INVESTOR EDUCATION GUIDE

Understanding Your K-1 and Tax Benefits in Real Estate Investing

Depreciation, Passive Losses, Real Estate Professional Status - and how debt fund income is taxed — in plain language.

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This guide is for general informational purposes only and does not constitute tax, legal, or accounting advice. Always consult a qualified CPA for guidance specific to your situation.

What's Inside

This guide is written for accredited investors who receive K-1s from real estate partnerships, funds, or syndications. It explains general tax concepts in plain language. Tax rules are complex, fact-specific, and change frequently. Nothing here constitutes tax advice. Work with your own CPA for guidance that applies to your specific situation.

Introduction

Why Your K-1 Looks the Way It Does

Every year, investors who hold interests in real estate partnerships and funds receive a document that raises the same question: ***Why does this show a large loss when I know the investment is performing?***

The answer almost always comes down to depreciation a non-cash tax deduction that reduces taxable income on paper without any money actually leaving the investment. It is one of the most powerful and most misunderstood features of real estate as an asset class.

But depreciation losses are not automatically usable. Whether you can deduct them, and against what kind of income, depends on how the IRS classifies your activity and your level of participation in it. Those rules are the subject of this guide.

KEY CONCEPT

Three things determine what you can do with your K-1 losses:

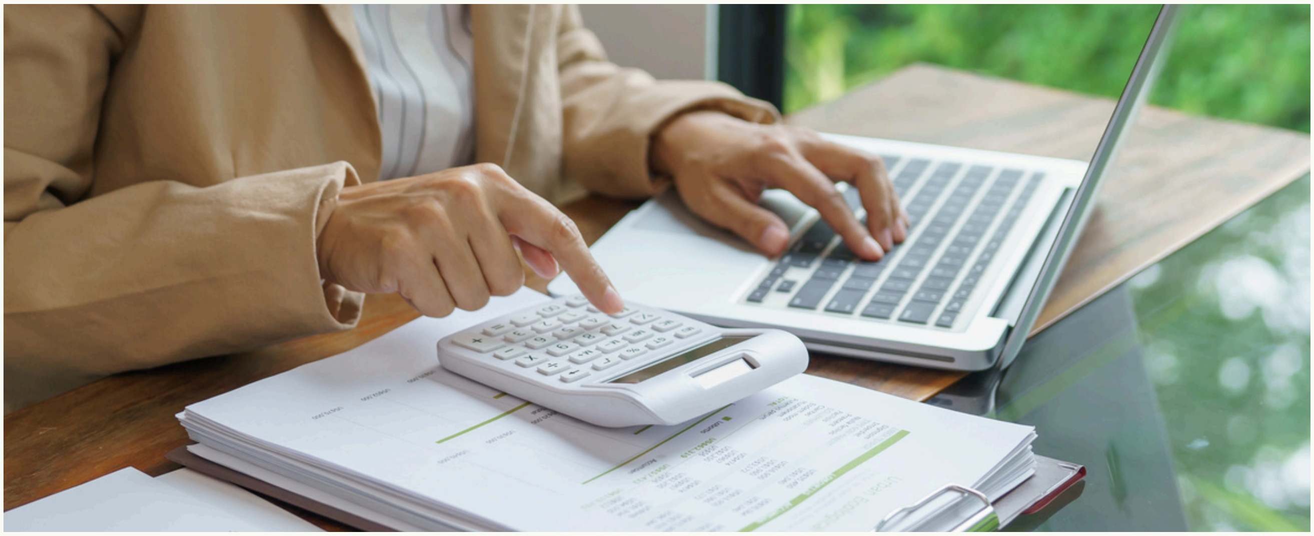
(1) whether you have passive income to absorb them,

(2) whether you qualify as a Real Estate Professional, and

(3) what type of investment generated them.

This guide explains all three.

This is not a simple subject, and a short guide cannot substitute for a CPA who knows your full picture. What this guide can do is give you a foundation, so when you sit down with your tax advisor, you are asking the right questions.



Part 1

What Is a K-1 and How Do You Read It?

If you invested in a real estate syndication, fund, or partnership, you receive a Schedule K-1 (Form 1065) instead of a 1099. The K-1 is how the partnership reports your proportionate share of the entity's income, losses, deductions, and credits for the year.

