Tax Considerations for Rental Properties

Many people have become landlords due to sites like Airbnb, Vrbo.

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Over the past decade, the rise of Airbnb, Vrbo and other sharing platforms has introduced a sea-change in real estate, with more people than ever dipping their toe into the rental real estate industry.

While the potential benefits are attractive, it's important to understand how to navigate the tax treatment of rental income, particularly in light of changes to tax laws over the past few years. This article covers a broad overview of the tax landscape with rental real estate. Given the complexity involved, it's imperative that you consult a tax professional if you're engaged in, or plan to start, rental real estate activity.

PASSIVE ACTIVITY INCOME AND LOSSES

Rental real estate owned by individuals or pass-through tax entities such as LLCs (limited liability companies) or partnerships, typically falls under the Internal Revenue Service's passive activity rules. Rental income is generally considered passive activity income, which is a separate category of income from your paycheck (wage or salary) income and your investment (dividend, interest or capital gain) income. These rules say you can generally deduct passive losses only to the extent you have passive income from other sources.

For example, if you have passive losses from some rental properties but other properties throw off passive income, you can deduct these losses up to the amount of income.

If you have little or no passive income, your passive losses are suspended and carried over to future tax years, where they accrue until you either generate passive income or have sold a property with suspended losses, at which time these losses become currently deductible.

WHAT CAN BE DEDUCTED?

There are a number of deductions that can be taken against your rental income to reduce overall taxable income from rental property. If you rent out your property for 14 days or less, you don't have to report income on your taxes and you can't deduct any expenses. In order to qualify as a rental property, against which these deductions can be taken, you (or your family) must use the property for less than 15 days, or less than 10% of the total days you rent it to others. If you meet those requirements, you can deduct a number of expenses against rental income.

■ INTEREST AND PROPERTY TAXES

Interest is often the biggest deductible expense. Property owners can deduct mortgage interest payments on loans used to acquire or improve rental property. Property taxes are also deductible and aren't subject to the current $10,000 limit on your primary residence. In addition, unlike personally owned property, rental property owners can also deduct interest on credit cards for goods or services used in a rental activity.

■ DEPRECIATION

Rental property owners reclaim the cost of rental real estate by taking depreciation on the dwelling. This involves deducting a portion of the cost of the property, including some improvements, over several years. For a rental home, the depreciation period is 27.5 years.

Note that this applies to the structure only and not to the value of land. Appliances can also be depreciated over shorter timetables.

Be aware that depreciation taken as a deduction is at the same time subtracted from the property's cost basis, for the purposes of calculating your gain on a later sale.

Consider an investor who purchases a rental property for $300,000 and takes depreciation deductions totaling $55,000 over the years. When the property is sold, the cost basis used to calculate the gain on the sale now will be $245,000 — the original purchase price minus the depreciation deductions.

■ REPAIRS

The cost of ordinary, necessary and reasonable repairs to rental property is fully deductible in the year they're incurred. Good examples of deductible repairs include repainting, fixing gutters or floors or leaks, and plastering and replacing broken windows.

It's important to research what's done to make sure your expense will constitute a repair that's deductible in full in the year of the cost and not an improvement that must be depreciated over time.

■ INSURANCE

You can deduct the premiums you pay for almost any insurance for your rental activity. This includes fire, theft and flood insurance for rental property, as well as landlord liability insurance.

■ TRAVEL

You're entitled to a tax deduction for travel to your rental property or to go to the hardware store to purchase a part for a repair. Keep track of the mileage so that you can use the current IRS guidelines for cents per mile, which change annually, or your actual costs if you use a vehicle frequently for rental real estate.

■ **LEGAL AND PROFESSIONAL SERVICES**

You can deduct fees that you pay to attorneys, management companies, real estate investment advisers and other professionals. You can deduct these fees as operating expenses as long as the fees are properly paid for work related to your rental activity.

SMALL LANDLORD EXEMPTION FOR PERSONALLY OR PASS-THROUGH OWNED REAL ESTATE

Given the number of deductions available, it's not uncommon for a taxpayer to have a net loss for the year from passive rental activities. Under the passive activity loss (PAL) rules some taxpayers are allowed to deduct up to $25,000 of these passive losses from rental real estate properties against ordinary income, even if they have no other passive income. To qualify, you must own at least 10% of the property generating the loss and you must "actively participate." Passing the active participation test requires that you at least exercise management control over the property by approving tenants and leases, authorizing maintenance and repairs, etc. But this deduction is only available to a limited number of taxpayers, as this small-landlord exception is phased out for those with adjusted gross income (AGI) of between $100,000 and $150,000. Those below $100,000 in AGI can deduct the full $25,000. Those above $150,000 in AGI are phased out entirely, while those in the middle get a reduced deduction.

TAX ISSUES FOR AIRBNB, VRBO, ROOM RENTALS

If you rent your property or a room on your property via Airbnb or Vrbo, they will issue you a Form 1099-K at tax time. This can be a source of confusion, as this form is issued for any rental income, even if you rented your property for less than 14 days (and thus tax-free). In this case, you would not include this income on your tax return, provided you kept good documentation that the rentals for the year totaled less than two weeks.

If you rent out property through one or more sharing platforms, you should consider filing a Form W-9 with each. This form, commonly used by freelancers and gig workers, provides your taxpayer information to the platform. If this form is not filed, they may withhold up to 30% in federal tax from your rental income.

If you rent a room in your primary residence for more than 14 days, that activity is subject to passive income and loss treatment. But you must keep detailed records, as you can't deduct 100% of your expenses for the property as passive expenses. Instead, you most prorate the cost of your mortgage, property taxes, etc., between the rental space and your primary living space. If you rent out a 200-square-foot room in a 2,000-square-foot house, then 10% of your qualified expenses can be deducted against passive income.

TAX ON SALES OF RENTAL PROPERTIES

Sales of rental properties are generally subject to capital gains tax at the same rates that apply to other investment assets. The majority of taxpayers are subject to a 15% tax on all capital gains, while those households making roughly $500,000 or more pay 20% on capital gains.

This differs notably from the tax treatment of the sale of a primary residence. For a primary residence, the first $250,000 of gain for single taxpayers, or $500,000 for joint taxpayers, is excluded from tax. This creates a planning opportunity if you own rental real estate that you plan to sell in the coming years.

In order to qualify for the $500,000 primary residence exclusion, you must have lived in the home for two of the past five years. By converting your rental property to your primary residence for at least two years, you can shield a portion of the gain when you sell the property in the future. As usual, the IRS has put some limits in place.

First and foremost, the exclusion only applies to periods when the property was used as a primary residence. So, if you rented the property for eight years, moved in for two years, and then sold the home, 20% of your gain would be eligible for the exclusion, as 20% of your use of the property was as a primary residence. In addition, the exclusion doesn't apply to any gains related to depreciation deductions taken while the property was a rental. Lastly, this rule has been in effect since 2009, so any ownership from 2008 and prior is counted as if you lived in the home.

What about converting your primary residence to a rental property? We often see this when someone is downsizing and rents out their old home rather than selling it. In this case, there is no prorating of gains on sales. If you convert your home to a rental, and sell it within three years, 100% of the gain is eligible for the exclusion. The home was your primary residence in two of the past five years, and converting from primary to rental does not trigger any prorating of the gain.

KEEP GOOD RECORDS AND TALK TO AN EXPERT

There are separate and complex rules in place for full-time real estate professionals, which are beyond the scope of this article. But, as you can see, even for those with rental real estate interests in addition to a day job, there are plenty of opportunities for tax savings. It's crucial that you keep good records, and consult a tax professional, in order to maximize your savings and return on investment.

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