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**Internal
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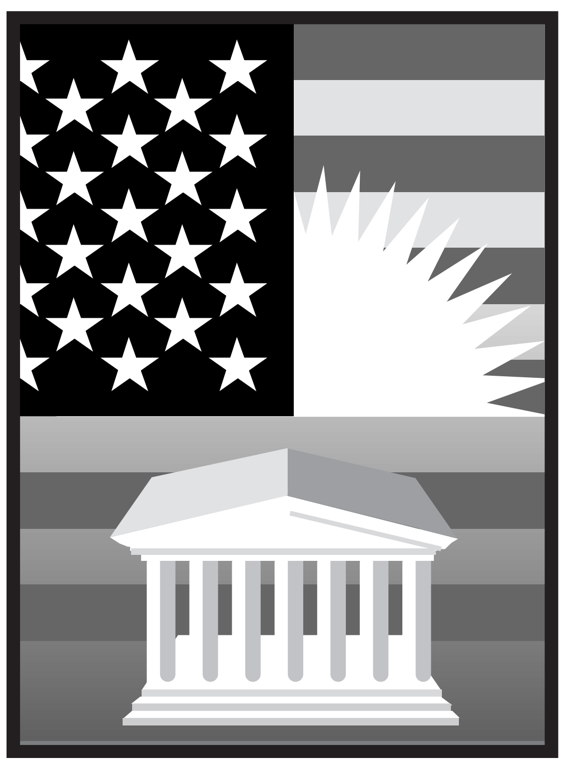
Residential Rental Property
(Including Rental of Vacation Homes)

For use in preparing
1998 Returns



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See *How To Get More Information* in this publication.

Contents

Introduction

This publication discusses rental income and expenses, including depreciation, and explains how to report them on your return. It also covers casualty losses on rental property and the passive activity limits and at-risk rules.

This publication is designed for those who only rent out a few residential dwelling units.

Sale of rental property. For information on how to figure and report any gain or loss from the sale or other disposition of your rental property, get Publication 544, *Sales and Other Dispositions of Assets*.

Sale of main home used as rental property. For information on how to figure and report any gain or loss from the sale or other disposition of your main home that you also used as rental property, get Publication 523, *Selling Your Home*.

Useful Items

You may want to see:

Publication

☐ **463** Travel, Entertainment, Gift, and Car Expenses

☐ **534** Depreciating Property Placed in Service Before 1987

☐ **535** Business Expenses

☐ **547** Casualties, Disasters, and Thefts (Business and Nonbusiness)

☐ **551** Basis of Assets

☐ **925** Passive Activity and At-Risk Rules

☐ **946** How To Depreciate Property

Form (and Instructions)

☐ **4562** Depreciation and Amortization

☐ **5213** Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit

☐ **6251** Alternative Minimum Tax—Individuals

☐ **8582** Passive Activity Loss Limitations

☐ **Schedule E (Form 1040)** Supplemental Income and Loss

See *How To Get More Information* near the end of this publication for information about getting these publications and forms.

Rental Income

You generally must include in your gross income all amounts you receive as rent. Rental income is any payment you receive for the use or occupation of property. In addition to amounts you receive as normal rent payments, there are other amounts that may be rental income.

When to report. Report rental income on your return for the year you actually or constructively receive it (if you are a cash basis taxpayer). You are considered to constructively receive income when it is made available to you, for example, by being credited to your bank account.

For more information about when you constructively receive income, see Publication 538, *Accounting Periods and Methods*.

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.

Example. You sign a 10–year lease to rent your property. In the first year, you receive $5,000 for the first year's rent and $5,000 as rent for the last year of the lease. You must include $10,000 in your income in the first year.

Security deposits. 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.

Payment for canceling a lease. If your tenant pays you to cancel a lease, the amount you receive is rent. Include the payment in your income in the year you receive it regardless of your method of accounting.

Expenses paid by tenant. If your tenant pays any of your expenses, the payments are rental income. You must include them in your income. You can deduct the expenses if they are deductible rental expenses. See *Rental Expenses*, later, for more information.

Example 1. The water and sewage bill for your rental property is mailed to the property. Under the terms of the lease, your tenant does not have to pay this bill. Your tenant pays the bill and deducts it from the normal rent payment.

Include in your rental income both the net amount of the rent payment and the amount the tenant paid for the utility bill. You can include the amount of the bill as a rental expense.

Example 2. While you are out of town, the furnace in your rental property stops working. Your tenant pays for the necessary repairs and deducts the repair bill from the rent payment.

Include in your rental income both the net amount of the rent payment and the amount the tenant paid for the repairs. You can include the cost of the repairs as a rental expense.

Property or services. 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. Your tenant is a painter. He offers to paint your rental property instead of paying 2 months' rent. You accept his offer.

Include in your rental income the amount the tenant would have paid for 2 months' rent. You can include that same amount as a rental expense for painting your property.

