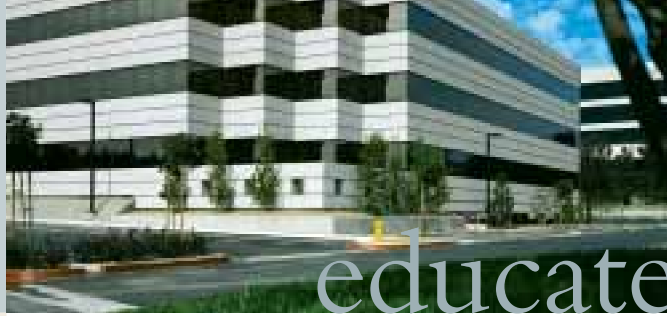

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Rental Real Estate as an Investment

Client Information Series

for the year, and (2) it is rented at a fair rental value (not at a discount), then no limitations apply. You simply treat it like any other rental property. However, if it is rented to a relative below fair rental value, all of the expenses, except mortgage interest and property taxes, are considered personal expenses and therefore not deductible.

- **Vacation Home Rental** – There are special tax consequences when you rent out your vacation home for part of the year. The tax treatment depends on how many days it is rented and your level of personal use. Personal use includes vacation use by your relatives (even if you charge them market rate rent) and use by non-relatives if a market rate rent is not charged.

  When determining the personal-use days, do not include days when you are performing repairs or fixing up the property.

Selling, Exchanging or Converting the Rental

Buying, operating and selling a rental property can have profound tax ramifications. Rental property, if owned for longer than a year or if inherited[1], will qualify for long-term capital gains when sold. This means any gain is taxed at a maximum of 20% with one exception. The exception is recaptured depreciation which, depending upon your tax bracket, can be taxed up to 25%. When it comes time to cash in on a rental investment, there are a number of options available to the owner:

- **Outright Sale** – When a rental property is sold outright, the entire gain will be taxable in the year of sale.
- **Installment Sale** – If the seller carries back a note (mortgage) for all or part of the buyer's purchase price, the seller qualifies for installment sale treatment, which in effect spreads the taxation of the gain over the life of the note.[2]
- **Convert to Personal Use** – The rental can be converted to personal use of the taxpayer and any gain deferred until the property is ultimately sold.
- **Tax-Deferred Exchange** – A tax-deferred exchange can be used as a means of avoiding immediate taxation on the gain from a rental property by deferring the gain into a replacement property.[2]

Business or Investment Use Requirement – To qualify for a Sec 1031 exchange, the properties exchanged must both be held for business or investment use.

Like-Kind Requirement – The properties exchanged must be like-kind (similar in nature, but not necessarily of the same quality). Real estate must be exchanged for real estate (improved or unimproved qualifies).

Caution: Sometimes real estate is held in a partnership or other entity. Generally, an entity ownership does not qualify as like-kind. Although, tenant-in-common interests (sometimes referred to as TICS), if structured properly, can.

Property Acquired with Intent to Exchange – If a taxpayer acquires (or constructs) property solely for the purpose of exchanging it for like-kind property, the IRS says that the taxpayer doesn't hold the property for productive use in a trade or business or for investment, and as to the taxpayer, the exchange doesn't qualify for non-recognition treatment under Code Sec. 1031.

Simultaneous or Delayed – The exchange can be simultaneous or delayed. If delayed, the property received in the exchange must be identified within 45 days after the property given is transferred. No matter how many properties are given up in an exchange, a taxpayer is allowed to designate a maximum of either:

(a) Three replacement properties regardless of FMV (fair market value), or

(b) Any number of properties, as long as the total FMV isn't more than 200% of the total FMV of all properties given up.

If a taxpayer identifies replacement properties over these limits, he/she is treated as if none were identified. A taxpayer can, however, revoke an identification at any time before the end of the 45-day time period.

