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Passive Activity and At-Risk Rules

For use in preparing
2004 Returns



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Contents

What's New	1
Reminder	1
Introduction	2
Passive Activity Limits	2
Who Must Use These Rules?	2
Passive Activities	2
Activities That Are Not Passive Activities	4
Passive Activity Income and Deductions	5
Grouping Your Activities	7
Recharacterization of Passive Income	8
Dispositions	9
How To Report Your Passive Activity Loss	10
Comprehensive Example	10
At-Risk Limits	21
Who Is Affected?	21
Activities Covered by the At-Risk Rules	21
At-Risk Amounts	22
Amounts Not At Risk	23
Reductions of Amounts At Risk	23
Recapture Rule	23
How To Get Tax Help	24
Index	26

What's New

Definition of at-risk amounts expanded. The following rules apply to amounts borrowed after May 3, 2004.

- You must file Form 6198 if you are 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.

Reminder

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. 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 1-800-THE-LOST (1-800-843-5678) 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 your suggestions for future editions.

You can write to us at the following address:

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We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

You can email us at taxforms@irs.gov. (The asterisk must be included in the address.) Please put "Publications Comment" on the subject line. Although we cannot respond individually to each email, we do appreciate your feedback and will consider your comments as we revise our tax products.

Tax questions. If you have a tax question, visit www.irs.gov or call 1-800-829-1040. We cannot answer tax questions at either of the addresses listed above.

Ordering forms and publications. Visit www.irs.gov/formspubs to download forms and publications, call 1-800-829-3676, or write to one of the three addresses shown under *How To Get Tax Help* in the back of this publication.

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

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

Passive Activity Limits

In general, you can deduct passive activity losses only from passive activity income (a limit on loss deductions). You carry any excess loss forward to the following year or years until used, or until deducted in the year you dispose of your entire interest in the activity in a fully taxable transaction. See *Dispositions*, later.



Before applying this limit on passive activity losses, you must first determine the amount of your loss disallowed under the at-risk rules explained in the second part of this publication.

Passive activity credits. You can subtract passive activity credits only from the tax on net passive income. Passive activity credits include the general business credit and other special business credits, such as the credit for fuel produced from a nonconventional source. Credits that are more than the tax on income from passive activities are carried forward.

Unallowed passive activity credits, unlike unallowed passive activity losses, cannot be claimed when you dispose of your entire interest in an activity. However, to determine your gain or loss from the disposition, you can elect to increase the basis of the credit property by the amount of the original basis reduction for the credit, to the extent that the credit was not allowed because of the passive activity limits. You cannot elect to adjust the basis for a partial disposition of your interest in a passive activity.

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 also must apply the limit on passive activity credits separately to your credits from a passive activity held through a PTP.

You can offset losses 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.

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.

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 do not 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, includ-

ing definitions and how the passive activity rules apply to these corporations, see Form 8810 and its instructions.

Closely held corporation. A closely held corporation can offset net active income with its passive activity loss. It also can offset the tax attributable to its net active income with its passive activity credits. However, a closely held corporation cannot offset its portfolio income (defined later, under *Passive Activity Income*) with its passive activity loss.

Net active income is the corporation's taxable income figured without any income or loss from a passive activity or any portfolio income or loss.

Passive Activities

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.

Material participation in a trade or business is discussed later, under *Activities That Are Not 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 is not a passive activity in the current tax year. You can deduct a prior year's 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 is 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, 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.

You generally report trade or business activities on Schedule C, C-EZ, 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 Are Not 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 does not matter whether the use is under a lease, a service contract, or some other arrangement.

Exceptions. Your activity is not 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 do not 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 are 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, you 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 losses in excess of income from passive activities. 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 are married, filing a separate return, and lived apart from your spouse for the entire tax year, your special allowance cannot be more than \$12,500. If you lived with your spouse at any time during the year and are filing a separate return, you cannot 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. Kate, a single taxpayer, has \$70,000 in wages, \$15,000 income from a limited partnership, a \$26,000 loss from rental real estate activities in which she actively participated, and less than \$100,000 of modified adjusted gross income. She can use \$15,000 of her \$26,000 loss to offset her \$15,000 passive income from the partnership. She actively participated in her rental real estate activities, so she can use the remaining \$11,000 rental real estate loss to offset \$11,000 of her nonpassive income (wages).

Commercial revitalization deduction.

The special allowance must first be applied to losses from rental real estate activities figured without the commercial revitalization deduction. Any remaining part of the special allowance is available for the commercial revitalization deduction from the rental real estate activities and is not subject to the active participation rules or the phaseout based on modified adjusted gross income.

For more information about the commercial revitalization deduction, see Publication 954, *Tax Incentives for Distressed Communities*.

Active participation. Active participation is not 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 cannot be made later than the due date for the estate's first income tax return (including any extensions).

Limited partners are not treated as actively participating in a partnership's rental real estate activities.

You are not 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 is not required to take the low-income housing credit, the rehabilitation investment credit, or commercial revitalization deduction from rental real estate activities.

Example. Mike, 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 Mike owned. He advertised and rented the house to the current tenant himself. He also collected the rents and either did the repairs or hired someone to do them.

Even though the rental loss is a loss from a passive activity, Mike can use the entire \$4,000

loss to offset his other income because he 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 is more than \$100,000 (\$50,000 if you are married filing separately). If your modified adjusted gross income is \$150,000 or more (\$75,000 or more if you are married filing separately), you generally cannot use the special allowance.

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 Are Not Passive Activities*).
- Any overall loss from a publicly traded partnership (see *Publicly Traded Partnerships (PTPs)* in the instructions for Form 8582).
- The deduction for one-half of self-employment tax.
- The deduction allowed for interest on student loans.
- The deduction for qualified tuition and related expenses.

Example. During 2004, John was unmarried and was not a real estate professional. For 2004, he had \$120,000 in salary and a \$31,000 loss from his rental real estate activities in which he actively participated. His modified adjusted gross income is \$120,000. When he files his 2004 return, he may deduct only \$15,000 of his passive activity loss. He must carry over the remaining \$16,000 passive activity loss to 2005. He figures his 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 <u>\$16,000</u>

Exceptions to the phaseout rules. A higher phaseout range applies to low-income housing credits for property placed in service before 1990 and 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 are 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 for property placed in service after 1989 or for the commercial revitalization deduction. If you hold an indirect interest in the property through a partnership, S corporation, or other pass-through entity, the special exception for the low-income housing credit will not apply unless you also acquired your interest in the pass-through entity after 1989.

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. The portion of passive activity losses not attributable to the commercial revitalization deduction.
2. The portion of passive activity losses attributable to the commercial revitalization deduction.
3. The portion of passive activity credits attributable to credits other than the rehabilitation and low-income housing credits.
4. The portion of passive activity credits attributable to the rehabilitation credit and low-income housing credit for property placed in service prior to 1990.
5. The portion of passive activity credits attributable to the low-income housing credit for property placed in service after 1989.

Activities That Are Not Passive Activities

The following are not 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 which you hold directly or through an entity that does not limit your liability (such as a general partner interest in a partnership). It does not 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 should not enter income and losses from these activities on Form 8582. Instead, enter them on the forms or schedules you would normally use.

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.

You are not treated as a limited partner, however, if you also were 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 are a retired or disabled farmer, you are 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 are a surviving spouse of a farmer, you are 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 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. See the instructions for Schedule E (Form 1040) for information about making this choice.

If you qualified as a real estate professional for 2004, 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 did not 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.

Do not 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, do not 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.

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 do not 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 does not include the following items.

- Income from an activity that is not a passive activity. These activities are dis-

cussed under *Activities That Are Not 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 is held for investment. The exclusion for portfolio income does not 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 Are Not 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 was not a passive activity deduction.
- Alaska Permanent Fund dividends.
- Cancellation of debt income, if at the time the debt is discharged the debt is not allocated to passive activities under the interest expense allocation rules. See chapter 5 of Publication 535, *Business Expenses*, for information about the rules for allocating interest.

Disposition of property interests. Gain on the disposition of an interest in property generally is 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 is not passive activity income if, at the time of disposition, the property was used in an activity that was not 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 is not 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 is not passive activity income. However, it is 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 ap-

plies 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 does not 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 did not 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

Passive activity deductions include all deductions from activities that are passive activities for the current tax year and all deductions from passive activities that were disallowed under the passive loss rules in prior tax years and carried forward to the current tax year. They also include losses from dispositions of property used in a passive activity at the time of the disposition and losses from a disposition of less than your entire interest in a passive activity.

Passive activity deductions do not 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.
- Charitable contribution deductions.
- Net operating loss deductions.
- Percentage depletion carryovers for oil and gas wells.
- Capital loss carrybacks and carryovers.
- 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 for one-half of self-employment tax.

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 do not 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. John Jackson 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 John's activities. For example, John 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. Betty is a partner in ABC partnership, which sells nonfood items to grocery stores. Betty 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 Betty is involved. Based on the rules of this section, Betty 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 Internal Revenue Service (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.

Regrouping by the IRS. If any of the activities resulting from your grouping is not 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 cannot 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. Herbert and Wilma are married and file a joint return. Healthy Food, an S corporation, is a grocery store business. Herbert is Healthy Food's only shareholder. Plum Tower, an S corporation, owns and rents out the building. Wilma 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 are not insubstantial in relation to each other.

