

MONEY IN YOUR POCKET: THE 10 BIGGEST TAX BREAKS FOR LANDLORDS

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No landlord would pay more than necessary for utilities or other operating expenses for a rental property. Yet millions of landlords pay more taxes on their rental income than they have to. Why? Rental real estate provides more tax benefits than almost any other investment. Often, these benefits make the difference between losing money and earning a profit on a rental property. Here are the top ten tax deductions for owners of residential rental property.

1. OPERATING EXPENSES:

There are many different types of operating expenses, which may vary depending on the type of property. Accordingly, the IRS does not attempt to provide an all-inclusive list: rather, the tax code gives the definition of an operating expense, so you can decide for yourself (subject to IRS second-guessing, of course). To be deductible, the expense must be: (1) *“ordinary and necessary; (2) current (i.e., less than a year); (3) directly related to your rental activity; and (4) reasonable in amount.”* (IRC sec. 162). Therefore, all expenses reasonable and necessary to operate and maintain an income producing property are tax deductible. These include expenses such as property management fees, property taxes, office supplies, leasing commissions, license fees, accounting fees, advertising costs, legal fees and judgments and settlements, insurance premiums, janitorial service, lawn maintenance services, pest control, repair costs, salary and wages, snow removal service, miscellaneous supplies, telephone, trash removal, vehicle mileage expenses, utilities, etc.

Operating expenses that are not deductible include federal income taxes paid on rental income, professional examination fees, club dues (country club, social club, airline club, athletic club) charitable donations (unless made by a C Corp.), lobbying expenses beyond a \$2,000 limit, illegal bribes or kickbacks, 2/3 of federal antitrust damages, and fines or penalties paid for law violations.

2. START UP EXPENSES:

Closely related to operating expenses are “start up expenses.” The only difference is that operating expenses occur *after* the business begins; start up expenses occur *before* the business begins. However, they are usually the same kinds of expenses. These include: make ready repairs, home office expenses, seminars, insurance costs, office expenses (telephone, rent, utilities, etc.), market research costs, permits and fees, professional service fees, hiring expenses, and maintenance expenses.

Up to \$5,000 in start up expenses can be deducted your first year in business. Amounts over \$5,000 are a capital expense and are amortized over 15 years.

Note that the deduction rules refer to a business. Investors (who do not have a business) may not deduct start up expenses. Further, if you have expenses investigating a business but never start one, you may not deduct start up expenses.

3. REPAIRS:

Repairs can be some of the most valuable deductions available to a property owner. Yet, the IRS will disallow some repair deductions on the basis that they are “improvements,” which must be depreciated. Knowing the difference between “repairs” and “improvements” can provide valuable deductions in a given year.

Repairs:

A “repair” keeps your rental property in good condition, but it does not (1) materially add value to your property, (2) substantially prolong its useful life, or (3) make it more useful. (Regulation sec. 1.162-4). A repair is a deductible expense in the year that you pay for it. Repairs include painting, fixing a broken toilet and replacing a faulty light switch. The cost of repairs to rental property (provided the repairs are ordinary, necessary, and reasonable in amount) are fully deductible in the year in which they are incurred. Good examples of deductible repairs include repainting, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows.

Improvements:

Rental property owners may assume that anything they do on their property is a deductible expense. *Not so*, according to the IRS. “Improvements” add value to your property and are not deductible when you pay for them. You must recover the cost of improvements by depreciating the expense over your property’s life expectancy. Improvements can include a new roof, patio or garage. From a tax standpoint, you should make repairs as the problems arise instead of waiting until they multiply and require an improvement.

A good thumbnail test of whether a fix is a repair or an improvement is a repair merely returns the property to more or less the state it was in before the repaired item stopped working properly.

4. DEPRECIATION:

Depreciation is one of the greatest tax benefits to a real estate investor. It has often been said that “depreciation” means “money in your pocket.”

As a general rule, business expenses are deductible. The biggest expense to a landlord is the price paid for the rental property itself. Unlike interest or other operating expenses that are deducted in the year they are paid, real estate lasts much longer than a year. Therefore, the IRS requires that the cost of rental real estate be deducted over the useful life of the property. This type of long-term deduction is called depreciation.

