Chapter 4: Passive Activities

Being able to identify passive activities and understanding the rules and limitations associated with passive activities is important due to numerous tax consequences. The passive activity rules may limit the amount of losses that a taxpayer can claim. Practitioners who fail to apply the rules properly may be subject to preparer penalties and/or other adverse consequences.

Note. Rules associated with passive activities are used to determine which income is subject to the net investment income tax (NIIT), which affects higher-income taxpayers.

For those unfamiliar with classifying and reporting passive activities, the nomenclature can be confusing. The word active is used in two different ways within this context.

1. An activity is a business endeavor.
2. The word active is used in contrast to passive. A passive activity is subject to limitations. An active endeavor is not. Also, in this context, the words nonpassive and active are used interchangeably.

Certain activities are by definition passive, and other activities are classified as passive or nonpassive based on the amount of time the taxpayer spends on the activity. For many activities, the taxpayer’s participation varies from year to year. Because of this, an activity that is passive during one tax year may not necessarily be passive in others.

Activities reported directly on Form 1040, U.S. Individual Income Tax Return (Schedules C, E, and F) may be subject to passive activity limitations. Income and losses from pass-through entities are affected by the passive activity rules. These include the following.

- S corporations
- Partnerships
- Limited liability companies (LLCs)
- Limited partnerships
- Trusts
- Estates

Additionally, the following taxpayers are also affected by the passive activity rules.¹

- Closely-held C corporations
- Personal service corporations

¹ IRC §469(a)(2).
For purposes of the passive activity rules, a closely-held C corporation is one in which not more than five individuals hold, directly or indirectly, more than 50% of the value of outstanding stock at any time during the last half of the tax year.2 A personal service corporation (PSC) is defined as one whose principal activity is the performance of personal services that are substantially performed by employee-owners who own any of the outstanding stock.3

Note. Stock ownership in the PSC may be owned directly by the taxpayer or indirectly through attribution. The attribution rules of IRC §318 apply if a party related to the taxpayer owns any stock.4 Under §318(a)(1), stock owned by a spouse, child, grandchild, or parent is attributed to the taxpayer. See IRC §318(a)(2) for further information about stock ownership attribution from a partnership, estate, trust, or corporation.

Special reporting requirements may apply to a taxpayer with passive activities, and it may be necessary to track amounts suspended or used from year to year for each activity. In many cases, tax software relies upon the practitioner to properly classify and track activities affected by the passive activity rules.

Generally, passive activity loss (PAL) amounts and the PAL limitation for the taxpayer are reported using Form 8582, Passive Activity Loss Limitations. If there are limitations in connection with tax credits associated with the passive activities, Form 8582-CR, Passive Activity Credit Limitations, is used.

Note. IRS Pub. 925, Passive Activity and At-Risk Rules, provides further guidance and a detailed example with completed forms for the practitioner.

MATERIAL PARTICIPATION

A passive activity is generally any trade or business activity engaged in by the taxpayer in which the taxpayer does not materially participate.5 For purposes of these rules, a trade or business activity generally includes:

- An activity considered a trade or business under IRC §162,
- An activity engaged in to start a business, or
- An activity that generates deductible research or experimental expenditures under IRC §174.

The concept of material participation is key to identifying activities as active or passive. Generally, the nature of the activity itself is not determinative of whether the activity is active or passive. Rather, the determining factor generally is whether the taxpayer’s degree of engagement or involvement in the activity meets the definition of material participation.

However, by definition, most rental real estate activities are passive, regardless of the taxpayer’s level of participation.6 Rental real estate activities are discussed later.

2. IRC §469(j)(1), referencing §465(a)(1)(B), which references the definition under §542(a)(2).
3. IRC §469(j)(2), referencing §269A(b) with modifications.
4. IRC §469(j)(2)(B), referencing §318(a)(2)(C) with modifications.
5. IRC §469(c)(1).
7. IRC §469(c)(2).
There are general rules that apply in order for the taxpayer’s participation in an activity to constitute material participation. The conduct of the taxpayer in connection with an activity must be:\(^8\)

1. Regular,
2. Continuous, and

This section discusses the various rules that can be used by the taxpayer to establish material participation in an activity. Not all work or types of involvement in an activity count toward material participation. In order to qualify, the nature of the work or involvement must be the type customarily done by an owner of the activity, and it must have a principal purpose other than to meet the material participation test.\(^9\) Management duties performed by a taxpayer do not qualify unless both of the following items apply.\(^10\)

1. No person other than the taxpayer performs management services for the activity for compensation, and
2. The taxpayer spends more hours engaged in providing management services for the activity than anyone else.

Generally, investor functions do not qualify towards material participation. The types of investment activities that do not qualify include the following.\(^11\)

- Studying and reviewing financial statements or reports regarding the activity’s operations
- Preparing financial analyses or summaries for the taxpayer’s own use
- Monitoring the finances or operations of the activity in a manner that is not managerial in nature

However, if the taxpayer is directly involved in the day-to-day management of the activity, time spent on such activities does qualify towards meeting the material participation test.\(^12\)

**Observation.** Although the regulatory guidance provides some insight on what type of activities qualify as material participation, there are many types of activities that a taxpayer can engage in that are unclear. Practitioners should review the guidance closely to properly advise clients on whether the nature of a taxpayer’s participation in an activity is likely to qualify as material participation. Documentation of material participation is discussed later.

The determination of whether the taxpayer materially participates is made separately for each tax year. However, under certain circumstances, a taxpayer is deemed to have met the material participation standards in the current year based on prior years’ activity.

\(^8\) IRC §469(h)(1).
\(^12\) Ibid.