



2023 Annual Conference Rentals

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Objectives



- At the end of this course, you will be able to:
 - Report income and expenses for typical monthly rentals
 - Describe tax-free short-term rentals
 - Calculate personal use days
 - Identify and allocate short-term rental deductions
 - Know how and when to take losses
 - Summarize IRS reporting for short-term rentals

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Rental Income



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Most Common Rental



- An actual, real, long-term rental property
- No personal use
- Rented at fair rental value
- Nothing weird going on



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Form Overview



- Schedule E is a 5 part form
- Only Part I (1st page) applies to rentals

SCHEDULE E
 (Form 1041)
 Supplemental Income and Loss
 (From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)
 Attach to Form 1040, 1040-SA, 1040-PR, or 1041.
 Go to www.irs.gov/ScheduleE for instructions and the latest information.

Part I **Income or Loss From Rental Real Estate and Royalties**
 Note: If you are in the business of renting personal property, use Schedule C. See instructions. If you are an individual, report farm rental income or loss from Form 9882 on page 2, line (c).

A Did you make any payments in 2022 that would require you to file Form(s) 1099? See instructions. Yes No
B If "Yes," did you or will you file the required Form(s) 1099? Yes No

1a Physical address of each property (street, city, state, ZIP code)

1b Type of Property (From list below)	2 For each rental real estate property listed above, report the number of fair rental and personal use days. Check the Q/W line only if you meet the requirements to file as a qualified joint venture. See instructions.	Fair Rental Days		Personal Use Days	Q/W
		A	B	C	D
A					
B					
C					

Type of Property:
 1 Single Family Residence 3 Vacation/Short-Term Rental 5 Land 7 Self-Rental
 2 Multi-Family Residence 4 Commercial 6 Royalties 8 Other (describe)

	Properties		
	A	B	C
Income:			
3 Rents received			
4 Royalties received			
Expenses:			
5 Advertising			
6 Auto and travel (see instructions)			
7 Cleaning and maintenance			
8 Commissions			
9 Insurance			
10 Legal and other professional fees			
11 Management fees			
12 Mortgage interest paid to banks, etc. (see instructions)			
13 Other interest			
14 Repairs			
15 Supplies			
16 Taxes			
17 Utilities			
18 Depreciation expense or depletion			
19 Other (list)			
20 Total expenses. Add lines 5 through 19			
21 Subtract line 20 from line 3 (rental) and/or 4 (royalties). If result is a loss, see instructions to find out if you must file Form 9882			
22 Deductible rental real estate loss after limitation, if any, on Form 9882 (see instructions)			
23a Total of all amounts reported on line 3 for all rental properties			
b Total of all amounts reported on line 4 for all royalty properties			
c Total of all amounts reported on line 12 for all properties			
d Total of all amounts reported on line 18 for all properties			
e Total of all amounts reported on line 20 for all properties			
24 Income. Add positive amounts shown on line 21. Do not include any losses			
25 Losses. Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here			
26 Total rental real estate and royalty income or loss. Combine lines 24 and 25. Enter the result here. If Parts I, II, IV, and line 40 on page 2 do not apply to you, also enter the amount on Schedule E (Form 1041), line 5. Otherwise, include the amount in the total on line 41 on page 2			

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11346L Schedule E (Form 1041) 2022

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Security Deposits per the IRS



- Do not include a security deposit in your income when you receive it if you plan to return it to your tenant at the end of the lease. But if you keep part or all of the security deposit during any year because your tenant does not live up to the terms of the lease, include the amount you keep in your income in that year.
- If an amount called a security deposit is to be used as a final payment of rent, it is advance rent. Include it in your income when you receive it.
- *IRS Rental Income and Expenses - Real Estate Tax Tips*

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Security Deposits



- But be aware of state laws!
- Arizona Security Deposit Law: *Only when a landlord no longer must return the security deposit is it considered taxable income. In such cases, it is to be declared during the period in which the obligation for return was removed.*
- North Carolina Security Deposit Law: *Landlords must report the security deposit as income if they included repair costs as expenses. If a North Carolina landlord and tenant agreed to it, they can use any security deposit amount to cover last month's rent. However, the landlord will have to report that received amount as income.*

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Advance Rent



- Advance rent is any amount you receive before the period that it covers.
- Include advance rent in your rental income in the year you receive it regardless of the period covered or the method of accounting you use.
- So using the accrual method of accounting doesn't help here!

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Expenses Paid by Tenant

- If a tenant pays any of your expenses, the payments must be included in income. But the landlord can deduct the expenses if they are deductible rental expenses.
- Example: While Joan was out of town, the furnace in her rental property stopped working. Her tenant paid for the necessary repairs and deducted the repair bill from the rent payment. Joan must include in income both the net amount of the rent payment and the amount the tenant paid for the repairs. She can deduct the cost of the repairs as a rental expense.



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Property/Services in Lieu of Rent

- If you receive property or services, instead of money, as rent, include the fair market value of the property or services in your rental income.
- If the services are provided at an agreed upon or specified price, that price is the fair market value unless there is evidence to the contrary.
- Example: Joan's tenant is a painter. He offers to paint her rental property instead of paying 2 months' rent. She accepted his offer. She must include in rental income the amount the tenant would have paid for 2 months' rent, and can then deduct that amount as a rental expense for painting your property.



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Rental Expenses



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Most Common Rental Expenses



- Advertising
- Auto and travel expenses
- Cleaning and maintenance
- Commissions
- Depreciation
- Insurance
- Legal/professional fees
- Management fees
- Mortgage interest
- Points
- Repairs
- Supplies
- Taxes
- Utilities

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Real Estate Taxes at Closing



- Both buyer and seller pay taxes when a home is sold.
- This is because taxes are paid in arrears, meaning paid for time already passed, rather than in advance.
 - Seller pays prorated amount for the time they've lived in the home since the beginning of the new year.
 - The buyer pays a prorated amount to cover the taxes for the rest of that year.
 - (Sometimes the seller offers to pay for the buyer's share of the taxes.)
 - You have to look at the closing statement!

