



Instructions for Form 8582

Passive Activity Loss Limitations

Section references are to the Internal Revenue Code, unless otherwise noted.

General Instructions

Purpose of Form

Form 8582 is used by noncorporate taxpayers to figure the amount of any passive activity loss (PAL) for the current tax year.

A PAL occurs when total losses (including prior year unallowed losses) from all your passive activities exceed the total income from all your passive activities.

Generally, passive activities include:

- Trade or business activities in which you did not materially participate for the tax year.
- Rental activities, regardless of your participation.

PALs cannot be used to offset income from nonpassive activities. However, a special allowance for rental real estate activities may allow some losses even if the losses exceed passive income.

PALs not allowed in the current year are carried forward until they are allowed either against passive activity income, against the special allowance, if applicable, or when you sell or exchange your entire interest in the activity in a fully taxable transaction to an unrelated party.

For more information, see Pub. 925, *Passive Activity and At-Risk Rules*, which contains a filled-in example of Form 8582 with step-by-step instructions for reporting losses from passive activities.

Note. Corporations subject to the passive activity rules must use Form 8810, *Corporate Passive Activity Loss and Credit Limitations*.

Who Must File

Form 8582 is filed by individuals, estates, and trusts who have losses (including prior year unallowed losses) from passive activities. You do not have to file Form 8582 if you meet Exception 1 or 2 below.

Exception 1

You do not have an overall loss when you combine all your net income and net losses (including any prior year unallowed losses) from business or

rental passive activities. Overall loss is defined under *Definitions* on page 2.

In figuring your overall gain or loss from all passive activities for the year, do not include the following:

1. Net income that is not passive activity income. See *Passive Activity Income* beginning on page 5.
2. Net losses that are not passive activity net losses. See *Activities That Are Not Passive Activities* on page 2.
3. Net income or net loss from your interest in any publicly traded partnership (PTP). See *Publicly Traded Partnerships (PTPs)* beginning on page 11.
4. Any overall loss from an entire disposition of a passive activity. See *Dispositions* beginning on page 6 for more information.

Exception 2

You actively participated in rental real estate activities (see *Special Allowance for Rental Real Estate Activities* on page 3), and you meet all of the following conditions.

- Rental real estate activities with active participation were your only passive activities.
- You have no prior year unallowed losses from these activities.
- Your total loss from the rental real estate activities was not more than \$25,000 (\$12,500 if married filing separately and you lived apart from your spouse all year).
- If you are married filing separately, you lived apart from your spouse all year.
- You have no current or prior year unallowed credits from a passive activity.
- Your modified adjusted gross income was not more than \$100,000 (not more than \$50,000 if married filing separately and you lived apart from your spouse all year).
- You do not hold any interest in a rental real estate activity as a limited partner or as a beneficiary of an estate or a trust.

For the definition of modified adjusted gross income, see the instructions for line 7 on page 8.

If all the above conditions are met, your rental real estate losses are not

limited, and you do not need to complete Form 8582. Enter losses reported on Schedule E (Form 1040), Part I, line 22, on Schedule E, line 23. For losses from a partnership or an S corporation, enter the amount of the allowable loss from Schedule K-1 in Schedule E, Part II, column (f). Enter losses reported on line 32 of Form 4835, *Farm Rental Income and Expenses*, on Form 4835, line 33c.

If you do not qualify for Exception 1 or 2, you must complete Form 8582.

Coordination With Other Limitations

Generally, PALs are subject to other limitations (for example, basis and at-risk limitations) before they are subject to the passive loss limitations. Once a loss becomes allowable under these other limitations, you must determine whether the loss is limited under the passive loss rules. See Form 6198, *At-Risk Limitations*, for details on the at-risk rules. Also, capital losses that are allowable under the passive loss rules may be limited under the capital loss limitations of section 1211. Percentage depletion deductions that are allowable under the passive loss rules may be limited under section 613A(d).

Before Completing Form 8582

To find out if your activity is treated as a passive activity, read:

- *Trade or Business Activities* if your activity is a trade or business activity (page 3).
- *Rental Activities* if your activity is the renting of tangible property (beginning on page 2).
- *Material Participation* (page 4).
- *Grouping of Activities* (page 5).

To find out how to treat income and deductions from your activity, read:

- *Passive Activity Income and Deductions, Former Passive Activities, and Dispositions* (pages 5 through 7).

To find out how to enter income and losses on Form 8582, read the instructions for Worksheets 1, 2, and 3 (beginning on page 7).

Definitions

Except as otherwise indicated, the following terms in these instructions are defined as shown below.

Net income. This is the excess of current year income over current year deductions from the activity. This includes any current year gains or losses from the disposition of assets or an interest in the activity.

Net loss. This is the excess of current year deductions over current year income from the activity. This includes any current year gains or losses from the disposition of assets or an interest in the activity.

Overall gain. This is the excess of the "net income" from the activity over the prior year unallowed losses from the activity.

Overall loss. This is (a) the excess of the prior year unallowed losses from the activity over the "net income" from the activity or (b) the prior year unallowed losses from the activity plus the "net loss" from the activity.

Prior year unallowed losses. These are the losses from an activity that were disallowed under the PAL limitations in a prior year and carried forward to the tax year under section 469(b). See Regulations section 1.469-1(f)(4) and Pub. 925.

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. Any rental real estate activity in which you materially participated if you were a "real estate professional" for the tax year. You were a real estate professional only if:

a. More than half of the personal services you performed in trades or businesses during the tax year were performed in real property trades or businesses in which you materially participated, and

b. You performed more than 750 hours of services during the tax year in real property trades or businesses in which you materially participated.

For purposes of item (2), each interest in rental real estate is a separate activity, unless you elect to treat all interests in rental real estate as one activity. For details on making this election, see page E-1 of the instructions for Schedule E (Form 1040).

If you are married filing jointly, one spouse must separately meet both (2)(a) and (2)(b), without taking into account services performed by the other spouse.

A real property trade or business is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

Services you performed as an employee are not treated as performed in a real property trade or business unless you owned more than 5% of the stock (or more than 5% of the capital or profits interest) in the employer.

Note. If a rental real estate activity is not a passive activity for the current year, any prior year unallowed loss is treated as a loss from a former passive activity. See *Former Passive Activities* on page 6.

3. A working interest in an oil or gas well. Your working interest must be held directly or through an entity that does not limit your liability (such as a general partner interest in a partnership). In this case, it does not matter whether you materially participated in the activity for the tax year.

If, however, 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), some of your income and losses 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).

4. The rental of a dwelling unit you used as a residence if section 280A(c)(5) applies. This section applies if you rented out a dwelling unit that you also used as a home during the year for a number of days that exceeds the greater of 14 days or 10% of the number of days during the year that the home was rented at a fair rental.

5. An activity of trading personal property for the account of owners of interests in the activity. For purposes of this rule, personal property means property that is actively traded, such as stocks, bonds, and other securities. See Temporary Regulations section 1.469-1T(e)(6) for more details.

Generally, income and losses from these activities are not entered on Form 8582. However, losses from these activities may be subject to limitations other than the passive loss rules.

Rental Activities

A rental activity is a passive activity even if you materially participated in the activity (unless it is a rental real estate activity in which you materially participated and you were a real estate professional).

However, if you meet any of the five exceptions beginning below, the rental of the property is not treated as a rental activity. See *Reporting Income and*

Losses From the Activities on page 3 if you meet any of the exceptions.