The receipt of the new property must be completed before the EARLIER of:

(1) 180 days after the transfer of the property given, OR

(2) The due date (including extensions) of the return for the year in which the property given was transferred.

Qualified Intermediary – Generally, to qualify for a delayed Sec 1031 exchange, a qualified intermediary is engaged to hold the funds from the sale until the replacement purchase is made. It is important to understand that the taxpayer cannot take possession of the proceeds from the sale and then buy another property. If that happens, the event does not qualify for exchange and is immediately taxable.

Reverse Exchanges – It is possible to structure a reverse exchange that complies with the Section 1031 delayed exchange requirements. However, it requires that the replacement property be purchased first, by the intermediary, without the benefits of the proceeds from the property given up in the exchange. Thus, only taxpayers with the cash financial resources can accomplish reverse exchanges.

Tax-deferred exchanges can be very tricky and should not be entered into without first analyzing the tax aspects.

Net Investment Income Tax – Rental income is generally considered to be passive income, as opposed to a trade or business and as such, for higher income taxpayers, is subject to a 3.8% net investment income tax (NIIT). There are exceptions, but those exceptions require the rental activity to rise to the level of a trade or business–a very difficult standard to meet for residential rental property. Thus you can expect this 3.8% NIIT to apply to both net rental profits and to any profits from the sale of the rental if your income exceeds the income threshold for the NIIT.

[1] Some property inherited from individuals who died in 2010 may be subject to other rules.

[2] This option is not available if the sale results in a loss.

DISCLAIMER

The tax advice included in this brochure is an overview of some complex tax rules and is not intended as a thorough in-depth analysis of the tax issues discussed. Do not act on the information included in this brochure without first determining how these issues apply to your particular set of circumstances and if there are any special tax laws or regulations that might apply to your situation.

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Rental Real Estate as an Investment

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A popular form of long-term investment is real estate rentals. Rentals can fall into several varieties, of which real estate rentals is the most common. This material will explain some of the tax ramifications of renting real estate, both residential and commercial.

One of the biggest benefits of owning rental property is that the tenants, over time, buy the property for you. In addition, if structured properly, the allowable depreciation deduction will shelter the rental income. Another historical benefit of real estate rentals is capital appreciation.

Before acquiring a rental property, consider the following:

- After-tax cash flow,
- Potential for long- or short-term appreciation,
- Property condition (with an eye on when you might get stuck with a large repair bill),
- Debt reduction,
- Type of tenants,
- Potential for rent increases or re-zoning, and
- Whether there is community rent control, etc.

Although most of the considerations are subjective, the after-tax cash flow can be estimated fairly easily.

Operating Expenses

For tax purposes, you will figure your profit or loss each year from operating the rental property. Generally, you can deduct all expenses incurred to operate the rental. The following are potential operating expenses that are deductible:

- Advertising
- Cleaning & maintenance
- Bank charges – if a separate account is maintained.
- Insurance – fire, casualty and liability
- Utilities – gas, electricity, water, cable, etc.
- Services – yard care, pool service, pest control, etc.
- Rental commissions
- Property management fees
- Mortgage interest – on debt to acquire or improve the rental.
- Property taxes
- Repairs – see repairs vs. improvements below.
- Local transportation expenses
- Homeowners' or association dues
- Tax return preparation fees
- Depreciation allowance – see depreciation below.

Repairs vs. Improvements

When figuring your profit or loss from operating the rental property each year, you can deduct the cost of repairs to the rental property. However, any improvements that were made must be depreciated over the improvement's useful life.
How do you distinguish a repair from an improvement?

- **Repairs –** A repair keeps your property in good operating condition and does not materially add to the value of your property or substantially prolong its life.
- **Improvements –** An improvement will add to the value of the property, prolong its useful life, or adapt it to new uses. If you make an improvement to a property, the cost of the improvement must be capitalized.
- **Safe Harbor Election –** IRS regulations permits a taxpayer with $10 million or less in average annual gross receipts in the three preceding years, and whose building has an unadjusted basis of $1 million or less, to make an irrevocable election to immediately deduct rather than depreciate improvements. To qualify, the total amount paid during the year for repairs, maintenance, improvements and similar activities made to the building may not exceed the lesser of 2% of the building's unadjusted basis or $10,000. The election is made on a building-by-building basis and generally can only be made on an original return. Special rules apply if the taxpayer leases rather than owns the building.

