

Rental Deductions



Rental Deductions Tax Preparation

Posted Sunday, May 12, 2024

Rental properties can be great investments and offer some ways to shelter your taxable income through rental deductions. However, there are several tax related issues during the purchase, management, and sale of your rental property which can ultimately affect your rental income tax rate.

The proper handling, coordination, and reporting of taxable events such as closing costs, repairs versus improvements, depreciation, 1031 exchanges (and even reverse 1031 exchanges) seemingly innocent HOA dues and mileage can improve your tax consequence. While incorrect tax reporting can start the slow brewing of future problems.

Rental Property Business Owners

Most rental property owners would define themselves as investors. Yeah, sure, why not? However, would you call Warren Buffett an investor or a business owner? We would call him a business owner who happens to make investments with his business into other businesses. Perhaps we are splitting hairs and getting caught up in semantics, but at the same time, we look at you and your rental properties as a business. As such, your business needs the care and guidance of business consultants, and that's where **WCG** excels. We help you take the emotions out of rental property management and have a detached, business-oriented perspective to help you build wealth by maximizing your rental deductions.

Vacation Rentals

This is not necessarily complicated, but many rental properties and several tax professionals get this wrong. So, here we are, trying to right the world of its terrible ways, one rental article at a time. You have four basic scenarios —

1. Long-term rental
2. Short-term rental
3. Short-term rental where you provide substantial services
4. Short-term rental where you use the property as well

Long-Term Rental

This is easy. This is your common situation where you buy a single family home or a commercial building and rent it out on an annual basis.

Short-Term Rental

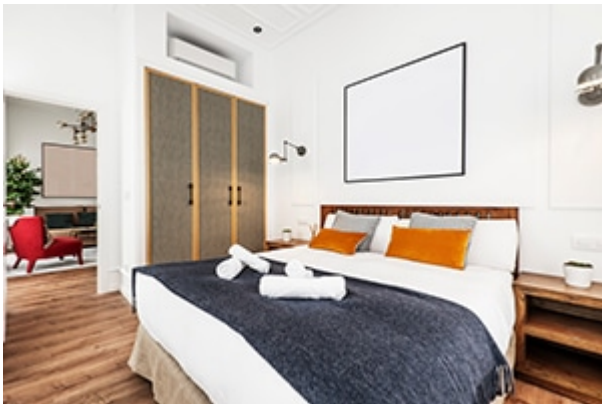
This one is easy too (or at least can be easy). If you have a rental that has multiple tenants over the course of the year, but you do not provide substantial services (defined below) nor do you use it personally, then you have a simple **short-term rental** that is reported on Schedule E of your individual tax return (Form 1040). Whether your losses are considered deductible will depend on the average guest stay and your level of participation.

Short-Term Rental with Substantial Services

If you have a short-term rental similar to above, but provide substantial services then your rental activities are reported on Schedule C... read that again... Schedule C of your individual tax return and subjected to self-employment taxes. Yuck! What the heck are substantial services? According to **IRS Publication 527**, substantial services are-

If you provide substantial services that are primarily for your tenant's convenience, such as regular cleaning, changing linen, or maid service, you report your rental income and expenses on Schedule C. Use Form 1065, U.S. Return of Partnership Income, if your rental activity is a partnership (including a partnership with your spouse unless it is a qualified joint venture). Substantial services don't include the furnishing of heat and light, cleaning of public areas, trash collection, etc. For more information, see Pub. 334, Tax Guide for Small Business. Also, you may have to pay self-employment tax on your rental income using Schedule SE (Form 1040 or 1040-SR), Self-Employment Tax.

Think hotel or hunting lodge.



Short-Term Rental with Personal Use (Vacation Home)

Let's say you have a ski condo in Aspen and you use it from time to time, and you also rent it out to others. If your personal days exceed 14 days or 10% of the days it was rented to others at fair market rates, then you have to prorate your rental deductions and expenses based on rental use percentage.

Rental Use % = Days Rented / (Days Rented + Days Used Personally)

Ok, so you use the rental use percentage to limit your rental deductions. Now what? Can you create a loss? Perhaps. If the rental property activity triggers vacation rules, then No. Vacation rules apply when 1) the rental was rented for less than 140 days during the year, or 2) personal use days exceeds 10% of the rented days. Prorated rental deductions and expenses are limited to income (in other words you cannot have a rental loss). Here is a sample **Vacation Home Worksheet** from our tax software. Don't laugh, but here is **H&R Block's AirBNB Guide** which is very good at explaining all this.