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

An activity is not a rental activity if:

1. The average period of customer use is:
 - a. 7 days or less, or
 - b. 30 days or less and significant personal services were provided in making the rental property available for customer use.

Figure the average period of customer use for a class of property 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 the ratio of the gross rental income from that class to the activity's total gross rental income. The activity's average period of customer use equals the sum of these class-by-class average periods weighted by gross income. See Regulations section 1.469-1(e)(3)(iii).

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.

2. Extraordinary personal services were provided in making the rental property available for customer use. This applies only if the services are performed by individuals and the customers' use of the property is incidental to their receipt of the services.

3. Rental of the property 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 is less than 2% of the smaller of the unadjusted basis or the fair market value (FMV) of the property.

Unadjusted basis is the cost of the property without regard to depreciation deductions or any other basis adjustment described in section 1016.

The rental of property is incidental to a trade or business activity if:

- a. You own an interest in the trade or business activity during the tax year,
- b. The rental property was mainly used in the trade or business activity during the tax year or during at least 2 of the 5 preceding tax years, and
- c. The gross rental income from the property is less than 2% of the smaller of the unadjusted basis or the FMV of the property.

Lodging provided for the employer's convenience to an employee or the employee's spouse or dependents is incidental to the activity or activities in which the employee performs services.

4. You customarily make the rental property available during defined business hours for nonexclusive use by various customers.

5. You provide property for use in a nonrental activity of a partnership, S corporation, or a joint venture in your capacity as an owner of an interest in the partnership, S corporation, or joint venture.

Example. If a partner contributes the use of property to a partnership, none of the partner's distributive share of partnership income is income from a rental activity unless the partnership is engaged in a rental activity.

Also, a partner's gross income from a guaranteed payment under section 707(c) is not income from a rental activity. The determination of whether the property used in the activity is provided in the partner's capacity as an owner of an interest in the partnership is made on the basis of all the facts and circumstances.

Reporting Income and Losses From the Activities

If an activity meets any of the five exceptions listed above, it is not a rental activity. You must then determine:

1. Whether your rental of the property is a trade or business activity (see *Trade or Business Activities* on this page) and, if so,

2. Whether you materially participated in the activity for the tax year (see *Material Participation* on page 4).

- If the activity is a trade or business activity in which you did not materially participate, enter the income and losses from the activity on Worksheet 3.
- If the activity is a trade or business activity in which you did materially participate, report any income or loss from the activity on the forms or schedules normally used.

If the rental activity did not meet any of the five exceptions, it is generally a passive activity. However, special rules apply if you conduct the rental activity through a PTP or if any of the rules

described under *Recharacterization of Passive Income* on page 6 apply. See the PTP rules beginning on page 11.

If none of the special rules apply, enter the income and losses from the passive rental activity on Worksheet 1, 2, or 3.

Worksheet 1 is for passive rental real estate activities in which you actively participated. See *Special Allowance for Rental Real Estate Activities* on this page.

Worksheet 2 is for commercial revitalization deductions (CRDs) from rental real estate activities. CRDs from rental real estate activities are not entered on Worksheet 1 or 3. See *Commercial revitalization deduction (CRD)* on page 4.

Worksheet 3 is for passive rental real estate activities in which you did not actively participate, activities of renting personal property, and other passive trade or business activities.

See the instructions for Worksheets 1, 2, and 3 beginning on page 7.

Trade or Business Activities

A trade or business activity is an activity (other than a rental activity or an activity treated as incidental to an activity of holding property for investment) that:

1. Involves the conduct of a trade or business (within the meaning of section 162),
2. Is conducted in anticipation of starting a trade or business, or
3. Involves research or experimental expenditures deductible under section 174 (or that would be if you chose to deduct rather than capitalize them).

Trade or business activities are generally reported on Schedule C, C-EZ, or F, or in Part II or III of Schedule E. See *Publicly Traded Partnerships (PTPs)* on page 11. For trade or business activities that are significant participation passive activities (defined on page 4), see Pub. 925 for how to report their income or losses.

Special Allowance for Rental Real Estate Activities

Active participation. If you actively participated in a passive rental real estate activity, you may be able to 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.

The special allowance is not available if you were married, are filing

a separate return for the year, and lived with your spouse at any time during the year.

Only an individual, a qualifying estate, or a qualified revocable trust that made an election to treat the trust as part of the decedent's estate may actively participate in a rental real estate activity. Unless future regulations provide an exception, limited partners are not treated as actively participating in a partnership's rental real estate activity.

A qualifying estate is the estate of a decedent for tax years ending less than 2 years after the date of the decedent's death if the decedent would have satisfied the active participation requirements for the rental real estate activity for the tax year the decedent died.

A qualified revocable trust may elect to be treated as part of a decedent's estate for purposes of the special allowance for active participation in rental real estate activities. The election must be made by both the executor (if any) of the decedent's estate and the trustee of the revocable trust. For details, see Regulations section 1.645-1.

You are not considered to actively participate in a rental real estate activity if at any time during the tax year your interest (including your spouse's interest) in the activity was less than 10% (by value) of all interests in the activity.

Active participation is a less stringent requirement than material participation (see *Material Participation* on page 4). You may be treated as actively participating if, for example, you participated in making management decisions or arranged for others to provide services (such as repairs) in a significant and bona fide sense. Management decisions that may count as active participation include:

- Approving new tenants,
- Deciding on rental terms,
- Approving capital or repair expenditures, and
- Other similar decisions.

The maximum special allowance is:

- \$25,000 for single individuals and married individuals filing a joint return for the tax year.
- \$12,500 for married individuals who file separate returns for the tax year and lived apart from their spouses at all times during the tax year.
- \$25,000 for a qualifying estate reduced by the special allowance for which the surviving spouse qualified.

Modified adjusted gross income limitation. If your modified adjusted gross income (defined on page 8) is \$100,000 or less (\$50,000 or less if married filing separately), your loss is deductible up to the amount of the

maximum special allowance referred to in the preceding paragraph.

If your modified adjusted gross income is more than \$100,000 (\$50,000 if married filing separately) but less than \$150,000 (\$75,000 if married filing separately), your special allowance is limited to 50% of the difference between \$150,000 (\$75,000 if married filing separately) and your modified adjusted gross income.

Generally, if your modified adjusted gross income is \$150,000 or more (\$75,000 or more if married filing separately), there is no special allowance.

If you qualify under the active participation rules, use Worksheet 1 and see page 7 of the instructions.

Commercial revitalization deduction (CRD). The special \$25,000 allowance for the CRD from rental real estate activities is not subject to the active participation rules or modified adjusted gross income limits discussed above. The \$25,000 allowance must first be applied to losses from rental real estate activities with active participation, figured without regard to the CRD (see Part II). Any remaining portion of the \$25,000 allowance is available for the CRD from rental real estate activities (see Part III). See the instructions for Worksheet 2 beginning on page 7. For general information about the CRD, see Pub. 954, Tax Incentives for Distressed Communities, and section 1400I.

Material Participation

For the material participation tests listed below, participation generally includes any work done in connection with an activity if you owned an interest in the activity at the time you did the work. The capacity in which you did the work does not matter. However, work is not participation if:

- It is not work that an owner would customarily do in the same type of activity, and
- One of your main reasons for doing the work was to avoid the disallowance of losses or credits from the activity under the passive activity rules.

Proof of participation. You may prove your participation in an activity by any reasonable means. You do not have to maintain contemporaneous daily time reports, logs, or similar documents if you can establish your participation by other reasonable means. For this purpose, reasonable means include, but are not limited to, identifying services performed over a period of time and the approximate number of hours spent performing the services during that period, based on appointment books, calendars, or narrative summaries.