Lease with option to buy. If the rental agreement gives the tenant the right to buy your rental property, the payments you receive under the agreement are generally rental income. If, however, your tenant exercises the right to buy the property, the payments you receive for the period after the date of sale are part of the selling price.

Rental of property also used as a home. If you rent property that you also use as your home and you rent it for fewer than 15 days during the tax year, do not include the rent you receive in your gross income. You cannot deduct rental expenses. However, you can deduct on Schedule A (Form 1040) the interest, taxes, and casualty and theft losses that are allowed for non-rental property. See *Personal Use of Vacation Home or Dwelling Unit,* later.

Part interest. If you own a part interest in rental property, you must report your part of the rental income from the property.

Rental Expenses

This part discusses repairs and certain other expenses of renting property that you ordinarily can deduct from your gross rental income. It includes information on the expenses you can deduct if you rent a condominium or cooperative apartment, if you rent part of your property, or if you change your property to rental use. Depreciation, which you can also deduct from your gross rental income, is discussed later.

When to deduct. You generally deduct your rental expenses in the year you pay or incur them.

Vacant rental property. If you hold property for rental purposes, you may be able to deduct your ordinary and necessary expenses for managing, conserving, or maintaining the property while the property is vacant. However, you cannot deduct any loss of rental income for the period the property is vacant.

Pre-rental expenses. You can deduct your ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time you make it available for rent.

Expenses for rental property sold. If you sell property you held for rental purposes, you can deduct the ordinary and necessary expenses for managing, conserving, or maintaining the property until it is sold.

Personal use of rental property. If you sometimes use your rental property for personal purposes, you must divide your expenses between rental and personal use. Also, your rental expense deductions may be limited. See *Personal Use of Vacation Home or Dwelling Unit,* later.

Part interest. If you own a part interest in rental property, you can deduct your part of the expenses that you paid.

Repairs and Improvements

You can deduct the cost of repairs that you make to your rental property. You cannot deduct the cost of improvements. You recover the cost of improvements by taking depreciation (explained later).

RECORDS Separate the costs of repairs and improvements, and keep accurate records. You will need to know the cost of improvements when you sell or depreciate your property.

Repairs. A repair keeps your property in good operating condition. It does not materially add to the value of your property or substantially prolong its life. Repainting your property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs.

If you make repairs as part of an extensive remodeling or restoration of your property, the whole job is an improvement.

Improvements. An improvement adds to the value of property, prolongs its useful life, or adapts it to new uses. *Table 1* shows examples of many improvements.

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.

Table 1. **Examples of Improvements**

Caution: Work you do (or have done) on your home that does not add much to either the value or the life of the property, but rather keeps the property in good condition, is considered a repair, not an improvement.

Additions Bedroom Bathroom Deck Garage Porch Patio **Lawn & Grounds** Landscaping Driveway Walkway Fence Retaining wall Sprinkler system Swimming pool **Miscellaneous** Storm windows, doors New roof Central vacuum Wiring upgrades Satellite dish Security system	**Heating & Air Conditioning** Heating system Central air conditioning Furnace Duct work Central humidifier Filtration system **Plumbing** Septic system Water heater Soft water system Filtration system **Interior Improvements** Built-in appliances Kitchen modernization Flooring Wall-to-wall carpeting **Insulation** Attic Walls, floor Pipes, duct work

Other Expenses

Other expenses you can deduct from your gross rental income include advertising, janitor and maid service, utilities, fire and liability insurance, taxes, interest, commissions for the collection of rent, ordinary and necessary travel and transportation, and other expenses discussed next.

Rental payments for property. You can deduct the rent you pay for property that you use for rental purposes. If you buy a leasehold for rental purposes, you can deduct an equal part of the cost each year over the term of the lease.

Rental of equipment. You can deduct the rent you pay for equipment that you use for rental purposes. However, in some cases, lease contracts are actually purchase contracts. If so, you cannot deduct these payments. You can recover the cost of purchased equipment through depreciation.

Insurance premiums. You can deduct insurance premiums you pay for rental property. If you pay a premium for more than one year in advance, each year you can deduct the part of the premium payment that will apply to that year. You cannot deduct the total premium in the year you pay it.

Local benefit taxes. Generally, you cannot deduct charges for local benefits that increase the value of your property, such as charges for putting in streets, sidewalks, or water and sewer systems. These charges are capital expenditures that you cannot depreciate. You must add them to the basis of your property. You can deduct local benefit taxes if they are for maintaining, repairing, or paying interest charges for the benefits.

Interest expense. You can deduct mortgage interest you pay on your rental property. Chapter 8 of Publication 535 explains mortgage interest in detail.

Expenses paid to obtain a mortgage. Expenses you pay to obtain a mortgage on your rental property cannot be deducted as interest. These expenses, which include mortgage commissions, abstract fees, and recording fees, are capital expenses. You can amortize them over the life of the mortgage.