If vacation rules do not apply, then you could have a net rental loss. Could? Yes, could. There is ordering rules where mortgage interest and property taxes are used first to offset rental income, and operating expenses and rental depreciation are applied next. If operating expenses and rental depreciation create a net rental loss, then that loss is carried forward.

We have to briefly mention the Bolton Method or what is also called the Tax Court Method (which WCG uses). Before TCJA it was quite simple; if you itemized, then Bolton / Court Method was better. If you used the standard deduction, the IRS Method would be better. With TCJA, you must run both scenarios. **Bolton Method** is basically rental days divided by days in the year, whereas the IRS Method is rental days divided by number of days used for any purpose. The Bolton Method usually results in a lower percentage, and therefore a lower allocation of mortgage interest and property taxes to the rental activity.

Masters Rule

The Masters Rule stems from **Internal Revenue Code Section 280A(g)**. It is a unique rule in which homeowners who rent out their property for 14 days or less in a tax year are not considered to be engaged in the activity for profit, and therefore do not have to claim the rental income. This property could still be considered a second home where mortgage interest and property taxes are still deductible. Yeah baby! They call it the Masters Rule from those who rent out their homes for the Masters

Tournament in Augusta, Georgia.

Otherwise vacation rules do not apply, but your rental deductions and expenses are limited based on rental use percentage. The good news is that you can still have a net rental loss if those prorated rental deductions exceed the rental income.

Rental Property Tax Preparation

For our real estate investors and rental property owners, our tax return preparation fees start at \$800. There are four fees that might be added on depending on your empire.

Rental Setup

If you have just a simple rental, and we are transferring the data from your previous tax return, we usually don't have an add-on fee for setup.

If you have had 1031 exchanges in the past, a newly purchased rental property where we need to examine acquisition and loan costs, or an extensive depreciation schedule with several assets, an additional fee may apply.

This fee ranges from \$150 to \$500, depending on the complexity of the situation.

Cost segregation report? That will also trigger a setup fee.



Multiple or Complex Rentals

Our basic Form 1040 tax return preparation fee above includes 1-2 simple rentals. If you have more than that, or if your rental property is complex (think commercial or short-term or vacation home), then we might have a small add-on fee. Each rental beyond 1-2 might be \$100 to \$250.

State Tax Returns

You live in Colorado and have a rental property in California. You will need to file a California non-resident tax return even if the rental loses money. You have an income-generating asset in their state, Also, please consider that a taxing jurisdiction has the right to inspect your books and records to ensure your loss is truly a loss.

Disposition or Sale of a Rental Property

When you sell your rental property, including a 1031 or 721 exchange, there will likely be an add-on fee of \$150 to \$300. This is where the rubber hits the road in terms of capital gains, and we need to spend the extra time to ensure a) your purchase price is correctly being considered including acquisition costs, b) improvements are accounted for and c) selling expenses and other things are factored in.

Rental Property Tax Deductions

A lot of rental property owners miss out on tax deductions for not knowing how to position themselves correctly. For example, deducting travel expenses to and from your rental. Or the optimized way to deduct cell phones, mileage, and home offices. What about repairs and improvements? What about de minimis safe harbor from **IRS Notice 2015-82** which states that items \$2,500 or less are considered immediate rental deductions and do not have to be depreciated?

Rental Bookkeeping

WCG specializes in real estate investors and as such we provide accounting services for rental properties. Rental properties are a

business like any other, and the proper tracking of revenue and more importantly the associated expenses are essential. The bookends to the varying service levels are your common single-family rental (SFR) home and that large commercial property with several tenants. That's the X axis. The Y axis becomes tax return complexity based on number of owners, number of activities (rentals) or both. There are many considerations; please click on the button below to learn more about our **rental property accounting services**.

Let's not forget all the short-term and vacation rules stuff! Have WCG take care of all this navigation as we prepare your tax returns.

