



## **Tax Law Overview – Passive Activity Rules**

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Are losses from your business or rental activities able to be used to offset income from your other activities? Before you can answer this question, you should have a reasonable understanding of the passive activity rules. This article provides a brief overview of the passive activities and explains why the passive activity rules can be a thorn in the side of taxpayers.

### *What is a passive activity?*

The term “passive activity” is a creation of tax law that refers to an activity for which the taxpayer does not have regular, continuous and substantial involvement. Treasury regulations prescribe seven specific tests for determining whether a taxpayer’s participation meets this “regular, continuous and substantial” standard. The seven tests are:

1. 500 hour test - The simplest of the seven tests is the “500 hour” test, which provides that if a taxpayer works in the activity for at least 500 hours, the activity is not passive with respect to the taxpayer.
2. Substantially all test – Your activity represents substantially all of the effort required of the activity by all involved persons, this test is met regardless of the number of hours spent
3. 100 hour majority test – You spend more than 100 hours and more than any other person
4. Significant Participation Aggregation test – You spend more than 500 hours on several activities (in the aggregate) and at least 100 hours on this activity.
5. Five of Ten test – You materially participated in at least five of the last ten years
6. Facts and Circumstances test – You spend at least 100 hours but don’t meet any of the other tests, but facts and circumstances indicate that you materially participate
7. Personal Service test – The activity is a personal service activity and you materially participated for any three prior years

### *How do passive activity rules affect me?*

We need to understand what activities are “passive” in nature because losses arising from such activities are generally only able to be used to offset gains from other passive activities. In other words, passive losses cannot generally be used to offset nonpassive income. Unused passive activity losses are carried forward to offset passive income in future years, or until there is a complete disposition of the passive activity.

*What about rental activities? Are they passive?*

Subject to several exceptions, tax law provides that rental activities are passive in nature, regardless of the level of participation of the taxpayer. The major exception applies to rental activities owned by real estate professionals. If a real estate professional holds a rental activity, the rule requiring the rental activity to be automatically classified as a passive activity is not applicable. However, the real estate professional must still meet the material participation tests with regard to the rental activity. Because it may be difficult to meet the material participation tests with regard to a single rental activity, many real estate professionals elect to group all of their rental activities for purposes of the material participation test. The election by a real estate professional to group activities is a one-time irrevocable election. The downside of making the election is that the taxpayer loses the ability to deduct unused passive losses from a passive activity when there is a complete disposition of the activity (unless all of the real estate professional's rental activities are disposed).

*How do I know if I'm "real estate professional" for purposes of passive activity rules?*

Tax law generally provides that a real estate professional is someone that performs more than 750 hours of service in a year in the real property trades or businesses in which they materially participate and more than half of the personal services they perform are in real property trades or businesses.

The information provided above is intentionally brief due to space constraints. A more complete discussion of the passive activity rules is beyond the scope of this format. However, if you have any additional questions or would like further clarification of any of the points made, please contact us. We are happy to answer any questions you may have.

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