Form 1098. If you paid $600 or more of mortgage interest on your rental property to any one person, you should receive a Form 1098, *Mortgage Interest Statement,* or a similar statement showing the interest you paid for the year. If you and at least one other person (other than your spouse if you file a joint return) were liable for, and paid interest on the mortgage, and the other person received the Form 1098, report your share of the interest on line 13 of Schedule E (Form 1040). Attach a statement to your return showing the name and address of the other person. In the left margin of Schedule E, next to line 13, write “See attached.”

Points. The term “points” is often used to describe some of the charges paid by a borrower when the borrower takes out a loan or a mortgage. These charges are also called ***loan origination fees,*** maximum loan charges, or premium charges. If any of these charges (points) are solely for the use of money, they are interest.

Points paid when you take out a loan or mortgage result in original issue discount (OID). In general, the points (OID) are deductible as interest unless they must be capitalized. How you figure the amount of points (OID) you can deduct each year depends on whether or not your total OID, including the OID resulting from the points, is de minimis. If the OID is not de minimis, you must use the constant-yield method to figure how much you can deduct.

De minimis rule. In general, the OID is de minimis if it is less than one-fourth of 1% (.0025) of the stated redemption price at maturity (generally, the principal amount of the loan) multiplied by the number of full years from the date of original issue to maturity (the term of the loan).

If the OID is de minimis, you can choose one of the following ways to figure the amount you can deduct each year.

1) Constant-yield basis over the term of the loan.
2) Straight line basis over the term of the loan.
3) In proportion to stated interest payments.
4) Entire amount at maturity of the loan.

You make this choice by deducting the OID in a manner consistent with the method chosen on your timely filed tax return for the taxable year in which the loan or mortgage is issued.

Example of de minimis amount. On January 1, 1998, you take out a loan for $100,000. The loan matures on January 1, 2008 (a 10-year term) and the stated principal amount of the loan ($100,000) is payable on that date. An interest payment of $10,000 is payable to the bank on January 1 of each year, beginning on January 1, 1999. When the loan is made, you pay $1,500 in points to the bank. The points reduce the issue price of the loan from $100,000 to $98,500, resulting in $1,500 of OID. You determine that the points (OID) you paid are de minimis based on the following computation.

Redemption price at maturity (principal amount of the loan)	$100,000
Multiplied by: The term of the loan in complete years	× 10
Multiplied by	× .0025
De minimis amount	$2,500

The points (OID) you paid ($1,500) are less than the de minimis amount; therefore, you have de minimis OID and you can choose one of the four ways discussed earlier to figure the amount you can deduct each year. Under the straight line method, you can deduct $150 each year for 10 years.

Constant-yield method. If the OID is not de minimis, you must use the constant-yield method to figure how much you can deduct each year.

You figure your deduction for the first year in the following manner.

1) Determine the issue price of the loan. For example, if you paid points on a loan, subtract the points you paid from the principal amount of the loan to get the issue price.
2) Multiply the issue price (the result in (1)) by the yield to maturity.
3) Subtract any qualified stated interest payments from the result in (2).
4) The result in (3) is the amount of OID you can deduct in the first year.

To figure your deduction in any subsequent years, you start with the ***adjusted issue price.*** To get the adjusted issue price, add to the issue price any OID previously deducted. Then follow steps (2) through (4) above.

The ***yield to maturity (YTM)*** is generally shown in the literature you receive from your lender. If you do not have this information, consult your lender or tax advisor. In general, the YTM is the discount rate that, when used in computing the present value of all principal and interest payments, produces an amount equal to the principal amount of the loan.

Qualified stated interest (QSI) generally is stated interest that is unconditionally payable in cash or property (other than debt instruments of the issuer) at least annually at a single fixed rate.

Example of constant yield. The facts are the same as in the previous example. The yield to maturity on your loan is 10.2467%, compounded annually.

You figure the amount of points (OID) you can deduct in 1998 as follows.

Principal amount of the loan	$100,000
Minus: Points	1,500
Issue price of the loan	$ 98,500
Multiplied by: YTM	× .102467
Total	10,093
Minus: QSI	10,000
Points (OID) deductible in 1998	$93

You figure the deduction for 1999 as follows.

Issue price	$98,500
Plus: Points (OID) deducted in 1998	93
Adjusted issue price	$98,593
Multiplied by: YTM	× .102467
Total	10,103
Minus: QSI	10,000
Points (OID) deductible in 1999	$103

Loan or mortgage ends. If your loan or mortgage ends, you may be able to deduct any remaining points (OID) in the taxable year in which the loan or mortgage ends. A loan or mortgage may end due to a refinancing, prepayment, foreclosure, or similar event. However, if the refinancing is with the same lender, the remaining points (OID) generally are not deductible in the year in which the refinancing occurs, but may be deductible over the term of the new mortgage or loan.

Charges for services. You can deduct charges you pay for services provided for your rental property, such as water, sewer, and trash collection.

