

# **Rental Real Estate Deductions**

---

**12<sup>th</sup> Edition**

**Stephen Fishman, J.D.**

# Table of Contents

---

<b>Chapter 1 – Tax Deduction Basics for Landlords .....</b>	<b>1</b>
Learning Objectives .....	1
Introduction.....	1
How Landlords Are Taxed.....	1
Income Taxes on Rental Income.....	1
Income Taxes on Profits When You Sell Your Property .....	1
Social Security and Medicare Payroll Taxes.....	2
Net Investment Income Tax .....	2
Property Taxes .....	2
How Income Tax Deductions Work .....	3
What Can You Deduct? .....	4
How Your Tax Status Affects Your Deductions .....	6
The Value of a Tax Deduction.....	6
How Property Ownership Affects Taxes .....	7
Individual Ownership.....	8
Ownership Through a Business Entity.....	11
The Mini-Landlord: Renting Out a Room in Your Home .....	14
The IRS and the Landlord .....	15
Automated Underreporter Program .....	15
Six Tips for Avoiding an Audit .....	15
Review Questions.....	18
Review Answers .....	19
 <b>Chapter 2 – Landlord Tax Classifications .....</b>	 <b>21</b>
Learning Objectives .....	21
Introduction.....	21
The Landlord Tax Categories.....	21
Business Owner Versus Investor .....	21
Are You a Business Owner or an Investor? .....	22
The Importance of Good Records .....	24
Tax Consequences .....	24
Are You Profit Motivated? .....	25
What Is a Not-for-Profit Activity? .....	25
Tax Consequences of Not-for-Profit Rentals .....	27
How to Show Your Profit Motive.....	27
Real Estate Dealers.....	30
What Is a Real Estate Dealer? .....	31
Determining If You Are a Dealer.....	31
Other Factors That Point to Dealership .....	32
Tax Consequences of Being a Dealer .....	33
Review Questions.....	34
Review Answers .....	35
 <b>Chapter 3 – Deducting Your Operating Expenses .....</b>	 <b>37</b>
Learning Objectives .....	37
Introduction.....	37
Requirements for Deducting Operating Expenses .....	37
Ordinary and Necessary .....	37
Current Expense.....	39
Business-Related.....	39
Reasonable in Amount.....	40
Operating Expenses That Are Not Deductible .....	41
Review Questions.....	42
Review Answers .....	43

## Table of Contents

<b>Chapter 4 – Repairs .....</b>	<b>45</b>
Learning Objectives .....	45
Introduction.....	45
The New IRS Rules: Repair Versus Improvement.....	45
Three New Safe Harbors .....	46
Safe Harbor for Small Taxpayers (SHST).....	46
Routine Maintenance Safe Harbor .....	49
De Minimis Safe Harbor .....	51
Repair Versus Improvement Analysis Under the Regulations .....	52
Defining the Unit of Property (“UOP”) .....	52
What is an Improvement? .....	54
Other Issues Under the Repair Regulations .....	58
How New IRS Regulations Affect Prior Years.....	60
How to Deduct Repairs and Maintenance .....	61
Making Tenants Pay for Repairs .....	61
Repairs Paid for or Performed by Tenants.....	62
Tips for Maximizing Your Repair Deductions .....	62
Patch, Mend, and Make Do—Don’t Replace .....	62
Properly Document Repairs .....	63
Do Preventive Maintenance .....	63
Delay Big Repair Expenses.....	63
Review Questions.....	64
Review Answers .....	65
<b>Chapter 5 – Depreciation Basics .....</b>	<b>67</b>
Learning Objectives .....	67
Introduction.....	67
Depreciation: The Landlord’s Best Tax Break.....	67
Understanding the Basics .....	68
What Property Can Be Depreciated? .....	68
How Depreciation Works.....	70
Taking Separate Deductions .....	71
How to Depreciate Buildings .....	72
What Is a Building? .....	72
When a Building Is Placed in Service .....	72
Determining a Building’s Basis .....	73
The Depreciation Period .....	76
How Much You Depreciate Each Year .....	77
Depreciating Additions and Improvements .....	78
Depreciating Land Improvements.....	80
Changes to Land .....	80
Structures Other Than Buildings .....	81
Depreciation Methods .....	81
Deducting Personal Property .....	81
What Is Personal Property? .....	82
How to Deduct or Depreciate Personal Property .....	83
De Minimis Safe Harbor .....	83
Materials and Supplies Deduction .....	86
Bonus Depreciation .....	87
Regular Depreciation .....	89
When Is Personal Property Placed in Service?.....	89
Determining the Basis of Personal Property .....	89
Depreciation Period .....	90
First-Year Depreciation .....	91
Depreciation Methods .....	92
Listed Property .....	93
Section 179 Expensing .....	94

