TaxBrief

Keeping you informed

Tax Tips for Rental Property Owners

The real estate market offers many opportunities for investors and rental property owners to earn income, but the tax issues raised by their activities can be confusing. This newsletter provides a practical guide to help with questions about the tax implications of their rental activities.

Taxation of rental income

Income earned from residential rental properties is subject to the federal income tax and must be reported on your federal income tax return. Rental income is any payment received for the use or occupation of a property, including normal rent payments, payments for canceling a lease, security deposits used as a final rent payment or retained for damages, expenses paid directly by the tenant and services received in lieu of rent. Security deposits that will be returned to the tenant are not considered income at the time they are received.

Rent received from a residential property that is rented out fewer than 15 days a year does not need to be reported as income, but the owner is also not allowed to deduct any expenses. This is known as the "Masters exception" and generally applies to areas where individuals will rent out homes that are not normally available during popular events, such as the Masters golf tournament.

Deductible expenses

Landlords are allowed to deduct the ordinary and necessary expenses they incur while maintaining and managing their rental property. These deductions reduce the amount of their income that is subject to tax. Common deductions include:

- Mortgage interest
- Property taxes
- Insurance premiums
- Advertising
- Utilities
- Repairs

Note: The portion of a mortgage payment that is applied to paying down the principal is not deductible because it reduces the landlord's outstanding loan balance on a dollar-for-dollar basis. Thus, there is no "expense" to deduct.

Passive activity loss rules

There are limitations on the amount that a landlord may deduct if they are passive investors and rental activities are generally classified as passive activities, with an exception that is available to those who materially participate in the activity. Under the passive activity loss rules, if the deductible expenses of operating a rental property are greater than the amount earned from renting the property (in other words, the rental activity is operating at a loss), the deductible amounts can't exceed the income earned from the rental.

However, if a landlord can demonstrate that they materially participated in the rental activity, they can use the losses from their rental activity to offset ordinary income from other sources. The IRS uses seven tests to determine whether an individual materially participates in a passive activity, but the most applied test is whether they participated in the activity for more than 500 hours over the tax year.

Selling a rental property

When you sell your rental property, the sale is considered a sale of a business asset. This means that any gain is a capital gain, subject to the more favorable capital gains tax rates. If you have a loss on the sale of the property, you have an ordinary loss. An ordinary loss is deducted in full against your other income.

You should keep accurate records of the improvements you make to your property, the cost and when it was made. Improvements you make add to the basis of your property, and you'll need the records in the event of a sale. The more accurately you compute the basis, the more accurately you'll compute your gain or loss.

Net investment income tax

Individuals with a modified adjusted gross income (MAGI) of more than $200,000 ($250,000 if married filing jointly) may be subject to the 3.8% net investment income tax (NIIT) if they also have net investment income, which includes capital gains from the sale of a residential rental property. It's essentially a tax on investment income for high-income earners. The NIIT is imposed on the lessor of the taxpayer's net investment income or the amount by which their income exceeds the applicable threshold.

For example, an individual with a MAGI of $250,000 for the year had capital gains of $300,000. The tax would be applied to the $50,000 by which the individual's income exceeded the NIIT threshold and not the $300,000 in capital gains because it is the lower of the two amounts. Thus, the individual would owe $1,900 in NIIT ($50,000 x 0.38).

§1031 exchanges

To postpone the tax bite from selling a rental property, the owner can take advantage of an exchange under §1031 of the tax code. These are known as like-kind exchanges and allow a taxpayer to postpone recognizing the capital gains taxes the sale of a business or investment property by reinvesting the proceeds from the sale in a similar property. While the taxes are deferred, they are not forgiven, and the deferred gain must be recognized when the property is eventually sold without another §1031 exchange.

The replacement property must be identified within 45 days of the sale, and the purchase of the replacement property must be completed within 180 days. A qualified intermediary is usually required to hold the funds between the sale of the relinquished property until the purchase of the replacement property.

Still have questions?

If you have additional questions about the tax implications of being a landlord, we are here to help. Please feel free to contact us.