Travel expenses. You can deduct the ordinary and necessary costs of traveling away from home if the primary purpose of the trip was to collect rental income or to manage, conserve, or maintain your rental property. You must properly allocate your expenses between rental and nonrental activities. For information on travel expenses, see chapter 1 of Publication 463.

RECORDS To deduct travel expenses, you must keep records that follow the rules in chapter 5 of Publication 463.

Local transportation expenses. You can deduct your ordinary and necessary local transportation expenses if you incur them to collect rental income or to manage, conserve, or maintain your rental property.

Generally, if you use your personal car, pickup truck, or light van for rental activities, you can deduct the expenses using one of two methods: actual expenses or the standard mileage rate. The standard mileage rate for 1998 is ***32.5 cents a mile*** for all business miles. For more information, see chapter 4 of Publication 463.

RECORDS To deduct car expenses under either method, you must keep records that follow the rules in chapter 5 of Publication 463.

In addition, you must complete Part V of Form 4562, and attach it to your tax return.

Tax return preparation. You can deduct, as a rental expense, the part of tax return preparation fees you paid to prepare Part I of Schedule E (Form 1040). You can also deduct, as a rental expense, any expense you paid to resolve a tax underpayment related to your rental activities. On your 1998 Schedule E you can deduct fees paid in 1998 to prepare Part I of your 1997 Schedule E.

Condominiums and Cooperatives

If you rent out a condominium or a cooperative apartment, some special rules apply to you even though you receive the same tax treatment as other owners of rental property. Condominiums are treated differently from cooperatives.

Condominium

If you own a condominium, you own outright a dwelling unit in a multi-unit building. You also own a share of the common elements of the structure, such as land, lobbies, elevators, and service areas. You and the other condominium owners may pay dues or assessments to a special corporation that is organized to take care of the common elements.

If you rent your condominium to others, you can deduct depreciation, repairs, upkeep, dues, and other expenses, such as interest and taxes, and assessments for the care of the common parts of the structure. You cannot deduct special assessments you pay to a condominium management corporation for improvements. But you may be able to recover your share of the cost of any improvement by taking depreciation.

Cooperative

If you have a cooperative apartment that you rent to others, you can usually deduct, as a rental expense, all the maintenance fees you pay to the cooperative housing corporation. However, you cannot deduct a payment earmarked for a capital asset or improvement, or otherwise charged to the corporation's capital account. For example, you cannot deduct a payment used to pave a community parking lot, install a new roof, or pay the principal of the corporation's mortgage. You must add the payment to the basis of your stock in the corporation.

Treat as a capital cost the amount you were assessed for capital items. This cannot be more than the amount by which your payments to the corporation exceeded your share of the corporation's mortgage interest and real estate taxes.

Your share of interest and taxes is the amount the corporation elected to allocate to you, if it reasonably reflects those expenses for your apartment. Otherwise, figure your share in the following way.

1) Divide the number of your shares of stock by the total number of shares outstanding, including any shares held by the corporation.

2) Multiply the corporation's deductible interest by the number you figured in (1). This is your share of the interest.

3) Multiply the corporation's deductible taxes by the number you figured in (1). This is your share of the taxes.

In addition to the maintenance fees paid to the cooperative housing corporation, you can deduct your direct payments for repairs, upkeep, and other rental expenses, including interest paid on a loan used to buy your stock in the corporation. The depreciation deduction allowed for cooperative apartments is discussed later.

Not Rented for Profit

If you do not rent your property to make a profit, you can deduct your rental expenses only up to the amount of your rental income. You cannot carry forward your rental expenses that are more than your rental income. For more information about the rules for an activity not engaged in for profit, see chapter 1 of Publication 535.

Where to report. Report your not-for-profit rental income on line 21, Form 1040. Deduct your mortgage interest, real estate taxes, and casualty losses on the appropriate lines of Schedule A (Form 1040), *Itemized Deductions*.

Claim your other expenses, subject to the rules explained in chapter 1 of Publication 535, as miscellaneous itemized deductions on line 22 of Schedule A (Form 1040). You can deduct these expenses only if they, together with certain other miscellaneous itemized deductions, total more than 2% of your adjusted gross income. For more information about miscellaneous deductions, see Publication 529, *Miscellaneous Deductions*.

Postponing decision. If your rental income is more than your rental expenses for at least 3 years out of a period of 5 consecutive years, you are presumed to be renting your property to make a profit. You may choose to postpone the decision of whether the rental is for profit by filing **Form 5213**, *Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit*.

See Publication 535 for more information.

Property Changed to Rental Use

If you change your home or other property (or a part of it) to rental use at any time other than at the beginning of your tax year, you must divide yearly expenses, such as depreciation, taxes, and insurance, between rental use and personal use.

You can deduct as rental expenses only the part of the expense that is for the part of the year the property was used or held for rental purposes.

You cannot deduct depreciation or insurance for the part of the year the property was held for personal use. However, you can deduct the allowable part of the interest and tax expenses for the part of the year the property was held for personal use as an itemized deduction on Schedule A (Form 1040).