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Real Estate Taxes at Closing Example



- The Sellers sell a home to the Buyers; they agree to each pay for their own portion of the property taxes.
- Closing date is on July 27th; total taxes for the year is \$4,200.
- Monthly amount is $\$4,200 \div 12 = \350 per month or \$11.67 per day.
- Sellers are responsible for 6 months and 26 days = \$2,403.42.
- Buyers are responsible for 5 months and 4 days = \$1,796.68.
- Closing documents will debit and credit these amounts appropriately.
- And each family can deduct the amount they paid!

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Interest, Taxes, Insurance



- Mortgage interest is deductible and is reported to the taxpayer on Form 1098.
- Real estate tax is deductible when paid to the city/county/state, NOT when it is paid into an escrow account.
- Insurance is deductible when paid to the insurance company, NOT when it is paid into an escrow account.

CORRECTED (if checked)		OMB No. 1545-0047	Form 1098	Mortgage Interest Statement
RECIPIENT'S/LENDER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		Date: January 2023		For calendar year 20
RECIPIENT'S/LENDER'S TIN		1 Outstanding mortgage principal	9 Mortgage origination date	Copy B For Payer/Borrower The information on this Form 1098 is important for information and is being furnished to the IRS. If you are required by the IRS, a mortgage servicer or other service provider to report this information, that an underpayment of tax results because you operated a deduction for the mortgage interest or for these points, reported in boxes 10 or 11, because you did not report the actual interest (Box 2) or because you claimed a non-deductible loan.
PAYER'S/BORROWER'S TIN		2 Substantiating mortgage purchase	10 Mortgage insurance premium	
PAYER'S/BORROWER'S name		3 Full amount of unpaid interest	11 Mortgage acquisition date	
Street address (including apt. no.)		4 Points paid on purchase of principal residence		
City or town, state or province, country, and ZIP or foreign postal code		5 If address of property securing mortgage is the same as PAYER'S/BORROWER'S address, the box is checked, or the address or description is entered in box 6.		
6 Address or description of property securing mortgage		7 If address of property securing mortgage is the same as PAYER'S/BORROWER'S address, the box is checked, or the address or description is entered in box 6.		
8 Number of properties securing the mortgage	10 Other			
Account number (see instructions)				

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Deducting Points



- Mortgage points aka discount points are fees paid to the lender to get a reduced interest rate.
- Typically expressed as a percentage of the mortgage
- Regarded as a type of interest
- Deductible or amortizable?
 - Points paid for rental property must be amortized over the life of the loan per Schedule E instructions! (Different rules apply to principal residences!)

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Transportation Expense



- Local travel is defined as by car or similar means within the area of your tax home.
- If rental is in same city as taxpayer's residence, this may be a fairly small deduction.
- Local travel for picking up supplies or repair materials is also deductible.
- Typically use a standard mileage rate.



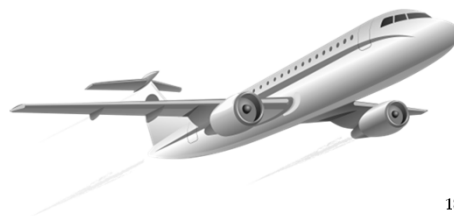
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Long Distance Transportation



- Defined as travel away from tax home requiring an overnight stay at the destination prior to returning home.
- To be deductible, the travel must be primarily in service of the rental activity, meaning that the taxpayer spends over half his time working at rental purposes while away.
- Beware of out-of-town visits to family disguised as rental expense!



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Travel Deductions



- Travel to improve the property such as putting on a new roof is not deductible!!!
- The cost of the travel is added to the basis of the improvement!



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Legal & Professional Fees



- Legal and professional fees paid to attorneys, accountants, someone to process sales tax forms, etc.
- Preparation of forms related to the rental are deductible, but payments made for the personal portion of tax return are not deductible.



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De Minimis Safe Harbor



- Owners of rental property may deduct – rather than depreciate – any expense of \$2,500 or less as substantiated by invoice.
- These amounts may apply to each item on the invoice, not the invoice total BUT do not subdivide a remodel!
- Election is made by attaching a statement titled “Section 1.263(a)-1(f) election” to a timely filed (including extensions) 1040. The statement should include taxpayers name, address and TIN, and a sentence stating that you are making the de minimis safe harbor election.
- Shown as a “Misc Expense” with the explanation of “De Minimis Safe Harbor” rather than under repairs or supplies.

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Generally Speaking...



- Maintenance is undertaken to prevent something from breaking
- Repairs are undertaken after something has already broken
- Improvements are undertaken to:
 - **B**etter the property,
 - **A**dapt the property to a new use or
 - **R**estore the property
- Just remember that improvements raise the **BAR**

What's the important distinction between repairs and improvements on the tax return?

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George & Emma's Expenses



- Clients George and Emma tell you they had these expenses:
 - Advertising for the tenant \$100
 - Yard maintenance fees \$250
 - Repair of plumbing \$475
 - New toilet seat \$75
 - Legal fees for the lease \$175
 - FMV of labor they performed \$900
 - \$2,000 paid to escrow for insurance and taxes

Comments on these expenses?



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Depreciation for Rentals



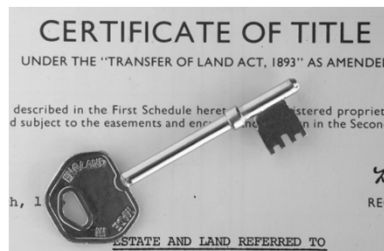
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When is Property Depreciable?