Rental Depreciation

One of the most frequent questions from taxpayers is regarding rental property depreciation. Should you do it or no? Well, the IRS says it doesn't matter because of a little rule called allowed versus allowable. This little nugget basically says if depreciation was allowable, then it's considered taken (deducted). In other words, even if you do not take depreciation as a rental deduction, the IRS will assume you did. Yuck. What can be done if you haven't deducted rental property depreciation in the past?

We can usually true up under a Section 481(a) adjustment when combined with the more complicated Form 3115 (Change in Accounting Methods). Either way, we can help.

Do you depreciate your short-term rental? Perhaps.

Repairs Versus Improvements

Here are some common questions about rental property repairs (rental deductions) and improvements (rental depreciation).

- We repainted inside and out. Do I depreciate that?
- I'm re-carpeting the whole place. Do I expense that? I put carpet in just one room. Now what?
- The water heater busted and I replaced it. How does that work?
- My family flies to Tahoe every winter to ski, and I look at possible condos to buy while I'm there. Can I deduct my travel expenses?
- I drove back and forth to Home Depot a zillion times for a kitchen renovation. Can I deduct mileage?
- In between tenants, I bought four dishwashers for my quad-plex. Can I expense them, or must I depreciate them? (spoiler alert: you can immediately expense under safe harbor rules).

Deducting expenses and capitalizing improvements must be handled properly. There is an acronym that we and others use, either BAR or BRA... take your pick!

- B for **Betterment** such as adding a wing to the rental or finishing the basement,
- A for **Adaptations** such as remodeling a home to be an office space where the use is "new or different" since it's not consistent with the "intended ordinary use," or
- R for **Restoration** such as major repairs that returns the rental property to its "ordinary efficient operating condition."

Stapling a bunch of bras on the ceiling of a bar is probably not an improvement in the eyes of the IRS, but certainly something to giggle at. Another way of saying this is:

BAR = improvement, and improvement = depreciate (and not expensed as immediate rental deductions).

Wealth Building

Rental properties are lousy tax vehicles for two big reasons. First, if you make too much money (adjusted gross income over \$100,000 for married taxpayers), then your rental losses are slowly capped from \$25,000 at \$100,000 to \$0 at \$150,000. In other words, if your rental loses \$20,000, but your income is \$150,000, your rental loss deduction is zippo. Those losses do carry forward to future years, however. There are exceptions for **Real Estate Professionals** as defined by the IRS and those who

have **short-term rentals** (average guest stay <7 days + material participation).

Second — and this is a bite you in the butt thing — most rental losses are created by depreciation. However, when you sell the property, you must add back depreciation into your gains calculations. This little surprise is known as depreciation recapture. Therefore, your rental deductions created in part by rental depreciation all these years were truly an IOU to the IRS upon sale.

All is not lost; you can perform a **1031 like-kind exchange**, or you can do a reverse 1031 which is where you buy the next property first and then less the relinquished property. This is tricky, but we can guide you. **721 exchanges or UPREIT** also exist too, and they are becoming more popular.

So why do people want to own a whole gaggle of rental properties if they stink at lowering your tax burden. Simple! Rental properties build wealth, and at the end of the day, wealth building is what your primary objective should be. If you can save some taxes along the way, then winner, winner, chicken dinner. But the prize is truly wealth building.

Real Estate Professional IRS Election

To qualify as a real estate professional, an individual must dedicate the majority of their time to real property businesses. These businesses include:

- Development or redevelopment
- Construction or reconstruction
- Acquisition or conversion
- Rental
- Management or operation
- Leasing and/or brokerage

In addition, more than half of the personal services performed in all businesses during the year must be performed in real estate businesses. So, if you have a garden variety W2 job working 2000 hours a year, you need to spend 2001 hours in real estate activities. Wait! There's more. Second, your hours worked in the real estate activity must be more than 750 hours. Steep thresholds.



If you own multiple rental properties each will be considered a separate entity and you must satisfy the above requirements on each property independently unless an election is made to treat all those interests as a single activity. This election is simply a statement that is attached to your tax return. And under Revenue Procedure 2010-13, you can make the election retroactively (typically requires amending a tax return just for the election).

Once you qualify as a real estate professional, you must **materially participate** in the operation of your rental property business. This is where it gets tricky, and this is where most rental property owners get into trouble. If you cannot prove material participation in your rental activities, you will be subjected to passive loss limitations (currently \$25,000).