Example. Your tax year is a calendar year. You moved from your home in May and started renting it out on June 1. You can deduct as rental expenses seven-twelfths of your yearly expenses, such as taxes and insurance.

Starting with June, you can deduct as rental expenses the amounts you pay for items generally billed monthly, such as utilities.

Renting Part of Property

If you rent part of your property, you must divide certain expenses between the part of the property used for rental purposes and the part of the property used for personal purposes, as though you actually had two separate pieces of property.

You can deduct a part of some expenses, such as mortgage interest and property taxes, as a rental expense. You can deduct the other part, subject to certain limitations, only if you itemize your deductions. You can also deduct as a rental expense a part of other expenses that normally are nondeductible personal expenses, such as expenses for electricity, or painting the outside of your house. You cannot deduct any part of the cost of a single phone line even if your tenants have unlimited use of it.

You do not have to divide the expenses that belong only to the rental part of your property. If you paint a room that you rent, or if you pay premiums for liability insurance in connection with renting a room in your home, your entire cost is a rental expense. If you install a second phone line strictly for your tenant's use, all of the cost of the second line is deductible as a rental expense. You can deduct depreciation, discussed later, on the part of the property used for rental purposes as well as on the furniture and equipment you use for these purposes.

How to divide expenses. If an expense is for both rental use and personal use, such as mortgage interest or heat for the entire house, you must divide the expense between rental use and personal use. You can use any reasonable method for dividing the expense. It may be reasonable to divide the cost of some items (for example, water) based on the number of people using them. However, the two most common methods for dividing an expense are one based on the number of rooms in your home and one based on the square footage of your home.

Example. You rent a room in your house. The room is 12 × 15 feet, or 180 square feet. Your entire house has 1,800 square feet of floor space. You can deduct as a rental expense 10% of any expense that must be divided between rental use and personal use. If your heating bill for the year for the entire house was $600, $60 ($600 × 10%) is a rental expense. The balance, $540, is a personal expense and you cannot deduct it.

Personal Use of Vacation Home or Dwelling Unit

If you have any personal use of a vacation home or other dwelling unit that you rent out, you must divide your expenses between rental use and personal use. See *Figuring Days of Personal Use* and *How To Divide Expenses*, later. If your expenses for rental use are more than your rental income, you may not be able to deduct all of the rental expenses. See *How To Figure Rental Income and Deductions*, later.

Exception for minimal rental use. If you use the dwelling unit as a home and you rent it for fewer than 15 days during the year, do not include any of the rent in your income and do not deduct any of the rental expenses. See *Dwelling Unit Used as Home,* later.

Dwelling unit. The rules in this section apply to vacation homes and other dwelling units. A dwelling unit includes a house, apartment, condominium, mobile home, boat, or similar property. A dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities. A dwelling unit does not include property used solely as a hotel, motel, inn, or similar establishment.

Property is used solely as a hotel, motel, inn, or similar establishment if it is regularly available for occupancy by paying customers and is not used by an owner as a home during the year.

Example. You rent out a room in your home that is always available for short-term occupancy by paying customers. You do not use the room yourself and you allow only paying customers to use the room. The room is used solely as a hotel, motel, inn, or similar establishment and is not a dwelling unit.

Dwelling Unit Used as Home

The tax treatment of rental income and expenses for a dwelling unit that you also use for personal purposes depends on whether you use it as a home. (See *How To Figure Rental Income and Deductions,* later).

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

1) 14 days, or

2) 10% of the total days it is rented to others at a fair rental price.

See *Figuring Days of Personal Use,* later.

If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price, do not count that day as a day of rental in applying (2) above. Instead, count it as a day of personal use in applying both (1) and (2) above. This rule does not apply when dividing expenses between rental and personal use.

Fair rental price. A fair rental price for your property generally is an amount that a person who is not related to you would be willing to pay. The rent you charge is not a fair rental price if it is substantially less than the rents charged for other properties that are similar to your property.

Ask yourself the following questions when comparing another property with yours.

- Is it used for the same purpose?
- Is it approximately the same size?
- Is it in approximately the same condition?
- Does it have similar furnishings?
- Is it in a similar location?

If any of the answers are no, the properties probably are not similar.

Examples. The following examples show how to determine whether you used your rental property as a home.

Example 1. You converted the basement of your home into an apartment with a bedroom, a bathroom, and a small kitchen. You rented the apartment at a fair rental price to college students during the regular school year. You rented to them on a 9-month (273 days) lease.

During the summer, your brothers stayed with you for a month (30 days) and lived in the apartment rent free.

Your basement apartment was used as a home because you used it for personal purposes for 30 days. That is more than the greater of 14 days or 10% of the total days it was rented.

Example 2. You rented out the guest bedroom in your home at a fair rental price during the local college's homecoming, commencement, and football weekends (a total of 27 days). Your sister-in-law stayed in the room, rent free, for the last 3 weeks (21 days) in July.

