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TaxBrief

Keeping you informed

Tax Tips for Rental Property Owners

The real estate market presents numerous opportunities for investors and rental property owners to generate income; however, the tax implications associated with these activities can be complex. This newsletter provides a practical guide to help answer questions about the tax implications of rental real estate activities.

Taxation of rental income

Income earned from residential rental properties is subject to federal income tax and must be reported on your federal income tax return. Rental income is any payment received for the use or occupation of a property, including regular rent payments, payments for canceling a lease, security deposits used as a final rent payment or retained for damages, expenses paid directly by the tenant and the value of services received in lieu of rent. Security deposits that will be returned to the tenant are not considered income at the time they are received.

If you rent out a residence for fewer than 15 days in the year, the income isn't taxable and related expenses aren't deductible. This is known as the "Masters exception" and generally applies when people rent out a personal residence for short periods during major events, such as the Masters golf tournament.

Short-term rentals, such as those listed on Airbnb or similar platforms, are subject to increased IRS scrutiny, and lower informational return reporting thresholds may impact landlords. Please note that income from short-term rentals is generally taxable and may be subject to self-employment tax, depending on the services provided.

Deductible expenses

Landlords are allowed to deduct the ordinary and necessary expenses they incur while maintaining and managing their rental property. These deductions reduce the amount of taxable income. Common deductions include:

- Mortgage interest
- Property taxes
- Insurance premiums (including homeowner's and mortgage insurance premiums on your rental property)
- Advertising
- Utilities
- Repairs
- Depreciation

Note: The portion of a mortgage payment that is applied to paying down the principal is not deductible because it reduces the landlord's outstanding loan balance on a dollar-for-dollar basis. Thus, there is no "expense" to deduct.

Landlords who own commercial or residential rental properties used in a trade or business may qualify for business energy tax credits, such as the investment tax credit under §48 for commercial solar installations.

Passive activity loss rules

Rental losses are usually considered passive and can't offset other income. But if you qualify as a real estate professional or materially participate in a short-term rental, losses may be fully deductible.

Many landlords qualify for a special $25,000 loss allowance if they actively participate and have modified AGI under $100,000 (phases out at $150,000).

Losses you can't deduct now aren't lost; they carry forward and may be used in future years or when the property is sold.

Selling a rental property

When you sell your rental property, it is generally treated as the sale of a business or investment asset. This means that any gain is usually subject to the more favorable long-term capital gains tax rates, although any depreciation taken during the property's life may be taxed at higher "recapture" rates. If the property is used in a rental trade or business, a loss is typically treated as an ordinary business loss that can fully offset other income; if it is held purely for investment, the loss is generally a capital loss and subject to annual limits.

You should keep accurate records of any improvements made to the property, including the costs and dates of completion. Improvements add to the tax basis of your property, which will reduce taxable gain upon sale. The IRS requires substantiation, so you'll need complete records in your files.

Net investment income tax

Individuals with a modified adjusted gross income (MAGI) of more than $200,000 ($250,000 if married filing jointly) may owe the 3.8% net investment income tax (NIIT) if they also have net investment income, such as capital gains from the sale of a residential rental property. NIIT is essentially a tax on investment income for high-income earners, imposed on the lesser of the taxpayer's net investment income or the amount by which their income exceeds the applicable threshold.

For example, an individual with a MAGI of $250,000 for the year had capital gains of $300,000. The tax would be applied to the $50,000 by which the individual's income exceeded the NIIT threshold (not the $300,000 in capital gains), because it is the lower of the two amounts. Thus, the individual would owe $1,900 in NIIT ($50,000 x 0.038).

§1031 exchanges

To postpone the tax bite from selling a rental property, owners can use a §1031 exchange. These "like-kind exchanges" let taxpayers defer capital gains tax on the sale of business or investment property by reinvesting the proceeds into similar property. While the taxes are deferred, they are not forgiven; the deferred gain must be recognized if the property is eventually sold without using another §1031 exchange.

These exchanges can get complicated quickly, as the rules vary at the state level, and must meet key components to qualify for special federal tax treatment. The key criteria includes:

- The replacement property must be identified within 45 days of the sale.
- The purchase of the replacement property must be completed within 180 days.
- A qualified intermediary typically holds the funds between the sale of the relinquished property and the purchase of the replacement property.

Still have questions?

Have questions about the tax rules for landlords? We're here to help; reach out anytime.