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**Ten Tax Concepts
Our Rental Real Estate
Clients Need To Know**

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PROFILE



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Jerry is a member of the Solano-Napa Chapter of Enrolled Agents. He had previously been a member of the East Bay Association of Enrolled Agents and the North Bay Chapter of the California Society of Enrolled Agents, where he served three terms as Chapter President. He is a past 4-term CSEA State Director. Jerry became an Enrolled Agent in 1983 and is also a member of the National Association of Enrolled Agents. He became a Fellow of the National Tax Practice Institute in 1999.

Jerry is the owner of Gerald Pusateri, EA & Associates in Fairfield, California. He has been in the tax profession for 28 years. Services of the office include tax preparation, representation and consultation.

Jerry has taught Income Tax and QuickBooks classes for the Fairfield-Suisun Adult School dating back to 1983. For the past five years, Jerry has served as the lead instructor for the East Bay Association of Enrolled Agents Special Enrollment Exam Class.

In his leisure time, Jerry enjoys watching football, and baseball; avidly collecting sports cards from each sport. Jerry has also been collecting old radios and old radio shows from the 30's, 40's and 50's for a number of years.

Jerry has been married for 40 years to his wife Susan, who manages the office. They have a daughter and two grandchildren. Their household includes one dog, two cats and a horse.

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Ten Tax Concepts

Our Rental Real Estate Clients Need to Know

1. *Basis Considerations*

Cost Basis: Basis is your investment in property for tax purposes.

Your original basis is usually your cost to acquire the asset. The cost is the amount you pay for it in cash, debt obligations, other property or services.

Your adjusted basis (which is the basis you use to determine gain or loss or depreciation amounts) is the result of increasing or decreasing your original basis according to certain events.

The difference between the selling price of your asset and your adjusted basis determines whether there is a taxable gain or loss on the disposition of your property.

Increases to basis include but are not limited to:

- Improvements having a useful life of more than a year
- Assessments for local improvements
- Sales tax
- Costs of extending utility lines to the property
- Legal fees such as the cost of defending or perfecting title
- Zoning Costs

Decreases to basis include but are not limited to:

- Depreciation
- Casualty and theft losses
- Easements
- Rebates from the manufacturer or seller

When you hold property for personal use and change it to business use or use it to produce income (such as renting out your former home), your basis for depreciation is the lesser of the fair market value of the property on the date of the change, or your adjusted basis on the date of the change.

2. *Depreciation*

In general, if property is acquired for use in a business or another income-producing activity and is expected to last more than one year, taxpayers cannot deduct the entire cost as a business expense in the year it is acquired.

The cost must be depreciated over the property's useful life (as defined by the Internal Revenue Code) and part of the cost is deducted each year on Form 4562, Depreciation and Amortization.

In order to be depreciated, property must:

- Be property the taxpayer owns or capital improvements the taxpayer leases
- Be used in the taxpayer's business or income producing activity
- Have a determinable useful life
- Be expected to last more than one year.

Certain property cannot be depreciated, including:

- Land
- Property placed in service and disposed of in the same year
- Certain types of intangible assets, such as franchises, agreements not to compete, and goodwill

When you hold property for personal use and change it to business use or use it to produce income (such as renting out your former home), your basis for depreciation is the lesser of the fair market value of the property on the date of the change, or your adjusted basis on the date of the change.

Computing Depreciation: In order to compute depreciation correctly a taxpayer must know the following:

- The date the asset was "placed in service" for use in a business or income-producing activity,
- The basis of the depreciable asset,
- The depreciation methods available,
- The depreciation lives available

Placed in Service

Generally, property is considered placed in service when it is ready and available for a specific use, regardless of whether or not it is actually used at the time.

Example: A house purchased for use as rental property is placed in service when it is ready and available to rent, even if it is not actually rented at that time.

Depreciation reduces the owner's basis in the property. The property ceases to be depreciable when the taxpayer has fully recovered the property's cost or other basis or when the taxpayer retires it from service, whichever happens first.

When depreciable property is sold or disposed of, depreciation that was allowed or allowable on that property must be taken into consideration in figuring gain or

loss. If no depreciation was taken, the net profit or loss on the disposition of the property must be computed as if depreciation was actually taken. Taxpayers must also follow recapture rules to determine the amount of gain to be treated as ordinary income rather than capital gain.

3. Capital Gains and Losses

Almost everything you own and use for personal or investment purposes is a capital asset. When you sell a capital asset, the difference between the amount you sell it for and your basis, which is usually what you paid for it, is a capital gain or a capital loss.

You have a capital gain if you sell the asset for more than your basis. You have a capital loss if you sell the asset for less than your basis.

Capital gains and losses are classified as

- Long Term-assets held for more than one year prior to disposition or sale.
- Short Term-assets held one year or less prior to disposition or sale.