The room was used as a home because you used it for personal purposes for 21 days. That is more than the greater of 14 days or 10% of the total days it was rented.

Example 3. You own a condominium apartment in a resort area. You rented it out at a fair rental price for a total of 170 days during the year. For 12 of these days, the tenant was not able to use the apartment and allowed you to use it even though you did not refund any of the rent. Your family actually used the apartment for 10 of those days. Therefore, the apartment is treated as having been rented for 160 (170 – 10) days. Your family also used the apartment for 7 other days during the year.

You used the apartment as a home because you used it for personal purposes for 17 days. That is more than the greater of 14 days or 10% of the total days it was rented.

Figuring Days of Personal Use

A day of personal use of a dwelling unit is any day that it is used by any of the following persons.

1) You or any other person who has an interest in it, unless you rent it out to another owner as his or her main home under a shared equity financing agreement (defined later).

2) A member of your family or a member of the family of any other person who has an interest in it, unless the family member uses the dwelling unit as his or her main home and pays a fair rental price. Family includes only brothers and sisters, half-brothers and half-sisters, spouses, ancestors (parents, grandparents, etc.) and lineal descendants (children, grandchildren, etc.).

3) Anyone under an arrangement that lets you use some other dwelling unit.

4) Anyone at less than a fair rental price.

Main home. If the other owner or member of the family in (1) or (2) above has more than one home, his or her main home is the one lived in most of the time.

Shared equity financing agreement. This is an agreement under which two or more persons acquire undivided interests for more than 50 years in an entire dwelling unit, including the land, and one or more of the co-owners is entitled to occupy the unit as his or her main home upon payment of rent to the other co-owner or owners.

Donation of use of property. You use a dwelling unit for personal purposes if:

- You donate the use of the unit to a charitable organization,
- The organization sells the use of the unit at a fund-raising event, and
- The purchaser uses the unit.

Examples

The following examples show how to determine days of personal use.

Example 1. You and your neighbor are co-owners of a condominium at the beach. You rent the unit out to vacationers whenever possible. The unit is not used as a main home by anyone. Your neighbor uses the unit for 2 weeks every year.

Because your neighbor has an interest in the unit, both of you are considered to have used the unit for personal purposes during those 2 weeks.

Example 2. You and your neighbors are co-owners of a house under a shared equity financing agreement. Your neighbors live in the house and pay you a fair rental price.

Even though your neighbors have an interest in the house, the days your neighbors live there are not counted as days of personal use by you. This is because your neighbors rent the house as their main home under a shared equity financing agreement.

Example 3. You own a rental property that you rent to your son. Your son has no interest in this dwelling unit. He uses it as his main home. He pays you a fair rental price for the property.

Your son's use of the property is not personal use by you because your son is using it as his main home, he has no interest in the property, and he is paying you a fair rental price.

Example 4. You rent your beach house to Rosa. Rosa rents her house in the mountains to you. You each pay a fair rental price.

You are using your house for personal purposes on the days that Rosa uses it because your house is used by Rosa under an arrangement that allows you to use her house.

Example 5. You rent an apartment to your mother at less than a fair rental price. You are using the apartment for personal purposes on the days that your mother rents it because you rent it for less than a fair rental price.

Days Not Counted as Personal Use

Some days you spend at the dwelling unit are not counted as days of personal use.

Repairs and maintenance. Any day that you spend working substantially full time repairing and maintaining your property is not counted as a day of personal use. Do not count such a day as a day of personal use even if family members use the property for recreational purposes on the same day.

Example. You own a cabin in the mountains that you rent out during the summer. You spend 3 days at the cabin each May, working full time to repair anything that was damaged over the winter and get the cabin ready for the summer. You also spend 3 days each September, working full time to repair any damage done by renters and get the cabin ready for the winter.

These 6 days do not count as days of personal use.

Use as main home before or after renting. Use the following special rule when determining if you used your property as a home. Do not count as days of personal use the days you used the property as your main home before or after renting it or offering it for rent in either of the following circumstances.

1) You rented or tried to rent the property for 12 or more consecutive months.
2) You rented or tried to rent the property for a period of less than 12 consecutive months and the period ended because you sold or exchanged the property.

This special rule does not apply when dividing expenses between rental and personal use.

Example 1. On February 28, you moved out of the house you had lived in for 6 years because you accepted a job in another town. You rent your house at a fair rental price from March 15 of that year to May 14 of the next year. On the following June 1, you move back into your old house.

To determine whether you used the house as a home, the days you used it as your main home from January 1 to February 28, and from June 1 to December 31 of the next year are not counted as days of personal use.

Example 2. On January 31, you moved out of the condominium where you had lived for 3 years. You offered it for rent at a fair rental price beginning on February 1. You were unable to rent it until April. On September 15, you sold the condominium.

The days you used the condominium as your main home from January 1 to January 31 are not counted as days of personal use when determining whether you used it as a home.

