

RENTAL PROPERTY INFORMATION

Overview

Rental profit and loss is determined by applying actual income to actual expenses. There is no such thing, for example, as a “deduction” for the loss or rent not collected due to vacancy or eviction. Instead, the loss is reflected in the excess of expenses not offset by any income for that period.

Income

Income is rent collected during the year. This will include first and last month’s rent but it will not include the security deposit. The security deposit is held for the benefit of the tenant and must be returned, minus appropriate charges, at the conclusion of the lease period. If, at some future date the security deposit is applied to rent (such as for the last month), at that point it will count as income.

Fair Market Rent

Though it has never been clearly litigated, the IRS is of the opinion that if you do not have the subjective intent to make a profit, you will not be allowed to deduct a rental loss. Common examples of failing to have a subjective intent to make a profit include:

1. Renting property to an immediate family member at below fair market value.
2. Having a rental allegedly available which is either not advertised or advertised for an exorbitant rate.
3. Renting to a non-family member at a very low rate not reflecting a reasonable rental market.

Very Important – Expenses vs. Repairs

One of the most successful audit programs of the IRS involves the difference between repairs and improvements. There is a long line of case law supporting the rule that repairs are deductible and improvements are not. The difference in treatment can have dramatic tax consequences.

A typical example is the unsuspecting, do-your-return-yourself taxpayer who deducts the full \$8000 he just paid for a new roof on his rental. Completely unaware he should depreciate this new roof over 27.5 years rather than all at once, he is easy pickings for the IRS computer system. Programmed to look for very large expenditures relative to the operating costs of a rental, these mis-allocations are extremely easy to find. A quick audit will result in the taxpayer receiving his 1/28th deduction and having to give all the rest back with interest and penalties.

But even taxpayers receiving expert advice might run afoul of this program. The roof case I cite above is a clear-cut case,¹ others are not. If a property owner replaces a series of windows, for example, how many windows will it take before a repair crosses over into an improvement. Aggressive attorneys (and I include myself) stay away from certain hot-button issues like the roof case, and concentrate on grey areas like the window case.

The fundamental difference, as far as I can tell, is that an improvement increases the value of the property while a repair maintains the value of the property. Having said that, there are dozens of cases all over the map on which is which. It is truly an area fraught with peril and ripe for litigation. The courts have decided on very few issues as to what is a repair. A notable one to keep in mind is that painting is always a repair.

This is an area where careful planning cannot be overemphasized. I will discuss below how to prepare for this decision making if you are affected.

Methodology for Repairs vs. Improvements

My method here is to breakdown large expenditures into smaller parts. In the tax world this is known as “cost segregation.” Each expense may then be managed and properly allocated. Installing a new bathroom is a prime example. Upgrading bathroom fixtures and pipes will probably be improvements. But replacing the rotted out under flooring will be a repair, as it is absolutely necessary to the maintenance of the property. Were these expenses to be lumped together, there is little chance they would not have to be depreciated. But broken into their smaller parts, the position taken is far more defensible.

Expenditures Requiring Depreciation

Unlike other businesses, rental property owners do not have the option to expense depreciable property in one year. This means a large purchase, such as carpeting or appliances, may not be deducted in their entirety in a single year. The property must be depreciated over time. These types of expenditures include carpeting, appliances and furniture. When bringing me information on these expenditures, I will need the date of purchase as well as the cost.

General Expenses

Here are some of the expenses I want to see totaled on an annual basis for each rental property. You may find all these items on my [rental property checklist](#).

1. All Forms 1098 showing mortgage interest paid during the year.
2. Property tax paid during the year, if not on Form 1098
3. Hazard insurance paid during the year, if not on Form 1098
4. Advertising
5. Cost of leasing (credit checks, etc)

¹ Though some might disagree, since a recent Tax Court case allowed the deduction of a new roof. Almost the entire tax law community, however, feels this was an anomaly.

6. Memberships (apartment owners association, etc.)
7. Utilities you pay
8. Homeowners Association Dues
9. Gardening expenses
10. Repairs (see above discussion)
11. Supplies (cleaning, gardening, etc)
12. Telephone (telephone expenses you incurred, including cell phone expenses)
13. Other interest (did you finance any rental operations)
14. [Do you have a home office for your rental business?](#)
15. Professional fees (legal fees for evictions, etc.)
16. Cleaning fees
17. Routine maintenance expense
18. Management fees
19. Travel expenses to rental property

Depreciation of the Property

The improvements on rental property must be depreciated. The value used is the lower of the basis (usually, but not always, the purchase price) or the fair market value as of the day the property is placed into service.

Only the portion of the value of the property representing improvements may be depreciated. A starting point for this analysis is the county tax bill, but this should not be accepted as the last word by any means. A careful analysis of the nature of the property may yield a different, more beneficial value.

I will therefore need to know the value of land and improvements on the date the property was first used as a rental, as well as the date itself.