Capital gains and deductible capital losses are reported on Form 1040, Sch. D.

If you have a net capital gain, that gain may be taxed at a lower tax rate. "Net Capital Gain" means the amount by which your long-term capital gain for the year is more than your net short-term capital loss.

The highest tax rate on a net capital gain is generally 15% (or 5%, if it would otherwise be taxed at 15% or less). There are three exceptions:

1. The taxable part of a gain from qualified small business stock is taxed at a maximum 28% rate.
2. Net capital gain from selling collectibles (such as coin or art) is taxed at a maximum 28% rate.
3. The part of any net capital gain from selling section 1250 real property that results from straight-line depreciation is taxed at a maximum 25% rate ("Unrecaptured §1250 Gain").

If your capital losses exceed your capital gains, the amount of the excess loss that can be claimed is limited to:

- \$3,000, or
- \$1,500 if you are filing married filing separately.

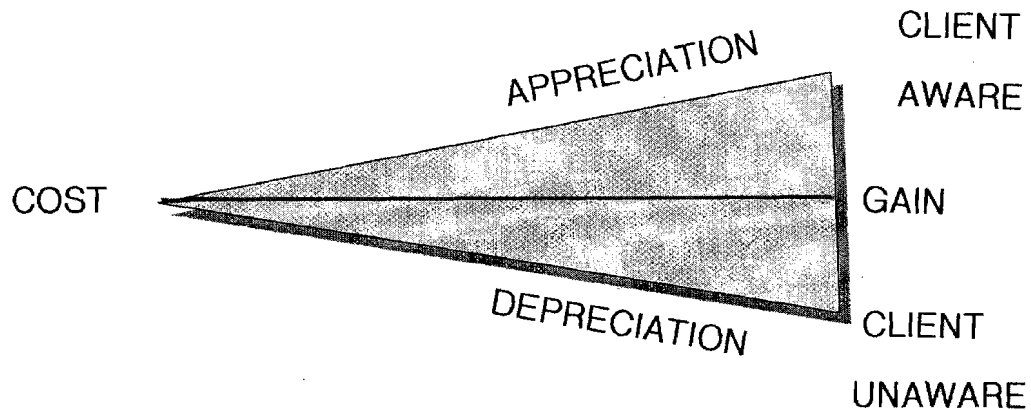
If your net capital loss is more than this limit, you can carry the loss forward to later years.

If you have a taxable capital gain, you may be required to make estimated tax payments.

4. The Triangle of Gain

Upon the sale of a rental, most clients will be aware of the gain caused by the appreciation of the rental property and the capital gain rate associated with the gain.

Many clients, without a little education from their tax professional, will be unaware of the gain caused by depreciation and the ordinary income aspect of depreciation recapture.



While this may look a little basic or out of the ordinary for our type of work, it can help the client visualize at the beginning of his or her rental real estate journey, what will materialize at the end of the journey.

Many clients are beside themselves at the actual gain and imposed tax upon the sale of their rental property. I have had good success with this as a handout in schooling clients of the tax to come.

I've gone so far as to place a copy of the triangle in the client file so that I can pull it out on occasion when the tax discussion meanders onto the potential sale of the client's rental(s).

How do you answer your client's question when he says, "What do you mean I have to pay back tax on the gain caused by the depreciation I wrote off over the last 10 years. I don't understand?"

5. Repairs versus Improvements

You can deduct the cost of repairs to your rental property. You can not deduct the cost of improvements. You recover the cost of improvements by taking depreciation.

Repairs:

- Keep property in good operating condition
- Do not materially add to the value of your property
- Do not substantially prolong its life.

Examples of Repairs:

- Repainting property inside or out,
- Fixing gutters or floors,
- Fixing leaks,
- Plastering, and
- Replacing broken windows.

If repairs are made as part of an extensive remodeling or restoration project to the property, the whole job is considered an improvement.

Improvements:

- Adds to the value of the property,
- Prolongs its useful life, or
- Adapts it to new uses.

Examples of Improvements:

- Bedroom/bathroom additions
- Landscaping
- Driveways
- Storm windows or doors
- New roof
- Heating system or air conditioning
- Wall to wall carpeting
- Insulation to attic, walls, floor or pipes

If you make an improvement to property, the cost of the improvement must be capitalized. The capitalized cost can generally be depreciated as if the improvement were separate property.

Keep accurate records. Separate the costs of repairs from improvements. The costs of improvements will need to be known when the property is depreciated or sold.

6. Limits on Rental Losses

A rental activity is an activity from which you receive income mainly from the use of tangible property, rather than for services.

Rental real estate activities are generally considered passive activities, and the amount of your loss may be limited.

Generally you cannot deduct losses from rental real estate activities unless you have income from other passive activities.

You may be able to deduct rental losses without regard to whether you have income from other passive activities if you “materially” or “actively” participated in the rental activity.