How To Divide Expenses

If you use a dwelling unit for both rental and personal purposes, divide your expenses between the rental use and the personal use based on the number of days used for each purpose. Expenses for the rental use of the unit are deductible under the rules explained in *How To Figure Rental Income and Deductions*, later.

When dividing your expenses, follow these rules.

1) Any day that the unit is rented at a fair rental price is a day of rental use even if you used the unit for personal purposes that day. This rule does not apply when determining whether you used the unit as a home.
2) Any day the unit is held out for rent but not actually rented is not a day of rental use.

Example. You offer your beach cottage for rent from June 1 through August 31 (92 days). Your family uses the cottage during the last 2 weeks in May (14 days). You were unable to find a renter for the first week in August (7 days). The person who rented the cottage for July allowed you to use it over a weekend (2 days) without any reduction in or refund of rent. The cottage was not used at all before May 17 or after August 31.

You figure the part of the cottage expenses to treat as rental expenses by using the following steps.

1) The cottage was used for rental a total of 85 days (92 – 7). The days it was held out for rent but not rented (7 days) are not days of rental use. The July weekend (2 days) you used it is rental use because you received a fair rental price for the weekend.
2) You used the cottage for personal purposes for 14 days (the last 2 weeks in May).
3) The total use of the cottage was 99 days (14 days personal use + 85 days rental use).
4) Your rental expenses are 85/99 (86%) of the cottage expenses.

When determining whether you used the cottage as a home, the July weekend (2 days) you used it is personal use even though you received a fair rental price for the weekend. Therefore, you had 16 days of personal use and 83 days of rental use for this purpose. Because you used the cottage for personal purposes more than 14 days and more than 10% of the days of rental use, you used it as a home. If you have a net loss, you may not be able to deduct all of the rental expenses. See *Property Used as a Home* in the following discussion.

How To Figure Rental Income and Deductions

How you figure your rental income and deductions depends on whether the dwelling unit was used as a home and, if used as a home, how many days the property was rented.

Property Not Used as a Home

If you do not use a dwelling unit as a home, report all the rental income and deduct all the rental expenses. See *How To Report Rental Income and Expenses*, later.

Your deductible rental expenses can be more than your gross rental income. However, see *Limits on Rental Losses*, later.

Property Used as a Home

If you use a dwelling unit as a home during the year (see *Dwelling Unit Used as Home,* earlier), how you figure your rental income and deductions depends on how many days the unit was rented.

Rented fewer than 15 days. If you use a dwelling unit as a home and you rent it for fewer than 15 days during the year, you do not include in income any of the rental income. Also, you cannot deduct any expenses as rental expenses.

Rented 15 days or more. If you use a dwelling unit as a home and rent it for 15 days or more during the year, you include all your rental income in your gross income. See *How To Report Rental Income and Expenses,* later. If you had a net profit from the rental property for the year (that is, if your rental income is more than the total of your rental expenses, including depreciation), deduct all of your rental expenses. However, if you had a net loss, you may not be able to deduct all of your rental expenses. See *Limit on Certain Expenses,* next.

Limit on Certain Expenses

If you use your rental property as a home (as explained earlier), rented it for 15 days or more during the year, and your rental expenses are more than your rental income, there is a limit on the amount you can deduct for certain rental expenses.

This limit ensures that the rental expenses are used to offset only rental income. If the total of these expenses exceeds the rental income, you cannot use the excess to offset income from other sources. The excess can be carried forward and treated as rental expenses for the next year.

To figure your deductible rental expenses and any carryover to next year, use *Table 2.*

Carryover of expenses. If the total of your rental expenses is more than your gross rental income, the expenses that you are not allowed to deduct can be carried forward to the next year and treated as rental expenses for the same property. Any expenses carried forward to next year will be subject to any limits that apply next year. You can deduct the expenses carried over to a year only up to the amount of your rental income for that year, even if you do not use the property as your home for that year.

Depreciation

When you use your property to produce income, such as rents, you can recover (get back) some or all of what you paid for the property through tax deductions. You do this by ***depreciating*** the property; that is, by deducting some of your cost on your tax return each year.

Several factors determine how much depreciation you can deduct. The main factors are: (1) your basis in the property, (2) the recovery period for the property, and (3) the depreciation method (including convention) used. You cannot simply deduct your mortgage or principal payments as an expense.

You can deduct depreciation only on the part of your property used for rental purposes. Depreciation reduces your basis for figuring gain or loss on a later sale or exchange.

You may have to use **Form 4562,** to figure and report your depreciation. See *How To Report Rental Income and Expenses,* later. Also see Publication 946.

Claiming the correct amount of depreciation. You should claim the correct amount of depreciation each tax year. If, in an earlier year, you did not claim depreciation that you were entitled to deduct, you must still reduce your basis in the property by the amount of depreciation that you should have deducted. You generally cannot deduct the unclaimed depreciation in the current year or in any later tax year. However, you may be able to claim the correct amount of depreciation on an amended return (Form 1040X) for the earlier year. You must file an amended return within 3 years from the date you filed your original return, or within 2 years from the time you paid your tax, whichever is later. A return filed early is considered filed on the due date.