Herbert and Wilma file a joint return, so they are treated as one taxpayer for purposes of the passive activity rules. The same owner (Herbert and Wilma) 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, Herbert and Wilma 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 cannot 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. 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
- Does not actively participate in the management of the enterprise.

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.

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

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 is 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 is allocable to the part of the activity disposed of.

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 are 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, do not enter any of the income or losses from the activity or property on Form 8582 or its worksheets. Instead, enter income or losses on the form and schedules you normally use. However, see *Significant Participa-*

tion 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 cannot 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 did not 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 is not 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, do not 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. Do not 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's net income from the activity over any prior year unallowed losses from the activity.

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 Worksheet 3 of Form 8582 (or Worksheet 2 of Form 8810).

If column (d) shows net income and you must complete Form 8582 because you have other passive activities to report, complete Worksheet B on page 9. However, you do not have to complete Form 8582 if column (d) shows net income and you have only significant participation activities. If you do not have to complete Form 8582, skip Worksheet B and report the net income and net losses from columns (b) and (c) on the forms and schedules you normally use.

Worksheet B. 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

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		

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 Worksheet 3 of Form 8582 or Worksheet 2 of Form 8810. (Also, see *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.

Example. Calvin acquires vacant land for \$300,000, constructs improvements at a cost of \$100,000, and leases the land and improvements to a tenant. He 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. Calvin'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 passive 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 section 1.469-2(f)(5) of the regulations.

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 does not apply to net income from renting property under a written binding contract entered into before February 19, 1988. It also does not apply to property just described 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 does not 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 includable 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 have not been allowed (including current year losses) generally are allowed in full in the tax year 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.



CAUTION If you have a capital loss on the disposition of an interest in a passive activity, the loss may be limited by the capital loss rules. The limit is generally \$3,000 for individuals (\$1,500 in the case of married individuals filing separate returns). See Publication 544, *Sales and Other Dispositions of Assets*, for more information.

Example. Ray earned a \$60,000 salary and owned one passive activity through a 5% interest in the B Limited Partnership. In 2004, he sold his entire interest in the current tax year to an unrelated person for \$30,000. His adjusted basis in the partnership interest was \$42,000, and he had carried over \$2,000 of passive activity losses from the activity.

Ray's deductible loss for 2004 is \$5,000, figured as follows:

Sales price	\$30,000
Minus: adjusted basis	<u>42,000</u>
Capital loss	\$12,000
Minus: capital loss limit	<u>3,000</u>
Capital loss carryover	<u>\$9,000</u>
Allowable capital loss on sale	\$3,000
Carryover losses allowable	<u>2,000</u>
Total current deductible loss	<u>\$5,000</u>

Ray deducts the \$5,000 total current deductible loss in 2004. He must carry over the remaining \$9,000 capital loss, which is not subject to the passive activity loss limit. He 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 is not 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. John Ash has a total gain of \$10,000 from the sale of an entire interest in a passive activity. Under the installment method he 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 have not been allowed generally are allowed in full. They also will be allowed if the partnership (other than a PTP) disposes of all the property used in that passive activity.

If you do not 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 cannot 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).

Partial dispositions. If you dispose of substantially all of an activity during your tax year, you may 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, and
- Form 8582-CR, Passive Activity Credit Limitations.

Regardless of the number or complexity of passive activities you have, you should use only one Form 8582.

Comprehensive Example

The following example shows how to report your passive activities. In addition to Form 1040, Charles and Lily Woods use Form 8582 (to figure allowed passive activity deductions), Schedule E (to report rental activities and partnership activities), Form 4797 (to figure the gain and allowable loss from assets sold that were used in the activities), and Schedule D (to report the sale of partnership interests).

General Information

Charles and Lily are married, file a joint return, and have combined wages of \$132,000 in 2004. They own interests in the activities listed below. They are at risk for their investment in the activities. They did not materially participate in any of the business activities. They actively participated in the rental real estate activities in 2004 and all prior years. Charles and Lily are not real estate professionals.

1. Activity A is a rental real estate activity. The income and expenses are reported on Schedule E. Charles and Lily's records

show a loss from operations of \$15,000 in 2004. Their records also show a gain of \$2,776 from the sale in January 2004 of section 1231 assets used in the activity. The section 1231 gain is reported in Part I of Form 4797 and is identified as being from a passive activity (FPA). For 2003, they completed the worksheets for Form 8582 and calculated that \$6,667 of Activity A's Schedule E loss for 2003 was disallowed by the passive activity rules. That loss is carried over to 2004 as a prior year unallowed loss and will be used to figure the allowed loss for 2004.

2. Activity B is a rental real estate activity. Its income and expenses are reported on Schedule E. Charles and Lily's records show a loss from operations of \$11,600 in 2004. For 2003, they completed the worksheets for Form 8582 and calculated that \$8,225 of Activity B's Schedule E loss for 2003 was disallowed by the passive activity rules. That loss is carried over to 2004 as a prior year unallowed loss and will be used to figure the allowed loss for 2004.
3. Partnership #1 is a trade or business activity and is not a publicly traded partnership (PTP). Partnership #1 reports a \$4,000 distributive share of its 2004 profits to Charles and Lily in box 1 of Schedule K-1 (Form 1065). They report that profit on Schedule E. For 2003, they completed the worksheets for Form 8582 and calculated that \$2,600 of their distributive share of the loss from Partnership #1 in 2003 was disallowed by the passive activity rules. That loss is carried over to 2004 as a prior year unallowed loss and will be used to figure the allowed loss for 2004.
4. Partnership #2 is a trade or business activity and also a PTP. In December 2004 Charles and Lily sold their entire interest in Partnership #2. To indicate they made an entire disposition of a passive activity, they enter EDPA on the appropriate lines. They do not report that sale on Form 8582 because Partnership #2 is a PTP. They recognize a long-term capital gain of \$15,300 (\$25,300 selling price minus \$10,000 adjusted basis) that they report on Schedule D. The partnership reports a \$1,200 distributive share of its 2004 losses to them in box 1 of Schedule K-1 (Form 1065). They report that loss on Schedule E. For 2003, they followed the instructions for Form 8582 and calculated that \$2,445 of their distributive share of Partnership #2's 2003 loss was disallowed by the passive activity rules. That loss is carried over from 2003 and reported on Schedule E loss for 2004. (For discussion of PTPs, see the instructions for Form 8582.)
5. Partnership #3 is a single trade or business activity and is not a PTP. Charles and Lily sold their entire interest in Partnership #3 in November 2004. To indicate they made an entire disposition of a passive activity, they enter EDPA on the appropriate lines. They recognize a \$4,000 (\$15,000 selling price minus \$11,000 adjusted basis) long-term capital gain, which they report on Schedule D. For 2003, they completed the worksheets for Form 8582 and calculated that \$3,000 of

their distributive share of the partnership's loss for 2003 was disallowed by the passive activity rules. That loss is carried over to 2004 as a prior year unallowed Schedule E loss. Charles and Lily's distributive share of partnership losses for 2004 reported in box 1 of Schedule K-1 (Form 1065) is \$6,000.

- Partnership #4 is a trade or business activity that is a limited partnership. Charles and Lily are limited partners who did not meet any of the material participation tests. Their distributive share of 2004 partnership loss, reported in box 1 of Schedule K-1 (Form 1065), is \$2,400. For 2003 they completed the worksheets for Form 8582 and calculated that \$1,500 of their distributive share of loss for 2003 was disallowed by the passive activity rules. That loss is carried over to 2004 as a prior year unallowed loss and will be used to figure the allowed loss for 2004.

Step One—Completing the Tax Forms Before Figuring the Passive Activity Loss Limits

Charles and Lily complete the forms they usually use to report income or expenses from their activities. They enter their combined wages, \$132,000, on Form 1040. They complete Schedule D, line 8, showing long-term capital gains of \$15,300 from the disposition of Partnership #2 and \$4,000 from the disposition of Partnership #3. Partnership #2 is a PTP so it is not entered on Form 8582. The disposition of Partnership #3 is a disposition of an entire interest in an activity with an overall loss of \$5,000 (\$4,000 – \$3,000 – \$6,000) so that partnership also is not entered on Form 8582. They combine the PTP \$1,200 current year loss with its \$2,445 prior year loss, and also combine the Partnership #3 \$6,000 current year loss with its \$3,000 prior year loss, and enter the two combined amounts in column (f) on Schedule E, Part II, line 28. Normally, current year and prior year losses should be entered on separate lines of Schedule E. For purposes of this example only, the amounts have been combined on one line. They enter the \$4,000 profit from Partnership #1 in column (g). Before completing the rest of Schedule E, Part II, they must complete Form 8582 to figure out how much of their losses from Partnerships #1 and #4 they can deduct.

They complete Schedule E, Part I, through line 22. Their rental activities are passive so they must complete Form 8582 to figure the deductible losses to enter on line 23.

They enter the gain from the sale of the section 1231 assets of Activity A on Form 4797.

Step Two—Form 8582 and Its Worksheets

Charles and Lily now complete Form 8582 including the worksheets that apply to their passive activities. Because they are at risk for their investment in the activities, they do not need to complete Form 6198 before Form 8582. (The second part of this publication explains the at-risk rules.)

Worksheet 1. Worksheet 1 is for rental real estate activities with active participation. Charles and Lily enter the gains and losses from

Activity A and Activity B on Worksheet 1. They enter all amounts from the activities even though they already reported the gain of \$2,776 from Activity A on Form 4797 because all income or loss from these activities must be taken into account to figure the loss allowed.