- To be depreciable, property must meet these requirements:
 - Taxpayer owns the property
 - The property is used in an income-producing activity
 - The property has a determinable useful life
 - The property is expected to last more than one year
 - The property is not placed in service and taken out of service in the same year



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Depreciation Systems Come and Go



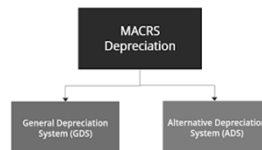
- Deductions for depreciation have been around since income tax started.
- Prior to 1971, there were a variety of lives and systems.
- In 1971, Congress introduced Class Life Asset Depreciation Range (ADR) to try to introduce some uniformity.
- In 1981, Congress again changed the system, creating the Accelerated Cost Recovery System (ACRS), which provided shorter lives.
- *Tax Reform Act of 1986* created the Modified Accelerated Cost Recovery System (MACRS) which is in use today.
- At various times, additional depreciation deductions have been allowed to encourage investment (bonus depreciation, §179).

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Depreciation Method – GDS vs. ADS

- GDS vs. ADS
 - GDS (General Depreciation System) default system
 - ADS (Alternative Depreciation System) is required for:
 - Listed property used 50% or less for business
 - Tangible property used predominantly **outside** the U.S.
 - Tax-exempt use and bond-financed property



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Calculation Methods

- MACRS provides three different depreciation methods
 - 200% DB over a GDS recovery period
 - 150% DB over a GDS recovery period
 - SL over a GDS recovery period
 - SL over an ADS recovery period
 - ADS can only use SL!

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MACRS Class Lives for Rental Assets



- 5-year: appliances/ flooring/ furniture for rental property
- 15-year: land improvements
- 27.5-year: residential rentals, remodels, roofs
- 39-year: commercial building, store, warehouse that is not residential property

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Depreciating Appliances



- Appliances depreciated over 5 years under MACRS if placed in service after the rental house was placed in service
- Includes washing machines, dryers, stoves, dishwashers, refrigerators, window AC units
- Half-year or mid-quarter convention
- Or they may be expensed under Bonus or §179!



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Depreciating Flooring



- Flooring depreciated over 5 years under MACRS if placed in service after rental house was placed in service
- Flooring in non-residential properties is depreciated over 7 years
- Half-year or mid-quarter convention
- Or it may be expensed under Bonus or §179!



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Depreciating Remodels



- Remodels are treated like buildings, depreciated under MACRS over 27.5 years
- Includes windows, doors, cabinets, central AC, furnaces, driveways
- Mid-month convention
- Cannot be expensed under §179 or bonus



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Depreciating Landscaping



- Landscaping depreciated under MACRS for 15 years, including fences, landscaping, roads
- Half-year or mid-quarter convention
- Can be expensed under bonus because life is less than 20 years!



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Residential or Commercial?



- Residential properties depreciate over 27.5 years, while non-residential properties depreciate over 39 years.
- If your short-term rental only averages 30 days or less as an average rent period, it classifies as transient.
- It is then classified as a commercial property and depreciates over 39 years.



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Conventions



- Mid-month convention applies to residential and non-residential real property. It treats property as having been placed in service at the midpoint of the given month.
- Mid-quarter convention is required if mid-month does not apply, and total depreciable bases of MACRS property placed in service during the last quarter of the year is more than 40% of the bases of all MACRS property placed in service during the entire year. It treats property as having been placed in service at the midpoint of the quarter.
- Half-year convention applies if neither mid-month nor mid-quarter apply. It treats property as placed in service at the midpoint of the year.

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Start Date for Depreciation



- John and Isabelle purchase a rental property on May 15
- It's ready to rent on July 15, so they advertise it, looking for a tenant
- They find a tenant and sign a lease that begins on Sept 15th

When does their depreciation start?



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Stopping Depreciation



- Depreciation continues until one of three things happens:
 - You have deducted your entire cost basis in the property (what it cost you to acquire the property, including certain taxes and fees paid at settlement, plus any improvements to the property).
 - You remove the property from service (you stop using it to generate income because you sold the property or just decided to stop renting it).
 - The rental situation becomes one in which depreciation is not permitted.

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Bonus Depreciation



- Bonus depreciation can be used to deduct the cost of any asset with a class life of more than 20 years:
 - 2022 100%
 - 2023 80%
 - 2024 60%
 - 2025 40%
 - 2026 20%
 - 2027 0%
- 15-year land improvements qualify
 - Excavating, grading, landscaping, fences, swimming pools, sprinkler systems

I'd better hurry up and buy something!!



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Electing Out of Bonus Depreciation



- Bonus depreciation must be elected OUT OF, not INTO
- To elect out:

Bonus Depreciation Opt Out

Taxpayer's name: _____

Taxpayer's address: _____

Taxpayer's identification #: _____

The taxpayer is hereby electing out of bonus depreciation for the following class(es) of property:

(describe: 5 yr, 7 yr, etc.)

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Section 179



- §179 is a special type of depreciation that allow business owners to depreciate 100% of the property in the year in which it is placed in service, but cannot create or increase a business loss.
- In addition, there is a limit of \$1.16M for 2023.
- Any property that is used **personally** 50% or more of the time is not eligible for §179.
- If property was §179'd and business use falls below 50% in a later year, the excess depreciation must be recaptured in that year.

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Section 179



- It can be used for any sort of personal property, including roofs, heating, ventilation, air conditioners, fire alarms, security systems
- It cannot be used for land, land improvements, buildings, swimming pools, fences, paved parking areas or property outside the U.S.
- Unlike bonus depreciation, it is not necessary to apply it class-wide or even to all of a single asset!
- It is elected INTO not out of.
 - The election to use §179 is made by taking the depreciation on Form 4562.