Unlike a W-2 or 1099, a K-1 does not represent money paid to you. It represents your share of the partnership's tax activity, which may look very different from the cash distributions you received. The partnership itself pays no income tax. You do, on your share of what the entity earned, lost, or deducted.

Key boxes you will commonly see:

Box	What It Represents	Where It Goes on Your 1040
Box 1	Ordinary business income (loss)	Schedule E, Part II
Box 2	Net rental real estate income (loss)	Schedule E, Part II
Box 5	Interest income	Schedule B
Box 9a	Long-term capital gain (loss)	Schedule D
Box 11	Section 1231 gains / other income	Form 4797 / Schedule D
Box 13W	Section 179 deduction	Form 4562
Box 20Z	Section 199A (QBI) information	Form 8995

TIP

Timing note: Partnership returns (Form 1065) are due March 15, with a six-month extension to September 15. Many real estate funds file on extension, meaning K-1s may not arrive until late summer. If you are waiting on a K-1, file a personal extension (Form 4868, due April 15) to avoid late-filing penalties. This is free and takes minutes.

Cash distributions from a partnership are generally **not a taxable event on their own.** They are a return of capital. You are taxed on your share of the partnership's economic activity, not just on what hit your bank account. That said, distributions do reduce your tax basis in the partnership, which matters when the property eventually sells.

TIP

Save every K-1 you receive for as long as you hold an interest, and for several years after you exit. Your cost basis calculation at sale depends on your cumulative K-1 history. Missing early K-1s creates real problems when the property eventually sells.

Part 2

Depreciation — The Paper Loss Explained

Depreciation is the IRS's recognition that physical real estate wears out over time. It allows the owner to deduct a portion of the property's value each year as a non-cash expense, meaning no money leaves the investment, but taxable income is reduced.

Residential rental property is depreciated over 27.5 years. Commercial property is depreciated over 39 years. A $1 million commercial building generates roughly $25,600 per year in depreciation deductions, reducing the partnership's taxable income even when the property is cash-flowing well.

Cost Segregation — Accelerated Depreciation

Many real estate partnerships conduct a **cost segregation study,** an engineering analysis that reclassifies components of a building (flooring, lighting, landscaping, etc.) into shorter depreciation categories of 5, 7, or 15 years instead of the standard 27.5 or 39 years. This accelerates the deductions into earlier years.

Under **bonus depreciation** rules, certain eligible components can be fully deducted in Year 1. This is why some investors receive a K-1 showing a very large loss in the first year of a new acquisition, the partnership may have recognized years of depreciation at once.

IMPORTANT

Important: Under the One Big Beautiful Bill Act (2025), bonus depreciation has been restored to 100% and made permanent. Eligible components placed in service can be fully deducted in Year 1. Your CPA can confirm how this applies to your specific K-1 year and investment structure.

What this means for your K-1:

It is entirely possible, and in fact common, for your K-1 to show a significant loss in a year when the property collected rent, covered all expenses, and distributed cash to you. The loss is a tax result, not an economic one. The property is not losing money. Depreciation is doing its job.

The critical question is not whether you have the loss, it is whether you can **use** it. That depends on the passive activity rules, which are covered in Part 3.

TIP

Depreciation recapture: When a property is eventually sold, the IRS recaptures depreciation deductions you took by taxing a portion of the gain at a higher rate (up to 25% for real property). This is called Section 1250 unrecaptured gain. Your CPA will calculate this at the time of sale.

Part 3

Passive Loss Rules — Who Can Use What

Having a K-1 loss and being able to ***use*** that loss are two different things. The IRS divides income and losses into two buckets: **passive** and **non-passive.**

NON-PASSIVE INCOME

- W-2 wages
- Self-employment income
- Business income (active)
- Interest & dividends
- Ordinary income

PASSIVE INCOME

- Rental real estate income
- LP interests in partnerships
- Fund distributions (equity)
- Income from activities you don't materially participate in

Under Section 469, **passive losses can only offset passive income.** They cannot offset W-2 wages or other non-passive income, for most investors.

As an LP investor in a real estate partnership, if you have no other passive income to absorb the loss, it gets **suspended** and carried forward. It is not lost. It accumulates on Form 8582 until you either generate passive income or sell your interest.

The Three Paths to Using Your K-1 Losses

1. **Offset passive income from other investments**
If you have passive income from other real estate deals, partnerships, or activities, your suspended losses can offset that income dollar for dollar in any year.

