Sy Accountancy Corporation
Member, American Institute of CPAs
704 Mira Monte Place, Pasadena, California 91101
Tel (626) 744-0200 • Fax (626) 744-0300 • vsy@victorsycpa.com • www.victorsycpa.com

HOW TO RECORD PURCHASE OF RENTAL PROPERTY

By Victor Sy, CPA, MBA

You have just have closed escrow on the purchase of a rental property. You will be receiving rents which you will report as income. You will also be paying mortgage interests, property taxes, utilities, insurance, and repairs that you can deduct as expenses. You also have to depreciate the basis (cost) of the building. Below are 10 tips to guide you through a maze of documents and computations to arrive at a basis which you can depreciate to hopefully produce a tax shelter for your hard-earned dollars.

The depreciable basis of property is usually its cost. That cost can be initially computed from an escrow closing statement. Look for the final statement form HUD-1 (not estimated closing costs). Get a copy of your supplemental or adjusted property tax bill (not prior tax bills before reassessment).

1. Include the following settlement fees and closing costs: escrow fees, recording fees, title insurance, transfer taxes, legal fees, and abstract fees. Also include amounts that the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

2. Do not include the following settlement fees and closing costs: loan origination fees and discount points, loan assumption fees, credit reports, appraisal fees required by a lender, mortgage insurance premiums, fire insurance premiums, rent adjustments, and reserve deposits for future payments for taxes and insurance. Amortize loan-related costs over the period of the loan (usually 30 years). Deduct all unamortized costs in the year of refinance or pay off.

3. If you buy real property and agree to pay real estate taxes on it that were owed by the seller, the taxes you pay are treated as part of your basis in the property. Do not deduct them as taxes paid.

4. If you buy property and take over an existing mortgage on the property, your basis is the amount you pay for the property plus remaining balance on the mortgage.

5. While cost usually becomes the basis for depreciating a rental property, you cannot use cost as a basis for property that you received as a gift, inheritance, divorce settlement, or tax-deferred exchange.

6. Use assessed values from your supplemental or adjusted property tax bill. Take a ratio of land and improvements and apply that to the total basis. Depreciate the building and improvements over 27 ½ years for residential and 39 years for commercial properties. Do not depreciate land.

7. Make certain adjustments to the basis as years go by. Increase your basis by the cost of additions or improvements having a useful life of more than one year, amounts spent after a casualty to restore the damaged property, the cost of extending utility service lines to the property, and legal fees to defend or perfect your title.

8. Add expenditures for additions or improvements, including any amount you borrow to make the addition or improvement. This includes all direct costs, such as material and labor (but <u>not</u> your own labor).

9. Decrease the basis of your property by any items that represent a return of your cost. These include amount of any insurance or reimbursement from casualty or theft loss, as well as amount you receive for granting an easement.

10. Assessments for items which tend to increase the value of property, such as streets and sidewalks, are not deductible and must be added to the basis of the property.

Good Luck.