Tests for individuals. You materially participated for the tax year in an

activity if you satisfy at least one of the following tests.

1. You participated in the activity for more than 500 hours.
2. Your participation in the activity for the tax year was substantially all of the participation in the activity of all individuals (including individuals who did not own any interest in the activity) for the year.
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 for the tax year, and you participated in all significant participation activities during the year 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 fourth test).

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, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or in 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 tax year.

You did not materially participate in the activity under this seventh test, however, if you participated in the activity for 100 hours or less during the tax year.

Your participation in managing the activity does not count in determining whether you materially participated under this test if:

- a. Any person (except you) received compensation for performing services in the management of the activity, or
- b. Any individual spent more hours during the tax year performing services in the management of the activity than you did (regardless of whether the individual was compensated for the management services).

Test for a spouse. Participation by your spouse during the tax year in an activity you own may be counted as

your participation in the activity even if your spouse did not own an interest in the activity and whether or not you and your spouse file a joint return for the tax year.

Tests for investors. Work done as an investor in an activity is not treated as participation unless you were directly involved in the day-to-day management or operations of the activity. For purposes of this test, work done as an investor includes:

1. Studying and reviewing financial statements or reports on operations of the activity.
2. Preparing or compiling summaries or analyses of the finances or operations of the activity for your own use.
3. Monitoring the finances or operations of the activity in a nonmanagerial capacity.

Special rules for limited partners. If you were a limited partner in an activity, you generally did not materially participate in the activity. You did materially participate in the activity, however, if you met material participation test 1, 5, or 6 (see *Tests for individuals* on this page) for the tax year.

However, for purposes of the material participation tests, you are not treated as a limited partner 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 the portion of the partnership's tax year in which you directly or indirectly owned your limited partner interest).

A limited partner's share of an electing large partnership's taxable income or loss from all trade or business and rental activities is treated as income or loss from the conduct of a single passive trade or business activity.

Special rules for certain retired or disabled farmers and surviving spouses of farmers. Certain retired or disabled farmers and surviving spouses of farmers are treated as materially participating in a farming activity if the real property used in the activity would meet the estate tax rules for special valuation of farm property passed from a qualifying decedent. See Temporary Regulations section 1.469-5T(h)(2).

Estates and trusts. The PAL limitations apply in figuring the distributable net income and taxable income of an estate or trust. See Temporary Regulations section 1.469-1T(b)(2) and (3). The rules for determining material participation for this purpose have not yet been issued.

Grouping of Activities

Generally, one or more trade or business activities or rental activities may be treated as a single activity if the activities make up an appropriate economic unit for the measurement of gain or loss under the passive activity rules.

Whether activities make up an appropriate economic unit depends on all the relevant facts and circumstances. The factors given the greatest weight in determining whether activities make up an appropriate economic unit are:

1. Similarities and differences in types of trades or businesses,
2. The extent of common control,
3. The extent of common ownership,
4. Geographical location, and
5. Interdependencies between or among the activities.

Example. You have a significant ownership interest in a bakery and a movie theater in Baltimore and in a bakery and a movie theater in Philadelphia. Depending on all the relevant facts and circumstances, there may be more than one reasonable method for grouping your activities. For instance, the following groupings may or may not be permissible:

- A single activity,
- A movie theater activity and a bakery activity,
- A Baltimore activity and a Philadelphia activity, or
- Four separate activities.

Once you choose a grouping under these rules, you must continue using that grouping in later tax years unless a material change in the facts and circumstances makes it clearly inappropriate.

The IRS may regroup your activities if your grouping fails to reflect one or more appropriate economic units and one of the primary purposes of your grouping is to avoid the passive activity limitations.

Limitation on grouping certain activities. The following activities may not be grouped together.

1. A rental activity with a trade or business activity unless the activities being grouped together make up an appropriate economic unit and:
 - a. The rental activity is insubstantial relative to the trade or business activity or vice versa, or
 - b. Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity. If so, the portion of the rental activity involving the rental of property used in the trade or business activity may be grouped with the trade or business activity.

2. An activity involving the rental of real property with an activity involving the rental of personal property (except personal property provided in connection with the real property or vice versa).

3. Any activity with another activity in a different type of business and in which you hold an interest as a limited partner or as a limited entrepreneur (as defined in section 464(e)(2)) if that other activity engages in holding, producing, or distributing motion picture films or videotapes; farming; leasing section 1245 property; or exploring for or exploiting oil and gas resources or geothermal deposits.

Activities conducted through partnerships, S corporations, and C corporations subject to section 469.

Once a partnership or corporation determines its activities under these rules, a partner or shareholder may use these rules to group those activities with:

- Each other,
- Activities conducted directly by the partner or shareholder, or
- Activities conducted through other partnerships and corporations.

A partner or shareholder may not treat as separate activities those activities grouped together by the partnership or corporation.

Passive Activity Income and Deductions

Take into account only passive activity income and passive activity deductions to figure your net income or net loss from all passive activities or any passive activity.

If your passive activity is reported on Schedule C, C-EZ, E, or F, and the activity has no prior year unallowed losses or any gain or loss from the disposition of assets or an interest in the activity, take into account only the passive activity income and passive activity deductions from the activity to figure the amount to enter on Form 8582 and the worksheets.

If you own an interest in a passive activity through a partnership or an S corporation, the partnership or S corporation will generally provide you with the net income or net loss from the passive activity. If, however, the partnership or S corporation must state an item of gross income or deduction separately to you, and the gross income or deduction is passive activity gross income or a passive activity deduction (respectively), include that amount in the net income or net loss entered on Form 8582 and the worksheets.



The partnership or S corporation does not have a record of any prior year unallowed losses from the passive activities of the partnership or S corporation. If you had prior year unallowed losses from these activities, they can be found in column (c) of your 2003 Worksheet 5.

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. 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

To figure your overall gain or loss from all passive activities or any passive activity, take into account only passive activity income. Do not enter income that is not passive activity income on Form 8582 or the worksheets.

Passive activity income includes all income from passive activities, including (with certain exceptions described in Temporary Regulations section 1.469-2T(c)(2) and Regulations section 1.469-2(c)(2)) gain from the disposition of an interest in a passive activity or of property used in a passive activity at the time of the disposition.

Passive activity income does not include the following.

- Income from an activity that is not a passive activity.
- Portfolio income, including interest (other than self-charged interest treated as passive activity income), dividends, annuities, and royalties not derived in the ordinary course of a trade or business, and gain or loss from the disposition of property that produces portfolio income or is held for investment (see section 163(d)(5)). See Temporary Regulations section 1.469-2T(c)(3).
- Alaska Permanent Fund dividends.
- Personal service income, including salaries, wages, commissions, self-employment income from trade or business activities in which you

materially participated for the tax year, deferred compensation, taxable social security and other retirement benefits, and payments from partnerships to partners for personal services. See Temporary Regulations section 1.469-2T(c)(4).