Material participation: Being involved in its operations on a regular, continuous, and substantial basis during the year.

Active participation: Requires ownership of at least 10% of the rental property and making management decisions in a significant and bona fide sense.

Management decisions include:

- Approving new tenants,
- Deciding on rental terms,
- Approving expenditures and
- Similar decisions.

The \$25,000 Special Allowance:

A taxpayer may deduct up to \$25,000 in rental real estate losses as long as the taxpayer actively participates and MAGI (Modified Adjusted Gross Income) is less than \$100,000. For every \$2 a taxpayer’s MAGI exceeds \$ 100,000, the allowance is reduced by \$1.

Example: If MAGI = \$ 110,000, the \$25,000 allowance is reduced by \$ 5,000 to a \$20,000 maximum allowance. Once MAGI exceeds \$ 150,000, the special allowance is no longer available.

Exception: The amount allowed for married taxpayers filing separately is either \$12,500 (if they did not live together) or zero (if they did live together during the year).

7. What Happens to Passive Losses that are Disallowed

Generally, you can deduct passive activity losses only from passive activity income (limit on loss deductions). You can carry excess losses forward to the following year or years until used, or until deducted in the year you dispose of your entire interest in the activity in a fully taxable transaction.

8. Exclusion of Gain on Home Converted to Rental

If you have a gain from the sale or exchange of your main home, you may be able to exclude from income all or part of the gain.

This exclusion, up to \$250,000 for individuals and \$500,000 for married taxpayers filing joint returns, is allowed each time that you sell your main home, but generally no more frequently than once every two years.

To qualify for this exclusion of gain, you must meet ownership and use tests.

Ownership Test: During the 5-year period ending on the date of the sale, you must have owned the home for at least 2 years.

Use Test: During the 5-year period ending on the date of the sale, you must have lived in the home as your main home at least 2 years.

If you and your spouse file a joint return for the year of the sale, you can exclude the gain if either of you qualify for the exclusion. But both of you would have to meet the use test to claim the \$500,000 maximum amount.

Most of the above, clients understand. What they fail to see is the potential for loss of home sale exclusion when they convert their personal residence to rental.

Based on the above rules, if a client were to convert his or her personal residence to rental property and continued to use it as rental property for 3 years and 1 day or more, the client could,

- Lose the ability to sell the property as a personal residence, and
- Lose the ability to take the exclusion of gain.

Thus the client will need to know the drop dead date for losing the availability of the home sale exclusion. Also, the client needs to be aware of the average time it takes a property to sell once it is placed on the market. Be advised that the client's realtor will not be the one to give the client this information.

9. Renting to Relatives at Less than Fair Market Value

For determining whether a home is used for rental purposes or for personal use, there are several factors to consider, but the factor carrying the largest weight is whether or not the related family member paid a fair rental price for the use of the home. If they did not, then the use of the dwelling unit is considered to be personal use by the owner.

If the property cannot be considered rental property:

- Schedule E cannot be used,
- A majority of the expenses will not be deductible,
- Rental income received will be reported on Form 1040, Line 21,
- The \$25,000 special allowance for passive activity losses is lost.

Also, if the property is deemed to be non rental, the only deductions that would be available would be mortgage interest and property taxes. And these deductions would only be deductible for the client's main home and a second home.

A client owning three homes:

- living in one as client's main home,
- renting one to client's son (at less than FMV),
- a second to client's daughter (at less than FMV),

would not be allowed to deduct the mortgage interest on the second rental.

10. Selling a Rental to Relatives at Less than Fair Market Value

Many times, parent clients will buy a residential property and allow their children or other relatives to live in the property until the relatives have the ability to buy the property from the client. The client may or may not have been collecting rent.

When client sells property to a relative at less than Fair Market Value, the transfer may be subject to gift tax.

Under the gift tax rules, the gift tax applies not only to the gratuitous transfer of any kind of property, but also to sales or exchanges, not made in the ordinary course of business, where money or money's worth is exchanged but the value of the money (or property) or money's worth received is less than the value of what is sold or exchanged.

Example: Married Taxpayers J & P sell, to their daughter, the rental residence daughter has been renting at less than fair market value.

- FMV of home sold, \$409,000 (appraised)
- Selling price of home \$309,000
- Gift for less than full and adequate consideration \$100,000.

A gift tax return will be required. There could very well be no tax due. Our clients can each exclude \$12,000 of the gift from being reportable. Thus the net reportable gift will be \$100,000 less \$24,000 equals \$76,000.

Note that while the example above states that the daughter had been renting at less than FMV, even if she was renting at FMV, the above would still apply if the home was sold to her for less than FMV.

While this is a simplistic discussion of gift taxes, it alerts the clients of the necessity to seek professional tax help prior to entering into the transaction.