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Closing Statement



- | | | |
|---|--|---|
| <ul style="list-style-type: none"> • Deductible: <ul style="list-style-type: none"> • Mortgage interest • Real estate tax • Insurance | <ul style="list-style-type: none"> • Added to basis: <ul style="list-style-type: none"> • Title insurance • Legal fees • Title fees • Recording fees • Surveys • Transfer/stamp taxes | <ul style="list-style-type: none"> • Neither deductible nor added to basis: <ul style="list-style-type: none"> • Fire insurance premiums • Loan assumption fees • Cost of a credit report • Fee for appraisal required by lender • Expenses incurred while living in the house prior to closing |
|---|--|---|

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Allocating Basis to Land

- How much of the purchase price do we allocate to land?
- Options:
 - Rely on county tax assessor's allocation
 - Commission an appraisal
 - Replacement cost method
 - Rule of thumb method



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Using Tax Assessor Info

- Tax Assessor bill says the land is worth \$35,000 of the total property value of \$165,000
- These numbers never match the sale price, but we use the ratio
- $\$130\text{K}/\$165\text{K} = 78.8\%$
- $\$212,500 \times 78.8\% = \$167,450$ is depreciable property
- Remaining amount is land which doesn't depreciate

Figure 1
Sample Annual Property Tax Bill

Property Owner Information		Detail of Taxes Due			
Agency	Rate	Amount			
Property Valuation on Jan 1, 2012		General Tax Levy	1.0000	\$3,500.00	B
Land \$35,000		Voter-Approved Debt Rates			
Improvements \$130,000		City	0.0201	\$70.35	
Net assessed value \$165,000		Water District	0.0018	6.30	
		School District	0.1010	353.50	
		Community College District	0.0102	35.70	
		Direct Levies			C
		Sidewalk District Assessment		\$9.36	
		Flood Control District Assessment		64.39	
		Street Lighting District Assessment		12.71	
		Mello-Roos District		96.51	
		School District Parcel Tax		125.00	
		Total Taxes Due		\$4,263.82	D
		1st Installment		\$2,131.91	
		2nd Installment		2,131.91	

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Depreciation and Amortization



- Residential real estate is depreciated over 27.5 years
- $167,450 \div 27.5 = \$6,089$
- But \$5,836 for first year!

Why is it different the first year?

Form 4562, Depreciation and Amortization (including information on Listed Property). The form shows a total depreciation deduction of \$5,836 for the first year, which is less than the straight-line calculation of \$6,089. This is due to the half-year convention for the first year of depreciation.

Amortization Reported Separately!



- Points are amortized over the 30-year mortgage
 - $\$2,000 \div 30 = \67
- Reported on Form 4562, but you may be prompted to enter it on Other Expenses on Schedule E.

19	Other (list) ▶ Amortization	19	67
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QUIZ

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Arizona
Chapter 35^{Years}

- Deductible, added to basis, or neither?
 - a. Appraisal required by lender
 - b. Mortgage interest
 - c. Real estate tax
 - d. Title insurance
 - e. Title fees
 - f. Cost of credit report
 - g. Transfer or stamp taxes

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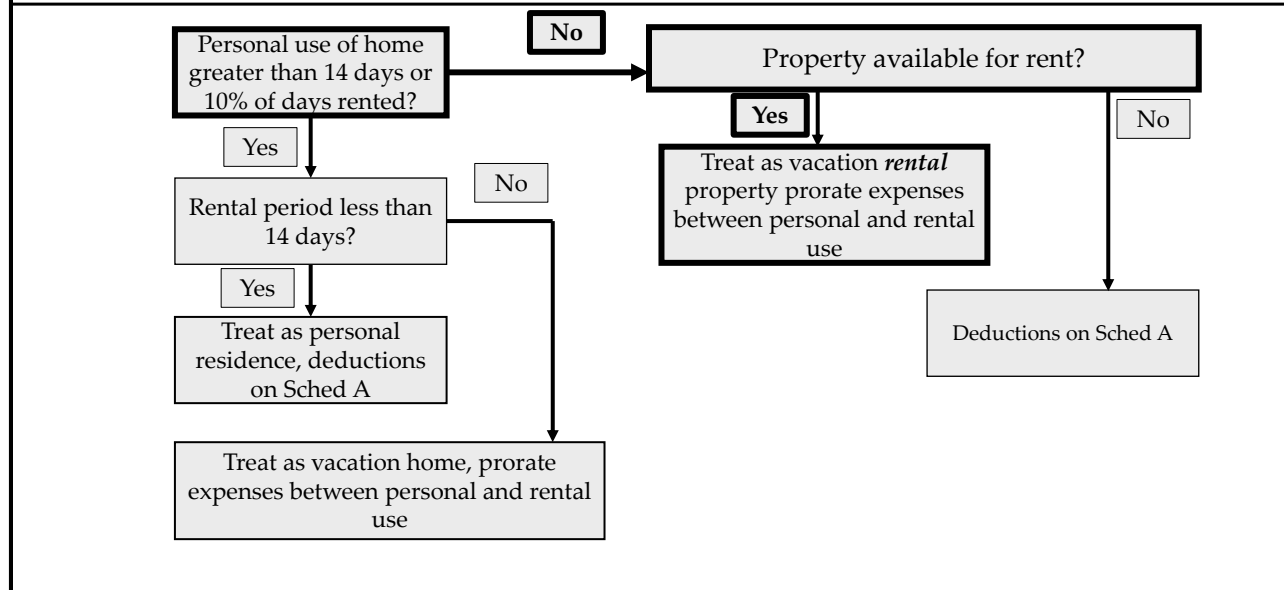
Dual Use Properties & Personal Use Days

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Reporting Dual Use Properties

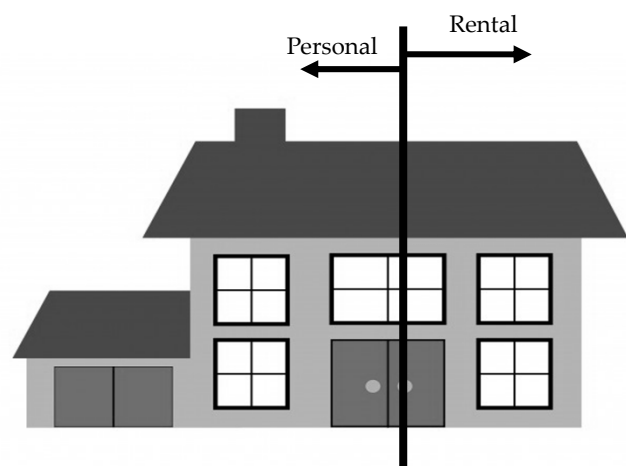


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Reporting Dual Use Properties



- When a property is dual-use, deductions are generally allocated between Schedule A (personal deductions) and Schedule E (rental deductions)
- Details vary depending on the situation and the number of personal use days!!