- Income from positive section 481 adjustments allocated to activities other than passive activities. See Temporary Regulations section 1.469-2T(c)(5).
- 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 under the rule excluding working interests in oil and gas wells from passive activities (see item 3 under *Activities That Are Not Passive Activities* on page 2). See Regulations section 1.469-2(c)(6).
- Any income from intangible property if your personal efforts significantly contributed to the creation of the property.
- Any income treated as not from a passive activity under Temporary Regulations section 1.469-2T(f) and Regulations section 1.469-2(f). See *Recharacterization of Passive Income* on this page.
- Overall gain from any interest in a PTP (see item 2 under *Special Instructions for PTPs* beginning on page 11).
- State, local, and foreign income tax refunds.
- Income from a covenant not to compete.
- Any reimbursement of a casualty or theft loss included in income as recovery of all or part of a prior year loss deduction if the deduction for the loss was not treated as a passive activity deduction.
- Cancellation of debt income to the extent that at the time the debt was discharged the debt was not properly allocable under Temporary Regulations section 1.163-8T to passive activities.

Recharacterization of Passive Income

Certain income from passive activities must be recharacterized and excluded from passive activity income. The amount of income recharacterized equals the net income from the sources given below. If during the tax year you received net income from any of these sources (either directly or through a partnership or an S corporation), see Pub. 925 to find out how to report net income or loss from these sources. For more information, see Temporary Regulations section 1.469-2T(f) and Regulations section 1.469-2(f).

Income from the following sources may be subject to the net income recharacterization rules.

- Significant participation passive activities defined on page 4.
- Rental of property if less than 30% of the unadjusted basis of the property is subject to depreciation.
- Passive equity-financed lending activities.
- Rental of property incidental to a development activity.
- Rental of property to a nonpassive activity.
- Acquisition of an interest in a pass-through entity that licenses intangible property.

Passive Activity Deductions

To figure your overall gain or overall loss from all passive activities or any passive activity, take into account only 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 PAL rules in prior tax years and carried forward to the current tax year. See Regulations section 1.469-1(f)(4).

Passive activity deductions include losses from a disposition 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. See *Dispositions* on this page for the treatment of losses upon disposition of your entire interest in an activity.

Passive activity deductions do not include the following.

- 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 (except self-charged interest treated as a passive activity deduction (discussed on page 5) and interest expenses properly allocable to passive activities).
- 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 under section 67.
- Charitable contribution deductions.
- Net operating loss deductions, percentage depletion carryovers under section 613A(d), and capital loss carryovers.
- Deductions and losses that would have been allowed for tax years beginning before 1987, but for basis or at-risk limitations.
- Net negative section 481 adjustments allocated to activities other than passive activities. See Temporary Regulations section 1.469-2T(d)(7).
- Deductions for losses from fire, storm, shipwreck, or other casualty or

from theft if losses similar in cause and severity do not recur regularly in the activity.

- The deduction allowed for one-half of self-employment taxes.

Former Passive Activities

A former passive activity is any activity that was a passive activity in a prior tax year but is not a passive activity in the current tax year. A prior year unallowed loss from a former passive activity is allowed to the extent of current year income from the activity.

If current year net income from the activity is less than the prior year unallowed loss, enter the prior year unallowed loss and any current year net income from the activity on Form 8582 and the applicable worksheets.

If current year net income from the activity is more than or equal to the prior year unallowed loss from the activity, report the income and loss on the forms and schedules normally used; do not enter the amounts on Form 8582.

If the activity has a net loss for the current year, enter the prior year unallowed loss (but not the current year loss) on Form 8582 and the applicable worksheets.

To report a disposition of a former passive activity, follow the rules below under *Dispositions*.

Dispositions

Disposition of an Entire Interest

If you disposed of your entire interest in a passive activity or a former passive activity to an unrelated person in a fully taxable transaction during the tax year, your losses allocable to the activity for the year are not limited by the PAL rules.

A fully taxable transaction is a transaction in which you recognize all realized gain or loss.

If you are using the installment method to report this kind of disposition, figure the loss for the current year that is not limited by the PAL rules by multiplying your overall loss (which does not include losses allowed in prior years) by the following fraction:

$$\frac{\text{Gain recognized in the current year}}{\text{Unrecognized gain as of the beginning of the current year}}$$

A partner in a PTP is not treated as having disposed of an entire interest in an activity of a PTP until there is an entire disposition of the partner's interest in the PTP.

Reporting an Entire Disposition on Schedule D or Form 4797

If you completely dispose of your entire interest in a passive activity or a former passive activity, you may have to report net income or loss and prior year unallowed losses from the activity. All the net income and losses are reported on the forms and schedules normally used.

Combine all income and losses (including any prior year unallowed losses) from the activity for the tax year to see if you have an overall gain or loss.

If you have an overall gain and you have other passive activities to report on Form 8582, include the income, losses, and prior year unallowed losses on Worksheet 1, 2, or 3.

If you have an overall gain and this is your only passive activity or a former passive activity, report all income and losses (including any prior year unallowed losses) on the forms and schedules normally used and do not use Form 8582.

If you have an overall loss when you combine the income and losses, do not use the worksheets or Form 8582 for the activity. All losses (including prior year unallowed losses) are allowed in full. Report the income and losses on the forms and schedules normally used.

An overall loss from an entire disposition of a passive activity is a nonpassive loss if you have an aggregate loss from all other passive activities. When figuring your modified adjusted gross income for line 7 of Form 8582, be sure to take into account the overall loss from the disposition of the activity.

Example 1. Activity with overall gain. You sell your entire interest in a rental real estate activity in which you actively participated for a gain of \$15,525. \$7,300 of the gain is section 1231 gain reported on Form 4797, Part I, and \$8,225 is ordinary recapture income reported on Form 4797, Part II. On line 23 of Schedule E (Form 1040), you report a total loss of \$15,450, which includes a current year \$2,800 net loss and a \$12,650 prior year unallowed loss. You have an overall gain from the disposition ($\$15,525 - \$15,450 = \$75$).

Because you had other passive activities reportable on Form 8582, you make the following entries on Worksheet 1. You enter the \$15,525 gain on the disposition in column (a), the current year loss of \$2,800 in column (b), and the prior year unallowed loss of \$12,650 in column (c).

Example 2. Activity with overall loss. You sell your entire interest in an oil and gas limited partnership that was your only passive activity for a gain of \$2,000. You have a current year Schedule E loss of \$3,330 and a Schedule E prior year unallowed loss of \$1,115.

Because you have an overall loss of \$2,445 after combining the gain and losses, none of the amounts are entered on Worksheet 3 or on Form 8582.

You enter the net loss plus the prior year unallowed loss ($\$3,330 + \$1,115 = \$4,445$) on Schedule E, Part II, column (h), and the \$2,000 gain on the sale on Schedule D, in either Part I or Part II, depending on how long you held the partnership interest.

Disposition of Less Than an Entire Interest

Gains and losses from the disposition of less than an entire interest in an activity are treated as part of the net income or net loss from the activity for the current year.



A disposition of less than substantially all of an entire interest does not trigger the allowance of prior year unallowed losses.

Disposition of substantially all of an activity. You may treat the disposition of substantially all of an activity as a separate activity if you can prove with reasonable certainty:

1. The prior year unallowed losses, if any, allocable to the part of the activity disposed of, and
2. The net income or loss for the year of disposition allocable to the part of the activity disposed of.

Specific Instructions

Part I—2004 Passive Activity Loss

Use Part I to combine the net income and net loss from all passive activities to determine if you have a passive activity loss (PAL) for 2004. Use Worksheets 1, 2, and 3 to determine the entries for lines 1–3 of Part I, as follows.

- Worksheet 1 is used for rental real estate activities with active participation.
- Worksheet 2 is used for commercial revitalization deductions (CRDs) from rental real estate activities (with or without active participation).
- Worksheet 3 is used for all other passive activities.

See Pub. 925 for examples showing how to complete the worksheets.