## Table of Contents

When You Sell Your Property .....	96
Adjusted Basis.....	96
Effect of Adjusted Basis When You Sell .....	97
Like-Kind Exchanges: Deferring Taxes on Rental Property.....	98
The Home Sale Exclusion—Avoiding Taxes When You Sell Your Rental .....	99
Tax Reporting and Record Keeping for Depreciation.....	100
Review Questions.....	102
Review Answers .....	105
<b>Chapter 6 – Maximizing Your Depreciation Deductions .....</b>	<b>109</b>
Learning Objectives .....	109
Introduction.....	109
Determining the Value of Your Land and Buildings.....	109
There Is No One Way to Determine Land and Building Values.....	110
Figuring Your Improvement Ratio.....	110
Property Tax Bill .....	111
Replacement Cost .....	112
Buyer-Seller Valuation .....	113
Comparable Land Sales.....	114
Segmented Depreciation.....	114
Identifying Your Personal Property.....	116
Determining Fair Market Value of Personal Property .....	117
Steps to Calculate Segmented Depreciation .....	117
Review Questions.....	120
Review Answers .....	122
<b>Chapter 7 – Interest .....</b>	<b>125</b>
Learning Objectives .....	125
Introduction.....	125
Interest Landlords Can (and Can't) Deduct.....	125
Mortgage Interest.....	126
Interest, Not Principal, Is Deductible .....	126
Expenses to Obtain a Mortgage .....	126
Private Mortgage Insurance .....	127
Mortgage Refinancing .....	127
Mixed-Use Properties .....	127
Other Interest Expenses .....	127
Credit Cards and Loans .....	127
Car Loans.....	128
Home Offices.....	128
Home Equity Loans .....	128
Points and Prepaid Interest.....	128
Interest on Construction Loans.....	129
Loans With Low or No Interest .....	129
Loans on Rental Property Used for Nonrental Purposes.....	130
Keeping Track of Borrowed Money .....	130
30-Day Rule .....	131
Allocation Rules.....	131
Review Questions.....	132
Review Answers .....	134
<b>Chapter 8 – Start-Up Expenses.....</b>	<b>137</b>
Learning Objectives .....	137
Introduction.....	137
What Are Start-Up Expenses? .....	137
Determining Your Business Start Date .....	138
Rental Business Begins When You Offer Property for Rent.....	138

## Table of Contents

Expanding an Existing Rental Business .....	139
Avoiding the Start-Up Rule's Bite .....	140
How to Deduct Start-Up Expenses .....	140
Expenses You Can Deduct .....	141
Costs That Are Not Start-Up Expenses .....	141
If Your Business Doesn't Last 15 Years .....	143
If Your Business Never Begins.....	143
Review Questions.....	144
Review Answers .....	145
<b>Chapter 9 – The Home Office Deduction .....</b>	<b>147</b>
Learning Objectives .....	147
Introduction.....	147
Qualifying for the Home Office Deduction.....	147
Threshold Requirements.....	148
Additional Requirements .....	149
Calculating the Home Office Deduction.....	150
How Much of Your Home Is Used for Your Rental Business? .....	151
What Expenses Can You Deduct? .....	151
Simplified Home Office Deduction Method .....	154
How the Simple Method Works .....	154
Is the Simplified Method a Good Deal? .....	155
IRS Reporting Requirements .....	155
Audit-Proofing Your Home Office Deduction.....	155
Prove That You Are Following the Rules .....	156
Keep Good Expense Records .....	156
Deducting an Outside Office .....	156
Renting an Office .....	156
Using an Office in Your Rental Building.....	156
Buying a Separate Office Building.....	157
Review Questions.....	158
Review Answers .....	160
<b>Chapter 10 – Car and Local Transportation Expenses .....</b>	<b>163</b>
Learning Objectives .....	163
Introduction.....	163
Deductible Local Transportation Expenses.....	163
Travel Must Be for Rental Activities.....	163
Driving From and to Home .....	164
The Standard Mileage Rate .....	166
How the Standard Mileage Rate Works.....	166
Requirements to Use the Standard Mileage Rate .....	166
The Actual Expense Method .....	167
How the Actual Expense Method Works.....	167
Record-Keeping Requirements .....	168
Vehicle Depreciation Deductions.....	168
Leasing a Car .....	172
Other Local Transportation Expenses .....	172
Reporting Transportation Expenses on Your Tax Return .....	172
Review Questions.....	173
Review Answers .....	174
<b>Chapter 11 – Travel Expenses .....</b>	<b>175</b>
Learning Objectives .....	175
Introduction.....	175
What Are Travel Expenses?.....	175
Where Is Your Tax Home?.....	175