- They write "Activity A" on the first line under "Name of activity." Then they enter:
 - \$2,776 gain in column (a) from Form 4797, line 2, column (g),
 - (\$15,000) loss in column (b) from Schedule E, line 22, column A, and
 - (\$6,667) prior year unallowed loss in column (c) from their 2003 worksheets.

They combine the three amounts. The result, (\$18,891), is an overall loss so they enter it in column (e).

- Charles and Lily write "Activity B" on the second line under "Name of activity." Then they enter:
 - (\$11,600) loss in column (b) from Schedule E, line 22, column B, and
 - (\$8,225) prior year unallowed loss in column (c) from their 2003 worksheets.

Then they combine these two figures and enter the total loss, (\$19,825), in column (e).

- They separately add the amounts in columns (a), (b), and (c).
 - They enter \$2,776 in column (a) on the *Total* line and also on Form 8582, Part I, line 1a.
 - They enter (\$26,600) in column (b) on the *Total* line and also on Form 8582, Part I, line 1b.
 - They enter (\$14,892) in column (c) on the *Total* line and also on Form 8582, Part I, line 1c.
- They combine lines 1a, 1b, and 1c, Form 8582, and put the net loss, (\$38,716), on line 1d.

Worksheet 3. Partnership #1 and Partnership #4 are nonrental passive activities so Charles and Lily enter the appropriate information about those activities on Worksheet 3 in the same way they reported their rental activities on Worksheet 1. Then they enter the totals on Form 8582, Part I, lines 3a through 3d.

Reporting income from column (d), Worksheets 1 and 3. Activities that have an overall gain in column (d) are not used any further in the calculations for Form 8582. At this point, all income and losses from those activities should be entered on the forms or schedules that would normally be used. Charles and Lily have one activity with an overall gain (\$4,000 – \$2,600 = \$1,400). This is Partnership #1, which is shown in Worksheet 3. They already reported the \$4,000 income from this activity on Schedule E, Part II. They now enter the entire \$2,600 loss on Schedule E, Part II, as well.

Step Three—Completing Form 8582

Next, Charles and Lily complete Form 8582, Part II, to determine the amount they can deduct

for their net losses from real estate activities with active participation (Activities A and B). They enter all amounts as though they were positive (without brackets around losses). They then complete Form 8582, Part IV.

- They enter \$38,716 on line 5 since this is the smaller of the loss on line 1d or the loss on line 4.
- They enter \$150,000 on line 6 since they are married and filing a joint return.
- They enter \$138,655, their modified adjusted gross income, on line 7. (See page 3 for discussion of modified adjusted gross income.) The \$138,655 is made up of their wages, \$132,000, plus their overall gain of \$11,655 from Partnership #2, a PTP, less their \$5,000 overall loss from Partnership #3.

On Schedule D, they reported long-term gains of \$15,300 from the PTP disposition and \$4,000 from the Partnership #3 disposition. On Schedule E, they combined the PTP 2004 loss of \$1,200 with its prior year loss of \$2,445, and combined the Partnership #3 2004 loss of \$6,000 with its prior year loss of \$3,000. Netting these amounts gives them the PTP overall gain of \$11,655 (\$15,300 – \$1,200 – \$2,445) and the Partnership #3 overall loss of \$5,000 (\$4,000 – \$6,000 – \$3,000) that were used in figuring modified adjusted gross income.

- They subtract line 7 from line 6 and enter the result, \$11,345, on line 8.
- They multiply line 8 by 50% and enter the result, \$5,673, on line 9. No matter what the result, they cannot enter more than \$25,000 on line 9.
- They enter the smaller of line 5 or line 9, \$5,673, on line 10.
- They add the income on lines 1a and 3a and enter the result, \$6,776, on line 15.
- They add lines 10 and 15 and enter the result, \$12,449, on line 16.

Step Four—Completing Worksheet 4

Charles and Lily must complete Worksheet 4 because they entered an amount on Form 8582, line 10, and have two activities, each with an overall loss in Worksheet 1, column (e). Worksheet 4 allocates the amount on line 10 (their special allowance for active participation rental real estate activities) between Activity A and Activity B.

- In the two left columns, they write the name of each activity, A and B, and the schedule and line number on which each activity is reported.
- They fill in column (a) with the losses from Worksheet 1, column (e). They add up the amounts, and enter the result, \$38,716, in the *Total* line without brackets.
- They figure the ratios for column (b) by dividing each amount in column (a) by the amount on the column (a) *Total* line. They enter each result in column (b). The total of the ratios must equal 1.00.
- They multiply the amount from line 10, Form 8582, \$5,673, by each of the ratios

in Worksheet 4, column (b) and enter the results on the appropriate line in column (c). The total must equal \$5,673.

- They subtract column (c) from column (a) and enter each result in column (d).

Step Five—Completing Worksheet 5

Worksheet 5 must be completed if any activity has an overall loss in Worksheet 3, column (e), or a loss in Worksheet 4, column (d) (or Worksheet 1, column (e), if Worksheet 4 was not needed). This worksheet allocates the unallowed loss among the activities with an overall loss. Charles and Lily complete Worksheet 5 with the activities from Worksheet 4 and the one activity showing a loss in Worksheet 3, column (e). They write the name of each activity and the schedule or form and the line number on which each loss will be reported in the two left columns of Worksheet 5.

1. In column (a), they enter the losses from Worksheet 3, column (e) and Worksheet 4, column (d). These losses are entered as positive numbers, not in brackets. They add the numbers and enter the total, \$36,943, on the *Total* line.
2. They divide each of the losses in column (a) by the amount on the column (a) *Total* line, and enter each result in column (b). The ratios must total 1.00.
3. Now they use the computation worksheet for column (c) (see the worksheet in the instructions for Form 8582) to figure the unallowed loss to allocate in column (c).
 - a. On line A of the computation worksheet, they enter the amount from line 4 of

Form 8582, \$41,216, as a positive number.

- b. On line B, they enter the amount from line 10 of Form 8582, \$5,673.
- c. They subtract line B from line A and enter the result, \$35,543, on line C. This is the total unallowed loss.

They multiply line C, \$35,543, by each of the ratios in column (b) and enter the results in column (c). These amounts are the unallowed losses from each activity and must add up to \$35,543.

Step Six—Using Worksheets 6 and 7

Charles and Lily now decide whether they must use Worksheet 6, Worksheet 7, or both to figure their allowed losses. If the loss from any activity entered on Worksheet 5 is reported on only one form or schedule, then Worksheet 6 is used for that activity. If an activity has a loss that is reported on two or more schedules or forms (for example, a loss that must be reported partly on Schedule C and partly on Form 4797) Worksheet 7 is used for that activity. All of the activities Charles and Lily entered on Worksheet 5 will be reported on Schedule E. Therefore, they use Worksheet 6 to figure the allowed loss for each activity.

Worksheet 6. They complete Worksheet 6 with the activities from Worksheet 5.

- They write the name of each activity and the schedule and line number to be used in the two left columns of Worksheet 6.
- In column (a), they enter the total loss for each activity. This includes the current

year loss plus the prior year unallowed loss. They find these amounts by adding columns (b) and (c) on Worksheets 1 and 3.

- In column (b), they enter the unallowed loss for each activity already figured in Worksheet 5, column (c). They must save this information to use next year in figuring their passive losses.
- In column (c), they figure their allowed losses for 2004 by subtracting their unallowed losses, column (b), from their total losses, column (a). These allowed losses are entered on the appropriate schedules.

Reporting allowed losses. Charles and Lily enter their allowed losses from Activities A and B on Schedule E, Part I, line 23, because these are rental properties. They report their allowed loss from Partnership #4 on Schedule E, Part II, line 28D.

Step Seven—Finishing the Reporting of the Passive Activities

Charles and Lily summarize the entries on Schedule E, Schedule D, and Form 4797, and enter the amounts on the appropriate lines of their Form 1040. They enter:

- The total Schedule D gain, \$22,076, on line 13a, and
- The Schedule E loss, (\$21,094), on line 17.

Charles and Lily are now able to complete their tax return, having correctly limited their losses from their passive activities.

Label

(See instructions on page 16.)

Use the IRS label.

Otherwise, please print or type.

Presidential Election Campaign (See page 16.)

Label Here

For the year Jan. 1–Dec. 31, 2004, or other tax year beginning , 2004, ending , 20
Your first name and initial Charles Last name Woods
If a joint return, spouse's first name and initial Lily Last name Woods
Home address (number and street). If you have a P.O. box, see page 16. 6925 Country Road Apt. no.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 16. Anytown, VA 22306

OMB No. 1545-0074
Your social security number 123 : 00 : 4567
Spouse's social security number 567 : 00 : 1234

Important! You must enter your SSN(s) above.

You Spouse
Yes No Yes No

Filing Status

Check only one box.

- 1 Single
2 Married filing jointly (even if only one had income)
3 Married filing separately. Enter spouse's SSN above and full name here.
4 Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here.
5 Qualifying widow(er) with dependent child (see page 17)

Exemptions

If more than four dependents, see page 18.