Worksheet 1

Individuals and qualifying estates who actively participated in rental real estate activities must include the income or loss from those activities in Worksheet 1 to figure the amounts to enter on lines 1a through 1c of Form 8582. Do not include any commercial revitalization deductions (CRDs) from these activities in the net income or loss reported in Worksheet 1.

Do not enter a prior year unallowed loss in column (c) of Worksheet 1 unless you actively participated in the activity in both the year the loss arose and the current tax year. If you did not actively participate in both years, enter the prior year unallowed loss in column (c) of Worksheet 3.



Married individuals who file separate returns and lived with their spouses at any time during the tax year do not qualify under the active participation rule and must use Worksheet 3 instead of Worksheet 1.

Column (a). Enter the current year net income from each activity. Enter the total of column (a) on line 1a of Form 8582.

Example. A Schedule E rental activity has current year profit of \$5,000 and a Form 4797 gain of \$2,000. You enter \$7,000 in column (a).

Column (b). Enter the current year net loss for each activity. Do not enter any prior year unallowed losses in this column. Enter the total of column (b) on line 1b of Form 8582.

If an activity has net income on one form or schedule and a net loss on another form or schedule, report the net amounts separately in columns (a) and (b) of Worksheet 1.

Example. A Schedule E rental activity has current year income of \$1,000 on line 22 of Schedule E and a current year Form 4797 loss of \$4,500. You enter \$1,000 in column (a) and (\$4,500) in column (b).

Column (c). Enter the prior year unallowed losses for each activity. You find these amounts on Worksheet 5, column (c), of your 2003 Form 8582. Enter the total of column (c) from your 2004 Worksheet 1 on line 1c of Form 8582.

Columns (d) and (e). Combine income and losses in columns (a) through (c) for each activity, and either enter the overall gain for the activity in column (d) or enter the overall loss for the activity in column (e). Do not enter amounts from columns (d) and (e) on Form 8582. These amounts will be used when Form 8582 is completed to figure the loss allowed for the current year.

Worksheet 2

Use Worksheet 2 to figure the amounts to enter on lines 2a and 2b for

commercial revitalization deductions (CRD) from rental real estate activities (see *Commercial revitalization deduction (CRD)* on page 4). Do not include the following amounts.

- Income or other deductions from the same activity. Instead, report any net income or net loss from the activity, except for the CRD, in Worksheet 1 if you actively participated in the activity or in Worksheet 3 if you did not actively participate.
- CRDs from passive activities other than rental real estate activities. Instead, report these deductions as part of the net income or loss from the passive activity in Worksheet 3.

Column (a). Enter the current year CRD from each rental real estate activity. Enter the total of column (a) on line 2a of Form 8582.

Column (b). Enter the unallowed CRDs from the prior year for each rental real estate activity. Enter the total of column (b) on line 2b of Form 8582.

Column (c). Combine the amounts in columns (a) and (b) for each activity and enter the overall loss for the activity in column (c). Do not enter amounts from column (c) on Form 8582. These amounts will be used when Form 8582 is completed to figure the loss allowed for the current year.

Worksheet 3

Use Worksheet 3 to figure the amounts to enter on lines 3a through 3c for:

1. Passive trade or business activities,
2. Passive rental real estate activities that do not qualify for the special allowance (but do not include CRDs reported in Worksheet 2), and
3. Rental activities other than rental real estate activities.

Column (a). Enter the current year net income for each activity. Enter the total of column (a) on line 3a of Form 8582. (See the example under *Column (a)* for Worksheet 1, on page 7.)

Column (b). Enter the current year net loss for each activity. Enter the total of column (b) on line 3b of Form 8582. (See the example under *Column (b)* of Worksheet 1, on page 7.)

Column (c). Enter the unallowed losses for the prior years for each activity. You find these amounts on Worksheet 5, column (c), of your 2003 Form 8582. Enter the total of column (c) from your 2004 Worksheet 3 on line 3c of Form 8582.

Columns (d) and (e). Combine income and losses in columns (a) through (c) for each activity, and either enter the overall gain for the activity in column (d) or enter the overall loss for the activity in column (e). Do not enter amounts from columns (d) and (e) on Form 8582. These amounts will be used

when Form 8582 is completed to figure the loss allowed for the current year.

Part II—Special Allowance for Rental Real Estate With Active Participation

Use Part II to figure the maximum amount of rental loss allowed if you have a net loss from a rental real estate activity with active participation.

Enter all numbers in Part II as positive amounts (that is, greater than zero).

Example. Line 5 has a loss of \$42,000 (reported as a positive amount) and line 9 is \$25,000. You enter \$25,000 on line 10 (the smaller of line 5 or line 9, both treated as positive amounts).

Line 5. Enter on line 5 the smaller of the loss on line 1d or the loss on line 4.

Example. Line 1d has a loss of \$3,000, line 2c is zero, and line 3d has a gain of \$100. The combined loss on line 4 is \$2,900. You enter \$2,900 as a positive number on line 5 (the smaller of the loss on line 1d or the loss on line 4).

Line 6. Married persons filing separate returns who lived apart from their spouses at all times during the year must enter \$75,000 on line 6 instead of \$150,000. Married persons filing separate returns who lived with their spouses at any time during the year are not eligible for the special allowance. They must enter -0- on line 10 and go to line 15.

Line 7. To figure modified adjusted gross income, combine all the amounts used to figure adjusted gross income except do not take into account:

- Passive income or loss included on Form 8582,
- Any rental real estate loss allowed to real estate professionals (defined under *Activities That Are Not Passive Activities* on page 2),
- Any overall loss from a PTP,
- The taxable amount of social security and tier 1 railroad retirement benefits,
- The deduction allowed under section 219 for contributions to IRAs and certain other qualified retirement plans,
- The deduction allowed for one-half of self-employment taxes,
- The exclusion from income of interest from series EE and I U.S. savings bonds used to pay higher education expenses,
- The exclusion of amounts received under an employer's adoption assistance program,
- The student loan interest deduction, or
- The tuition and fees deduction.

Include in modified adjusted gross income any portfolio income and

expenses that are clearly and directly allocable to portfolio income. Also include any income that is treated as nonpassive income, such as overall gain from a PTP and net income from an activity or item of property subject to the recharacterization of passive income rules. When figuring modified adjusted gross income, include any overall loss from the entire disposition of a passive activity (considered a nonpassive loss).

Example. Your adjusted gross income on line 37 of Form 1040 is \$92,000, and you have taxable social security benefits of \$5,500 on line 20b. Your modified adjusted gross income is \$86,500 (\$92,000 – \$5,500).

Line 9. Do not enter more than \$12,500 on line 9 if you are married filing a separate return and you and your spouse lived apart at all times during the year. Married persons filing separate returns who lived with their spouses at any time during the year are not eligible for the special allowance. They must enter -0- on line 10 and go to line 15.

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

Use Part III to figure the maximum amount of commercial revitalization deductions allowed if you have a commercial revitalization deduction from a rental real estate activity.

Enter all numbers in Part III as positive amounts (that is, greater than zero.)

Line 11. Enter \$12,500 (reduced by the amount, if any, on line 10) on line 11 if you are married filing a separate return and you and your spouse lived apart at all times during the year. Married persons filing separate returns who lived with their spouses at any time during the year are not eligible for the special allowance. They must enter -0- on line 14 and go to line 15.

Part IV—Total Losses Allowed

Use Part IV to figure the amount of the PAL (as determined in Part I) allowed for 2004 from all passive activities.

