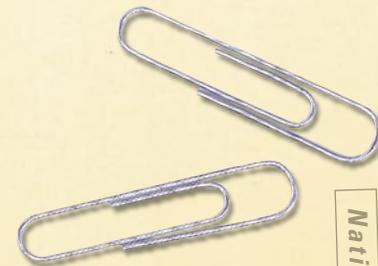


# Rental Property

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# Rental Property

## HOW WILL TAX CHANGES AFFECT MY RENTAL?

The rules for rental property change continuously through new legislation, IRS regulations, and court cases. It is always a good idea to consult an Enrolled Agent before buying, selling, trading, or making changes to a rental property.

## ARE THERE ANY LIMITATIONS ON MY RENTAL LOSSES?

Maybe. Rental losses are considered “passive” losses for taxpayers. This means that owning rental property is not the usual “trade or business” of the taxpayer. Many taxpayers can take at least the first \$25,000 of the losses from rental property. Phase out rules may prohibit higher income taxpayers from using losses to offset other income.

## WHAT HAPPENS IF I HAVE LOSSES FROM MY RENTAL PROPERTY THAT I CANNOT USE BECAUSE OF THESE LIMITATIONS?

Losses which cannot be used in the year incurred are suspended and carried over indefinitely until they can be used.

## WHAT IF I DIE BEFORE I USE UP THESE SUSPENDED LOSSES?

The value of your property to your heirs will be “stepped up” to fair market value. To the extent the fair market value exceeds your basis in the property, your suspended losses will be extinguished. Any remaining suspended loss can be used on your final Form 1040 to offset any type of income. The suspended losses cannot be transferred to the estate or heirs.

## MY TENANTS PAY ME FIRST AND LAST MONTH'S RENT AND A SECURITY DEPOSIT. HOW MUCH OF THAT MUST I DECLARE AS INCOME?

Advance rent is always included as income in the year you receive it regardless of the period the rent covers or the method of accounting you use. The security deposit is not counted as income until you keep all or part of it because your tenant did not live up to the terms of the lease.

## I OWN A RENTAL HOUSE. THIS YEAR I PAINTED IT AND ADDED A DECK. CAN I DEDUCT THESE EXPENSES?

Repairs, which keep your property in good condition, are fully deductible. Painting is usually considered a repair. Improvements—which add value to your property, prolong its useful life, or adapt it to new uses—are capital expenditures and must be depreciated. This would apply to the new deck. In either case, you cannot take any deduction for the value of your own labor.

## I HEARD THAT I CAN RENT MY HOME AND NOT PAY TAX ON THE INCOME. IS THIS TRUE?

If you rent your residence or vacation home for less than 15 days during the year, you are not required to report the rent as income. You may not deduct any expenses incurred in operating the home while it was rented. You may deduct property taxes and interest on your mortgage as usual, if you itemize deductions.

## I AM PLANNING TO BUY A NEW WASHER, DRYER, AND REFRIGERATOR FOR MY RENTAL HOUSE. I KNOW I MUST DEPRECIATE THESE ITEMS, BUT OVER HOW LONG A PERIOD OF TIME?

Consult the Modified Accelerated Cost Recovery System (MACRS) to determine the number of years.

## CAN I SELL MY PERSONAL RESIDENCE AS RENTAL PROPERTY?

Yes, but you may create a large tax increase. Under new capital gains rules and new rules for the sale of personal residence, you may not owe any tax on the sale of your home. You are allowed to exclude \$500,000 for a joint return and \$250,000 for a single filer on the sale of a residence. There is no such exclusion for the sale of a rental property.

## I BOUGHT A RENTAL PROPERTY FOR \$50,000 AND HAVE TAKEN DEPRECIATION DEDUCTIONS OF \$20,000. IF I SELL THE PROPERTY FOR \$75,000, ON HOW MUCH GAIN WILL I HAVE TO PAY TAX?

You should pay gain on \$45,000. Your basis in the property is \$30,000: \$50,000 cost less \$20,000 of depreciation. Your gain is the difference between the selling price and your basis. You can reduce this gain by any expenses of sale you incur.

## WILL MY GAIN BE TAXED AT CAPITAL GAINS RATES?

For assets held more than 1 year, the part of the gain attributable to depreciation is taxed at your ordinary income tax rate to a maximum rate of 25%. The remaining part of the gain is taxed at a maximum rate of 20%. Note: these rates are maximums—the rate can be lower. As an example, for taxpayers in a 15% tax bracket, the depreciation gain would also be taxed at a 15% rate to the extent of any remaining 15% tax bracket amount. This is a complicated area. Consulting your Enrolled Agent is advisable.

## CAN I POSTPONE TAX WHEN SELLING MY RENTAL PROPERTY?

Yes, if you exchange your property for another like property. This is known as a Section 1031 tax deferred exchange. You may also sell your property on the installment method and spread the gain over the life of the loan (except for depreciation). Special rules apply to both types of sales.