## Table of Contents

Your Trip Must Be for Rental Business.....	176
Deductible Travel Expenses.....	178
Traveling First Class or Steerage.....	178
Taking People With You.....	178
How Much You Can Deduct.....	179
Calculating Time Spent on Rental Activities .....	179
50% Limit on Meal Expenses .....	180
Maximizing Your Travel Deductions .....	181
Plan Ahead.....	181
Make a Paper Trail .....	181
Maximize Your Rental Activity Days.....	182
Take Advantage of the Sandwich Day Rule.....	182
Review Questions.....	183
Review Answers .....	184
<b>Chapter 12 – Hiring Help .....</b>	<b>185</b>
Learning Objectives .....	185
Introduction.....	185
Deducting Payments to Workers .....	185
Operating Expenses .....	185
Start-Up Expenses.....	186
Depreciation Expenses .....	186
Employees Versus Independent Contractors.....	186
Tests to Determine Workers' Tax Status .....	187
Common Classifications for Workers.....	188
Tax Rules When Hiring Independent Contractors.....	188
Threshold for IC Income Reporting.....	189
Obtaining Taxpayer Identification Numbers.....	190
Filing IRS Form 1099-MISC .....	190
Reporting Requirements Don't Apply to Corporations.....	192
New Hire Reporting Requirements for ICs.....	192
Paying Independent Contractors' Expenses .....	192
Tax Rules for Employees .....	193
Employer's FICA Contributions .....	193
FUTA.....	193
FITW .....	194
State Payroll Taxes.....	194
Hiring Your Family .....	195
Employing Your Children .....	195
Employing Your Spouse.....	196
Rules to Follow When Employing Your Family .....	196
Hiring a Resident Manager .....	198
No Payroll Taxes for Free Lodging .....	199
Minimum Wage Requirements .....	200
Review Questions.....	201
Review Answers .....	203
<b>Chapter 13 – Casualty and Theft Losses.....</b>	<b>205</b>
Learning Objectives .....	205
Introduction.....	205
What Is a Casualty?.....	205
External Force Required .....	206
Theft or Vandalism.....	206
Calculating a Casualty Loss Deduction .....	206
Insurance.....	207
Property a Total Loss.....	207
Property a Partial Loss.....	207

## Table of Contents

Deducting Separate Components .....	208
Damage to Your Home Office .....	209
Effect of Casualty Losses on Basis .....	209
Disaster Area Losses .....	209
Repair and Replacement Costs for Casualty Losses .....	210
Casualty Gains .....	210
Tax Reporting and Record Keeping for Casualty Losses .....	211
Review Questions .....	212
Review Answers .....	213
<b>Chapter 14 – Additional Deductions.....</b>	<b>215</b>
Learning Objectives .....	215
Introduction.....	215
Dues and Subscriptions .....	215
Education Expenses .....	215
Before You Are in Business .....	216
Traveling for Education .....	216
Gifts.....	216
Insurance for Your Rental Activity .....	217
Homeowners’ Insurance for Your Home Office.....	217
Car Insurance .....	217
Prepaying Your Insurance Premiums.....	217
Legal and Professional Services .....	218
Buying Long-Term Property .....	218
Management Fees.....	218
Starting a Business .....	218
Accounting Fees.....	218
Meals and Entertainment .....	219
Whom Can You Entertain? .....	219
You Must Discuss Your Rental Activity.....	219
Calculating Your Deduction.....	219
Taxes .....	220
Real Property Taxes .....	220
Employment Taxes .....	220
Tax Break for Accessibility Changes .....	221
Energy Efficiency Deduction .....	221
Unpaid Rent .....	222
Review Questions .....	223
Review Answers .....	224
<b>Chapter 15 – Vacation Homes.....</b>	<b>225</b>
Learning Objectives .....	225
Introduction.....	225
The Vacation Home Tax Morass .....	225
Regular Rental Property.....	226
Tax-Free Vacation Home .....	226
No Tax Due on Rental Income .....	227
Tax Deductions.....	227
Vacation Home Used as Rental Property .....	228
Deducting Expenses .....	228
The Hobby Loss and Passive Loss Rules .....	229
Vacation Home Used as Residence .....	230
You Cannot Deduct Losses.....	230
Calculating Your Deductions .....	230
Calculating Personal and Rental Use .....	232
Calculating Personal Use .....	232
Calculating Rental Use .....	234

