

# *Sy Accountancy Corporation*

Member, American Institute of CPAs  
704 Mira Monte Place, Pasadena, California 91101  
Tel (626) 744-0200 ■ Fax (626) 744-0300 ■ vsy@victorycpa.com

## **Q&A ON RENTAL INCOME, DEDUCTIONS, AND RECORDKEEPING**

By Victor Sy, CPA

### **What Records Should I Keep?**

- Collection Journal to keep track of rents received each month from each tenant.
- Disbursements Journal to keep track of rental expenses.
- Paid Invoice Files arranged alphabetically by vendor.
- Permanent Business Files for escrow statements, loan documents, as well as roof, water heater, and other items that extend beyond the year of payment. Save these files for warranty, insurance, or sale of property.
- Bank Statements arranged by year and month. TIP: You save more by paying a few dollars for copies of cancelled checks with your monthly statements rather than pay for expensive photocopies if you file an insurance claim for water damage or if you get audited by the IRS years later.

**Where Do I Report Rental Income and Expenses?** Use Schedule E, Part 1 of Form 1040.

### **When Do I Report Rental Income?**

- Report rental income in the year received if you are a cash basis taxpayer (most of us are).
- Cash basis taxpayers report income in the year received, regardless of when it was earned.

### **What is Considered Rental Income?**

- All amounts received as rent.
- It also includes tenant services offset against rent (discussed below).

### **How do I Treat Advance Rent?**

- Advance rent is any amount you receive before the period that it covers.
- If you receive \$2,000 rent at the start of a lease (\$1,000 for the first month and \$1,000 for the last), report the full \$2,000 at the start of the lease.

### **Should I Include Security Deposits as Rental Income?**

- No - if you plan to return it at the end of the lease.
- Yes - if it is intended to be used as a final payment of rent.
- If you keep all or part of it because of property damage or for cleaning at the end of the lease, include what you keep in that year.

### **What about Lease with Option to Buy?**

- This occurs if you give your tenant the right to buy your rental property.
- The payments you receive are generally rental income.

### **What Rental Expenses Can I Deduct?**

- Mortgage interest, property tax, depreciation, repairs, and other operating expenses.
- Repairs keep your property in good operating condition and does not materially add value to the property (painting, fixing leaks, replacing broken windows).
- You can deduct ordinary and necessary expenses for managing and maintaining your property.

### **How do I Treat the Cost of a New Roof, New fence, or Major Plumbing?**

- You may not deduct the cost of improvements.
- An improvement adds to the value of your property or prolongs its useful life.
- Capitalize the cost and claim annual depreciation.

### **Can I Deduct Expenses Paid by Tenant?**

- If your tenant pays any of your expenses, deduct the expense and report that same amount as income.
- For example, if your water heater leaks and your tenant repairs it and deducts the cost from rent, deduct the amount and report the same as income.

#### Can I Deduct Painting and Other Services Performed by my Tenant?

- If your tenant paints your property instead of paying rent, include the amount that the tenant would pay as rental income and claim the same as deduction.