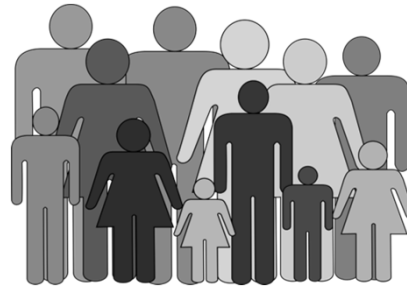


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What are Personal Use Days?



- When an owner or family member uses the property, even if fair market value is paid for the time, it's a personal use day!
- Exception: if the family member uses the property as his personal residence and has no ownership interest



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Personal Use Days Example



- John owns a mountain cabin. His son, Paul, stays there for six months and pays fair market rent of \$1,000 per month.
- If this is Paul's principal residence for those six months, then the six months do **NOT** count as personal use days for John.
- But if this is not Paul's principal residence and he's just hanging out there while writing his novel, these six months count as personal use days for John.



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Personal Use Days Example

- Jane owns a beach house!
- Jane rents it to her mother for a month at a reduced rate.

Personal use days for Jane?

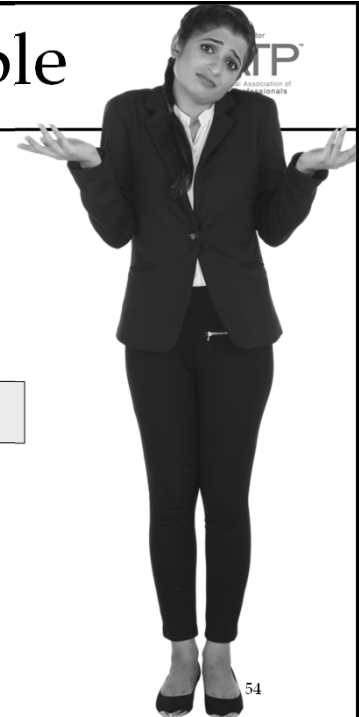


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Personal Use Days Example

- Jane owns a beach house!
- Jane rents it to her mother for a month at a fair market rent.

Personal use days for Jane?

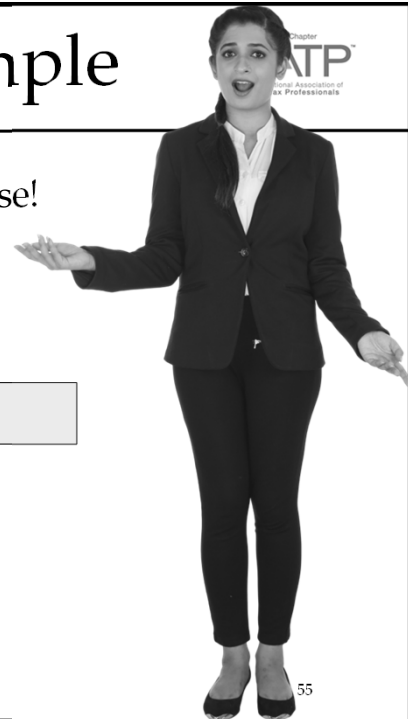


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Personal Use Days Example

- Swapping vacation houses counts as personal use!
- Jane trades a month at her beach house for a month at a house in Australia.

Personal use days for Jane?



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Pro-Rating Expenses



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Renting Out Entire Property



- If the taxpayer rents an entire property to short-term guests, the expenses are allocated based on the number of days the property was rented out over the tax year over a denominator.
- The denominator depends on whether the calculation is using the “IRS method” or the “Tax Court method” aka “Bolton method.”
- The IRS method uses the total number of days used (rental use + personal use) while the Tax Court method uses 365 days as the denominator.

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Prorating Expenses



- Jane’s beach house was used a total of 100 days during the year
- It was rented at FRV for 78 days and she used it personally 22 days
 - It was vacant the remaining 265 days
- Her expenses:
 - Mortgage interest \$12,200
 - Real estate taxes \$3,700
 - Repairs and maintenance \$6,200
 - Depreciation \$5,500



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What Do I Do About Vacant Days?



- Good question!
- IRS position: expenses are prorated based on period of actual use throughout the year
- Tax Court position: mortgage interest and real estate tax are prorated based on 365 days. Other deductions follow the IRS position.

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Jane's Deductions: Tax Court vs IRS



- Using IRS position:
 - $78 \div 100 = 78\%$ rented
 - 78% interest = \$9,516
 - 78% taxes = \$2,886
 - 78% repairs = \$4,836
 - 78% depreciation = \$4,290
 - Total expenses \$21,528 (but not really because expenses are limited to income!)

Mortgage interest \$12,200
 Real estate taxes \$3,700
 Repairs \$6,200
 Depreciation \$5,500

- Using the IRS Method, mortgage interest on Schedule A is only \$12,200 - \$9,516 = \$2,684
- Taxes on Schedule A is only \$3,700 - \$2,886 = \$814

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Jane's Deductions: Tax Court vs IRS



• Using Tax Court position:

- $78 \div 365 = 21\%$ rented
- 21% interest = \$2,562
- 21% taxes = \$777
- 78% repairs = \$4,836
- 78% depreciation = \$4,290
- Total expenses \$12,465

Mortgage interest \$12,200
 Real estate taxes \$3,700
 Repairs \$6,200
 Depreciation \$5,500

- Using the Tax Court Method, mortgage interest on Schedule A is $\$12,200 - \$2,562 = \$9,638$
- Taxes on Schedule A is $\$3,700 - \$777 = \$2,923$

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Comparing Jane's Deductions



• Using IRS position:

- $78 \div 100 = 78\%$ rented
- 78% interest = \$9,516
- 78% taxes = \$2,886
- 78% repairs = \$4,836
- 78% depreciation = \$4,290
- Total \$21,528 (but not really because expenses are limited to income!)

