



TAX BENEFITS AND IMPLICATIONS FOR PASSIVE INVESTORS IN REAL ESTATE SYNDICATIONS

A savvy real estate investor will diversify their portfolio with active and passive income. Investors in the real estate business who have an active role in property operations and decision-making are classified by the IRS as active.

However, this article focuses on the passive investor without an active role in the property's operations or the business matters of the owning entity. Passive investors want their holdings to work for them, and their distributions to be earned with limited liability and without time commitment. Passive investors provide only the equity cash contribution to the capital stack.

KEY TAKEAWAYS

- Passive investors want their investments to work for them with limited liability and risk exposure.
- There are three income categories: active, portfolio, and passive.
- Passive investors who actively participate in property operations risk losing their limited liability exposure.
- Passive investors do not have the most advantageous tax benefits, but have the least risk exposure.
- Passive income is only subject to income taxes, not FICA.

Tax benefits and considerations exist for a passive investor with a limited partner role. The tax implications involve:

- income categories,
- classifications, and
- the role in the syndicated entity.

Each of these implications is discussed below.

Income Categories Recognized by the IRS

The IRS places income into three categories: active, portfolio, and passive. Before an investor makes their equity contribution, they must understand the tax treatments of these income categories.

Active (Non-Passive) Income

Active income is earned. The taxpayer holds a W-2 wage-earning position or actively owns a business. Under certain conditions, revenue generated from a real estate investment can also be classified as active.



Distributions to an investor can be reclassified as active and taxed as ordinary income under IRS rules. A passive investor must understand how their distributions could be re-classified.

All active income is subject to income taxes and Social Security and Medicare contributions (FICA).

Portfolio Income

Earnings from savings and certain investment accounts, bonds, and stocks qualify as portfolio income. As a general statement, portfolio losses can only reduce portfolio gains.

It is important to note that accounts, stocks, and bonds are passive sources of income, but the IRS taxes these incomes differently.

Interest earned from savings and certain investment accounts is categorized as active income from a passive source. Therefore, the income from these passive sources is subject to income taxes and FICA.

Passive Income

Passive income is only subject to income taxes, not FICA.

This income category is generated from passive sources. Rent from income-producing properties, distributions paid to a passive investor, and royalties are passive income. This category is relevant to most real estate investors.

As a general statement, passive losses can reduce only passive income.

Tax Classifications of Real Estate Investors

It is also important for a passive investor to know the three classifications the IRS uses for investors. As mentioned above, an investor could enter an investment as a limited partner, only to be reclassified by the IRS because of the investor's actions and role in the operations.

The IRS classifies real estate investors as:

- a Real Estate Professional,
- Active, or
- Passive.

The above classifications are in order from the most to least advantageous from the perspective of tax benefits, but not from the risk perspective.

These classifications are explained below.



Real Estate Professional

“Real Estate Professional (REP)” is specific to the IRS and not a designation in the real estate industry. An investor who is a licensed Realtor may not be recognized as an REP. This designation is considered for each investment, and the investor must prove their qualifications annually. REP is not a permanent classification.

The qualifications are in the tax code and are subject to change. The specific tax benefits specific to an REP are beyond the scope of this article.

For now, understand that higher risk offsets the most beneficial tax advantages. REPs do not have the benefit of limited liability. Most often, REPs have full risk exposure associated with the investment, and their financial risk can be more than their initial investment.

However, there is no limit on applying passive losses across a portfolio.

Active Investor

From a tax perspective, active investors have more tax advantages than passive investors, but not as advantageous as those of an REP.

The IRS can classify an investor as active without meeting the criteria of an REP.

The role of active investors in income-producing properties is that of a property manager. They qualify tenants, approve lease agreements, and have hands-on responsibilities concerning the budget and operations.

The most significant tax benefit to an active investor is the partial reclassification of passive losses to non-passive losses. An active investor can apply up to \$25,000 of passive losses to active income.

By way of example, let’s say an active investor has:

- \$30,000 of passive losses
- \$25,000 passive loss threshold
- \$15,000 of taxable passive income
- \$50,000 of taxable active income

Because the IRS classifies the investor as active, \$25,000 of the passive losses can be applied as follows:

Taxable Passive Income	\$15,000	Taxable Active Income	\$50,000
Allocation of Passive Losses	(\$15,000)	Remaining Allocation of Losses	(\$10,000)
Passive Income Subject to Tax	\$0	Taxable Active Income	\$40,000



Passive Loss Carryover	\$5,000*		
------------------------	----------	--	--

*[\$30,000 – (\$15,000 + \$10,000)]

Passive Investor

If a passive investor experiences losses at the end of a tax year, these losses can only offset passive income. In no instance can passive losses be applied to active income.

If passive income is less than the losses, the balance is carried forward to future tax years with passive income to offset.

By way of example, let's say a passive investor has:

- \$20,000 in passive losses
- \$5,000 in taxable passive income
- \$100,000 of taxable active income

The passive losses would be applied as follows:

Taxable Passive Income	\$5,000	Taxable Active Income	\$100,000
Allocation of Passive Losses	(\$5,000)	Allocation of Passive Losses	\$0
Taxable Passive Income	\$0	Taxable Active Income	\$100,000
Passive Loss Carryover	\$15,000*		

*(\$20,000 - \$5,000)

Passive investors consider the value of their time and tolerance to risk. Most often, these investors have careers outside of real estate and do not have the expertise or the ambition to commit time to their real estate holdings.

Passive investors with careers outside of real estate would not qualify under the IRS's definition of REP or active investor.

The risk to passive investors is limited to their initial investment without additional cash calls during operations. The investment offering documents define an investor's risk exposure.

Tax Implications of Real Estate Syndications

Overview

A real estate syndication is the investment vehicle for an investor group to pool their initial investments as the total equity contribution. These opportunities are commonly structured as an LLC or a limited partnership. Passive investors are the limited partners or the minority members.

Equity investors consider the earning potential of a property and the expertise of the general partner (the active investor) to achieve a successful investment.



The limited partners have an ownership interest in the underlying asset and have access to high-end properties that normally would be out of the reach of individual investors.

Tax Implications

Syndications provide two sources of passive income: cash flow from operations and proceeds from the property's sale. A limited partner's prorated share of earnings is typically the percentage of ownership in the asset, unless otherwise provided in the offering documents.

As a limited partner, all income and losses are passive. Therefore, the income can only be reduced by the losses generated from the investment. The passive losses cannot be applied to active income. This taxable income will only be subject to income taxes, not FICA.

A limited partner's share of sale proceeds is the same percentage applied to income and losses, unless the offering documents provide otherwise. The IRS will recognize the capital gain as passive portfolio income. Any remaining carryover losses will reduce the proceeds.

The net gain will be taxed at the appropriate 0%, 15%, or 20% rate, often lower than the investor's marginal rate used to tax ordinary income.

Conclusion

Passive investors can build personal and generational wealth over time with less risk and time commitment.

It is rare for an investor with a career outside of real estate to be reclassified as an active investor, or to have their passive income reclassified as active.

It is the REP or active investor who enters an investment passively but, over time, begins to take an active role in the operations and involves themselves with property management functions that run the risk of reclassification by the IRS. Reclassified investors lose their limited liability and will become exposed to all risks associated with the investment.

All investors must consider the tax implications across their portfolio to build a balanced and diversified income stream at tolerable risk levels.

Investing with REM Capital Partners

Investors with a lower 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.