6a Yourself. If someone can claim you as a dependent, do not check box 6a
6b Spouse
6c Dependents: (1) First name Last name (2) Dependent's social security number (3) Dependent's relationship to you (4) if qualifying child for child tax credit (see page 18)
6d Total number of exemptions claimed 2

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 19.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

Table with 2 columns: Description and Amount. Rows include Wages, salaries, tips, etc. (132,000); Taxable interest; Tax-exempt interest; Ordinary dividends; Qualified dividends; Taxable refunds, credits, or offsets of state and local income taxes; Alimony received; Business income or (loss); Capital gain or (loss) (22,076); Other gains or (losses); IRA distributions; Pensions and annuities; Rental real estate, royalties, partnerships, S corporations, trusts, etc.; Farm income or (loss); Unemployment compensation; Social security benefits; Other income; Total income (132,982).

Adjusted Gross Income

Table with 2 columns: Description and Amount. Rows include Educator expenses; Certain business expenses of reservists, performing artists, and fee-basis government officials; IRA deduction; Student loan interest deduction; Tuition and fees deduction; Health savings account deduction; Moving expenses; One-half of self-employment tax; Self-employed health insurance deduction; Self-employed SEP, SIMPLE, and qualified plans; Penalty on early withdrawal of savings; Alimony paid; Total adjusted gross income (132,982).

**SCHEDULE D
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ **Attach to Form 1040.** ▶ **See Instructions for Schedule D (Form 1040).**
▶ **Use Schedule D-1 to list additional transactions for lines 1 and 8.**

OMB No. 1545-0074

2004

Attachment
Sequence No. **12**

Name(s) shown on Form 1040

Charles and Lily Woods

Your social security number

123 00 4567

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1					
2 Enter your short-term totals, if any, from Schedule D-1, line 2					
3 Total short-term sales price amounts. Add lines 1 and 2 in column (d)					
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824					4
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1					5
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet on page D-6 of the instructions					6 ()
7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f)					7

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8					
Partnership #2 EDPA	12-2-91	12-4-04	25,300	10,000	15,300
Partnership #3 EDPA	12-15-92	11-18-04	15,000	11,000	4,000
9 Enter your long-term totals, if any, from Schedule D-1, line 9			9 40,300		
10 Total long-term sales price amounts. Add lines 8 and 9 in column (d)			10		
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824					11 2,776
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1					12
13 Capital gain distributions. See page D-1 of the instructions					13
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet on page D-6 of the instructions					14 ()
15 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). Then go to Part III on the back					15 22,076

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11338H

Schedule D (Form 1040) 2004

**SCHEDULE E
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Supplemental Income and Loss
(From rental real estate, royalties, partnerships,
S corporations, estates, trusts, REMICs, etc.)

▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule E (Form 1040).

OMB No. 1545-0074

2004

Attachment
Sequence No. **13**

Name(s) shown on return

Charles and Lily Woods

Your social security number

123 : 00 : 4567

Part I Income or Loss From Rental Real Estate and Royalties Note. If you are in the business of renting personal property, use Schedule C or C-EZ (see page E-3). Report farm rental income or loss from Form 4835 on page 2, line 40.

1	List the type and location of each rental real estate property:	2	For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of:	Yes	No
A	Brick Duplex -- 6924 -- 26 Country Road Anytown, VA 22306		<ul style="list-style-type: none"> • 14 days or • 10% of the total days rented at fair rental value? (See page E-3.)	<input type="checkbox"/>	<input checked="" type="checkbox"/>
B	Condo -- 6915 Country Road Anytown, VA 22306			<input type="checkbox"/>	<input checked="" type="checkbox"/>
C				<input type="checkbox"/>	<input type="checkbox"/>

Income:	Properties			Totals	
	A	B	C	(Add columns A, B, and C.)	
3 Rents received	3 25,000	8,300		3 33,300	
4 Royalties received	4			4	
Expenses:					
5 Advertising	5 600	210			
6 Auto and travel (see page E-4)	6				
7 Cleaning and maintenance	7 1,500	525			
8 Commissions	8 1,200	420			
9 Insurance	9 2,000	700			
10 Legal and other professional fees	10 1,000	390			
11 Management fees	11				
12 Mortgage interest paid to banks, etc. (see page E-4)	12 9,000	8,510		12 17,510	
13 Other interest	13				
14 Repairs	14 700	245			
15 Supplies	15 600	210			
16 Taxes	16 2,000	700			
17 Utilities	17 2,400	840			
18 Other (list) ▶ Wages and salaries	18 9,000	3,150			
19 Add lines 5 through 18	19 30,000	15,900		19 45,900	
20 Depreciation expense or depletion (see page E-4)	20 10,000	4,000		20 14,000	
21 Total expenses. Add lines 19 and 20	21 40,000	19,900			
22 Income (or loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-4 to find out if you must file Form 6198	22 (15,000)	(11,600)			
23 Deductible rental real estate loss. Caution. Your rental real estate loss on line 22 may be limited. See page E-4 to find out if you must file Form 8582. Real estate professionals must complete line 43 on page 2	23 (6,155)	(3,546)			
24 Income. Add positive amounts shown on line 22. Do not include any losses				24	
25 Losses. Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here				25 (9,701)	
26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 41 on page 2				26 (9,701)	

Name(s) shown on return. Do not enter name and social security number if shown on other side.

Charles and Lily Woods

Your social security number

123 : 00 : 4567

Caution. The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations **Note.** If you report a loss from an at-risk activity for which any amount is not at risk, you must check column (e) on line 28 and attach Form 6198. See page E-1.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? Yes No
If you answered "Yes," see page E-6 before completing this section.

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if any amount is not at risk
A	Partnership #2 (EDPA)	P		10-1672810	
B	Partnership #3 (EDPA)	P		10-9876243	
C	Partnership #1	P		10-5566650	
D	Partnership #4	P		10-7435837	

Passive Income and Loss			Nonpassive Income and Loss		
(f) Passive loss allowed (attach Form 8582 if required)	(g) Passive income from Schedule K-1	(h) Nonpassive loss from Schedule K-1	(i) Section 179 expense deduction from Form 4562	(j) Nonpassive income from Schedule K-1	
A From PTP (3,645)					
B (9,000)					
C (2,600)	4,000				
D (148)					
29a Totals	4,000				
b Totals	(15,393)				
30 Add columns (g) and (j) of line 29a				30	4,000
31 Add columns (f), (h), and (i) of line 29b				31	(15,393)
32 Total partnership and S corporation income or (loss). Combine lines 30 and 31. Enter the result here and include in the total on line 41 below				32	(11,393)

Part III Income or Loss From Estates and Trusts

33	(a) Name	(b) Employer identification number
A		
B		

Passive Income and Loss			Nonpassive Income and Loss		
(c) Passive deduction or loss allowed (attach Form 8582 if required)	(d) Passive income from Schedule K-1	(e) Deduction or loss from Schedule K-1	(f) Other income from Schedule K-1		
A					
B					
34a Totals					
b Totals					
35 Add columns (d) and (f) of line 34a				35	
36 Add columns (c) and (e) of line 34b				36	()
37 Total estate and trust income or (loss). Combine lines 35 and 36. Enter the result here and include in the total on line 41 below				37	

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder

38	(a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules Q, line 2c (see page E-6)	(d) Taxable income (net loss) from Schedules Q, line 1b	(e) Income from Schedules Q, line 3b
39 Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below					39

Part V Summary

40 Net farm rental income or (loss) from Form 4835. Also, complete line 42 below				40	
41 Total income or (loss). Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Form 1040, line 17				41	(21,094)
42 Reconciliation of farming and fishing income. Enter your gross farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), box 14, code B; Schedule K-1 (Form 1120S), box 17, code N; and Schedule K-1 (Form 1041), line 14 (see page E-6)	42				
43 Reconciliation for real estate professionals. If you were a real estate professional (see page E-1), enter the net income or (loss) you reported anywhere on Form 1040 from all rental real estate activities in which you materially participated under the passive activity loss rules	43				

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts
Under Sections 179 and 280F(b)(2))

▶Attach to your tax return. ▶See separate instructions.

Name(s) shown on return

Charles and Lily Woods

Identifying number

123-00-4567

1 Enter the gross proceeds from sales or exchanges reported to you for 2004 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions).

1

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
2 FPA - Land from Activity A	1-4-91	1-5-04	6,000		3,224	2,776
3 Gain, if any, from Form 4684, line 39						3
4 Section 1231 gain from installment sales from Form 6252, line 26 or 37						4
5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824						5
6 Gain, if any, from line 32, from other than casualty or theft						6
7 Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:						7 2,776
Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.						
All others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on Schedule D and skip lines 8, 9, 11, and 12 below.						
8 Nonrecaptured net section 1231 losses from prior years (see instructions)						8
9 Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on Schedule D (see instructions)						9

Part II Ordinary Gains and Losses

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11 Loss, if any, from line 7		11 ()
12 Gain, if any, from line 7 or amount from line 8, if applicable		12
13 Gain, if any, from line 31		13
14 Net gain or (loss) from Form 4684, lines 31 and 38a		14
15 Ordinary gain from installment sales from Form 6252, line 25 or 36		15
16 Ordinary gain or (loss) from like-kind exchanges from Form 8824		16
17 Combine lines 10 through 16		17
18 For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18a." See instructions		18a
b Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14.		18b

For Paperwork Reduction Act Notice, see page 8 of the instructions.

Passive Activity Loss Limitations

▶ See separate instructions.

▶ Attach to Form 1040 or Form 1041.

