

ROYALTIES AND RENTAL INCOME

Royalties

1. Royalties are payments to an owner from people who use a right belonging to that owner. Royalties constitute ordinary gross income and are not a return of capital.

Rental Income

2. Cash or the FMV of property or services received for the use of real estate or personal property is taxable as rental income.
 - a. Rental from real estate is income from an investment, not from the operation of a business.
 - b. Schedule F is not used to report income and expenses from the rental of personal property, such as equipment or vehicles. Instead, Schedule C is used if the taxpayer is in the business of renting personal property. A taxpayer is in the business of renting personal if the primary purpose of renting the property is income or profit and the taxpayer is involved in the rental activity with continuity and regularity. If rental of personal property is not a business, any income belongs on Form 1040 (Schedule 1), line 8, and any deductions from the rental of personal property for profit on line 22.
 - c. A bonus received by a landlord for granting a lease is included in gross income.
 - d. A lessee's refundable deposit intended to secure performance under the lease is not income to the lessor.
 - e. Value received by a landlord to cancel or modify a lease is gross income.
 - 1) Amounts received by a lessee to cancel or a lease, however, are treated as amounts realized on disposition of an asset/property (a capital gain).
 - f. An amount paid by a lessee to maintain the property in lieu of rent, e.g., for property tax, is gross income to the lessor.

1. The lessor includes the payment in gross income and may be entitled to a corresponding deduction, e.g., property tax deduction.

Not-for-Profit Rental Income

1. If property is not rented to make a profit, taxpayers can deduct their rental expenses only up to the amount of their rental income. A taxpayer cannot deduct a loss or carry it forward to the next year if rental expenses are more than rental income for the year.
 - a. Not-for-profit rental income is reported on Form 1040 or 1040NR. Taxpayers can include their mortgage interest (if the property is used as their main home or second home), real estate taxes, and casualty losses on the appropriate lines of Schedule A if they itemize their deductions.
 - b. If rental income is more than rental expenses for at least 3 years out of a period of 5 consecutive years, taxpayers are presumed to be renting property to make a profit.
 - c. If taxpayers are starting a rental activity and do not have 3 years showing a profit, they can elect to have the presumption made after they have the 5 years of experience required by the test. They may choose to postpone the decision of whether the rental is for profit by filing Form 5213.
1. Form 5213 must be filed within 3 years after the due date of the return (determined without extensions) for the year in which the taxpayer first carried on the activity or, if earlier, within 60 days after receiving written notice from the Internal Revenue Service proposing to disallow deductions attributable to the activity.