Line 16. Use the worksheets on Form 8582 and the following instructions for those worksheets to figure the unallowed loss to be carried forward and the allowed loss to report on your forms and schedules for 2004.

Worksheets 1, 2, and 3

Worksheets 1 and 3, columns (d) and (e), show whether an activity had an overall gain or loss. Worksheet 2, column (c), shows the overall loss for CRDs from rental real estate activities. If you have activities that show overall gain in column (d) of Worksheet 1 or 3, report all the income and losses listed in columns (a), (b), and (c) for those activities on the proper forms and schedules.

If you have activities that show an overall loss in column (e) of Worksheet 1 or 3 or column (c) of Worksheet 2, you must allocate your allowed loss on line 16 of Form 8582 to those activities by completing Worksheets 4, 5, and 6 or 7.

Complete Worksheet 4 only if you entered an amount (other than zero) on line 10 or 14 of Form 8582. Otherwise, skip Worksheet 4 and complete Worksheet 5 for all activities in Worksheets 1 or 3 that have overall losses in column (e) and all activities in Worksheet 2.

Worksheet 4

Use Worksheet 4 to allocate the special allowance on line 10 or line 14 of Form 8582 among your rental real estate activities.

In the first column of Worksheet 4, enter the name of each activity. In the second column, enter the form or schedule and line number on which the loss will be reported.

Example. You receive a Schedule K-1 from partnership P that reports losses from two rental real estate activities, Activity X and Activity Y. The losses from partnership P are reported on line 28A of Schedule E. In the first two columns of Worksheet 4, enter:

Name of Activity	Form or Schedule
Activity X	Sch E, line 28A
Activity Y	Sch E, line 28A

If the loss from an activity is reported in more than one place, identify both locations in the second column (for example, Sch E, line 28A/Form 4797, line 2). If you need additional space, show this information on an attached statement.

Enter all activities with overall losses from Worksheets 1 and 2 as follows.

- If you entered an amount on line 10, list on Worksheet 4 all activities with an overall loss in column (e) of Worksheet 1.
- If you entered an amount on line 14, list on Worksheet 4 all activities with an overall loss in column (c) of Worksheet 2.
- If you entered amounts on both lines 10 and 14 of Form 8582, you must complete two separate Worksheets 4.

For the second worksheet, you either may attach an extra copy of page 2 of Form 8582 or your own schedule in the same format as Worksheet 4. On the first Worksheet 4, list all activities with an overall loss in column (e) of Worksheet 1. On the second Worksheet 4, list all activities with an overall loss in column (c) of Worksheet 2.

Column (a). Enter the overall loss from column (e) of Worksheet 1 or column (c) of Worksheet 2 for each activity.

Column (b). Divide each of the individual losses shown in column (a) by the total of all the losses in column (a) and enter this ratio for each activity in column (b). The total of all the ratios in column (b) must equal 1.00.

Column (c). Multiply each ratio in column (b) by the amount on line 10 or line 14 of Form 8582, and enter the results in column (c). The total of column (c) must be the same as line 10 or line 14 of Form 8582.

Column (c) total is the same as column (a) total. If the total losses in column (c) are the same as those in column (a), the losses in Worksheets 1 and 2 are allowed in full and are not carried over to Worksheet 5. Report all amounts in columns (a), (b), and (c) of Worksheet 1 and columns (a) and (b) of Worksheet 2 on the proper forms and schedules.

Column (c) total is less than column (a) total. If the total losses in column (c) are less than the total losses in column (a), complete column (d).

Column (d). Subtract column (c) from column (a) and enter the results in column (d). Also enter the amounts from column (d) of Worksheet 4 in column (a) of Worksheet 5.

Worksheet 5

Complete Worksheet 5 if any activities have an overall loss in column (e) of Worksheet 3 or losses in column (d) of Worksheet 4 (in column (e) of Worksheet 1 or column (c) of Worksheet 2 if you did not have to complete Worksheet 4).

On Worksheet 5, enter the name of each activity and the form or schedule and line number on which the loss will be reported. See the example for Worksheet 4. Identify any deduction from Worksheet 2 on a separate line (even if the amount is from an activity also shown on Worksheet 1 or 3) and add "CRD" after the name of the activity.

Column (a). Enter the amounts, if any, from column (d) of Worksheet 4 (from column (e) of Worksheet 1 or column (c) of Worksheet 2 if you did not have to complete Worksheet 4). Also enter the losses, if any, from column (e) of Worksheet 3.

Column (b). Divide each of the individual losses shown in column (a) by the total of all the losses in column (a) and enter this ratio for each activity in column (b). The total of all the ratios must equal 1.00.

Column (c). Complete the following computation.

-
- A. Enter as a positive amount
line 4 of Form 8582 _____
- B. Add lines 10 and 14 of
Form 8582 _____
- C. Subtract line B from line A . . . _____
-

Multiply each ratio in column (b) by the amount on line C above, and enter the result in column (c).

Worksheets 6 and 7

These worksheets allocate your unallowed and allowed losses for each activity.

If you have losses from any activity that are reported on two or more different forms or schedules, use Worksheet 7 instead of Worksheet 6 for that activity.

Also use Worksheet 7 instead of Worksheet 6 for any activity with two or more transactions that are reported on the same form or schedule but must be separately identified for tax purposes. Transactions that must be separately identified include capital losses that are 28% rate losses and those that are not.

Note. 28% rate gain or loss includes all collectibles gains and deductible long-term losses and section 1202 gain on the sale of qualified small business stock. See the instructions for Schedule D (Form 1040) for details, including the definitions of "collectibles gains and losses" and "section 1202 gain."

Worksheet 6

Use Worksheet 6 for any activity listed in Worksheet 5 if all the loss from that activity is reported on one form or schedule and no transactions need to be identified separately (as discussed above).

Example. Use Worksheet 6 if all the loss from an activity is reported on Schedule E, even though part of the loss is a current year Schedule E loss and part of it is from a Schedule E prior year unallowed loss.

On Worksheet 6, enter the name of each activity and the form or schedule and line number on which the loss is reported. See the example for Worksheet 4. Identify each CRD from Worksheet 5 on a separate line and add "CRD" after the name of the activity.

Column (a). For each activity entered in Worksheet 6, enter the net loss plus the prior year unallowed loss for the activity. Figure this amount by adding the losses in columns (b) and (c) of

Worksheets 1 and 3 or enter the loss from column (c) of Worksheet 2.

Column (b). For each activity entered in Worksheet 6, enter the amount from column (c) of Worksheet 5 for the activity. These are your unallowed losses for 2004. Keep a record of these amounts so the losses can be used to figure your PAL next year.

Column (c). Subtract column (b) from column (a). These are your allowed losses for 2004. Report the amounts in this column on the forms and schedules normally used.

See the forms and schedules listed under *How To Report Allowed Losses* beginning on this page. Also, see Pub. 925 for an extensive example of how to report passive income and losses on the forms and schedules.

Worksheet 7

Use Worksheet 7 for any activity listed in Worksheet 5 that has losses that are reported on two or more different forms and schedules or on different parts of the same form or schedule (for example, 28% rate and non-28%-rate capital losses reported on Schedule D). Worksheet 7 allocates the allowed and unallowed loss for the activity and allocates the allowed loss to the different forms or schedules (or different parts of the same form or schedule) used to report the losses.

Only losses that would cause a difference in tax liability if they were reported on a different form or schedule or on different parts of the same form or schedule are kept separate. Those forms, schedules, and parts are:

- Schedules C, E, and F.
- Schedule D (Parts I and II (28% rate losses and non-28%-rate losses)).