Name(s) shown on return

Charles and Lily Woods

Identifying number
 123-00-4567

Part I 2004 Passive Activity Loss

Caution: See the instructions for Worksheets 1, 2, and 3 on pages 7 and 8 before completing Part I.

Rental Real Estate Activities With Active Participation (For the definition of active participation see **Special Allowance for Rental Real Estate Activities** on page 3 of the instructions.)

1a Activities with net income (enter the amount from Worksheet 1, column (a))	1a	2,776		
1b Activities with net loss (enter the amount from Worksheet 1, column (b))	1b	(26,600)		
1c Prior years unallowed losses (enter the amount from Worksheet 1, column (c))	1c	(14,892)		
1d Combine lines 1a, 1b, and 1c.	1d		(38,716)	

Commercial Revitalization Deductions From Rental Real Estate Activities

2a Commercial revitalization deductions from Worksheet 2, column (a)	2a			
2b Prior year unallowed commercial revitalization deductions from Worksheet 2, column (b)	2b	()		
2c Add lines 2a and 2b.	2c		()	

All Other Passive Activities

3a Activities with net income (enter the amount from Worksheet 3, column (a))	3a	4,000		
3b Activities with net loss (enter the amount from Worksheet 3, column (b))	3b	(2,400)		
3c Prior years unallowed losses (enter the amount from Worksheet 3, column (c))	3c	(4,100)		
3d Combine lines 3a, 3b, and 3c.	3d		(2,500)	

4 Combine lines 1d, 2c, and 3d. If the result is net income or zero, all losses are allowed, including any prior year unallowed losses entered on line 1c, 2b, or 3c. Do not complete Form 8582. Report the losses on the forms and schedules normally used	4		(41,216)	
---	----------	--	----------	--

- If line 4 is a loss and:
- Line 1d is a loss, go to Part II.
 - Line 2c is a loss (and line 1d is zero or more), skip Part II and go to Part III.
 - Line 3d is a loss (and lines 1d and 2c are zero or more), skip Parts II and III and go to line 15.

Caution: If your filing status is married filing separately and you lived with your spouse at any time during the year, **do not** complete Part II or Part III. Instead, go to line 15.

Part II Special Allowance for Rental Real Estate With Active Participation

Note: Enter all numbers in Part II as positive amounts. See page 8 for an example.

5 Enter the smaller of the loss on line 1d or the loss on line 4	5		38,716	
6 Enter \$150,000. If married filing separately, see page 8	6	150,000		
7 Enter modified adjusted gross income, but not less than zero (see page 8) Note: If line 7 is greater than or equal to line 6, skip lines 8 and 9, enter -0- on line 10. Otherwise, go to line 8.	7	138,655		
8 Subtract line 7 from line 6	8	11,345		
9 Multiply line 8 by 50% (.5). Do not enter more than \$25,000. If married filing separately, see page 8	9		5,673	
10 Enter the smaller of line 5 or line 9. If line 2c is a loss, go to Part III. Otherwise, go to line 15.	10		5,673	

Part III Special Allowance for Commercial Revitalization Deductions From Rental Real Estate Activities

Note: Enter all numbers in Part III as positive amounts. See the example for Part II on page 8.

11 Enter \$25,000 reduced by the amount, if any, on line 10. If married filing separately, see instructions	11			
12 Enter the loss from line 4	12			
13 Reduce line 12 by the amount on line 10	13			
14 Enter the smallest of line 2c (treated as a positive amount), line 11, or line 13	14			

Part IV Total Losses Allowed

15 Add the income, if any, on lines 1a and 3a and enter the total.	15		6,776	
16 Total losses allowed from all passive activities for 2004. Add lines 10, 14, and 15. See pages 10 and 11 of the instructions to find out how to report the losses on your tax return	16		12,449	

Caution: *The worksheets must be filed with your tax return. Keep a copy for your records.*

Worksheet 1—For Form 8582, Lines 1a, 1b, and 1c (See page 7 of the instructions.)

Name of activity	Current year		Prior years	Overall gain or loss	
	(a) Net income (line 1a)	(b) Net loss (line 1b)	(c) Unallowed loss (line 1c)	(d) Gain	(e) Loss
Activity A	2,776	(15,000)	(6,667)		(18,891)
Activity B		(11,600)	(8,225)		(19,825)
Total. Enter on Form 8582, lines 1a, 1b, and 1c ▶	2,776	(26,600)	(14,892)		

Worksheet 2—For Form 8582, Lines 2a and 2b (See pages 7 and 8 of the instructions.)

Name of activity	(a) Current year deductions (line 2a)	(b) Prior year unallowed deductions (line 2b)	(c) Overall loss
Total. Enter on Form 8582, lines 2a and 2b ▶			

Worksheet 3—For Form 8582, Lines 3a, 3b, and 3c (See page 8 of the instructions.)

Name of activity	Current year		Prior years	Overall gain or loss	
	(a) Net income (line 3a)	(b) Net loss (line 3b)	(c) Unallowed loss (line 3c)	(d) Gain	(e) Loss
Partnership #1	4,000		(2,600)	1,400	
Partnership #4		(2,400)	(1,500)		(3,900)
Total. Enter on Form 8582, lines 3a, 3b, and 3c ▶	4,000	(2,400)	(4,100)		

Worksheet 4—Use this worksheet if an amount is shown on Form 8582, line 10 or 14 (See page 9.)

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Ratio	(c) Special allowance	(d) Subtract column (c) from column (a)
Activity A	Sch. E, line 23	18,891	.487938	2,768	16,123
Activity B	Sch. E, line 23	19,825	.512062	2,905	16,920
Total ▶		38,716	1.00	5,673	33,043

Worksheet 5—Allocation of Unallowed Losses (See page 9 of the instructions.)

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Ratio	(c) Unallowed loss
Activity A	Sch. E, line 23	16,123	.436429	15,512
Activity B	Sch. E, line 23	16,920	.458003	16,279
Partnership #4	Sch. E, line 28D	3,900	.105568	3,752
Total ▶		36,943	1.00	35,543

Worksheet 6—Allowed Losses (See pages 9 and 10 of the instructions.)

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Unallowed loss	(c) Allowed loss
Activity A	Sch. E, line 23	21,667	15,512	6,155
Activity B	Sch. E, line 23	19,825	16,279	3,546
Partnership #4	Sch. E, line 28D	3,900	3,752	148
Total		45,392	35,543	9,849

Worksheet 7—Activities With Losses Reported on Two or More Different Forms or Schedules (See page 10.)

Name of Activity:	(a)	(b)	(c) Ratio	(d) Unallowed loss	(e) Allowed loss
Form or schedule and line number to be reported on (see instructions):					
1a Net loss plus prior year unallowed loss from form or schedule. ▶					
b Net income from form or schedule ▶					
c Subtract line 1b from line 1a. If zero or less, enter -0- ▶					
Form or schedule and line number to be reported on (see instructions):					
1a Net loss plus prior year unallowed loss from form or schedule. ▶					
b Net income from form or schedule ▶					
c Subtract line 1b from line 1a. If zero or less, enter -0- ▶					
Form or schedule and line number to be reported on (see instructions):					
1a Net loss plus prior year unallowed loss from form or schedule. ▶					
b Net income from form or schedule ▶					
c Subtract line 1b from line 1a. If zero or less, enter -0- ▶					
Total ▶			1.00		

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 is 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 are 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 does not include income from the recapture of previous losses (discussed later, under *Recapture Rule*).

Form 6198. Use Form 6198, At-Risk Limitations, to figure how much loss from an activity you can deduct. You must file Form 6198 with your tax return if:

- You have a loss from any part of an activity that is covered by the at-risk rules, and
- You are not at risk for some of your investment in the activity.

Loss limits for partners and S corporation shareholders. Three separate limits apply to a partner's or shareholder's distributive share of a loss from a partnership or S corporation, respectively. The limits determine the amount of the loss each partner or shareholder can deduct on his or her 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 "Limits on Losses" in Publication 541, and "Limitations on Losses, Deductions, and Credits" in "Shareholder's Instructions for Schedule K-1 (Form 1120S)."

Who Is Affected?

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

Closely held corporation. For the at-risk rules, a 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.

To figure if more than 50% in value of the stock is owned by five or fewer individuals, apply the following rules.

1. Stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by its shareholders, partners, or beneficiaries.
2. An individual is considered to own the stock owned directly or indirectly by or for his or her family. Family includes only brothers and sisters (including half-brothers and half-sisters), a spouse, ancestors, and lineal descendants.
3. If a person holds an option to buy stock, he or she is considered to be the owner of that stock.
4. When applying rule (1) or (2), stock considered owned by a person under rule (1) or (3) is treated as actually owned by that person. Stock considered owned by an individual under rule (2) is not treated as owned by the individual for again applying rule (2) to consider another the owner of that stock.
5. Stock that may be considered owned by an individual under either rule (2) or (3) is considered owned by the individual under rule (3).

Activities Covered by the At-Risk Rules

If you are involved in one of the following activities as a trade or business or for the production of income, you are subject to the at-risk rules.

1. Holding, producing, or distributing motion picture films or video tapes.
2. Farming.
3. Leasing section 1245 property, including personal property and certain other tangible property that is depreciable or amortizable. See *Section 1245 property*, next.
4. Exploring for, or exploiting, oil and gas.
5. Exploring for, or exploiting, geothermal deposits (for wells started after September 1978).
6. Any other activity not included in (1) through (5) that is carried on as a trade or business or for the production of income.