• Using Tax Court position:

- $78 \div 365 = 21\%$ rented
- 21% interest = \$2,562
- 21% taxes = \$777
- 78% repairs = \$4,836
- 78% depreciation = \$4,290
- Total \$12,465

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Which is Better?



- Before the TCJA, it was fairly simple to determine which method was best for allocating expenses for personal/rental vacation homes.
- If taxpayers itemized deductions, the court method usually was more favorable. If they used the standard deduction, the IRS method was more favorable.
- Post TCJA, taxpayers will have to estimate the amount of real estate taxes and mortgage interest allowed and compare that to estimates of net rental income to determine the preferable method.

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Pro-rating Expenses



- If the host doesn't rent out 100% of the property 100% of the time, expenses must be prorated between:
 - Property rented vs. property used personally
 - Amount of time in the year the property is rented
- Prorate: depreciation, mortgage interest and property taxes, rent if the taxpayer himself is a tenant of the property, repairs, maintenance, cleaning, trash removal, condo/HOA fees, utilities, internet, insurance

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Renting Out a Room



- Now the math gets a little more complicated!
- Divide the square footage of the room by the square footage of the house.
- Then multiply that number by the percentage of time the room was rented.



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Ruth's Room



- Ruth owns a two-bedroom townhouse in Manhattan which is her main residence.
- She rents one of the bedrooms occasionally through Airbnb.
- That one bedroom represents 20% of the square footage of the house.
- The room was rented out for 100 days.
- We do the math as follows: $(100 \div 365) \times 20\% = 5\%$
- Ruth can deduct 100% of her direct expenses and 5% of prorated expenses.



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Special Expenses for Hosts



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Operating Expenses



- Taxpayers can deduct in any given year any expense that is:
 - Ordinary and necessary: common, helpful, appropriate for the rental activity
 - Current: will benefit the rental for less than one year
 - Directly related to rental activity: not personal and mixed-use expenses must be prorated between personal and rental
 - Reasonable in amount: this is the most economical and practical way to achieve the result

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Direct Expenses



- Rental platform fees and commissions
 - Typically 3% for hosts
- Hosts may deduct whatever fees and commissions they pay
- Guests also pay fees but the host cannot deduct those
- Expect Airbnb, Venmo, etc., to request a W-9 to verify the taxpayer's identity.
- Ask the taxpayer to bring in any 1099s received from the platform.

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Home Office?



- Yes, it's possible for a short-term rental landlord to have a home office.
- All the usual requirements such as regular and exclusive use are in place.
- Actual or simplified methods are both available.



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Marketing Expenses



- These may include payments made to a professional photographer, copywriter who writes your ads, website hosting and SEO campaign payments.
- Cost of initially developing a website for the rental may have to be amortized over 3 years as software.
- Once in place, updating the website would be a deductible expense.



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Guest Amenity Deductions



- Guest amenities such as linens, soaps, shampoo, toothpaste, toothbrushes, razors, toilet paper, paper towels and the like are fully deductible if purchased for guests!
- If hosts also use these items, proration is required.



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Phone Line Deductions



- Cost of main phone line from taxpayer's own home is not deductible.
 - Second line for rental purposes only is deductible
- Portion of cell phone used for business may be deducted.



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Entertainment



- Entertainment for guests is not deductible!!
 - Theater tickets? No
 - Baseball tickets? No
 - Movie tickets? No
- But providing games and DVDs for in-rental use are deductible expenses.



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Other Operating Expenses



- Fees and service charges made to online payments services
- Cost of a lockbox and/or keys
- Cost of storing host's belongings while guests are in residence
- Cost of credit reports obtained to screen guests
- Dues and subscriptions
- Education related to rental activity



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Personal Property in Common Areas



- Personal property in common areas used by both the host and the guests are not deductible.
- Example:
 - If a bedroom is rented to short-term guests, the cost of the bedroom furniture is a deductible expense.
 - However, cost of a dining room table used by the host and the guests is not a deductible expense, nor may it be pro-rated.

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QUIZ



- Which of the following are fully deductible by the host in the year of the expense?
 - a. Amenities used only by guests
 - b. Home phone line
 - c. Transportation to the rental to put on a new roof
 - d. Fees paid by the host to the rental agency
 - e. Fees paid by the guest to the rental agency

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Providing Services



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Services



- Ordinary services: heat, cooling, water, electricity, trash collection
- Significant services: regular cleaning, changing linen, maid service, valet service, concierge services, meals provided
- Extraordinary services with no separate charge includes maid services, instruction in swimming/boating/fishing, conducting fishing parties, delivering messages and mail, furnishing bus schedules, church information and other services deemed necessary for the convenience of guests

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Chief Counsel Memorandum 202151005



- Taxpayer A rents out a fully furnished vacation property via an online rental marketplace.
- Taxpayer A provides linens, kitchen utensils, and all other items to make the vacation property fully habitable for each occupant. In addition, the taxpayer provides daily maid services, including delivery of individual use toiletries and other sundries, access to dedicated Wi-Fi service for the rental property, access to beach and other recreational equipment for use during the stay, and prepaid vouchers for ride-share services between the rental property and the nearest business district.
- Average stay is 7 days.

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Chief Counsel Memorandum 202151005



- Taxpayer B rents out a fully furnished room and bathroom in a dwelling via an online rental marketplace.
- Occupants only have access to the common areas of the home to enter and exit the room and bathroom and have no access to other common areas such as the kitchen and laundry room. The taxpayer cleans the room and bathroom in between each occupant's stay.
- Average stay is 7 days.

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Chief Counsel Memorandum 202151005



- Conclusion: The net rental income in Fact Situation 1 [Taxpayer A] is **not** excluded from NESE under § 1402(a)(1) because the taxpayer provides substantial services beyond those required to maintain the space in a condition suitable for occupancy.
- The net rental income from Fact Situation 2 [Taxpayer B] **is** excluded from NESE under § 1402(a)(1) because the taxpayer does not provide substantial services beyond those required to maintain the space in a condition suitable for occupancy.
- So even though average rental period in both cases was 7 days, the conclusion turned on the issue of services provided.