Depreciating Rental Property

"Depreciation" is an accounting term for writing off the wear and tear on an asset that has a useful life of more than one year and costs over $200. Generally, rental real estate improvements must be depreciated over a period of 39 years. However, there are exceptions for residential rental real estate, which is depreciated over 27.5 years and most personal property such as furniture, equipment, etc., which is depreciable over 5 or 7 years.

Passive Loss Limitations

As an investment (not a business), rental real estate income is not subject to Social Security taxes. However, as with business activities, real estate rentals are considered passive activities. Generally, passive activity losses are only deductible to the extent of passive activity income. However, there are two exceptions to that rule:

(1) Active Participation – If you "actively participate" in the residential rental activity, you may be able to deduct a loss of up to $25,000 ($12,500 if you're married, file separately, and live apart from your spouse for the entire year – but if you're married, file separately and don't live apart from your spouse for the entire year, you're not eligible for this break at all) against ordinary (nonpassive) income, such as your wages or investment income. You actively participate in the rental activity if you make key management decisions or arrange for others to provide services. Active participation does not require regular, continuous and substantial involvement with the property. But in order to satisfy the active participation test, you (together with your spouse) must own at least 10% of the rental property. Ownership as a limited partner does not count. If your adjusted gross income (AGI) is above $100,000, the $25,000 allowance amount is reduced by one-half the excess over $100,000. (If you're married, file separately and are eligible for the break, the $12,500 allowance amount is reduced by one-half the excess over $50,000.) Under this rule, if the AGI is $150,000 or more ($75,000 or more for eligible married taxpayers who file separately), the allowance is reduced to zero. For these purposes, AGI is modified to some extent, e.g., you ignore taxable Social Security income and the Individual Retirement Account (IRA) deduction.

(2) Real Estate Professional Exception – If you qualify as a "real estate professional" (which requires the performance of substantial services in real property trades or businesses), your rental real estate activities are not automatically treated as passive, and so losses from those activities can be deducted against earned income, interest, dividends, etc., if you materially participate in the activities.

Any losses not allowed under these two exceptions are not lost but suspended, and carried forward indefinitely to tax years in which your passive activities generate enough income to absorb the losses.

Special Situations

There are a number of special circumstances involving the rental of real estate.

- **First, Last and Security Deposits –** Generally, landlords require a new tenant to pay the first and last month's rent in advance along with a security deposit. The IRS says that advance rent payments are income in the year received. However, security deposits you plan to return to your tenant at the end of the lease are not income. 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, then the amount kept is income for that year.
- **Renting Part of Property –** If you rent part of your property, you must divide certain expenses between the part used for rental purposes and the part used for personal purposes, as though you actually had two separate pieces of property. You can deduct the expenses related to the part of the property used for rental purposes, such as home mortgage interest and real estate taxes, as rental expenses. You can also deduct as a rental expense other expenses that are normally nondeductible personal expenses, such as utilities and home repairs. You do not have to divide the expenses that belong only to the rental part of your property.

  Generally, the most frequently-used methods of allocating expenses between personal and rental use are:
  (1) based on the number of rooms in the home, and
  (2) based on the square footage of the home. You can use any reasonable method for dividing the expense.
- **Separating Improvements from Land –** Not all of the cost of acquiring real estate is depreciable. Specifically, the cost of the land is not depreciable and must be separated from the improvements.
- **Renting to a Relative –** Special rules may apply when renting a home or apartment to a relative. If you rent a home to a relative who: (1) uses it as his or her principal residence (that is, not just as a second or vacation home)