Section 1245 property. Section 1245 property includes any property that is or has been subject to depreciation or amortization and is:

1. Personal property,
2. Other tangible property (other than a building or its structural components) that is:
 - a. Used in manufacturing, production, extraction or furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services,
 - b. A research facility used for the activities in (a), or
 - c. A facility used in any of the activities in (a) for the bulk storage of fungible commodities,
3. A single purpose agricultural or horticultural structure, or

4. A storage facility (other than a building or its structural components) used for the distribution of petroleum.

Exception for holding real property placed in service before 1987. The at-risk rules do not apply to the holding of real property placed in service before 1987. They also do not apply to the holding of an interest acquired before 1987 in a pass-through entity engaged in holding real property placed in service before 1987. This exception does not apply to holding mineral property.

Personal property and services that are incidental to making real property available as living accommodations are included in the activity of holding real property. For example, making personal property, such as furniture, and services available when renting a hotel or motel room or a furnished apartment is considered incidental to making real property available as living accommodations.

Exception for equipment leasing by a closely held corporation. If a closely held corporation is actively engaged in equipment leasing, the equipment leasing is treated as a separate activity not covered by the at-risk rules. A closely held corporation is actively engaged in equipment leasing if 50% or more of its gross receipts for the tax year are from equipment leasing. Equipment leasing means the leasing, purchasing, servicing, and selling of equipment that is section 1245 property.

However, equipment leasing does not include the leasing of master sound recordings and similar contractual arrangements for tangible or intangible assets associated with literary, artistic, or musical properties, such as books, lithographs of artwork, or musical tapes. A closely held corporation cannot exclude these leasing activities from the at-risk rules nor count them as equipment leasing for the gross receipts test.

The equipment leasing exclusion also is not available for leasing activities related to other at-risk activities, such as motion picture films and video tapes, farming, oil and gas properties, and geothermal deposits. For example, if a closely held corporation leases a video tape, it cannot exclude this leasing activity from the at-risk rules under the equipment leasing exclusion.

Controlled group of corporations. A controlled group of corporations is subject to special rules for the equipment leasing exclusion. See section 465(c) of the Internal Revenue Code.

Special exception for qualified corporations. A qualified corporation is not subject to the at-risk limits for any qualifying business carried on by the corporation. Each qualifying business is treated as a separate activity.

Qualified corporation. A qualified corporation is a closely held corporation, defined earlier, that is not:

- A personal holding company,
- A foreign personal holding company, or
- A personal service corporation (defined in section 269A(b) of the Internal Revenue Code, but determined by substituting 5% for 10%).

Qualifying business. A qualifying business is any active business if all of the following apply.

1. During the entire 12-month period ending on the last day of the tax year, the corporation had at least:
 - a. One full-time employee whose services were in the active management of the business, and
 - b. Three full-time nonowner employees whose services were directly related to the business. A nonowner employee is an employee who does not own more than 5% in value of the outstanding stock of the corporation at any time during the tax year. (The rules for constructive ownership of stock in section 318 of the Internal Revenue Code apply. However, in applying these rules, an owner of 5% or more, rather than 50% or more, of the value of a corporation's stock is considered to own a proportionate share of any stock owned by the corporation.)
2. Deductions due to the business that are allowable to the corporation as business expenses and as contributions to certain employee benefit plans for the tax year exceed 15% of the gross income from the business.
3. The business is not an excluded business. Generally, an excluded business means equipment leasing as defined, earlier, under *Exception for equipment leasing by a closely held corporation*, and any business involving the use, exploitation, sale, lease, or other disposition of master sound recordings, motion picture films, video tapes, or tangible or intangible assets associated with literary, artistic, musical, or similar properties.

Separation of Activities

Generally, you treat your activity involving each film or video tape, item of leased section 1245 property, farm, oil and gas property, or geothermal property as a separate activity. In addition, each investment that is not a part of a trade or business is treated as a separate activity.

Leasing by a partnership or S corporation. For a partnership or S corporation, treat all leasing of section 1245 property that is placed in service in any tax year of the partnership or S corporation as one activity.

Aggregation of Activities

Activities described in (6) under *Activities Covered by the At-Risk Rules*, earlier, that constitute a trade or business are treated as one activity if:

- You actively participate in the management of the trade or business, or
- The trade or business is carried on by a partnership or S corporation and 65% or more of its losses for the tax year are allocable to persons who actively participate in the management of the trade or business.

Similar rules apply to activities described in (1) through (5) of that earlier discussion.

Active participation. Active participation depends on all the facts and circumstances. Factors that indicate active participation include making decisions involving the operation or management of the activity, performing services for the activity, and hiring and discharging employees. Factors that indicate a lack of active participation include lack of control in managing and operating the activity, having authority only to discharge the manager of the activity, and having a manager of the activity who is an independent contractor rather than an employee.

Partners and S corporation shareholders. Partners or shareholders may aggregate activities of their partnership or S corporation within each of the following categories.

- Films and video tapes,
- Farms,
- Oil and gas properties, and
- Geothermal properties.

For example, if a partnership or S corporation produces two films or video tapes, the partners or S corporation shareholders may treat the production of both films or video tapes as one activity for purposes of the at-risk rules.

At-Risk Amounts

You are at risk in any activity for:

1. The money and adjusted basis of property you contribute to the activity, and
2. Amounts you borrow for use in the activity if:
 - a. You are personally liable for repayment, or
 - b. You pledge property (other than property used in the activity) as security for the loan.

Amounts borrowed. You are at risk for amounts borrowed to use in the activity if you are personally liable for repayment. You are also at risk if the amounts borrowed are secured by property other than property used in the activity. In this case, the amount considered at risk is the net fair market value of your interest in the pledged property. The net fair market value of property is its fair market value (determined on the date the property is pledged) less any prior (or superior) claims to which it is subject. However, no property will be taken into account as security if it is directly or indirectly financed by debt that is secured by property you contributed to the activity.



If you borrow money to finance a contribution to an activity, you cannot increase your amount at risk by the contribution and the amount borrowed to finance the contribution. You may increase your at-risk amount only once.

Certain borrowed amounts excluded. Even if you are personally liable for the repayment of a borrowed amount or you secure a borrowed amount with property other than property used in the activity, you are not considered at risk if you borrowed the money from a person having an interest in the activity or from someone related to a person (other than you) having an interest in the activity. This does not apply to:

- Amounts borrowed by a corporation from a person whose only interest in the activity is as a shareholder of the corporation,
- Amounts borrowed from a person having an interest in the activity as a creditor, or
- Amounts borrowed before May 4, 2004, for an activity described in (6) under *Activities Covered by the At-Risk Rules*, earlier.
- Amounts borrowed after May 3, 2004, secured by real property used in the activity of holding real property (other than mineral property) that, if nonrecourse, would be qualified nonrecourse financing.

Related persons. Related persons include:

- Members of a family, but only an individual's brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.),
- Two corporations that are members of the same controlled group of corporations determined by applying a 10% ownership test,
- The fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts,
- A tax-exempt educational or charitable organization and a person who directly or indirectly controls it (or a member of whose family controls it),
- A corporation and an individual who owns directly or indirectly more than 10% of the value of the outstanding stock of the corporation,
- A trust fiduciary and a corporation of which more than 10% in value of the outstanding stock is owned directly or indirectly by or for the trust or by or for the grantor of the trust,
- The grantor and fiduciary, or the fiduciary and beneficiary, of any trust,
- A corporation and a partnership if the same persons own over 10% in value of the outstanding stock of the corporation and more than 10% of the capital interest or the profits interest in the partnership,
- Two S corporations if the same persons own more than 10% in value of the outstanding stock of each corporation,
- An S corporation and a regular corporation if the same persons own more than 10% in value of the outstanding stock of each corporation,
- A partnership and a person who owns directly or indirectly more than 10% of the capital or profits of the partnership,
- Two partnerships if the same persons directly or indirectly own more than 10% of the capital or profits of each,
- Two persons who are engaged in business under common control, and
- An executor of an estate and a beneficiary of that estate.

To determine the direct or indirect ownership of the outstanding stock of a corporation, apply the following rules.

1. Stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.
2. Stock owned directly or indirectly by or for an individual's family is considered owned by the individual. The family of an individual includes only brothers and sisters, half-brothers and half-sisters, a spouse, ancestors, and lineal descendants.
3. Any stock in a corporation owned by an individual (other than by applying rule (2)) is considered owned directly or indirectly by the individual's partner.
4. When applying rule (1), (2), or (3), stock considered owned by a person under rule (1) is treated as actually owned by that person. But, if a person constructively owns stock because of rule (2) or (3), he or she does not own the stock for purposes of applying either rule (2) or (3) to make another person the constructive owner of the same stock.

Effect of government price support programs. A government target price program or other government price support programs for a product that you grow does not, without agreements limiting your costs, reduce the amount you have at risk.

Effect of increasing amounts at risk in subsequent years. Any loss that is allowable in a particular year reduces your at-risk investment (but not below zero) as of the beginning of the next tax year and in all succeeding tax years for that activity. If you have a loss that is more than your at-risk amount, the loss disallowed will not be allowed in later years unless you increase your at-risk amount. Losses that are suspended because they are greater than your investment that is at risk are treated as a deduction for the activity in the following year. Consequently, if your amount at risk increases in later years, you may deduct previously suspended losses to the extent that the increases in your amount at risk exceed your losses in later years. However, your deduction of suspended losses may be limited by the passive loss rules.