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Deducting Losses



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Losses



- When expenses exceed income, it may not be deductible if there is owner use of the property.
- Different rules for different situations!
 - Vacation home rules
 - Hotel business rules
 - Regular rental activity loss rules

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Which Rental Loss Rule Applies?



Three sets of rules!!

Annual Rental Use	Annual Personal Use	Significant Services?	Rule Applies
More than 14 days	More than 14 days, or more than 10% of rental days	NA	Vacation home rules
More than 14 days	14 days or less, or no more than 10% of rental days	Yes	Hotel business rules
More than 14 days	14 days or less, or no more than 10% of rental days	No	Regular rental activity

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Three Loss Rules



- Vacation home loss rule: taxpayers deduct expenses in a certain order; expenses are limited to income; no loss allowed; remaining expenses carried forward.
- Hotel business loss rule: Schedule C activity, losses allowed subject to material participation tests.
- Regular rental activity loss rule: passive loss of \$25,000/\$12,500 permitted.

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Vacation Home Rules



- Rental losses are subject to vacation home rules if the taxpayer rents all or part of a property for more than 14 days during the year...
- AND personal use days number more the greater of 14 days or 10% of the number of days the property is rented at FRV

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Here's Jane Again



- Jane rented out her beach house at FRV for 78 days for \$15,600
- Personal use was 22 days
- It was vacant for the remaining 265 days
- Expenses:
 - Mortgage interest \$12,200
 - Real estate taxes \$3,700
 - Repairs \$6,200
 - Depreciation \$5,500

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Ordering Rules for Deductions



- Since deductions are limited to income, there's a particular order in which they must be taken
 - Mortgage interest
 - Real estate taxes
 - Casualty losses (suspended through 2025)
 - Direct expenses not related to operating and maintaining the property but related to the rental (agency fees, advertising, office supplies)
 - Expenses such as repairs, insurance, utilities
 - Depreciation

IRS Worksheet 5-1

From Pub 527
 Residential Rental Property
 (Including Rental of Vacation Homes)
 This worksheet is used if expenses +
 depreciation exceeded income and
 vacation home rules apply.

Worksheet 5-1. Worksheet for Figuring Rental Deductions for a Dwelling Unit Used as a Home

Keep for Your Records

Use this worksheet only if you answer "Yes" to all of the following questions.

- Did you use the dwelling unit as a home this year? (See *Qualifying Unit Used as a Home*.)
- Did you rent the dwelling unit at a fair rental price 15 days or more this year?
- Is the total of your rental expenses and depreciation more than your rental income?

PART I. Rental Use Percentage

A. Total days available for rent at fair rental price A. _____

B. Total days available for rent (line A) but not rented B. _____

C. Total days of rental use. Subtract line B from line A C. _____

D. Total days of personal use (including days rented at less than fair rental price) D. _____

E. Total days of rental and personal use. Add lines C and D E. _____

F. Percentage of expenses allowed for rental. Divide line C by line E F. _____

PART II. Allowable Rental Expenses

1. Enter rents received 1. _____

2a. Enter the rental portion of deductible home mortgage interest. See instructions 2a. _____

b. Enter the rental portion of deductible real estate taxes. See instructions b. _____

c. Enter the rental portion of deductible casualty and theft losses. See instructions c. _____

d. Enter direct rental expenses. See instructions d. _____

e. Fully deductible rental expenses. Add lines 2a-2d. Enter here and on the appropriate lines on Schedule E. See instructions 2e. _____

3. Subtract line 2e from line 1. If zero or less, enter -0- 3. _____

4a. Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities) 4a. _____

b. Enter the rental portion of excess mortgage interest. See instructions b. _____

c. Enter the rental portion of excess real estate taxes. See instructions c. _____

d. Carryover of operating expenses from 2021 worksheet d. _____

e. Add lines 4a-4d e. _____

f. Allowable expenses. Enter the smaller of line 3 or line 4e. See instructions 4f. _____

5. Subtract line 4f from line 3. If zero or less, enter -0- 5. _____

6a. Enter the rental portion of excess casualty and theft losses. See instructions 6a. _____

b. Enter the rental portion of depreciation of the dwelling unit b. _____

c. Carryover of excess casualty and theft losses and depreciation from 2021 worksheet c. _____

d. Add lines 6a-6c d. _____

e. Allowable excess casualty and theft losses and depreciation. Enter the smaller of line 5 or line 6d. See instructions 6e. _____

PART III. Carryover of Unallowed Expenses to Next Year

7a. Operating expenses to be carried over to next year. Subtract line 4f from line 4e 7a. _____

b. Excess casualty and theft losses and depreciation to be carried over to next year. Subtract line 6e from line 6d b. _____

IRS Worksheet 5-1 Part I



- Use this worksheet if you answer YES to the following:

- Did you use the dwelling unit as a home this year?

- Did you rent the dwelling unit at a fair rental price 15 days or more this year?

- Is the total of your rental expenses and depreciation more than your rental income?

Use this worksheet only if you answer "Yes" to all of the following questions.

- Did you use the dwelling unit as a home this year? (See *Dwelling Unit Used as a Home*.)
- Did you rent the dwelling unit at a fair rental price 15 days or more this year?
- Is the total of your rental expenses and depreciation more than your rental income?

PART I. Rental Use Percentage

A. Total days available for rent at fair rental price	A.	343
B. Total days available for rent (line A) but not rented	B.	265
C. Total days of rental use. Subtract line B from line A	C.	78
D. Total days of personal use (including days rented at less than fair rental price)	D.	22
E. Total days of rental and personal use. Add lines C and D	E.	100
F. Percentage of expenses allowed for rental. Divide line C by line E	F.	78%

You use a dwelling unit as a home during the tax year if you use it for personal purposes more than the greater of:

- 14 days, or
- 10% of the total days it is rented to others at a fair rental price.

