Rental Property Tax Guide

From Purchase to Sale | Residential Rental Property Owners

This guide explains the major federal tax considerations throughout rental property ownership, including basis, annual reporting, depreciation, rental losses, and sales.

Table of Contents **2**
1. Establishing Your Rental Property's Starting Tax Basis **3**
Property You Purchased 3
Converting a Primary Residence Into a Rental 3
Inherited Rental Property 3
Separate Land and Building Values 4
2. Reporting Rental Income and Expenses **4**
Rental Income 4
Common Rental Expenses 4
Repairs Versus Improvements 5
When Deductions Begin 5
3. Depreciation: A Valuable Rental Deduction **5**
The Basic Calculation 5
Improvements and Other Assets 5
Why Accurate Depreciation Matters at Sale 6
4. Passive Activity Loss Rules and Carryovers **6**
The General Passive Loss Rule 6
The Special $25,000 Allowance 6
Suspended Losses and Carryovers 6
What Happens When You Sell? 7
Real Estate Professional Rules 7
5. Selling a Rental Property **7**
Calculating Gain 7
How the Gain Is Taxed 8
Using Passive Loss Carryovers 8
Section 1031 Exchanges 8
Selling a Former Primary Residence 8
6. Maintaining Your Rental Property Records **8**
7. Tax Planning Throughout Ownership **9**
How Maryland Tax Service Can Help 9

Disclaimer: This guide provides general information about federal income tax rules for residential rentals and is not individualized tax advice. State tax rules and individual circumstances may differ. Short-term rentals, mixed personal/rental use, and rentals held through entities may require different treatment.

1. Establishing Your Rental Property's Starting Tax Basis

Your tax basis generally represents your investment in the property for tax purposes. It helps determine annual depreciation deductions and the taxable gain or loss when the property is sold. The starting calculation depends on how you acquired the property.

Property You Purchased

Starting basis generally includes the purchase price, qualifying acquisition closing costs (such as certain title and recording costs), and capital improvements completed before the property is placed in service. Financing charges, prepaid insurance, and escrow deposits generally do not become part of the building's basis.

Item	Amount
Purchase price	$350,000
Qualifying closing costs	$7,000
Improvements before renting	$18,000
Total starting basis	$375,000

Converting a Primary Residence Into a Rental

A former personal residence converted to rental use can have different bases for depreciation and for calculating a later gain or loss. The depreciation basis is generally the lower of adjusted tax basis or fair market value when the home is converted to rental use.

Example: A home purchased for $300,000 that is worth $450,000 at conversion generally retains a $300,000 depreciation basis, assuming no other adjustments. If it is worth $275,000 at conversion, the depreciation basis generally starts at $275,000. The gain/loss basis on a later sale follows separate rules when value declined at conversion.

Keep a reliable valuation and records of improvements as of the conversion date.

Inherited Rental Property

Inherited real estate generally receives a basis based on its fair market value at the decedent's date of death, subject to exceptions and certain estate valuation elections. For example, a property a parent purchased for $150,000 could have a $500,000 basis when inherited if that is its applicable date-of-death value.

Separate Land and Building Values

Land is not depreciable. Allocate the total basis reasonably between land and depreciable buildings, using an appraisal, relative fair market values, or appropriate property tax assessments. Retain the supporting documentation.

2. Reporting Rental Income and Expenses

Most individual owners report ordinary residential rental activity on Schedule E of Form 1040. Generally, cash-method landlords report rental income when received and qualifying operating expenses when paid.

Rental Income

- Rent and advance rent received
- Lease cancellation payments
- Nonrefundable deposits and security deposits retained
- Amounts tenants pay on your behalf that are your obligations

Refundable security deposits generally are not income upon receipt if intended to be returned. If retained or applied as rent, they generally become income.

Common Rental Expenses

Expense	General treatment
Mortgage interest	Generally deductible
Property taxes	Generally deductible
Insurance; management; HOA fees	Generally deductible when related to rental operations
Utilities, advertising, and professional fees	Generally deductible when related to rental operations
Ordinary repairs and maintenance	Generally deductible
Mortgage principal	Not deductible
Capital improvements	Generally capitalized and depreciated

Only the qualifying interest—not the principal—portion of a mortgage payment generally is deductible. Principal repayments reduce debt, not rental income.

Repairs Versus Improvements

Repairs ordinarily keep a property in working condition, such as fixing a faucet or patching drywall, and may be currently deductible. Major replacements or improvements, such as an entire roof or HVAC system, usually must be added to basis and depreciated. Certain IRS safe harbors can permit current deductions for qualifying costs.

When Deductions Begin

The property generally must be ready and available for rent before depreciation and ordinary operating treatment begin. Pre-rental costs may require different treatment. Record the date the property was first available for rent, not just the tenant move-in date.

3. Depreciation: A Valuable Rental Deduction

Depreciation spreads the depreciable cost of property over tax-prescribed recovery periods. It can reduce rental taxable income without requiring an equivalent annual cash payment.

The Basic Calculation

Most residential rental buildings under the general depreciation system are depreciated using straight-line depreciation over 27.5 years. The first and last years generally use the IRS mid-month convention, so the amounts differ from a full-year deduction.

Basis allocation	Amount
Land (20%)	$75,000
Building (80%)	$300,000
Total	$375,000
Approximate full-year building depreciation	$10,909

The $10,909 figure equals $300,000 ÷ 27.5; the deduction for the first year depends on the month placed in service.

Improvements and Other Assets

- Residential rental building and most structural improvements: generally 27.5 years
- Furniture and appliances: generally 5 years
- Certain land improvements: generally 15 years

Some assets may qualify for accelerated deductions under special rules. Property classification and placed-in-service dates matter.