Amounts Not At Risk

You are not considered at risk for amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

Nonrecourse financing. Nonrecourse financing is financing for which you are not personally liable. If you borrow money to contribute to an activity and the lender's only recourse is to your interest in the activity or the property used in the activity, the loan is a nonrecourse loan.

You are not considered at risk for your share of any nonrecourse loan used to finance an activity or to acquire property used in the activity unless the loan is secured by property not used in the activity.

However, you are considered at risk for qualified nonrecourse financing secured by real property used in an activity of holding real property.

Qualified nonrecourse financing is financing for which no one is personally liable for repayment and that is:

- Borrowed by you in connection with the activity of holding real property,
- Secured by real property used in the activity,
- Not convertible from a debt obligation to an ownership interest, and
- Loaned or guaranteed by any federal, state, or local government, or borrowed by you from a qualified person.

Other types of property used as security.

The rules in the next two paragraphs apply to any financing incurred after August 3, 1998. You also can choose to apply these rules to financing you obtained before August 4, 1998. If you do that, you must reduce the amounts at risk as a result of applying these rules to years ending before August 4, 1998, to the extent they increase the losses allowed for those years.

In determining whether qualified nonrecourse financing is secured only by real property used in the activity of holding real property, disregard property that is incidental to the activity of holding real property. Also disregard other property if the total gross fair market value of that property is less than 10% of the total gross fair market value of all the property securing the financing.

For this purpose, treat yourself as owning directly your proportional share of the assets in any partnership in which you own, directly or indirectly, an equity interest.

Qualified person. A qualified person is a person who actively and regularly engages in the business of lending money. The most common example is a bank.

However, none of the following persons can be a qualified person.

- A person related to you in one of the ways listed under *Related persons*, earlier. However, a person related to you may be a qualified person if the nonrecourse financing is commercially reasonable and on the same terms as loans involving unrelated persons.
- A person from which you acquired the property or a person related to that person.
- A person who receives a fee due to your investment in the real property or a person related to that person.

Other loss limiting arrangements. Any capital you have contributed to an activity is not at risk if you are protected against economic loss by an agreement or arrangement for compensation or reimbursement. For example, you are not at risk if you will be reimbursed for part or all of any loss because of a binding agreement between yourself and another person.

Example 1. Some commercial feedlots reimburse investors against any loss sustained on sales of the fed livestock above a stated dollar amount per head. Under such stop loss orders, the investor is at risk only for the portion of the investor's capital for which the investor is not entitled to a reimbursement.

Example 2. You are personally liable for a mortgage, but you separately obtain insurance to compensate you for any payments you must actually make because of your personal liability. You are considered at risk only to the extent of the uninsured portion of the personal liability to which you are exposed. You can include in the amount you have at risk the amount of any premium which you paid from your personal assets for the insurance. However, if you obtain casualty insurance or insurance protecting yourself against tort liability, it does not affect the amount you are otherwise considered to have at risk.

Reductions of Amounts At Risk

The amount you have at risk in any activity is reduced by any losses allowed in previous years under the at-risk rules. It may also be reduced because of distributions you received from the activity, debts changed from recourse to nonrecourse, or the initiation of a stop loss or similar agreement. If the amount at risk is reduced below zero, your previously allowed losses are subject to recapture, as explained next.

Recapture Rule

If the amount you have at risk in any activity at the end of any tax year is less than zero, you must recapture at least part of your previously allowed losses. You do this by adding to your income from the activity for that year the lesser of the following amounts:

- The negative at-risk amount (treated as a positive amount), or
- The total amount of losses deducted in previous tax years beginning after 1978, minus any amounts you previously added to your income from that activity under this recapture rule.

Do not use the recapture income to reduce any net loss from the activity for the tax year. Instead, treat the recaptured amount as a deduction for the activity in the next tax year.

Pre-1979 activity. If the amount you had at risk in an activity at the end of your tax year that began in 1978 was less than zero, you apply the preceding rule for the recapture of losses by substituting that negative amount for zero. For example, if your at-risk amount for that tax year was minus \$50, you will recapture losses only when your at-risk amount goes below minus \$50.

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate independently represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate toll free at 1-877-777-4778.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call 1-800-829-4059 if you are a TTY/TDD user.
- Visit www.irs.gov/advocate.

For more information, see Publication 1546, The Taxpayer Advocate Service of the IRS—How To Get Help With Unresolved Tax Problems.

Free tax services. To find out what services are available, get Publication 910, IRS Guide to Free Tax Services. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.



Internet. You can access the IRS website 24 hours a day, 7 days a week, at www.irs.gov to:

- *E-file* your return. Find out about commercial tax preparation and *e-file* services available free to eligible taxpayers.
- Check the status of your 2004 refund. Click on *Where's My Refund*. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2004 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.
- Download forms, instructions, and publications.
- Order IRS products online.
- Research your tax questions online.
- Search publications online by topic or keyword.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Figure your withholding allowances using our Form W-4 calculator.

- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.



Fax. You can get over 100 of the most requested forms and instructions 24 hours a day, 7 days a week, by fax. Just call 703-368-9694 from the telephone connected to your fax machine. When you call, you will hear instructions on how to use the service. The items you request will be faxed to you.

For help with transmission problems, call 703-487-4608.

Long-distance charges may apply.



Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call 1-800-829-3676 to order current-year forms, instructions, and publications and prior-year forms and instructions. You should receive your order within 10 days.
- *Asking tax questions.* Call the IRS with your tax questions at 1-800-829-1040.
- *Solving problems.* You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to www.irs.gov/localcontacts or look in the phone book under *United States Government, Internal Revenue Service*.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call 1-800-829-4477 and press 2 to listen to pre-recorded messages covering various tax topics.
- *Refund information.* If you would like to check the status of your 2004 refund, call 1-800-829-4477 and press 1 for automated refund information or call 1-800-829-1954. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2004 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.



Walk-in. Many products and services are available on a walk-in basis.

- *Products.* You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- *Services.* You can walk in to your local Taxpayer Assistance Center every business day to ask tax questions or get help with a tax problem. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. You can set up an appointment by calling your local Center and, at the prompt, leaving a message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. To find the number, go to www.irs.gov/localcontacts or look in the phone book under *United States Government, Internal Revenue Service*.



Mail. You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 business days after your request is received. Use the address that applies to your part of the country.

- **Western part of U.S.:**
Western Area Distribution Center
Rancho Cordova, CA 95743-0001
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- **Eastern part of U.S. and foreign addresses:**
Eastern Area Distribution Center
P.O. Box 85074
Richmond, VA 23261-5074



CD-ROM for tax products. You can order Publication 1796, IRS Federal Tax Products CD-ROM, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms and instructions.
- Frequently requested tax forms that may be filled in electronically, printed out for submission, or saved for recordkeeping.
- Internal Revenue Bulletins.

Buy the CD-ROM from National Technical Information Service (NTIS) at www.irs.gov/cdorders for \$22 (no handling fee) or call 1-877-233-6767 toll free to buy the CD-ROM for \$22 (plus a \$5 handling fee). The first release is

available in early January and the final release is available in late February.



CD-ROM for small businesses. Publication 3207, The Small Business Resource Guide, CD-ROM 2004, is a must for every small business owner or any taxpayer about to start a business. This handy,

interactive CD contains all the business tax forms, instructions, and publications needed to successfully manage a business. In addition, the CD provides other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy

and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer.

It is available in early April. You can get a free copy by calling 1-800-829-3676 or by visiting www.irs.gov/smallbiz.



