



# Rental Income and Expenses



## LET'S START A CONVERSATION

We'd love to meet you, talk about your financial goals, and see if we're the right fit to help you get there.

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### Rental Income

Rental income includes any payment received for the use or occupancy of property. In addition to normal rent payments, the following items are reported as rental income.

| Types of Rental Income         | Description   |
|--------------------------------|---|
| Advance rent                   | Any amount received prior to the period that the payment covers.  |
| Payment for cancelling a lease | Any amount paid by a tenant to cancel a lease.  |
| Expenses paid by tenant*       | Any amount paid by a tenant on behalf of the property owner to cover maintenance or improvement expenses. |
| Property or services**         | The fair market value (FMV) of property or services received in lieu of rent.                             |

*All of these types of rent are reported as income in the year received.*

\* **Example:** If a furnace in a rental property stops working, and the tenant pays the repair costs and subsequently deducts the amount from rent, the cost of the repair is treated by the property owner as rental income. The property owner would report the amount as income and also report the amount as a rental expense for repairs and maintenance.

\*\* **Example:** If the tenant provides services for the property owner in lieu of rent, the FMV of the services is reported by the property owner as rental income. If the services are provided at an agreed-upon price, that price is considered FMV unless there is evidence to the contrary.

### Security Deposits

A security deposit is not included in rental income when received if the property owner plans to return it to the tenant at the end of the lease. If any amount is kept during the year because the tenant did not live up to the terms of the lease, include that amount as rental income. If an amount called a security deposit is to be used as a final payment of rent, it is advance rent and is included as income in the year received.

**Note:** Individual states have laws requiring payment of interest by property owners who hold security deposits.

### Rental Expenses

A deductible expense is any expense that is both:

- **Ordinary.** Common and accepted in the taxpayer's line of work, and
- **Necessary.** Helpful and appropriate for work.

An expense need not be required in order to be considered necessary. Facts and circumstances must be considered in each case to determine whether an expense is ordinary and necessary.

### Depreciation

Depreciation deductions begin when property is ready and available for rent.

### Vacant Property

Expenses are deductible beginning at the time the property is available for rent regardless of when rental income is actually received.

### Insurance Premiums Paid in Advance

Insurance premiums paid more than 12 months in advance are deducted in the year to which the policy applies. Premiums paid for 12 months or less are deductible in the year paid.

### Local Transportation Expenses

Local transportation expenses incurred to collect rental income or to manage, conserve, or maintain rental property are deductible. The taxpayer may deduct either actual expenses or the standard mileage rate for an auto (57¢.5 per mile for 2020).



## Rental Income and Expenses

### Commuting

IRS regulations for investment expenses specifically mention commuting expenses as being nondeductible, making the same commuting rules that apply to business expenses also apply to passive rental activities.

### Travel Expenses

Expenses for traveling away from home, such as transportation and lodging, are deductible if the primary purpose of the trip is to manage, collect rental income, conserve, or maintain the rental property.

### Interest

Prepaid interest is not deducted when paid. Instead, prepaid interest is deducted in the period to which it applies. Points or loan origination fees paid for rental property are deducted over the life of the loan.

## Repairs and Improvements

| Repairs   | Improvements  |
|---|---|
| <p>Costs that:</p> <ul style="list-style-type: none"> <li>• Keep the property in good operating condition,</li> <li>• Do not materially add value to the property, or</li> <li>• Do not substantially prolong the property's life.</li> </ul>           | <p>Costs that:</p> <ul style="list-style-type: none"> <li>• Add to the value of the property,</li> <li>• Prolong the property's useful life, or</li> <li>• Adapt the property to new uses.</li> </ul>   |
| Deductible as a current expense.  | Must be capitalized and depreciated.  |
| <p><b>Examples:</b></p> <ul style="list-style-type: none"> <li>• Repainting inside or out.</li> <li>• Fixing gutters.</li> <li>• Fixing damaged carpet.</li> <li>• Fixing leaks.</li> <li>• Plastering.</li> <li>• Replacing broken windows.</li> </ul> | <p><b>Examples:</b></p> <ul style="list-style-type: none"> <li>• Room additions.</li> <li>• Remodeling.</li> <li>• Landscaping.</li> <li>• New roof.</li> <li>• Security system.</li> <li>• Replacing gravel driveway with concrete.</li> </ul> |

**Example:** Ashlyn's rental property has damage to a small section on one corner of the roof. If she fixes only that small portion of the roof, she can deduct the cost of the repair as a rental expense. However, if she replaces the entire roof, the new roof is an improvement because it increases the value and lengthens the life of the property. She would depreciate the cost of the new roof.

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The cost of repairs to a rental property may be deducted as a current expense. The cost of improvements must be recovered by taking depreciation. Whether an expenditure qualifies as a currently deductible repair, or is required to be capitalized, is a factual determination. The taxpayer bears the burden of proof and must have sufficient records to substantiate the expense as a deduction instead of a capital expenditure.

## Personal Use of Rental Property— Roommates and Boarders

### Renting Part of Property

If a portion of property is rented out, and a portion is used for personal purposes, any reasonable method of allocating expenses between personal and rental use is allowed. For example, dividing the cost of utilities by the number of people living in the home, or dividing expenses based on square footage of use, are reasonable methods.

**Example:** Phil owns and lives in a personal residence that has 1,800 square feet of floor space. Phil takes in a boarder and rents out a room that is 12 × 15 feet, or 180 square feet. Phil can allocate 10% of the home's expenses to the rental. The total utility bills for the year are \$2,700. Phil can deduct \$270 ( $\$2,700 \times 10\%$ ) from rental income.

### Phone Expense

The cost of the first phone line into a home that is used for both personal and rental purposes is not deductible.

### Direct Rental Expenses

A full deduction is allowed for expenses that belong only to the rental part of the property. Examples of fully-deductible rental expenses include painting a room that is rented out, additional liability insurance attributable to the rental, and the cost of a second phone line that is strictly for the tenant.

## Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 72.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of \$5,000.