Why Accurate Depreciation Matters at Sale

Depreciation reduces adjusted basis and can increase taxable gain when you sell. Tax law generally accounts for depreciation “allowed or allowable”—even if a deduction was not actually claimed. Keep a year-by-year depreciation schedule.

4. Passive Activity Loss Rules and Carryovers

A rental property can show a tax loss because of mortgage interest, operating costs, and depreciation. But that loss does not necessarily reduce tax on wages or other nonpassive income.

The General Passive Loss Rule

Rental real estate is generally treated as passive even when an owner is involved in management. Passive losses usually offset passive income; without an exception, they generally cannot offset wages, interest, dividends, or other nonpassive income.

The Special $25,000 Allowance

Taxpayers who actively participate in rental real estate may qualify to deduct up to $25,000 of rental losses against nonpassive income. Active participation generally involves meaningful management decisions, such as approving tenants and authorizing repairs, and usually requires at least a 10% ownership interest.

Modified adjusted gross income	Maximum potential allowance
$100,000 or less	$25,000
$110,000	$20,000
$125,000	$12,500
$150,000 or more	$0

This general phaseout applies to single and married-filing-jointly taxpayers. Married-filing-separately rules are more restrictive; other eligibility and loss limitations may apply.

Suspended Losses and Carryovers

Rental losses disallowed by passive activity rules generally carry forward rather than disappear. For example, if $12,000 is suspended in Year 1 and the property produces $5,000 of passive income in Year 2, $5,000 of the carryover may generally offset that income, leaving $7,000 carried forward, assuming no other limitations.

Carryovers generally continue until usable against passive income or released in a qualifying disposition. Maintain records by activity each year.

What Happens When You Sell?

A fully taxable sale of your entire interest in a passive activity to an unrelated buyer generally allows remaining suspended passive losses to be deducted, subject to ordering and other limitations. A related-party sale or tax-deferred exchange may not have the same effect.

Real Estate Professional Rules

Certain taxpayers who meet stringent real estate professional and material participation tests may deduct rental losses without the usual passive restrictions. Tests generally include more than 750 qualifying hours and more than half of all personal services in real property trades or businesses, along with material participation under the applicable rules. Holding a real estate license alone is not enough.

Basis and at-risk limitations may also restrict losses separately from the passive activity rules.

5. Selling a Rental Property

Selling rental property usually requires calculating adjusted basis, net sales proceeds, depreciation-related gain, and any available suspended passive losses. The outstanding mortgage balance generally does not reduce taxable gain.

Calculating Gain

Taxable gain generally equals net sales proceeds minus adjusted basis. Adjusted basis typically starts with acquisition basis, increases for capital improvements, and decreases for depreciation allowed or allowable and other relevant adjustments.

Item	Amount
Original basis	$350,000
Capital improvements	+$30,000
Accumulated depreciation	−$60,000
Adjusted basis	$320,000
Sale price	$500,000
Selling expenses	−$30,000
Net sales proceeds	$470,000
Taxable gain	$150,000

How the Gain Is Taxed

Gain attributable to straight-line building depreciation is generally treated as unrecaptured Section 1250 gain, subject to a maximum federal rate of 25%. Remaining qualifying long-term gain may be taxed at 0%, 15%, or 20%, depending on circumstances. Certain property or depreciation methods can create ordinary-income recapture instead.

Depending on income and location, the 3.8% net investment income tax and applicable state or local taxes may also apply.

Using Passive Loss Carryovers

Accumulated suspended passive losses may become deductible on a qualifying complete taxable sale to an unrelated party. This can materially change the net tax cost of a sale.

Section 1031 Exchanges

A properly structured like-kind exchange may defer gain when qualifying investment real estate is exchanged for other qualifying real estate. In a typical deferred exchange, replacement property generally must be identified within 45 days and acquired within 180 days (or by an earlier applicable return due date). Specialized rules govern use of sale proceeds, and a qualified intermediary is commonly used. Planning must begin before closing.

Selling a Former Primary Residence

If a property was once your main home, some gain may qualify for the principal residence exclusion of up to $250,000 ($500,000 for eligible married couples). Ownership and use tests, nonqualified-use rules, and the rule denying exclusion for post-May 6, 1997 depreciation can limit the benefit. Timing matters.

6. Maintaining Your Rental Property Records

Keep acquisition records, improvement costs, depreciation schedules, and suspended loss records for the entire period of ownership and the applicable tax-record retention period after sale.

- Purchase and sale settlement statements and qualifying closing costs
- Appraisals, conversion-date fair market value documentation, and land/building allocations
- Major improvement invoices and supporting receipts
- Annual rental income and expense records
- Mortgage interest, property taxes, and insurance statements
- Prior-year depreciation schedules and passive loss carryovers

Do not discard purchase and improvement documentation merely because the property was acquired many years ago. Those records often determine the gain or loss when it is sold.

7. Tax Planning Throughout Ownership

Tax planning should be part of each stage of rental property ownership:

- Before purchasing: evaluate after-tax cash flow and potential depreciation.
- When renting begins: document basis, land allocation, and the date placed in service.
- During ownership: classify repairs versus improvements and track depreciation and passive losses.
- Before selling: estimate capital gain, depreciation-related taxes, released passive losses, and whether a Section 1031 exchange is practical.

How Maryland Tax Service Can Help

Maryland Tax Service, Inc. assists rental property owners with federal and state tax preparation and planning, including Schedule E reporting, depreciation calculations, passive loss tracking, and tax planning for sales.

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