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RENTAL TAX PRIMER FOR PROPERTY OWNERS

Today's edition was especially written for the Apartment Association whose members own or operate rental properties. The objective of this article is to shed light on basic issues such as rental income, expenses, capital improvements, passive losses, depreciation, and audit risks.

Rental Income:

1. Include all collected rents as gross income from rents.
2. Most property owners are on cash basis (report income in the year received, not in the year earned)
3. Advance rent is income regardless of the period covered (last month rent is income in year received).
4. Security deposit is not income if you plan to return it at the end of the lease. Whatever you keep because tenant did not fix up the unit at the end of lease becomes income.
5. Payment received from a tenant to cancel lease is income.
6. If tenant pays an expense and offsets amount from rent, include the amount as both income and expense. For example, if a tenant paints your property in exchange for a full month rent of \$900, report that \$900 as income and deduct the same \$900 as rent expense. (TIP: Adding the \$900 to income also helps increase your gross multiplier when you sell your property).
7. Payment received under a lease with option to buy is generally rental income. If tenant exercises option, any payment after sale becomes part of selling price.

Rental Expenses:

1. Deduct expenses in the year paid.
2. Most of you are on a cash basis (deduct expense in the year paid, regardless of when it applies).
3. You can deduct pre-rental expenses as soon as your property is made available for rent.
4. You can deduct rental expenses until your property is sold (even if vacant before the sale).

Repairs Versus Capital Improvements:

1. Repairs are deductible in the current year while improvements are not.
2. Repairs keep your property in good condition (cleaning, maintaining, replacing broken windows, and fixing floors, leaks, plasters).
3. Improvements add to the value of your property or prolong its useful life (major remodel, major plumbing, major electrical work, room addition).
4. Local assessments for property tax that increase the value of your property, are not deductible expenses, and are not even depreciable capital expenditures.

Mortgage Interest:

1. Interest on your loan is usually the biggest expense for rentals.
2. Loan origination fees (called "points") are capital expenditures, cannot all be deducted in the year of refinance, but can be amortized over the life of the loan.
3. Any remaining unamortized balance is deductible in full when you refinance.
4. Base your deduction from Form 1098 (Mortgage Interest Statement) from the lender.

Audits Risks:

1. True, you can deduct travel expenses if the primary purpose of your trip is rental-related, but be careful especially if the amount is material compared to income and other expenses. It's not too cool

to visit your Las Vegas rental every payday. An IRS agent can easily connect this with gambling winnings and losses somewhere in your tax return. ☺

2. Exercise the same care with local auto expenses to collect income or manage, conserve, maintain your property. Be conservative with items that raise red flags.
3. Break down big tickets into smaller items. The strategy here is to file a tax return that does not stand out from amongst the crowd. Such care reduces your chances of getting an invitation from IRS.

Where To Report:

1. Use Schedule E to report rental activities for real estate.
2. Use Form 4562 for depreciation.

Depreciation:

1. The most critical aspect of setting up a rental unit in the year of acquisition is determining the correct depreciable basis. If you set it up wrong, it will be difficult to change it in subsequent years.
2. Start with the escrow closing statement to determine purchase price.
3. Use real estate assessments or appraisals to allocate costs between land and building.
4. Land is never depreciable while improvements are.
5. Use MACRS (Modified Accelerated Cost Recovery System) for all properties acquired after 1986.
6. Use 27 ½ years, straight-line method, and mid-month convention.
7. Start depreciating when the property is placed in service (when it is ready and available for rent).

Passive Losses:

1. Rental activities are considered “passive.”
2. Passive losses cannot be used to shelter active income from salaries and active businesses.
3. An exception allows you to deduct up to \$25,000 (\$12,500 for married filing separate) if you materially and actively participate in the management of your rental.
4. Real estate professionals have no such limitation and can shelter more than \$25,000. There are special requirements such as spending more than 750 hours of managing rentals and performing more than half of personal services in real property management.

Tips to Set Up Basis:

1. Delinquent taxes and mortgage payments owed by the seller are not currently deductible and should be added to your basis and depreciated.
2. Escrow fees, recording fees, title fees, abstract, and legal fees to acquire property are not currently deductible and should become part of your basis.

Other Tips:

1. Do not forget to allocate part of your tax preparation fees as rental expense as opposed to Schedule A where itemized deductions are limited or lost due to 2% floor.
2. Units rented to relatives at low rents convert to personal use. Expenses allocated to those units are not deductible. Auditors ask why other tenants rent for \$1,200 while one unit (with your last name ☺) of the same size rents for \$800. **Tip:** Use fair rental values when renting to your relatives.
3. Include a 1031 tax deferred provision, just in case. Have your tax accountant compute capital gains before signing that listing agreement. Remember that federal capital gains tax rate at 15% is the lowest it's ever been. A 1031 exchange merely postpones taxes. You'll have to deal with it anyway. If you're considering retirement or are retired, realize that an exchange may not be the wisest option for you. If you are tired of tenant complaints, join a TIC or simply cash out. Enjoy life.