Tax Tips for Owners of Rental Property

How is Rental Income Reported?

For most taxpayers, the income collected from renting property is reported on Schedule E, Supplemental Income and Loss. If two or more people jointly own rental property, they can elect to form a partnership that holds the property and passes the income through to them.

A security deposit is not income to you when you receive it if you plan on returning it to your tenant at the end of the lease. Once it is determined that you will not return the security deposit, it becomes taxable. If you apply the security deposit to the last month's rent, it is considered income when you receive it.

If your tenant pays you for canceling a lease, or pays for improvements to the property, the amount you receive is taxable as rental income.

Can I Deduct a Loss on a Rental Activity?

A rental activity is considered a passive activity. Generally, you may only deduct losses from a passive activity to the extent you have income from a passive activity. Losses from the rental of real estate are generally allowed provided you actively participate in the activity and you rent your property for a fair rental price. Fair rent is determined by the location you live in and what the market determines is a fair rent to charge. You actively participate in the rental activity if you manage the property, collect the rent, and approve tenants. If that's the case, you may be allowed to deduct up to $25,000 in losses regardless if you have other passive income.

What Expenses Are Deductible?

There are many expenses that can be deducted from your rental income to arrive at your profit or loss. Expenses that can be deducted in the year you pay them include:

- Mortgage interest
- Property taxes
- Insurance
- Travel expenses
- Legal or professional fees
- Advertising
- Utilities
- Cleaning and maintenance fees
- Repairs, including labor costs
- Supplies
- Pest control, lawn care, and trash disposal
- Credit checks for tenants
- Management fees

Repairs vs. Improvements

How do you determine whether an expense is a deductible repair or an improvement? The general rule is that an improvement adds to the value or life of the property. A repair keeps your property in good operating condition. It does not substantially add to the value of the property or prolong its life. Deductible repairs include:

- Fixing broken windows and doors
- Repainting inside or out
- Fixing gutters and downspouts
- Repairing leaky plumbing and replacing fixtures
- Replastering holes

If you make repairs as part of an extensive remodeling or restoration project, the entire job is considered an improvement. Examples of improvements include:

- Additions
- Landscaping, including fences, plants, driveways, walkways, etc.
- Roof replacement
- Door and window replacement
- Security systems
- Electrical wiring and plumbing
- Insulation
- Siding
- Heating and cooling systems
- Interior remodeling
- Carpeting
- Appliances

Improvements that you make to your rental property are depreciated over their class life. This means that the cost is recovered ratably over a specified number of years instead of deducted in full in the year you pay for them. Costs you incur for repairs are deducted currently.

Refinancing Your Rental Property

If you have owned your rental property for several years, there's a good chance you've built up some equity, or perhaps no longer have a mortgage on the property. While this may be a good source of funds for other purchases, you need to know the rules.

If you refinance your property, the interest on the mortgage will be traced to the use of the proceeds. Unless you use the proceeds for improving the rental property, or for purchasing another rental property, you may be losing a deduction. For example, if you mortgage your rental property and use the proceeds to buy a personal residence, none of the interest you pay will be deductible. The reasoning is that your new residence is not securing the debt, the rental property is.

If you use the proceeds to purchase investment property, such as stocks or bonds, you'll have an investment interest expense. Investment interest is only deductible to the extent you have investment income.

If you purchase personal-use assets, such as a car or boat, or use the proceeds to pay off a credit card, none of the interest is deductible. Personal interest is never deductible.

Selling or Exchanging Your Rental Property

When you sell your rental property, the sale is considered a sale of a business asset. This means that any gain is a capital gain, subject to the more favorable capital gains tax rates. If you have a loss on the sale of the property, you have an ordinary loss. An ordinary loss is deducted in full against your other income. You should keep accurate records of the improvements you make to your property, their cost, and when they were made. All the improvements you make add to the basis of your property and the records will be needed in the event of a sale. The more accurately you compute the basis, the more accurately you will compute your gain or loss.

A way to avoid paying tax on the gain from a sale of your rental property is to exchange it for another rental property. Special rules apply to what is commonly referred to as a like-kind exchange. To facilitate the transaction, you'll need to locate a qualified intermediary who specializes in like-kind exchanges. If handled properly, you won't pay tax on any gain unless you receive cash or unlike property in addition to the new real estate.

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