2. **Real Estate Professional Status**
If you qualify as a Real Estate Professional under Section 469(c)(7), you may be able to treat these losses as non-passive and deduct them against W-2 or business income. See Part 4 for full details.

3. **Complete disposition — when you sell**
When the partnership sells the property and you fully exit your interest, all accumulated suspended losses are released in that year, regardless of whether you have passive income. See Part 6.

TIP

The $25,000 rental exception: There is a limited exception that allows investors with modified AGI under $100,000 to deduct up to $25,000 in passive real estate losses against ordinary income, but this phases out completely at $150,000 AGI. Most accredited investors will not qualify for this exception.

Part 4

Real Estate Professional Status

Real Estate Professional (REP) status is a special IRS designation that allows qualifying individuals to treat rental real estate activities as **non-passive,** meaning losses can be deducted against W-2 wages, business income, or any other type of income, not just passive income.

This is one of the most powerful tax strategies available to real estate investors with significant earned income, but it comes with strict requirements, is heavily audited by the IRS, and is frequently misunderstood.

The Two Qualifying Tests

REP STATUS
50% Test: More than 50% of all personal services you perform during the year must be in real property trades or businesses in which you materially participate. If you have a full-time W-2 job outside real estate, this test is very difficult to meet.

REP STATUS
750 Hour Test: You must perform more than 750 hours of services in real property trades or businesses during the year. Both tests must be satisfied, not just one.

On a joint return, only **one spouse** needs to meet both tests. However, the qualifying spouse must meet both tests independently based on their own hours, a spouse's hours cannot be combined with the other's to meet the 50% or 750-hour thresholds.

Material Participation — The Second Requirement

Qualifying as a REP is not enough on its own. To deduct losses from a specific real estate activity against non-passive income, you must also **materially participate** in that activity. The IRS provides seven tests, you must meet at least one for each activity:

Test 1: 500+ hours

You work more than 500 hours in the activity during the year. Combined spouse hours count here.

Test 2: Substantially all

Your participation constitutes substantially all participation in the activity by anyone (including non-owners and employees).

Test 3: 100+ hours, most of anyone

You work more than 100 hours and no one else (including employees) works more than you.

Test 4: Significant participation activity

The activity is a significant participation activity and your total time across all such activities exceeds 500 hours.

Test 5: 5 of last 10 years

You materially participated in the activity for any 5 taxable years (consecutive or not) during the prior 10 years.

Test 6: 3 years personal service

You materially participated in a personal service activity for any 3 prior years.

Test 7: Facts and circumstances

Based on all facts and circumstances, you participate on a regular, continuous, and substantial basis, and you work more than 100 hours.

The Grouping Election

If you own interests in multiple real estate activities, you may be able to make a **grouping election** to treat them as a single activity for material participation purposes. This can make it easier to meet the 500-hour test across your portfolio rather than for each property individually. A grouping election, once made, is generally binding. Your CPA must file it properly with your return.

Documentation — The Most Important Practical Step

REP claims are among the most scrutinized in the tax code. The IRS will look for contemporaneous records, meaning records kept ***at the time***, not reconstructed later. A calendar, time log, or tracking app that records specific activities and hours by date is essential. General statements like 'I spent approximately 800 hours in real estate' are not sufficient.

> **IMPORTANT**
>
> REP status is a valuable strategy for the right person, typically a spouse or investor who is genuinely working full-time in real estate. It is not a paperwork exercise. The IRS audits REP claims closely, and courts have consistently upheld strict interpretations of both the 50% test and the material participation requirements. Work with a CPA who specializes in real estate taxation before claiming this status.

The Path to REP Status — Step by Step

1. **Step 1: Confirm you have usable losses**
   You must have passive losses from rental real estate that you want to apply against non-passive income. If you already have passive income to absorb them, REP status may not be necessary.

2. **Step 2: Meet both qualifying tests**
   You must satisfy the 50% test AND the 750-hour test based on your own hours of service in real property trades or businesses.

3. **Step 3: Materially participate in each activity**
   In addition to REP status, you must materially participate in each rental activity where you want to deduct losses. Consider whether a grouping election is appropriate.

4. **Step 4: Maintain real-time time logs**
   Keep detailed, contemporaneous records of every qualifying activity, dated as you go. Calendar entries, project logs, and communication records all support your position.

5. **Step 5: Work with a specialist CPA**
   File a proper grouping election if applicable. Have your CPA review your documentation before filing. REP status is too valuable, and too scrutinized, to handle without professional support.