Note. You must make a separate entry in Schedule D, Part I or Part II, for each transaction reported. See the Instructions for Schedule D (Form 1040).

- Forms 4684 (Section B), 4797 (Parts I and II), and 4835.

Use a separate copy of Worksheet 7 for each activity for which you have losses reported on two or more different forms or schedules or different parts of the same form or schedule (for example, 28% rate and non-28%-rate capital losses reported on Schedule D).

On Worksheet 7, enter the form or schedule and line number on the dotted line above each line 1a (for example, Schedule D, line 12, to report a 28% rate loss from a partnership).

Line 1a, column (a). Enter the net loss plus any prior year unallowed loss from the activity that is reported on the same form or, in the case of Schedule D and Form 4797, the same part.

If you have a Schedule D 28% rate loss and a Schedule D non-28%-rate loss, see *Example of Schedule D (Form*

1040) transactions on this page before completing Worksheet 7.

Line 1b, column (a). Enter any net income from the activity that is reported on the same form or schedule (or on the same part of the same form or schedule) as the loss on line 1a, column (a).

Example. You enter a prior year unallowed loss from Form 4797, Part I, on line 1a. If the activity has a current year Form 4797, Part I, gain, enter the gain on line 1b, column (a). If the activity does not have a Form 4797, Part I, gain, enter -0- on line 1b, column (a).

Line 1c, column (b). Subtract line 1b, column (a), from line 1a, column (a), and enter the result in column (b). If line 1b, column (a), is more than line 1a, column (a), enter -0- in column (b).

Column (c). Divide each of the losses entered in column (b) by the total of column (b) and enter the ratio in column (c). The total of this column must be 1.00.

Column (d). Multiply the unallowed loss for this activity, found in Worksheet 5, column (c), by each ratio in column (c) of Worksheet 7. If -0- is entered in column (b) of Worksheet 7, also enter -0- for that form or schedule in column (d).

The amount in column (d) is the unallowed loss for 2004. Keep a record of this worksheet so you can use the losses to figure your PAL next year.

Column (e). Subtract the amount in column (d) from the loss entered on line 1a, column (a). This is the allowed loss for 2004 to enter on the forms or schedules. The forms and schedules you use must show the losses from this column and the income, if any, for that activity from column (a) of Worksheet 1 or Worksheet 3.

Example of Schedule D (Form 1040) transactions. The taxpayer had the following Schedule D (Form 1040) transactions from passive activities in 2004.

Activity I

A passive activity prior year unallowed long-term capital loss (a 28% rate loss) of \$1,000 and a current year long-term capital loss (a non-28%-rate loss) of \$3,000.

Activity II

A current year collectibles loss (a 28% rate loss) of \$230 and net income of \$1,100 from Schedule E (Form 1040).

Worksheet 3

Activity I has an overall loss of \$4,000 (current year long-term capital loss of \$3,000 and a prior year unallowed long-term capital loss of \$1,000). Activity II has an overall gain of \$870 (current year net income of \$1,100 less a current year long-term

capital loss of \$230). Line 16 of Form 8582 shows an allowed loss of \$1,100.

Since Activity II has an overall gain, the amounts shown in columns (a) and (b) of Worksheet 3 for that activity are reported on the proper forms and schedules and are not shown on any other worksheet.

Worksheet 5

Activity I has an unallowed loss of \$3,130 (line 4 of Form 8582 (\$3,130) less the sum of lines 10 and 14 of Form 8582 (-0-) x 100%).

Worksheet 7

This worksheet is used to figure the portion of the unallowed loss attributable to the 28% rate loss and the portion attributable to the non-28%-rate loss.

The loss attributable to the 28% rate loss (\$1,000) and the loss attributable to the non-28%-rate loss (\$3,000) are separate entries in Worksheet 7. The ratio of each loss to the total of the two losses is figured as follows. $\$1,000/\$4,000 = .25$. $\$3,000/\$4,000 = .75$. Each of these ratios is multiplied by the unallowed loss for Activity I, shown in column (c) of Worksheet 5 (\$3,130).

Unallowed losses for Activity I:

- 28% rate loss: $.25 \times \$3,130 = \782.50 .
- Non-28%-rate loss: $.75 \times \$3,130 = \$2,347.50$.

Allowed losses for Activity I:

- 28% rate loss: $\$1,000 - \$782.50 = \$217.50$.
- Non-28%-rate loss: $\$3,000 - \$2,347.50 = \$652.50$.

The total loss allowed for Activity I (\$870) is entered in Part II of Schedule D (Form 1040). The 28% rate loss (\$217.50) is entered on the 28% Rate Gain Worksheet (see Schedule D instructions for line 18). Keep a record of the unallowed 28% rate and non-28%-rate losses to figure the PAL for these transactions next year.

See the forms and schedules listed under *How To Report Allowed Losses* beginning below. Also, see Pub. 925 for an extensive example of how to report passive income and losses on the forms and schedules.

How To Report Allowed Losses

Line 4 is income. If line 4 of Form 8582 shows net income or zero, all the losses in columns (b) and (c) of Worksheets 1 and 3 and all the deductions in columns (a) and (b) of Worksheet 2 are allowed in full. Report the income and losses in columns (a), (b), and (c) of Worksheets 1 and 3 and deductions in columns (a) and (b) of Worksheet 2 on the forms and schedules normally used.

Line 16 is the same as the total of lines 1b, 1c, 2a, 2b, 3b, and 3c. In this case also, all the losses in columns (b) and (c) of Worksheets 1 and 3 and all the deductions in columns (a) and (b) of Worksheet 2 are allowed in full. Report the income and losses in columns (a), (b), and (c) of Worksheets 1 and 3 and deductions in columns (a) and (b) of Worksheet 2 on the forms and schedules normally used.

Columns (a) and (c) of Worksheet 4 are the same amount. In this case, all the losses in columns (b) and (c) of Worksheet 1 and all the deductions in columns (a) and (b) of Worksheet 2 are allowed in full. Report the income and losses in columns (a), (b), and (c) of Worksheet 1 and the deductions in columns (a) and (b) of Worksheet 2 on the forms and schedules normally used.

Losses allowed in column (c) of Worksheet 6. The amounts in column (c) of Worksheet 6 are the losses or deductions allowed for 2004 for the activities listed in that worksheet. Report the loss allowed from column (c) of Worksheet 6 and the income, if any, for that activity from column (a) of Worksheet 1 or 3, on the form or schedule normally used.

Losses allowed in column (e) of Worksheet 7. The amounts in column (e) of Worksheet 7 are the losses or deductions allowed for 2004 for the activity listed on that worksheet. Report the losses allowed from column (e) of Worksheet 7 and the income, if any, for that activity from column (a) of Worksheet 1 or 3, on the forms or schedules normally used.

Schedules C and F, and Form 4835. Enter on the net profit or loss line of your schedule or form the allowed passive loss from the worksheet. To the left of the entry space enter "PAL."

If the net profit or loss line on your form or schedule shows net profit for the year, reduce the net profit by the allowed loss from Worksheet 6 or 7, and enter the result on the net profit or loss line.

Example. Schedule C shows net profit for the year of \$5,000 from a passive activity. The activity also has a Form 4797 gain of \$2,500 and a prior year unallowed Schedule C loss of \$6,000. The loss allowed for 2004 is \$6,000. You enter a net loss of \$1,000 on line 31 of Schedule C (the \$5,000 net profit for the year less the \$6,000 loss allowed for the year). To the left of the entry space, you enter "PAL."