<p>A</p> <p>Active participation 22</p> <p>Activity:</p> <p> Appropriate economic unit 7</p> <p> Nonpassive 4</p> <p> Trade or business 2</p> <p>Amounts borrowed 22</p> <p>Amounts not at risk 23</p> <p>Appropriate economic unit 7</p> <p>Assistance (See Tax help)</p> <p>At-risk activities:</p> <p> Aggregation of 22</p> <p> Separation of 22</p> <p>At-risk amounts 22</p> <p> Government price support programs 23</p> <p> Increasing amounts 23</p> <p> Nonrecourse financing 23</p> <p>At-risk limits 21</p> <p> Closely held corporation 21</p> <p> Loss defined 21</p> <p> Partners 21</p> <p> S corporation 21</p> <p> shareholders 21</p> <p> Who is affected 21</p> <p>At-risk rules:</p> <p> Activities covered by 21</p> <p> Exceptions to 21</p> <p> Excluded business 22</p> <p> Qualified corporation 21</p> <p> Qualifying business 21</p> <p> Recapture rule 23</p> <hr/> <p>B</p> <p>Borrowed amounts 22</p> <hr/> <p>C</p> <p>Closely held corporation 2, 21</p> <p>Comments on publication 2</p> <p>Corporations:</p> <p> Closely held 5, 8</p> <p> Controlled group of 21</p> <p> Personal service 5, 8</p>	<p> Qualified 21</p> <hr/> <p>D</p> <p>Deductions, passive activity 6</p> <p>Disabled farmer 5</p> <p>Disclosure requirement 7</p> <p>Dispositions:</p> <p> Death 10</p> <p> Gift 10</p> <p> Installment sale 10</p> <p> Partial 8</p> <hr/> <p>E</p> <p>Excluded business, definition of 22</p> <hr/> <p>F</p> <p>Farmer 5</p> <p>Form:</p> <p> 6198 21</p> <p> 8582 11</p> <p> 8810 2</p> <p>Former passive activity 2</p> <p>Free tax services 24</p> <hr/> <p>G</p> <p>Grouping passive activities 7</p> <hr/> <p>H</p> <p>Help (See Tax help)</p> <hr/> <p>I</p> <p>Income, passive activity 5</p> <hr/> <p>L</p> <p>Limited entrepreneur 7</p> <p>Limited partners 5</p> <p>Losses, closely held corporations 2</p> <hr/> <p>M</p> <p>Material participation 4, 5</p>	<p>Modified adjusted gross income 4</p> <p>More information (See Tax help)</p> <hr/> <p>N</p> <p>Nonrecourse loan 23</p> <hr/> <p>P</p> <p>Participation 5</p> <p> Active 22</p> <p> Material 4</p> <p>Passive activity 2</p> <p> Comprehensive example 10</p> <p> Credits 2</p> <p> Disposition 9</p> <p> Former 2</p> <p> Grouping 7</p> <p> Limits 2</p> <p> Material participation 4</p> <p> Rental 3</p> <p> Rules 2, 7</p> <p> Who must use these rules 2</p> <p>Passive activity deductions 6</p> <p>Passive activity income 5</p> <p>Passive income, recharacterization of 8</p> <p>Publications (See Tax help)</p> <p>Publicly traded partnership 2, 8</p> <hr/> <p>Q</p> <p>Qualified person, nonrecourse financing 23</p> <p>Qualifying business, at-risk rules 21</p> <hr/> <p>R</p> <p>Real estate professional 5</p> <p>Recapture rule under at-risk limits 23</p> <p>Recharacterization of passive income 8</p>	<p>Reductions of amounts at risk 23</p> <p>Related persons 22</p> <p>Rental activity:</p> <p> \$25,000 offset 3</p> <p> Active participation 3</p> <p> Exceptions 3</p> <p> Phaseout rule 4</p> <p> Real estate professional 5</p> <p>Retired farmer 5</p> <hr/> <p>S</p> <p>Section 1245 property 21</p> <p>Self-charged interest 5</p> <p>Separate activity 22</p> <p>Significant participation passive activities 8</p> <p>Special \$25,000 allowance 3</p> <p>Suggestions for publication 2</p> <p>Surviving spouse of farmer 5</p> <hr/> <p>T</p> <p>Tax help 24</p> <p>Taxpayer Advocate 24</p> <p>Trade or business activities:</p> <p> Definition of 2</p> <p> Real property 5</p> <p>TTY/TDD information 24</p> <hr/> <p>W</p> <p>Worksheet 1 11</p> <p>Worksheet 3 11</p> <p>Worksheet 4 11</p> <p>Worksheet 5 12</p> <p>Worksheet 6 12</p> <p>Worksheet 7 12</p> <p>Worksheet A 8</p> <p>Worksheet B 8</p>
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Tax Publications for Individual Taxpayers

See *How To Get Tax Help* for a variety of ways to get publications, including by computer, phone, and mail.

General Guides

- 1 Your Rights as a Taxpayer
- 17 Your Federal Income Tax (For Individuals)
- 334 Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)
- 509 Tax Calendars for 2005
- 553 Highlights of 2004 Tax Changes
- 910 IRS Guide to Free Tax Services

Specialized Publications

- 3 Armed Forces' Tax Guide
- 54 Tax Guide for U.S. Citizens and Residents Aliens Abroad
- 225 Farmer's Tax Guide
- 378 Fuel Tax Credits and Refunds
- 463 Travel, Entertainment, Gift, and Car Expenses
- 501 Exemptions, Standard Deduction, and Filing Information
- 502 Medical and Dental Expenses (Including the Health Coverage Tax Credit)
- 503 Child and Dependent Care Expenses
- 504 Divorced or Separated Individuals
- 505 Tax Withholding and Estimated Tax
- 514 Foreign Tax Credit for Individuals
- 516 U.S. Government Civilian Employees Stationed Abroad
- 517 Social Security and Other Information for Members of the Clergy and Religious Workers
- 519 U.S. Tax Guide for Aliens
- 521 Moving Expenses
- 523 Selling Your Home
- 524 Credit for the Elderly or the Disabled
- 525 Taxable and Nontaxable Income
- 526 Charitable Contributions
- 527 Residential Rental Property
- 529 Miscellaneous Deductions
- 530 Tax Information for First-Time Homeowners

- 531 Reporting Tip Income
- 533 Self-Employment Tax
- 536 Net Operating Losses (NOLs) for Individuals, Estates, and Trusts
- 537 Installment Sales
- 541 Partnerships
- 544 Sales and Other Dispositions of Assets
- 547 Casualties, Disasters, and Thefts
- 550 Investment Income and Expenses
- 551 Basis of Assets
- 552 Recordkeeping for Individuals
- 554 Older Americans' Tax Guide
- 555 Community Property
- 556 Examination of Returns, Appeal Rights, and Claims for Refund
- 559 Survivors, Executors, and Administrators
- 561 Determining the Value of Donated Property
- 564 Mutual Fund Distributions
- 570 Tax Guide for Individuals With Income From U.S. Possessions
- 571 Tax-Sheltered Annuity Plans (403(b) Plans)
- 575 Pension and Annuity Income
- 584 Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)
- 587 Business Use of Your Home (Including Use by Daycare Providers)
- 590 Individual Retirement Arrangements (IRAs)
- 593 Tax Highlights for U.S. Citizens and Residents Going Abroad
- 594 What You Should Know About the IRS Collection Process
- 595 Tax Highlights for Commercial Fishermen
- 596 Earned Income Credit (EIC)
- 721 Tax Guide to U.S. Civil Service Retirement Benefits
- 901 U.S. Tax Treaties

- 907 Tax Highlights for Persons with Disabilities
- 908 Bankruptcy Tax Guide
- 911 Direct Sellers
- 915 Social Security and Equivalent Railroad Retirement Benefits
- 919 How Do I Adjust My Tax Withholding?
- 925 Passive Activity and At-Risk Rules
- 926 Household Employer's Tax Guide
- 929 Tax Rules for Children and Dependents
- 936 Home Mortgage Interest Deduction
- 946 How To Depreciate Property
- 947 Practice Before the IRS and Power of Attorney
- 950 Introduction to Estate and Gift Taxes
- 967 The IRS Will Figure Your Tax
- 968 Tax Benefits for Adoption
- 969 Health Savings Accounts and Other Tax-Favored Health Plans
- 970 Tax Benefits for Education
- 971 Innocent Spouse Relief
- 972 Child Tax Credit
- 1542 Per Diem Rates
- 1544 Reporting Cash Payments of Over \$10,000 (Received in a Trade or Business)
- 1546 The Taxpayer Advocate Service—How to Get Help With Unresolved Problems

Spanish Language Publications

- 1SP Derechos del Contribuyente
- 579SP Cómo Preparar la Declaración de Impuesto Federal
- 594SP Comprendiendo el Proceso de Cobro
- 596SP Crédito por Ingreso del Trabajo
- 850 English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
- 1544SP Informe de Pagos en Efectivo en Exceso de \$10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

See *How To Get Tax Help* for a variety of ways to get forms, including by computer, fax, phone, and mail. For fax orders only, use the catalog number when ordering.

Form Number and Title	Catalog Number	Form Number and Title	Catalog Number
1040 U.S. Individual Income Tax Return	11320	2106 Employee Business Expenses	11700
Sch A&B Itemized Deductions & Interest and Ordinary Dividends	11330	2106-EZ Reimbursed Employee Business Expenses	20604
Sch C Profit or Loss From Business	11334	2210 Underpayment of Estimated Tax by Individuals, Estates, and Trusts	11744
Sch C-EZ Net Profit From Business	14374	2441 Child and Dependent Care Expenses	11862
Sch D Capital Gains and Losses	11338	2848 Power of Attorney and Declaration of Representative	11980
Sch D-1 Continuation Sheet for Schedule D	10424	3903 Moving Expenses	12490
Sch E Supplemental Income and Loss	11344	4562 Depreciation and Amortization	12906
Sch EIC Earned Income Credit	13339	4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return	13141
Sch F Profit or Loss From Farming	11346	4952 Investment Interest Expense Deduction	13177
Sch H Household Employment Taxes	12187	5329 Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts	13329
Sch J Farm Income Averaging	25513	6251 Alternative Minimum Tax—Individuals	13600
Sch R Credit for the Elderly or the Disabled	11359	8283 Noncash Charitable Contributions	62299
Sch SE Self-Employment Tax	11358	8582 Passive Activity Loss Limitations	63704
1040A U.S. Individual Income Tax Return	11327	8606 Nondeductible IRAs	63966
Sch 1 Interest and Ordinary Dividends for Form 1040A Filers	12075	8812 Additional Child Tax Credit	10644
Sch 2 Child and Dependent Care Expenses for Form 1040A Filers	10749	8822 Change of Address	12081
Sch 3 Credit for the Elderly or the Disabled for Form 1040A Filers	12064	8829 Expenses for Business Use of Your Home	13232
1040EZ Income Tax Return for Single and Joint Filers With No Dependents	11329	8863 Education Credits	25379
1040-ES Estimated Tax for Individuals	11340	9465 Installment Agreement Request	14842
1040X Amended U.S. Individual Income Tax Return	11360		