One reason that depreciation is so valuable to a rental property owner is because depreciation is a bit like residual income: you get it every year. This means that you make a purchase once, and without any additional expenditure, you continue to get the deduction. Another reason it is so valuable is that depreciation can make the difference between a profit and a loss on a given property.

The Internal Revenue Code (I.R.C.) section 167 states that property may be depreciated that: (1) lasts for more than one year (i.e., is a “capital asset”); (2) wears out or gets used up over time; (3) is owned for longer than one year; and (4) is used in rental or other income-producing activity. Each of these requirements is further defined below.

1. CAPITAL ASSETS/DURABLE GOODS

In economic terms, assets that last for more than one year are called “durable goods”: in tax language they are called “capital assets.” Either way, these are assets designed to last more than a year. Examples of capital assets are vehicles, stoves, refrigerators and other large appliances, office equipment, maintenance equipment, and, of

course, the building itself. By contrast, inventory is not a capital asset and is deducted as it is sold.

2. PROPERTY THAT GETS USED UP OR WEARS OUT OVER TIME

Depreciable assets are only those that get used up or wear out over time. Applying this test, several long-lasting assets cannot be depreciated, such as land, securities and collectibles. Land cannot be depreciated because, unlike a durable good, which has a limited useful life, land lasts forever. So do securities and collectibles. Thus, a property owner can only depreciate the buildings on the property and not the land itself.

Applying the “used up/wears out” test, buildings and structures are depreciable. These include apartment buildings, sheds, parking structures, swimming pools, houses, mobile homes, parking lots and driveways, tennis courts and recreational structures, clubhouses, and any other facility used in a rental property.

In addition to structures, landscaping costs are depreciable. Personal business property (that lasts for more than a year) can also be depreciated, such as stoves and other large appliances, furniture, carpeting, office equipment and maintenance equipment.

3. PROPERTY THAT IS OWNED FOR MORE THAN ONE YEAR

The key word is “owned.” In other words, leased property cannot be depreciated. However, the word “owned” does not mean that you must own the property free and clear. You may have little or no equity in the property, but as long as your name is on the title, you are the owner. Also, because the requirement is that the property must be owned for more than one year, property that is bought and sold within the same year cannot be depreciated.

4. PROPERTY USED IN RENTAL ACTIVITIES

This requirement mainly distinguishes business property, which is depreciable, from personal property, which is not depreciable. If certain property is used for both business and personal reasons, then it is proper to allocate the business and personal uses and depreciate only that portion of the property that is used in the business.

THE NUTS AND BOLTS OF DEPRECIATION

To depreciate an asset is to deduct a percentage of the asset’s basis each year of its recovery period. This simple statement requires a lot of detailed explanation.

1. Placed in service.

Depreciation begins when an asset is “placed in service.” For rental property, this means when the property is ready to rent. Property is not in service if it is being rehabbed or being made ready to rent. Conversely, depreciation ends when the property is retired from service, destroyed or sold.

2. Basis.

Basis is the amount of your total investment in the property, minus the land value. For a rental property recently purchased, the basis may include the cost of the property, transaction expenses, real estate transfer taxes and fees.

3. Recovery Period.

The recovery period is the length of time the IRS has determined you must use to depreciate an asset. The recovery period varies depending upon the type of asset. Examples of recovery periods for certain assets are: software -- 3 years; computers, vehicles, appliances, carpet, furniture and draperies -- 5 years; Office furniture/equipment -- 7 years; landscaping, fences, driveways, swimming pools -- 15 years; rental real estate -- 27.5 years; commercial real estate -- 39 years.

4. The Amount to Deduct

The amount to deduct is a fixed percentage of the property’s basis each year. However, the percentage will depend upon the depreciation method that is used. Real Property is required to use the straight line method, which means an equal amount each year of the recovery period. Eligible personal business property uses the accelerated depreciation method, which allows for larger depreciation amounts in the earlier years. For example, for residential rental property, you would be allowed to deduct approximately 3.636% of the basis of the property each year for

about 27.5 years (first and last years have special rules).

ADDITIONS AND IMPROVEMENTS

Changes you make to a building that “substantially add value or increase its useful life are classified as “additions or improvements.” These changes to the building will be depreciated separately from the way you depreciate the building itself. Some examples of additions or improvements are: adding new living areas or square footage; replacing roofs, windows, doors, or balconies; or installing new appliances, countertops, cabinets plumbing or wiring.