What This Means for REPs

A Real Estate Professional who invests $100,000 as a limited partner into a commercial syndication, such as a mobile home park, may receive a K-1 showing $240,000 or more in bonus depreciation losses in Year 1 via a cost segregation study. Because the REP has made the grouping election and qualifies under material participation rules, those losses flow through as non-passive, meaning they can offset W-2 income, business income, or any other income. Depending on tax bracket, a $240,000 loss could reduce tax liability by approximately $100,000 in that year alone.

This is one of the most compelling tax strategies available to accredited investors who qualify as REPs. The investment cash-flows positively, the paper loss is the bonus depreciation at work, and the investor has materially reduced their tax bill.

Also add the refinance point Mike raised: "A note on the refi event: if the partnership refinances the property rather than selling it, proceeds distributed to investors are generally a tax-free return of capital, not a taxable event. Depreciation recapture is not triggered. Investors can continue receiving cash distributions for years without a recapture event, as long as the property is not sold.

What This Means for Non-REPs

For investors who do not qualify as Real Estate Professionals, passive losses from real estate syndications are suspended, but not lost. They accumulate on Form 8582 and can be used to offset:

- Passive income from other real estate deals or funds
- Capital gains when a property eventually sells (including gains from other syndications)

Sometimes referred to as the "lazy man's 1031", instead of rolling proceeds into a new property through a formal exchange, an investor can use accumulated passive losses from one investment to offset taxable gains from the sale of another. No intermediary required, no tight timelines, no replacement property hunt. Just coordinate with your CPA to match the loss utilization.

Part 5

How Debt Income Is Taxed Differently

Not all real estate investment income is treated the same way for tax purposes. The type of investment structure, equity versus debt, significantly affects how income flows through to your K-1 and how it is taxed.

Equity Investments vs. Debt Investments

EQUITY INVESTMENTS	DEBT INVESTMENTS
• Income: rental income (Box 2)	• Income: interest income (Box 5)
• Depreciation passes through	• No depreciation pass-through
• Paper losses common in early years	• Ordinary income character
• Gain on sale: capital gain / 1231	• Taxed at ordinary income rates
• Recapture tax on depreciation at sale	• No recapture on sale
• Passive activity rules apply	• Still subject to passive rules

When you invest in a **mortgage fund, private credit fund, or debt fund,** the income your investment generates is interest income, not rental income. Interest income flows through Box 5 of your K-1 and is taxed at ordinary income rates.

This is materially different from equity fund income in two key ways:

- **No depreciation benefit.** Because the fund is the lender, not the property owner, there is no depreciation deduction to pass through to investors. You will not see the large paper losses on a debt fund K-1 that you might see from an equity syndication.
- **Ordinary income rates.** Interest income is taxed at your marginal rate, the same rate that applies to your W-2 wages. It does not qualify for the lower long-term capital gains rate.

DEBT FUNDS

Debt fund income is still subject to passive activity rules. Interest income from a fund in which you are a passive LP is passive income, which means it can absorb your suspended passive losses from equity real estate investments. For investors who have accumulated suspended losses waiting to be used, debt fund income can be a useful source of passive income to offset them.

UDFI — A Special Consideration for IRA Investors

If you invest in a real estate fund through an IRA or other tax-exempt account, and the fund uses leverage (borrowed money) to make investments, a portion of the fund's income may be subject to **Unrelated Debt-Financed Income (UDFI)** tax, also called Unrelated Business Income Tax (UBIT). This applies even inside a retirement account.

UDFI is calculated based on the proportion of the fund's income attributable to debt financing. If it applies, the fund will report it on a Schedule K-1 and your IRA custodian will need to file Form 990-T. This is a nuanced area that your CPA and IRA custodian should work through together.

Important distinction: If the debt fund does not use leverage, meaning it lends investor capital directly without borrowing, there is no UDFI and no UBIT exposure for IRA investors. Interest income earned by a non-leveraged debt fund inside an IRA is tax-deferred just like any other IRA income. UDFI applies only when the fund itself uses borrowed money to make investments. Always ask your fund manager whether leverage is used before assuming UBIT applies.

TIP

IRA investors: ask your fund manager directly whether the fund uses leverage and whether UDFI may apply to your account. Not all funds trigger this, but knowing in advance lets you plan appropriately with your CPA and custodian.

