Rental property tax guide

Owning rental property can provide you with a predictable stream of income and potential long term price appreciation of the property. With rents on the increase and property values still on the decline in many areas, it might be a good time to become a landlord.

Taxation:

Rent collected from your tenants, less operating expenses and depreciation is subject to Federal tax. Most recently purchased rental properties will create a loss in the beginning. This loss is classified as passive and may or may not be deductible depending on your situation. In general, actively managed rental property can create a current deductible a loss of up to $25,000 per year which can be used to offset other income. This deductibility is phased-out for taxpayers with incomes between $100,000 and $150,000, but not lost. It is carried forward for future use.

Rental income:

Rental income includes all payments received for occupancy of the property including

- Current rent
- Advance rent
- Expenses paid by the tenant that are deducted from rent

Security deposits are not currently included in income until you keep them.

Operating expenses: can be currently deducted and should be documented.

Expenses that are ordinary and necessary to collect rental income include the following:

- Advertising
- Auto expenses to manage and maintain the property (56¢/mile for 2014, 57.5¢/mile for 2015)
- Cleaning and maintenance including supplies tools, yard work, and snow removal
- Commissions paid
- Insurance
- Legal and professional fees
- Management fees
- Mortgage and other rental related interest
- Repairs that keep the property maintained carpentry, electrical, painting, decorating, plumbing, heating
- Supplies
- Taxes on real estate
- Travel to maintain and manage the property
- Utilities including electricity, garbage, sewer, heat, cable, telephone, water, softener…

Depreciation:

The depreciation deduction allows you to recover your costs on major purchases including the property itself. The depreciation deduction is mandatory. These large expenditures are depreciated over time, not deducted currently as the expenses above. Items to depreciate include:

- The cost of the building including closing costs. (Do not include the land cost).
- Improvements that make the property better, restore it, or adapt it to a different use.
- Equipment, furnishings, and appliances designed to last more than one year.
- Outdoor improvements such as fences, driveways, sidewalks…

Sale of your property:

Upon the sale of your rental property a taxable gain or a deductible loss might result. To calculate the gain/(loss), use the following formula:

Sale price
-cost plus improvements
+depreciation
<u>-costs of selling</u>
Gain or (loss)

> Because of the depreciation add-back and appreciation, the taxable gain could be large. You still have options. Section 1031 of the IRS Code allows you to trade your property for another and defer your gain to the future. This move requires professional help.