By contrast a *repair* does not substantially add to the value or useful life of a property but merely returns it to its normal condition. Repairs are operating expenses and can be deducted fully in the same year the expense was made.

TAX TIP: *Characterize changes to rental property as repairs rather than improvements to the extent allowable by law. You may maximize yearly deductions by carefully planning how you go about making changes to property. That means to keep the property in good condition with timely repairs rather than allowing repairs to mount until a major renovation is required.*

DEPRECIATING “NON-BUILDING” PERMANENT STRUCTURES

What does the tax code allow for sprinkler and drainage systems, driveways and parking structures, swimming pools, gazebos, fencing and gates, sidewalks and outdoor safety lighting at night? These are permanent structures that are associated with and support residential rental property. The tax code provides that these structures may be depreciated over a period of 15 years.

DEPRECIATING “PERSONAL PROPERTY”

Capital assets that are used in a rental activity but are not residential rental property are classified as “personal property.” A better term is “personal business property “ because it is clearly used for business, but could be considered of a “personal” nature. It can be deducted using one of three methods (in order of importance): (1) Section 179 expensing; (2) 50% first year bonus depreciation, if applicable; or (3) regular depreciation.

Personal property includes window treatments, furniture owned by the landlord, temporary partitions or barriers, signage, and tacked-down carpets, landscaping and maintenance equipment, vehicles and office equipment and furniture in the business office. It also includes equipment in common areas, such as laundry equipment, exercise equipment, recreational equipment.

SUMMARY OF DEPRECIATION

Depreciation is the most valuable tax break available to a rental property owner. It is simple in concept but complex in practice. To learn more details about depreciation for rental property owners, consult IRS Publication 946, available online at IRS.gov.

PASSIVE LOSSES

On paper at least, real estate often loses money. Even if the rent pays the mortgage and the operating expenses, the books still show a loss because you get to write off a portion of the purchase price through depreciation each year. However, the U.S. Congress has labeled real estate investment a passive activity and requires that, with two exceptions, you can't write off passive activity deductions unless you show overall positive passive income. This passive loss limitation rule means that many real estate investors lose valuable tax saving deductions from real estate.

Congress has created two exceptions to the passive loss rule: (1) If you're an *active real estate investor* with adjusted gross income below \$100,000, you can write off up to \$25,000 of passive losses annually. If your income is between \$100,000 and \$150,000, you get to write off a percentage of the \$25,000. For example, if your adjusted gross income is between \$100,000 and \$150,000, you can deduct up to $(\$150,000 - \text{Your Income})/2$. So if your AGI is \$120,000, you can deduct up to \$15,000 $(150k - 120k)/2$.

(2) If you're a real estate professional, Congress completely exempts you from the passive loss limitation rule with regard to real estate. A *real estate professional* is someone who spends at least 750 hours a year and more than 50% of their time working as a real estate agent, broker, property manager or developer. This includes property development, construction, acquisition and management.

5. INTEREST:

Interest can be one of the landlord's biggest deductible expenses. Common examples of interest that landlords can deduct include mortgage interest payments on loans used to acquire or repair rental property and interest on credit cards for goods or services used in a rental activity. All mortgage interest paid on any loan or loans secured by income property is tax deductible

All points paid on any mortgage or loan secured by an income producing property are deductible over the life of the loan. For example, if you obtain a \$100,000 loan with a 20 year term and you pay 1 point to obtain the loan, you can write-off \$50 a year over the 20 year period for a total of \$1,000. If you sell the income property and pay off the balance of the mortgage early, you can deduct all unused points in that year.

Miscellaneous closing costs connected with obtaining a loan for an income producing property such as mortgage insurance premiums, fees for an appraisal required by a lender, title search fees, loan origination fees, recording fees and abstract fees are added to the basis of the property and are depreciated along with the property itself.

You may also deduct home mortgage interest in the proportion of your home office to your personal residence if you take a home office deduction. You may also deduct interest on a car loan that is used for business, subject to proration for the percentage of business use.

6. HOME OFFICE:

Provided they meet certain minimal requirements, landlords may deduct their home office expenses from their taxable income. This deduction applies not only to space devoted to office work, but also to a workshop or any other home workspace you use for your rental business. This is true whether you own your home or apartment or are a renter.