## Table of Contents

Putting Your Calculations Together.....	234
Converting Your Home to a Rental Property.....	234
Review Questions.....	236
Review Answers .....	237
<b>Chapter 16 – Deducting Rental Losses .....</b>	<b>239</b>
Learning Objectives .....	239
Introduction.....	239
What Are Rental Losses? .....	239
Overview of the Passive Loss Rules .....	240
What Are the PAL Rules For?.....	240
How the PAL Rules Work.....	240
The \$25,000 Offset.....	242
Requirements .....	242
Determining Your Offset Deduction.....	245
The Real Estate Professional Exemption .....	245
Real Estate Professional Test .....	246
Materially Participate in Rental Activity .....	251
Applying the Test.....	252
What Happens If You Qualify for the Exemption? .....	253
The Real Estate Professional Exemption Is Not Optional.....	253
Record Keeping for the Real Estate Professional Exemption.....	254
Rental Activities Not Subject to PAL Real Property Rental Rules.....	256
Rentals for Seven Days or Less .....	256
Rentals for 30 Days or Less .....	256
Vacation Homes .....	256
Deducting Suspended Passive Losses.....	257
You Must Have Passive Income.....	257
The \$25,000 Offset.....	257
The Real Estate Professional Exemption .....	257
Profits From Sale of Property .....	257
Tax Reporting for Passive Rental Losses.....	258
Strategies for Dealing With the Passive Loss Rules .....	259
Lower Your Rental Expenses.....	259
Use Home Equity Loans .....	259
Generate More Passive Income.....	259
At-Risk Rules.....	260
How to Deduct Rental Losses .....	261
Calculating Your Net Operating Loss .....	261
Carrying a Loss Back.....	262
Electing to Carry Forward an NOL Instead .....	263
Review Questions.....	264
Review Answers .....	266
<b>Chapter 17 – Record Keeping and Accounting.....</b>	<b>269</b>
Learning Objectives .....	269
Introduction.....	269
What Records Do You Need? .....	269
Paper Versus Electronic Records.....	269
Create Your Own Spreadsheet .....	270
Software Programs .....	270
A Simple Record-Keeping System .....	271
An Easy Filing System .....	271
Separate Checkbook and Credit Cards .....	271
Dealing With Receipts, Canceled Checks, and Other Supporting Documents.....	272
Expense Journal .....	275
Rental Income Journal .....	278

## Table of Contents

Asset Records .....	279
Records Required for Local Travel .....	281
Records Required for Long-Distance Travel, Meals, Entertainment, and Gifts .....	283
How Long to Keep Records .....	284
When You Don't Have Proper Tax Records .....	285
Accounting Methods .....	286
Cash Method .....	286
Accrual Method.....	288
Tax Years.....	289
Review Questions.....	290
Review Answers .....	291
<b>Chapter 18 – All About Schedule E.....</b>	<b>293</b>
Introduction.....	293
Who Must File Schedule E?.....	293
Filling Out Schedule E .....	294
Filing IRS Forms 1099 (Lines A and B) .....	294
Property Description (Line 1).....	297
Dual Use Properties (Line 2).....	297
Qualified Joint Venture (Line 2).....	297
Rental Income (Line 3).....	297
Royalties Received (Line 4) .....	297
Expenses (Lines 5-20) .....	298
Rental Summary (Lines 21-26).....	299
Review Questions.....	301
Review Answers .....	302
<b>Chapter 19 – The Net Investment Income Tax.....</b>	<b>303</b>
Learning Objectives .....	303
Introduction.....	303
How the NII Tax Works .....	303
What Is the NII Tax? .....	303
Who Is Subject to the NII Tax.....	303
Amount of the Tax .....	304
Real Estate Professional Exemption From the NII Tax .....	305
Real Estate Professional.....	305
Material Participation in Rental Activity.....	305
Rental Activity a Business .....	306
Planning to Avoid the NII Tax.....	306
Review Questions.....	308
Review Answers .....	309
<b>Glossary.....</b>	<b>311</b>
<b>Index .....</b>	<b>315</b>