See *Schedule D and Form 4797* instructions on this page if you also had passive gains and losses from the sale of assets or of an interest in a passive activity.

Schedule E, Part I. Enter the allowed loss from the worksheet on line 23 of Schedule E. An activity that has net

profit for the year and prior year unallowed losses will have net profit on line 22 and the allowed loss on line 23. The allowed loss on line 23 will include the loss allowed to the extent of the net profit. Line 24 of Schedule E will show total net profit and line 25 will show total losses allowed (both passive and nonpassive). Line 26 will show the total net profit or loss.

Schedule E, Parts II and III. Any net income shown on your Schedule K-1 that is passive income must be entered as passive income in the appropriate column of Schedule E, Part II or III. Enter the passive loss allowed from Worksheet 6 or 7 in the appropriate column for passive losses. The passive losses allowed include the loss allowed to the extent of any net income from the activity. Passive net income or loss reportable on Schedule E, Part II, includes any self-charged interest income and deductions treated as passive activity income and deductions.

See *Schedule D and Form 4797* instructions on this page if you also had passive gains or losses from the sale of assets or of an interest in a passive activity.

Form 4684, Section B. Any passive activity gain from Form 4684 is unchanged. It was used on Form 8582 to determine allowable PALs. If you do not have passive losses on Form 4684, complete Form 4684 and follow the instructions for that form for where to report the gain.

If you have passive losses on Form 4684, cross through the amount you first entered on line 31, 32, 38a, 38b, or 39 of that form, and enter the allowed loss from the worksheet. To the left of the entry space, enter "PAL."

Schedule D and Form 4797. If you sold assets from a passive activity or you sold an interest in your passive activity, all gains from the activity must be entered on the appropriate line of Schedule D or Form 4797. Identify the gain as "FPA." Enter any allowed losses for Schedule D or Form 4797 on the appropriate line, and to the left of the entry space, enter "PAL."

Entire disposition with an overall loss. If you made an entire disposition of your interest in a passive activity and that activity had an overall loss, none of the gains, if any, or losses were entered on Form 8582 or the worksheets. However, all the gains and losses must be reported on the forms or schedules normally used. To the left of the entry space, enter "EDPA."

Entire disposition with an overall gain. Gains and losses from this activity were included on Form 8582 so that the gains might offset other PALs. Report all the gains and losses on the forms and schedules normally used, and to the left of the entry space, enter "EDPA."

Publicly Traded Partnerships (PTPs)

A PTP is a partnership whose interests are traded on an established securities market or are readily tradable on a secondary market (or its substantial equivalent).

An established securities market includes any national securities exchange and any local exchange registered under the Securities Exchange Act of 1934 or exempted from registration because of the limited volume of transactions. It also includes any over-the-counter market.

A secondary market generally exists if a person stands ready to make a market in the interest. An interest is treated as readily tradable if the interest is regularly quoted by persons, such as brokers or dealers, who are making a market in the interest.

The substantial equivalent of a secondary market exists if there is no identifiable market maker, but holders of interests have a readily available, regular, and ongoing opportunity to sell or exchange interests through a public means of obtaining or providing information on offers to buy, sell, or exchange interests. Similarly, the substantial equivalent of a secondary market exists if prospective buyers and sellers have the opportunity to buy, sell, or exchange interests in a timeframe and with the regularity and continuity that the existence of a market maker would provide.

Special Instructions for PTPs

Section 469(k) provides that the passive activity limitations must be applied separately to items from each PTP. PALs from a PTP generally may be used only to offset income or gain from passive activities of the same PTP. The special allowance (including CRDs) for rental real estate activities does not apply to PALs from a PTP.

Passive activity loss rules for partners in PTPs. Do not report passive income, gains, or losses from a PTP on Form 8582. Instead, use the following rules to figure and report your income, gains, and losses from passive activities you held through each PTP you owned during the tax year.

1. Combine any current year income, gains and losses, and any prior year unallowed losses to see if you have an overall loss from the PTP. Include only the same types of income and losses you would include to figure your net income or loss from a non-PTP passive activity. See *Passive Activity Income and Deductions* on page 5.

2. If you have an overall gain, the net gain portion (total gain minus total losses) is nonpassive income.

It is important to figure the nonpassive income because it must be included in modified adjusted gross income to figure the special allowance for active participation in a non-PTP rental real estate activity on Form 8582. Also, you may be able to include the nonpassive income in investment income when figuring your investment interest expense deduction. See Form 4952, Investment Interest Expense Deduction.

Report all gains and allowed losses from the activity on the forms or schedules normally used, and to the left of each entry space, enter "From PTP."

Example. You have Schedule E income of \$8,000 and a Form 4797 prior year unallowed loss of \$3,500 from the passive activities of a PTP. You have a \$4,500 overall gain (\$8,000 – \$3,500) that is nonpassive income. On Schedule E, Part II, you report the \$4,500 net gain as nonpassive income in column (j). In column (g), you report the remaining Schedule E gain of \$3,500 (\$8,000 – \$4,500) as passive income. On the appropriate line of Form 4797, you report the prior year unallowed loss of \$3,500. You enter "From PTP" to the left of each entry space.

3. If you have an overall loss (but did not dispose of your entire interest in the PTP to an unrelated person in a fully taxable transaction during the year), the losses are allowed only to the extent of the income, and the excess loss is carried forward to use in a future year if you have income to offset it. Report as a passive loss on the schedule or form you normally use the portion of the loss equal to the income. Report the income as passive income on the form or schedule you normally use.

Example. You have a Schedule E loss of \$12,000 (current year losses plus prior year unallowed losses) and Form 4797 gain of \$7,200 from the passive activities of a PTP. You report the \$7,200 gain on the appropriate line of Form 4797. On Schedule E, Part II,

you report \$7,200 of the losses as a passive loss in column (f). You carry forward to 2005 the unallowed loss of \$4,800 (\$12,000 – \$7,200).

If you have unallowed losses from more than one activity of the PTP or from the same activity of the PTP that must be reported on different forms or schedules, allocate the unallowed losses on a pro rata basis to figure the amount allowed for each activity or on each form or schedule.



To allocate and keep a record of the unallowed losses, use Worksheets 5, 6, and 7 of Form 8582.

List each activity of the PTP in Worksheet 5. Enter the overall loss from each activity in column (a). Complete column (b) of Worksheet 5 according to its instructions. Multiply the total unallowed loss from the PTP by each ratio in column (b) and enter the result in column (c) of Worksheet 5.

Next, complete Worksheet 6 for each activity listed in Worksheet 5 if all the loss from that activity is reported on one form or schedule. Use Worksheet 7 instead of Worksheet 6 for each activity with losses reported on two or more different forms or schedules (or on different parts of the same form or schedule). Enter the net loss plus any prior year unallowed losses in column (a) of Worksheet 6 (or Worksheet 7 if applicable). The losses in column (c) of Worksheet 6 (column (e) of Worksheet 7) are the allowed losses to report on your forms or schedules. Report these losses and any income from the PTP on the forms and schedules normally used.

4. If you have an overall loss and you disposed of your entire interest in the PTP to an unrelated person in a fully taxable transaction during the year, your losses (including prior year unallowed losses) allocable to the activity for the year are not limited by the passive loss rules. A fully taxable

transaction is one in which you recognize all your realized gain or loss. Report the income and losses on the forms and schedules normally used.

For rules on the disposition of an entire interest reported using the installment method, see *Disposition of an Entire Interest* on page 6.

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