The strict requirements for a home office deduction are: (1) you have a rental business (i.e., you are not an investor); (2) your home office is used exclusively for your business; and (3) you regularly use your home office for business. You must also meet one additional requirement: (1) you have no other office for your business; or (2) you have another office, but your most important work is done in your home office; or (3) you meet tenants at your home office; or (4) you use another, separate building on your property only for your business.

7. VEHICLE DEDUCTION:

For local travel (vs. overnight travel) Landlords often use a personal vehicle to conduct local business, regardless of whether you have a real estate business or merely an investment. Local travel for your rental activity can be deducted in the year you make the expenditure, but personal trips are not deductible.

Both investors and business owners can deduct business travel from their home to a business location IF they have a home office (which meets the IRS requirements for a home office). Without a home office, travel from home to a business location is not deductible, even if you had a business purpose for the trip. However, even if you do not have a home office, some trips may be deductible. For example, travel from your home to a “temporary work location” is deductible. A temporary work location is a place you may perform some amount of work for less than a year. This could be travel to a location where you have a P.O. box, or to a bank, a hardware store, to a seminar, etc.

There are three ways to deduct the cost of a vehicle.

1. Standard Mileage Rate

This is the simplest and easiest method to use. For 2012, the standard mileage rate is 55.5 cents/mile. You may also deduct parking expenses and tolls for business trips, interest on a car loan and property taxes you may have paid when you registered your car. No other vehicle expenses are allowed under this method.

2. Actual Expense Method

This method allows you to deduct the actual expenses of operating your vehicle for business use. It requires careful recordkeeping to document every expense you wish to deduct. This includes all expenses associated with operating a car, including gas, oil changes and even car washes. However, you must pro-rate the actual expense total by the amount of business vs. personal use. For example, if you used your car 60% of the time on business, you can deduct 60% of the actual expenses. However, you can deduct 100% of parking costs and tolls for business travel.

In addition, you can also depreciate the cost of your vehicle over five years. If you use your vehicle less than 50% of the time for business, you must use the straight-line method, which provides roughly equal deductions per year. If you use the car more than 50% of the time for business, you may use the accelerated depreciation method, which allows a larger deduction in the early years. Again, your deduction is prorated to the amount of personal vs. business use.

3. Section 179 Expensing

Subject to certain requirements, SUVs can be expensed under section 179 for up to \$25,000 in the first year. The limitations are: (1) the vehicle must have a gross vehicle weight of at least 6,000 pounds (hence, an SUV); (2) you must have a rental business (active) and not be an investor (passive); and (3) you must use the vehicle at least 51% of the time for business use.

Section 179 applies to either a new or used car you have purchased in the year you claim the deduction, but it does not apply to a vehicle you already owned and converted from personal use.

If the cost of the vehicle exceeds \$25,000, the remaining cost can be deducted over the next five years. In some cases this may amount to a deduction the first year of approximately \$36,000! No wonder a lot of people are buying SUVs!

8. TRAVEL EXPENSES:

Overnight Travel

If your rental business requires you to travel overnight, you can deduct the cost of your trip. This includes airfare, hotel bills, meals, and related expenses. If you do not stay overnight, your expenses are generally not deductible. Deductible business travel must be “ordinary and necessary.”

Travel expenses for properties you buy are not deductible, but instead are depreciated over 27.5 years. Travel expenses for properties you do not buy are deductible as an operating, rather than a travel expense. There are two broad categories of travel expenses: (1) transportation (“getting there”) expenses; and (2) destination (“once you’re there”) expenses. These expenses are fully deductible except for “business entertainment” expenses (only 50%

deductible) and meal and beverage expenses (also only 50% deductible).

Conventions and Cruises

Travel expenses to business conventions in North America that are related to your business are deductible, subject to the meal and entertainment 50% rule. Likewise, you may be able to deduct the cost of cruises that directly benefit your business, subject to certain limitations.

9. EMPLOYEES AND INDEPENDENT CONTRACTORS:

Whenever you hire anyone to perform services for your rental activity, you can deduct their wages as an operating expense. This is so whether the worker is an employee (a resident manager) or an independent contractor (a repair person). However, there is a big difference in your legal obligations when you hire an independent contractor (IC) vs. an employee.