Realtors and agents beware! Just because you spend 3,000 hours hauling around buyers doesn't mean you are a slam dunk for the real estate professional designation. Real estate agent DOES NOT automatically qualify you. The material participation rules must be met, and the 750 hours dedicated to your rental activity is outside your work as a real estate agent, realtor, broker, etc.

Also, and this is commonly missed by tax professionals, by being a Real Estate Professional, you can avoid the net investment

income tax (NIIT). As such, if you have taxable rental income (profits), you might want to avoid this pesky 3.8% additional tax.

For more information directly related to the IRS definition of real estate professional and the tests for material participation please click on the button for a our updated blog post including tax court cases-

Rental Income Tax Rate

Landlords and property owners ask us often about their rental income tax rate. There is not a special rental income tax rate for rental activities. Rather, those income-producing activities are considered ordinary income and taxed accordingly. However, given what you know about short-term rentals where you provide substantial services you could also be subjected to self-employment taxes. Therefore, your rental income tax rate would be your ordinary income tax rate plus 15.3%. Yuck.

And, let's keep in mind capital gains taxes including depreciation recapture when you sell the rental property. Depreciation recapture is taxed at your ordinary income tax rate up to a maximum of 25%, and capital gains tax could be either 0%, 10%, 15% or 20% plus the net investment income tax of 3.8% should you trigger it. However, and this is commonly missed by tax professionals, by being a Real Estate Professional, you can avoid the net investment income tax (NIIT). As such, if you have taxable rental income (profits), you might want to avoid this pesky 3.8% additional tax.

Section 199A Rental Reduction

Section 199A offers a 20% deduction for small business owners, but are rental properties considered a trade or business? The answer is Yes on Section 199A rental income, but it took us some time to get here. In August 2018, the IRS released **Proposed Regulations 1.199A** to offer some additional insight to Section 199A, but nothing was clarified or confirmed about rental income.

The Treasury Department and the IRS held a public hearing on the proposed regulations on October 16, 2018, and they received 335 comments which can be reviewed in **Treasury Decision 107892-18**. Concurrently with final Section 199A regulations, the IRS released **Notice 2019-7** titled Section 199A Trade or Business Safe Harbor: Rental Real Estate.

Rental Deductions Consultants

Tina and Jason Watson, founding partners of WCG, have been rental property owners since 1996, and can offer comprehensive tax advice coupled with real-life rental property business consultation. Whether you own one rental property or several, single-family homes or multi-units, personally, in a self-directed IRA, or in an LLC with partners, WCG has the expertise to prepare your rental property tax returns accurately. We can also help reduce your rental income tax rate. Most importantly, we have the expertise to help you plan for the future!

Other questions come up, such as moving back into your rental. How do you handle rental depreciation recapture? Should I put my rentals into an LLC? What about **Hold Harmless Agreements** with my tenants? How is the current gain on personal residence sale of \$250,000 and \$500,000 handled with part years being a rental? These are all common questions, but each answer must be customized to your unique situation.

Considering a **Section 1031 exchange** to defer capital gains? Also known as like-kind exchanges. This can be a great plan, but needs guidance before, during and after. How about a reverse 1031 exchange? Yes! This is where you buy the replacement property prior to selling the relinquished property. This requires the help of an intermediary and a sharp attorney, but it is easily done in situations where a great deal comes along, but your timing is all out of whack.

There are some tricks of trade for reducing capital gains and depreciation recapture like increasing land allocation upon sale to eat into some recaptured depreciation since land is not depreciated but goes up in value. Location location location. This gets tricky and might involve an appraisal (hopefully you can get a copy from your buyer).

What about a second home that you purchased for grandma? Do you call that a rental and have her pay rent? Or is it better to call it a second home, and let grandma pay you in casseroles and babysitting? Again, these are all common scenarios, and we help present various options including how to position yourself to maximize your wealth building.

Let's chat about you, your rentals and how you can build wealth!JTVCd2NnLWNvbnRhY3QtdXMINUQ=Rental properties can offer excellent retirement and cash flow options, but the tax planning needs to be done ahead of time and not later. Our team at **WCG inc.** are rental property and real estate investor experts, and we look forward to working with you!