.000		

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Example. Charlie acquires vacant land for $300,000, constructs improvements at a cost of $100,000, and leases the land and improvements to a tenant. Charlie then sells the land and improvements for $600,000, realizing a gain of $200,000 on the disposition.

The unadjusted basis of the improvements ($100,000) equals 25% of the unadjusted basis of all property ($400,000) used in the rental activity.

Charlie's net passive income from the activity (which is figured with the gain from the disposition, including gain from the improvements) is treated as nonpassive income.

Equity-Financed Lending Activities

If you have gross income from an equity-financed lending activity, the lesser of the net passive income or the equity-financed interest income is nonpassive income.

For more information, see Temporary Regulations section 1.469-2T(f)(4).

Rental of Property Incidental to a Development Activity

Net income from this type of activity will be treated as nonpassive income if all of the following apply.

- You recognize gain from the sale, exchange, or other disposition of the rental property during the tax year.
- You started to rent the property less than 12 months before the date of disposition.
- You materially participated or significantly participated for any tax year in an activity that involved the performance of services for the purpose of enhancing the value of the property (or any other item of property if the basis of the property disposed of is determined in whole or in part by reference to the basis of that item of property).

For more information, see Regulations section 1.469-2(f)(5).

Rental of Property to a Nonpassive Activity

If you rent property to a trade or business activity in which you materially participated, net rental income from the property is treated as nonpassive income. This rule doesn't apply to net income from renting property under a written binding contract entered into before February 19, 1988. It also doesn't apply to property described earlier under *Rental of Property Incidental to a Development Activity*.

Licensing of Intangible Property by Pass-Through Entities

Net royalty income from intangible property held by a pass-through entity in which you own an interest may be treated as nonpassive royalty income. This applies if you acquired your interest in the pass-through entity after the partnership, S corporation, estate, or

trust created the intangible property or performed substantial services or incurred substantial costs for developing or marketing the intangible property.

This recharacterization rule doesn’t apply if:

1. The expenses reasonably incurred by the entity in developing or marketing the property exceed 50% of the gross royalties from licensing the property that are includible in your gross income for the tax year, or
2. Your share of the expenses reasonably incurred by the entity in developing or marketing the property for all tax years exceeded 25% of the fair market value of your interest in the intangible property at the time you acquired your interest in the entity.

For purposes of (2) above, capital expenditures are taken into account for the entity's tax year in which the expenditure is

chargeable to a capital account, and your share of the expenditure is figured as if it were allowed as a deduction for the tax year.

Dispositions

Any passive activity losses (but not credits) that haven't been allowed (including current-year losses) are generally allowed in full in the tax year in which you dispose of your entire interest in the passive (or former passive) activity. However, for the losses to be allowed, you must dispose of your entire interest in the activity in a transaction in which all realized gain or loss is recognized. Also, the person acquiring the interest from you must not be related to you.

If you have a capital loss on the disposition of an interest in a passive activity, the loss may be limited. For individuals, your capital loss deduction is limited to the amount of your capital gains plus the lower of $3,000 ($1,500 in the case

of a married individual filing a separate return) or the excess of your capital losses over capital gains. See Pub. 544 *for more information.*

Example. Carter earned a $60,000 salary and owned one passive activity through a 5% interest in the B Limited Partnership. In 2023, Carter sold that entire partnership interest to an unrelated person for $30,000. Carter's adjusted basis in the partnership interest was $42,000, and Carter had carried over $2,000 of ordinary passive activity deductions from the activity.

Carter's deductible loss for 2023 is $5,000, figured as follows.

Amount realized	$30,000
Minus: adjusted basis	–42,000
Capital loss	$12,000

Minus: capital loss limit	–3,000
Capital loss carryover	$9,000
Allowable capital loss on sale	$3,000
Carryover losses allowable	2,000
Total current deductible loss	$5,000

Carter deducts the $5,000 total current deductible loss in 2023 and must carry over the remaining $9,000 capital loss, which isn't subject to the passive activity loss limit. Carter will treat it like any other capital loss carryover.

Installment sale of an entire interest. If you sell your entire interest in a passive activity through an installment sale, to figure the loss for the current year that isn't limited by the passive activity rules, multiply your overall loss (not including losses allowed in prior years) by a fraction. The numerator of

the fraction is the gain recognized in the current year, and the denominator is the total gain from the sale minus all gains recognized in prior years.

Example. Riley has a total gain of $10,000 from the sale of an entire interest in a passive activity. Under the installment method, Riley reports $2,000 of gain each year, including the year of sale. For the first year, 20% (2,000/10,000) of the losses are allowed. For the second year, 25% (2,000/8,000) of the remaining losses are allowed.

Partners and S corporation shareholders. Generally, any gain or loss on the disposition of a partnership interest must be allocated to each trade or business, rental, or investment activity in which the partnership owns an interest. If you dispose of your entire interest in a partnership, the passive activity losses from the partnership that haven’t been allowed are generally allowed in full. They will also be allowed if the partnership (other than

a PTP) disposes of all the property used in that passive activity.

