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Figuring and Reporting Rental Income and Deductible Expenses

How your rental income is taxed depends on the type of property you rent out, your personal use of the property, whether the property is considered a dwelling unit used as a home, and your participation in the rental activity. You may be able to claim all your rental expenses, even if you end up with a loss, or your loss may be subject to certain limitations. In this newsletter we will discuss general aspects related with figuring and reporting rental income and related deductible expenses.

Rental Income

Rental income is any income you receive for the use of property you own. In general, all amounts you receive as rent are includible in your income subject to U.S. federal income tax. The basic formula for the determination of net rental income or loss is as follows:

GROSS RENTAL INCOME PREPAID RENTAL INCOME RENT CANCELLATION PAYMENT IMPROVEMENT IN-LIEU-OF-RENT <DEDUCTIBLE RENTAL EXPENSES>
NET RENTAL INCOME OR NET RENTAL LOSS

Deductible rental expenses:

If you rent out part of your property, such as a part of your home, you must divide your expenses between rental use and personal use. Likewise, if you rent out a vacation home part of the year, you must also divide up your total expenses related to the vacation home between rental use and personal use. And, if you change your property from personal use to rental use during the year, you will also need to divide yearly expenses, such as taxes and insurance, between personal use and rental use.

We generally ***depreciate*** the cost of business property that has a useful life of more than a year, but gradually wears out, or loses its value due to wear and tear, weather damage, etc. To figure out the depreciation on our rental property we need to a) Determine the cost or other tax basis for the property. b) Allocate that cost to the different types of property included in our rental (such as land, buildings, so on). c) Calculate depreciation for each property type based on the methods, rates, and "useful lives" specified by the IRS.

The **cost of improvements** which increase the value and/or extend the life of the property or modify it for a new use (Examples include: Additions to the structure, Adding a swimming pool, Installing a water filtration system, Modernizing a kitchen, Installing insulation, Putting a recreation room in an unfinished basement, Paneling a den , Adding a bathroom or bedroom, Putting decorative grillwork on a balcony, Putting up a fence, Putting in new plumbing or wiring, Putting on a new roof, Paving a driveway, Putting in new cabinets, new carpet, new appliances etc.) can generally be depreciated.

Certain items normally considered maintenance (repairs, cleaning and maintenance, painting etc.) when done as part of a capital improvement project (such as remodeling), must be capitalized (added to the basis and depreciated) as part of the improvements.(Any repairs, cleaning and maintenance, painting etc. taking place after the remodeling project may be deducted as expense.).The capitalized cost can generally be depreciated as if the improvement were separate property. **Note** that the cost of ***landscaping*** improvements is usually treated as an addition to the basis of land, which is is not depreciable.

Other Deductible expenses include, but are not limited to, advertising in the newspaper for tenants and cost of signs, Cleaning, Supplies, Real estate taxes, Mortgage and other interest paid for the rental property, Cost of insurance-hazard, flood, fire, or liability, Payments for service such as lawn/yard maintenance care, pest control, trash removal, Payments for maintenance of the property, Professional fees for tax advice and tax return preparation fees for the part of the tax return dealing with rental property, Cost of new locks and keys , Commissions paid for finding tenants, Cost of repairs and maintenance (Example are: Minor repainting, Repairing appliances, Fixing leaks, fixing floors and windows), Cost of renting equipment used for the rental property, Any long distance calls associated with your rental property, The court costs for evicting a tenant, Legal fees pertaining to the rental property or tenants, Utilities,Local transportation expenses, Rents you paid to others, Expenses incurred when the property is not rented as long as you are actively trying to rent the property (even if you are renting it for the first time). However, you cannot deduct rental income lost due to vacancy.

Note that if part of the real property is used for business and a part is used for personal purpose, you cannot deduct any part of the cost of the ***first phone line*** even if your tenants have unlimited use of it, if you install a second phone line strictly for your tenant’s use, all of the cost of second line is deductible.

Reporting Rental Income and expenses

If you do not rent your property to make a profit, you can deduct your rental expenses only up to the amount of your rental income, with no loss carryover to the next year. Not-for-profit rental income is *reported as Other Income on Form 1040.* Related expenses such as mortgage interest and property taxes are taken as itemized deductions.

If you rent buildings, apartments, or rooms, and provide only the basic services, such as light, heat, and trash collection, you would normally report your rental income and expenses in *Part I of Schedule E (Form 1040)*, Supplemental Income and

Loss. *The personal portion* of deductible expenses like mortgage interest and property taxes would be *deductible as itemized deductions on Schedule A*.

If you provide significant services, such as regular cleaning or maid service, the activity would probably be considered a business, and you would report your rental income and expenses on Schedule C, Profit or Loss from Business, or Schedule C-EZ, Net Profit from Business.

You will need to complete Form 4562, Depreciation and Amortization, if you are claiming depreciation on property placed in service during 2006, or on any listed property, such as a vehicle, or if you are claiming expenses for the use of a vehicle on a form other than Schedule C or C-EZ (Form 2106-EZ) or Form 2106 or Form 2106-EZ.

Rental real estate activities are generally considered to be passive activities for tax purposes, and you can deduct real estate rental losses only to the extent you have other passive income. But if you materially or actively participated in the rental activity, you may be able to deduct a loss. If you do not rent out your property to make a profit, you can deduct your expenses up to the amount of your rental income. And, in the case of a dwelling unit used as a home, the passive activity rules do not apply.

If you work in real estate, you may be considered a real estate professional. The passive activity rules don't apply to real estate activities for many properties owned and managed by real estate professionals. For more information regarding this important exception, consult your tax adviser.

Important note: Many exceptions, definitions, and special rules in the law have been paraphrased, simplified, and/or omitted. Readers should not take specific action based on this summary without first consulting the statute and regulations or seeking advice from a qualified professional.

We appreciate and value your feedback very much. Let us know how we can help make this communication vehicle and the learning resource more valuable to you.

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