

PASSIVE INCOME EXPLAINED FOR TAX PURPOSES

Every non-participating real estate investor wants a diversified portfolio with a steady passive income stream. Passive income investors want their money to work for them without any involvement in property and business operations.

Passive income is taxable, but it is taxed at lower rates than “active” income if the investor understands and avoids the mechanisms that reclassify passive income as active. Active income is ordinary income taxed at the investor’s marginal rate.

The focus of this article is to explain how passive income is taxed and how to avert the reclassification of passive income by the IRS.

KEY TAKEAWAYS

- Passive income is taxable but can be taxed at lower rates.
- Passive investors must understand the mechanisms the IRS uses to reclassify passive income as active.
- Passive investors do not need to be real estate professionals to invest in an income-producing property.
- The investor’s holding period for an asset determines how the income is classified and taxed.

THE IRS DEFINITION

Income is categorized into two main groups: active and passive.

Active income is earned through wages reported on a W-2, commissions, profits earned from a side gig, and ordinary interest and dividends from investments. In other words, the taxpayer “worked” for the income and was actively involved in the work that generated the revenue.

Although ordinary interest and dividends are earned from passive sources, the IRS recognizes these income types as active due to their liquidity and availability to the investor. Only qualified dividends are recognized as passive income and taxed at lower rates.

Passive income is produced when the investment works for the earnings—not the investor. Rent paid by tenants, cash distributions from business operations, and value appreciation when the asset is sold at a gain are all examples of passive income.

Therefore, the key to maintaining a passive income category is for the investor to refrain from participating in the operations or being involved in the day-to-day management of the business. The investor must rely on the managing partner’s skill sets to produce risk-adjusted returns.

The less the investor is involved in the operations, the lower the tax rate.

TAX RATES ON PASSIVE INCOME

The rates applied to passive income depend on the investment's holding period and the investor's taxable income and filing status. Assets held for less than one year are short-term investments. Any cash distribution and profits from the sale are taxed as ordinary income. The higher marginal tax rate offsets the early access to earnings.

Earnings from assets held for the short term are recognized as ordinary income and taxed at the investor's marginal rate.

Assets held for one year or longer are a long-term holding. The cash distributions and the profits from a sale are recognized as passive income and taxed at lower rates.

Below is a comparison chart of tax rates and the taxable income thresholds for short- and long-term holding periods.

Taxpayers Single or Married Filing Separately in 2025

Taxable Income	Short-Term Marginal Rates	Long-Term Capital Gains Rates
≤ \$11,925	10%	0%
\$11,926 - \$48,475	12%	0%
\$48,486 - \$103,350	22%	15%
\$103,351 - \$197,300	24%	15%
\$197,301 - \$250,525	32%	15%
\$250,526 - \$626,350	25%	15%
\$626,351+	37%	20%

Taxpayers Married Filing Jointly in 2025

Taxable Income	Short-Term Marginal Rates	Long-Term Capital Gains Rates
≤ \$23,850	10%	0%
\$23,851 - \$96,950	12%	0%
\$96,951 - \$206,700	22%	15%
\$206,701 - \$394,600	24%	15%
\$394,601 - \$501,050	32%	15%
\$501,051 - \$751,600	25%	15%
\$751,601+	37%	20%

Source: IRS

PASSIVE VS ACTIVE INCOME IN REAL ESTATE INVESTING

The IRS will consider four factors to determine whether income is passive or active. In general, these drivers are based on the time spent and the expertise brought to the investment.

The drivers are Time, Risk, Management Control, and Expertise.

Time. The investor who spends the time to identify the property, negotiate the purchase, and manage the asset is recognized by the IRS as the general partner or managing member of the owning entity. Ordinarily, managing partners are paid a salary or a guaranteed payment in



addition to their cash distributions. The terms of the operating or partnership agreement will dictate the payment methods and income classification.

Typically, salaries and guaranteed payments are classified as active income, and distributions are classified as passive income.

The non-participating investors are the limited partners or minority members and hold a small ownership share. These partners have no involvement in the operations or the decision-making process. Capital is their only contribution to the entity.

The distributions to these partners are classified as passive income by the IRS and taxed at long-term rates if the asset is held for one year or more.

Risk. While there is risk in any investment, the active investors bear the most of it. The risk to the passive investor is spread across the active investors and the other limited partners. Their risk is limited to their capital contribution.

Management Control. Since active investors bear most of the risk, they naturally want control over management and day-to-day decisions.

Limited partners and minority members have no control over the assets, and, typically, real estate is not their primary profession. Therefore, partners with a minority ownership share depend upon the expertise of the managers for the success of the investment.

Expertise. The negotiating and analytical skills to identify a property with the highest potential for a lucrative investment are those of the general and managing partners. These partners are real estate professionals who make their careers managing the asset's life cycle.

Therefore, passive investors do not need to be real estate professionals to invest. Their investment is in both the property's potential and the trust in the managing partners.

BENEFITS AND RISKS OF PASSIVE INVESTING

Passive investors must understand that the work and expertise of the managing partners must be compensated. This compensation is an operating expense and will dilute the cash distributions to the minority investors.

Compensation to the managing partners is defined in the offering memorandum. Full transparency and thorough due diligence by the minority partners are key.

The passive investor cannot become involved in the "business" of the investment. Acting within the bounds of a limited partner will guide the IRS's classification of passive income and maintain the limited risks associated with minority partners.

It becomes a slippery slope when the IRS reclassifies a minority partner as a manager.

INVESTING WITH REM CAPITAL PARTNERS



Investors with a low risk tolerance who seek high-quality assets must invest in a professionally managed blind pool offering, where transparency is the core business model.

No representations or warranties are made regarding the tax consequences of any investment. Investors are strongly encouraged to seek advice from their personal CPA, tax advisor, and legal counsel before making any investment decision.