If you don’t dispose of your entire interest, the gain or loss allocated to a passive activity is treated as passive activity income or deduction in the year of disposition. This includes any gain recognized on a distribution of money from the partnership that you receive in excess of the adjusted basis of your partnership interest. These rules also apply to the disposition of stock in an S corporation.

Dispositions by gift. If you give away your interest in a passive activity, the unused passive activity losses allocable to the interest can’t be deducted in any tax year. Instead, the basis of the transferred interest must be increased by the amount of these losses.

Dispositions by death. If a passive activity interest is transferred because the owner dies, unused passive activity losses are allowed (to a certain extent) as a deduction against the decedent's income in the year of

death. The decedent's losses are allowed only to the extent they exceed the amount by which the transferee's basis in the passive activity has been increased under the rules for determining the basis of property acquired from a decedent. For example, if the basis of an interest in a passive activity in the hands of a transferee is increased by $6,000 and unused passive activity losses of $8,000 were allocable to the interest at the date of death, then the decedent's deduction for the tax year would be limited to $2,000 ($8,000 – $6,000).

If you inherited property from a decedent who died in 2010, special rules may apply if the executor of the estate filed Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent. For more information, see Pub. 4895, Tax Treatment of Property Acquired From a Decedent Dying in 2010, which is available at *IRS.gov/pub/irs-prior/p4895--2011.pdf.*

Partial dispositions. If you dispose of substantially all of an activity during your tax year, you may be able to treat the part of the activity disposed of as a separate activity. See *Partial dispositions* under *Grouping Your Activities*, earlier.

How To Report Your Passive Activity Loss

More than one form or schedule may be required for reporting your passive activities. The actual number of forms depends on the number and types of activities you must report. Some forms and schedules that may be required are:

- Schedule C (Form 1040), Profit or Loss From Business;
- Schedule D (Form 1040), Capital Gains and Losses;
- Schedule E (Form 1040), Supplemental Income and Loss;

- Schedule F (Form 1040), Profit or Loss From Farming;
- Form 4797, Sales of Business Property;
- Form 6252, Installment Sale Income;
- Form 8582, Passive Activity Loss Limitations;
- Form 8582-CR, Passive Activity Credit Limitations; and
- Form 8949, Sales and Other Dispositions of Capital Assets.

Regardless of the number or complexity of passive activities you have, you should use only one Form 8582. If you need additional lines for any of the Form 8582 parts, you can either use copies of page 1, page 2, and/or page 3 of Form 8582, whichever is applicable, or your own schedule that's in the same format as the applicable part.

For examples and further information, see the Form 8582 instructions.

At-Risk Limits

The at-risk rules limit your losses from most activities to your amount at risk in the activity. You treat any loss that's disallowed because of the at-risk limits as a deduction from the same activity in the next tax year. If your losses from an at-risk activity are allowed, they're subject to recapture in later years if your amount at risk is reduced below zero.

You must apply the at-risk rules before the passive activity rules discussed in the first part of this publication.

Loss defined. A loss is the excess of allowable deductions from the activity for the year (including depreciation or amortization allowed or allowable and disregarding the at-risk limits) over income received or accrued from the activity during the year. Income doesn't include income from the recapture of

previous losses (discussed, later, under *Recapture Rule*).

Form 6198. Use Form 6198 to figure how much loss from an activity you can deduct.

1. File Form 6198 with your tax return if:
    a. You have a loss from any part of an activity that's covered by the at-risk rules, and
    b. You aren't at risk for some of your investment in the activity.
2. File Form 6198 if you're engaged in an activity included in (6) under *Activities Covered by the At-Risk Rules*, later, and you have borrowed amounts described in *Certain borrowed amounts excluded* under *At-Risk Amounts,* later.

Loss limits for partners and S corporation shareholders. Separate limits may apply to a partner's or shareholder's distributive share

of an item of deduction or loss from a partnership or S corporation, respectively. The limits determine the amount each partner or shareholder can deduct on their own return. These limits and the order in which they apply are:

1. The adjusted basis of:
    a. The partner's partnership interest, or
    b. The shareholder's stock plus any loans the shareholder makes to the corporation,
2. The at-risk rules, and
3. The passive activity rules.

See *Limitations on Losses, Deductions, and Credits* in Partner's Instructions for Schedule K-1 (Form 1065) and Shareholder's Instructions for Schedule K-1 (Form 1120-S).

See *Coordination with other limitations on deductions that apply before the passive activity rules*, earlier.

See also *Excess business loss limitation that applies after the passive activity rules*, earlier, for limitations that may apply after an allowable passive activity loss is determined.

Who Is Affected?

The at-risk limits apply to individuals (including partners and S corporation shareholders), estates, trusts, and certain closely held C corporations.

Closely held C corporation. For the at-risk rules, a C corporation is a closely held corporation if at any time during the last half of the tax year, more than 50% in value of its outstanding stock is owned, directly or indirectly, by or for five or fewer individuals.