Part 6

The Sale Event:

When Suspended Losses Unlock

One of the most important events in your investment lifecycle, from a tax perspective, is a **complete disposition**: the year the partnership sells the underlying property and you fully exit your interest.

In the year of complete disposition, three things happen simultaneously that can have a significant impact on your tax return:

1. **All suspended passive losses are released**
Everydollar ofpassive loss youhaveaccumulated over the life of the investment, sitting unused on Form 8582, becomes deductible in the year of sale, even if you have no other passive income. This is the primary moment those losses pay off.

2. **Section 1231 gain is recognized**
Thegain from the sale ofbusiness real estate held more than one year is generally treated as Section 1231 gain, taxed at long-term capital gains rates (0%, 15%, or 20% depending on your income) rather than ordinary rates. This is more favorable than ordinary income treatment.

3. **Depreciation recapture is triggered**
Theportion of the gain attributable to depreciation deductions you previously took is subject to recapture, taxed at up to 25% under Section 1250. Your K-1 at sale will include a Section 1250 unrecaptured gain amount that your CPA will need to report separately.

IMPORTANT

The year of sale is typically the most complex K-1 you will receive from a given investment. It combines suspended loss releases, capital gain recognition, and depreciation recapture, all in a single return. Plan ahead: give your CPA as much lead time as possible when a property sale is anticipated.

1031 Exchanges — Deferring the Tax Event

If the partnership reinvests sale proceeds into a replacement property through a **1031 exchange,** the gain recognition and depreciation recapture are deferred, they do not appear on your K-1 in the year of the exchange. Your suspended passive losses, however, are typically ***not*** released in a 1031 exchange because you have not fully disposed of your interest. They continue to carry forward.

Individual investors may also use 1031 exchanges on their own real estate holdings, but this is a separate, highly rule-specific strategy that requires coordination with a qualified intermediary and CPA well before any sale occurs.

Checklist

Questions to Bring to Your CPA

Use this as a starting point for your annual K-1 conversation with your tax advisor. No guide can substitute for professional advice tailored to your situation, but going in prepared makes that conversation more productive.

About your K-1 generally

- Do I have suspended passive losses from prior years, and how much?
- Are any of my losses currently usable, or are they all suspended?
- Did the partnership conduct a cost segregation study this year?
- What is my current adjusted tax basis in this partnership interest?

About depreciation

- How much of my K-1 loss is attributable to depreciation vs. operating losses?
- What bonus depreciation percentage applies to this K-1 year?
- How will depreciation recapture affect me when this property eventually sells?

About Real Estate Professional status

- Based on my hours and activities, do I qualify, or could I qualify, as a REP?
- Should I make a grouping election, and has it been properly filed?
- Am I maintaining adequate contemporaneous records of my real estate hours?
- If my spouse is the qualifying REP, are we handling the filing correctly?

About debt fund income

- Is the income from my debt fund investment classified as passive interest income?
- Can I use suspended equity losses to offset this passive interest income?
- If I invest through an IRA, does UDFI apply to any of my fund interests?

About the sale event

- If a property is expected to sell, how much suspended loss will be released?
- What is my estimated Section 1231 gain and unrecaptured 1250 gain?
- Is a 1031 exchange being considered, and how does that affect my suspended losses?
- Should I make any year-end moves to optimize the tax result in the year of sale?

A Note on This Guide

What This Guide Is — and What It Isn't

DISCLAIMER

FULL DISCLAIMER: This guide is provided for general informational and educational purposes only. It does not constitute tax, legal, or accounting advice of any kind. Tax rules are complex, fact-specific, and subject to change. The concepts described here reflect general principles under current law and may not apply to your specific situation, investment structure, state of residence, income level, or filing status. Tempo Investments is not a tax advisor and does not provide tax advice. Always consult a qualified CPA or tax professional who is familiar with real estate taxation before making any decisions based on this material.

This guide was created because we believe investor education is part of what it means to be a good fund manager. The more clearly you understand how real estate investments work from a tax perspective, not just from a returns perspective, the better decisions you can make, and the better conversations you can have with your own CPA.

We do not prepare your taxes. We do not provide advice on how your K-1 should be reported. What we can do is help you ask the right questions, and point you toward the right professional to answer them.

Want to go deeper?

The Big Mike Fund Podcast covers real estate tax strategy, fund structures, and passive investing in depth, in conversations with operators, CPAs, and investors who have been through it.

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