IRS Worksheet 5-1 Part II



PART II. Allowable Rental Expenses

1. Enter rents received	1.	\$15,600
2a. Enter the rental portion of deductible home mortgage interest and qualified mortgage insurance premiums. See instructions	2a.	_____
b. Enter the rental portion of deductible real estate taxes. See instructions	b.	_____
c. Enter the rental portion of deductible casualty and theft losses. See instructions	c.	_____
d. Enter direct rental expenses. See instructions	d.	_____
e. Fully deductible rental expenses. Add lines 2a-2d. Enter here and on the appropriate lines on Schedule E. See instructions	2e.	_____
3. Subtract line 2e from line 1. If zero or less, enter -0-	3.	\$15,600

IRS Worksheet 5-1 Part II (cont.)



4a. Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities)	4a.	\$4,836	
b. Enter the rental portion of excess mortgage interest. See instructions	b.	\$9,516	
c. Enter the rental portion of excess real estate taxes. See instructions	c.	\$2,886	
d. Carryover of operating expenses from 2021 worksheet	d.		
e. Add lines 4a-4d	e.	\$17,238	
f. Allowable expenses. Enter the smaller of line 3 or line 4e. See instructions	4f.	\$15,600	
5. Subtract line 4f from line 3. If zero or less, enter -0-	5.	\$1,638	
6a. Enter the rental portion of excess casualty and theft losses. See instructions	6a.	\$4,290	
b. Enter the rental portion of depreciation of the dwelling unit	b.		
c. Carryover of excess casualty and theft losses and depreciation from 2021 worksheet	c.		
d. Add lines 6a-6c	d.	\$4,290	
e. Allowable excess casualty and theft losses and depreciation. Enter the smaller of line 5 or line 6d. See instructions	6e.	\$0	

Worksheet 5-1 Part III



Line 4e	\$17,238
-Line 4f	\$15,600
	= \$1,638

Line 6d	\$4,290
-Line 6e	\$ 0
	= \$4,290

PART III. Carryover of Unallowed Expenses to Next Year	
7a. Operating expenses to be carried over to next year. Subtract line 4f from line 4e	7a. \$1,638
b. Excess casualty and theft losses and depreciation to be carried over to next year. Subtract line 6e from line 6d	b. \$4,290

And the Unused Losses?



- They are carried forward to the next year
- And then the next year...
- And then the next year...
- The IRS has not told us that these unused losses can offset gain from the sale, so they are probably just lost.

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Hotel Business Rules



- Your client might be involved in an actual business if:
 - The taxpayer has used the property personally for 14 days or less during the year, OR
 - The days of personal use are equal to no more than 10% of the rental days
 - AND the taxpayer rents to guests for an average period of 7 days or less
 - OR significant services are provided by the host
- The good news? No problem deducting losses!
- The bad news? This might be a Schedule C activity.



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Hotel Business Losses



- Hotel hosts may deduct losses from other (nonrental) income if the host materially participates in the activity. The IRS has created 7 tests to determine material participation. Most common for this situation:
 - 500-hour test: taxpayer has participated in the activity for more than 500 hours.
 - Substantially all test: taxpayer did substantially all the work in the activity during the year.
 - 101-hour test: taxpayer participated in the business for more than 100 hours during the year and at least as much as any other person.
 - Note that spouse's hours count (but not children's)

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Regular Rental Activity Rules



- Taxpayer is subject to the regular rental activity rules if:
 - Taxpayer rented the property for MORE than 14 days and used it personally for 14 days or LESS or no more than 10% of the rental days
 - AND activity does not qualify as a hotel business, meaning average stay is either more than 30 days or is 8-10 days with no significant services and apparently can even be 7 days with no significant services!
- In this case, the passive activity loss rules apply!

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Regular Rental Activity Rules



- §469(i) allows for a loss of up to \$25,000 most people (\$12,500 MFS) if the taxpayers actively participate in rental real estate activity and other qualifications are met
 - Taxpayer must own at least 10% of the property
 - Taxpayer cannot be a limited partner, unless he is also a general partner eligible for the loss
 - Losses cannot be from an irrevocable trust that made a §645 election and cannot be from a net lease activity
 - Taxpayers must make management decisions in a significant and bona fide sense
- Phaseout begins at MAGI \$100K (\$50K MFS) and is fully phased out when MAGI is \$150K (\$75K MFS).

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Last Thoughts...



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When is a Rental Not for Profit?



- If there's no profit motive in the rental activity, then the income is reported as Other Income on Schedule 1 (Form 1040), Part I, Line z.
 - Charging less than fair market rent
 - Slow to collect back rent
 - Failing to take legal actions for arrears/damages
 - Allowing rentals to remain vacant for periods of time
- ***Can deduct mortgage interest and real estate tax on Schedule A, but other deductions not allowed!!!***

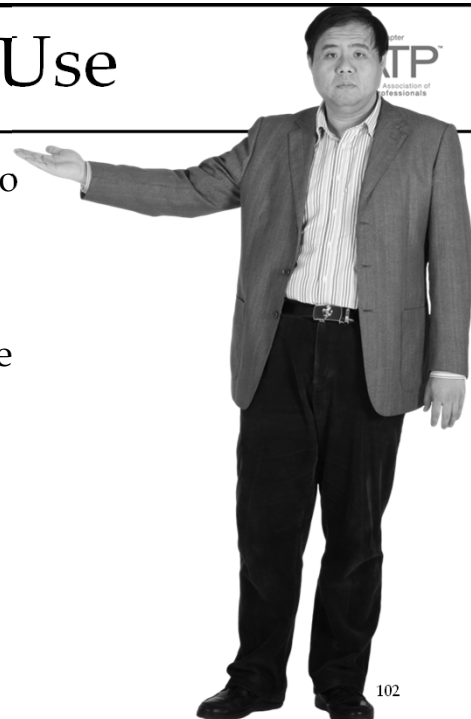
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Donation of Use

- Sam donates two weeks at his lake house to his favorite charity to be used in a silent auction.
- He tells you he has a charitable deduction for the amount of fair rental value for those two weeks.

What's the amount of his deduction?



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Questions?

North Carolina Chapter
NATP
National Association of
Tax Professionals



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