It is much easier for you to have an IC work for you than employee. Employees require you to pay a number of federal and state taxes and to comply with detailed bookkeeping and governmental reporting requirements. ICs require none of this.

The test for whether someone who works for you is an IC or employee is *whether you have the right to direct and control the worker and work product*. For example, if you supervise, train or can overrule decisions of the worker, you have an employee. A resident manager is usually an employee. On the other hand, if all you can do is accept or reject the final work product (as in the case of a lawyer, accountant, plumber, electrician, etc.), then you have an IC. A management company is an IC.

ICs typically offer their services to the general public and do not rely upon your work for their sole support. They have special expertise and do not require you to train or supervise them. There are a number of other factors that the IRS looks at to determine a worker's status, but the major factor is the degree of control that you exercise over that person and their work.

Tax requirements are blessedly easy for ICs: you give them a 1099 at year-end for payments over \$600. If they are a corporation, not even a 1099 is required. Done! Employees are another matter. For an employee you must pay FICA (social security and medicare tax), FUTA (federal unemployment tax) and FITW (federal withholding tax). State payroll taxes, unemployment insurance, state disability and workers' comp insurance may be required, depending upon the state. As a general rule, if you can avoid hiring an employee, do so!

With one exception. You will want to hire your children from the age of 7 to 17 as employees. This can result in major tax benefits. The reason is that you can pay your child up to about \$5,950 tax-free! This is because it is the approximate amount of the standard deduction. Further, there are no withholding or FICA taxes on the \$5,950. Even better, your business can deduct the amount paid to your child! The tax reporting requirements are easy. You will need to file Form 941 four times/year—it will have lots of zeroes on it. You will also need to file a W-2 at the end of the year.

You do need to track the child's hours and activities to prove that they did the work and that the type of work was within their capacity. A consistently kept Excel spreadsheet or a simple notebook is acceptable. The Tax Court has permitted parents to employ children as young as 7 years old, as long as the work and pay are reasonable. Seven-year-old children can pick up debris, lick envelopes, place stamps and the like. Obviously, the older the child, the more they can do. The pay should be a bit less than you'd pay a third party.

10. MISCELLANEOUS DEDUCTIONS:

(a) Casualty and Theft Losses

If your rental property is damaged or destroyed from a sudden event, such as a fire or flood, you may be able to take a tax deduction for all or part of your loss. These losses are called casualty losses. You usually won't be able to deduct the entire cost of property damaged or destroyed by a casualty. How much you may deduct depends on how much of your property was destroyed and whether the loss was covered by insurance.

(b) Deducting losses on the sale of a home.

Due to the weak real estate market, many homeowners are forced to sell at a loss, if they are able to sell at all. Can a homeowner deduct this loss from income taxes? The answer to that question is "no", as a loss incurred on the sale of a personal asset such as a personal residence cannot be a business deduction.

But there is a way to deduct a loss on the sale of a home: You can convert it to a rental before you sell. This requires you to rent out the home to someone who is not related to you for a reasonable market rent. Moreover, you'll have to report the rental income you receive to the Internal Revenue Service—but you may have little or no taxable rental profits due to depreciation and other deductions for rental expenses.

© Medical Deductions

Costs to insure rental property are deductible, so if you structure your rental business correctly, you may be able to deduct your life and medical insurance as a business expense. Structuring your rental property management company as a Limited Liability Company (LLC) taxed as a C corporation may permit you to deduct these costs for you and your family. Talk to a tax advisor to find out more.

A FINAL WORD: KEEP GOOD RECORDS.

Under the IRS's Schedule E there are spaces for numerous categories of expenses. Therefore, the IRS gives you flexibility in the items you can deduct. But be prepared to back up your claim, and be sure to break out expenses that are for repairs and maintenance from those that are capital improvements. Remember, money you spend on improvements could reduce your tax liability when you sell.

In addition, if you claim to be a real estate professional, you should keep supporting documentation (appointment books, diaries, calendars, logs, etc.) to prove your active participation and the time spent on your properties each year. If you arm yourself with knowledge of the tax deductions that are legally available to those with a real estate business, you can enjoy seeing your taxes shrink and your wealth grow.