If any business ventures are passive activities, the passive activity loss rules prevent you from deducting any expenses that are generated by those passive activities in excess of the income from those activities. You can't deduct the excess expenses—the losses—against your earned income or against any other nonpassive income. Unfortunately, nonpassive income for this purpose includes passive-sounding income such as interest, dividends, annuities, royalties, gains and losses from most dispositions of property, and income from certain working interests in oil and gas properties. So you can't deduct passive losses against those income items either.

Any losses that you can't use in a particular year because of these rules aren't lost; instead, they're carried forward, indefinitely, to tax years in which your passive activities generate enough income to absorb the losses. To the extent your passive losses from an activity aren't used up in this fashion, you will be allowed to use those losses in the tax year in which you dispose of your entire interest in the passive activity in a fully taxable transaction, or in the tax year you die.

Passive activities are trades or businesses, or income-producing activities, in which you don't "materially participate" (defined below—and for special rules governing your rental activities, see further below). The passive activity loss rules also apply to any items passed through to you by partnerships in which you're a partner, or by S corporations in which you're a shareholder. This means that any losses passed through to you by partnerships or S corporations will be treated as passive, unless, for you, the partnership or S corporation activities aren't passive. For example, let's say that in addition to your regular professional or salaried activities you are:

- a limited partner in a partnership that provides cleaning services to office buildings;
- a general partner in a partnership that operates an automobile dealership (but you don't participate in the dealership's operations); and
- a shareholder in an S corporation that operates a manufacturing business (but you don't participate in the business's operations).

If you don't materially participate in the partnerships, or S corporation, those activities would be passive. As a result, you wouldn't be able to deduct the losses they throw off against your earned income, interest, dividends, etc.

If you "materially participate" in an activity, on the other hand, the activity isn't passive (except for rental activities, as discussed below), and the passive activity rules won't apply to the losses from the activity. To materially participate in an activity, you must be involved in the operations of the activity on a regular, continuous, and substantial basis. IRS uses several tests to establish material participation in an activity. Under the most frequently used of these tests, you're treated as materially participating in an activity if you participate in it for more than 500 hours in the tax year. While other tests require fewer hours, all the tests require you to establish how you participated in the activity, and the amount of time you spent doing so. You may establish these factors by any reasonable means. But the most reliable substantiation consists of contemporaneously kept appointment books, calendars, daily time reports, logs, or similar documents. If you fail to substantiate your material participation, you might well lose the right to treat an activity as nonpassive.

Your rental activities are automatically treated as passive, regardless of how much you participate. This means that, even if you materially participate in these activities, you can't deduct the losses from these activities against your earned income, interest, dividends, etc. There are two significant exceptions to this rule:

- You can deduct up to $25,000 of losses from your rental real estate activities (even though these are passive) against your earned income, interest, dividends, etc., if you “actively participate” in the activities (requiring less participation than “material participation”) and if your adjusted gross income doesn't exceed specified levels.
- If you qualify as a “real estate professional” (which requires the performance of substantial services in real property trades or businesses), your rental real estate activities are not automatically treated as passive, so losses from those activities can be deducted against earned income, interest, dividends, etc., if you materially participate in the activities.