Changing your accounting method to deduct unclaimed depreciation. If you claimed less depreciation than allowable in an earlier year, you can change your accounting method to take a deduction in the current year for the unclaimed depreciation. To change your accounting method, you must have the consent of the IRS. In some instances, you can receive automatic consent. For more information, see chapter 1 of Publication 946.

What can be depreciated. You can depreciate your property if it meets all the following conditions.

1) It is used in business or held for the production of income (such as rental property).

2) It has a determinable useful life longer than one year.

3) It is something that wears out, gets used up, decays, becomes obsolete, or loses value from natural causes.

You can depreciate both ***real property,*** other than land (discussed later), and ***personal property***.

Real property. Real property is land and, generally, anything that is built on, growing on, or attached to land. Buildings, fences, sidewalks, and trees are real property.

Personal property. Personal property is property that is not real property. Furniture, appliances, and lawn mowers are personal property.

Rented property. Generally, if you pay rent on property, you cannot depreciate that property. Usually, only the owner can depreciate it. If you make permanent improvements to the property, you may be able to depreciate the improvements. See *Additions or improvements to property,* later.

Land. You can never depreciate land. The costs of clearing, grading, planting, and landscaping are usually all part of the cost of land and are not depreciable.

Cooperative apartments. If you rent your cooperative apartment to others, you can deduct your share of the cooperative housing corporation's depreciation.

If you bought your stock as part of its first offering, figure your depreciation deduction as a tenant-stockholder in a cooperative housing corporation in the following way.

1) Figure the depreciation for all the depreciable real property owned by the corporation. (Depreciation methods are discussed later.)

2) Subtract from (1) any depreciation for space owned by the corporation that can be rented but cannot be lived in by tenant-stockholders. The result is the yearly depreciation as reduced.

3) Divide the number of your shares of stock by the total number of shares outstanding, including any shares held by the corporation.

4) Multiply the yearly depreciation as reduced (from (2)) by the number you figured in (3). This is your share of the corporation's depreciation.

If you bought your cooperative stock after its first offering, figure the basis of the depreciable real property to use in (1) above as follows.

1) Multiply your cost per share by the total number of shares outstanding.

2) Add to the amount figured in (1) any mortgage debt on the property on the date you bought the stock.

3) Subtract from the amount figured in (2) any mortgage debt that is not for the depreciable real property, such as the part for the land.

Your depreciation deduction for the year cannot be more than the part of your adjusted basis (defined later) in the stock of the corporation that is for your rental property.

See *Cooperative apartments* under *What Can Be Depreciated* in chapter 1 of Publication 946 for more information.

Cannot be more than basis. The total of all your yearly depreciation deductions cannot be more than the cost or other basis of the property. For this purpose, your yearly depreciation deductions include any depreciation that you were allowed to claim, even if you did not claim it.

Depreciation systems. There are three ways to figure depreciation. The depreciation system you use depends on the type of asset and when the asset was placed in service. For property used in rental activities you use:

- MACRS if placed in service after 1986,
- ACRS if placed in service after 1980 but before 1987, or
- Useful lives and either straight line or an accelerated method of depreciation, such as the declining balance method, if placed in service before 1981.

CAUTION *This publication discusses MACRS only. If you need information about depreciating property placed in service before 1987, see Publication 534.*

If you placed property in service before 1998, continue to use the same method of figuring depreciation that you used in the past.

Section 179 deduction. You cannot claim the section 179 deduction for property held to produce rental income (unless renting property is your trade or business). See chapter 2 of Publication 946.

Alternative minimum tax. If you use accelerated depreciation, you may have to file **Form 6251.** Accelerated depreciation includes MACRS, ACRS, and any other method that allows you to deduct more depreciation than you could deduct using a straight line method.

Table 2. **Worksheet for Figuring the Limit on Rental Deductions for a Dwelling Unit Used as a Home**

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 Home.*)
- Did you rent the dwelling unit 15 days or more this year?
- Are the total of your rental expenses and depreciation more than your rental income?

1.	Enter rents received		______
2a.	Enter the rental portion of deductible home mortgage interest (see instructions)	______	
b.	Enter the rental portion of real estate taxes	______	
c.	Enter the rental portion of deductible casualty and theft losses (see instructions)	______	
d.	Enter direct rental expenses (see instructions)	______	
e.	**Fully deductible rental expenses.** Add lines 2a–2d		______
3.	Subtract line 2e from line 1. If zero or less, enter zero		______
4a.	Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities)	______	
b.	Enter the rental portion of excess mortgage interest (see instructions)	______	
c.	Add lines 4a and 4b	______	
d.	**Allowable operating expenses.** Enter the smaller of line 3 or line 4c		______
5.	Subtract line 4d from line 3. If zero or less, enter zero		______
6a.	Enter the rental portion of excess casualty and theft losses (see instructions)	______	
b.	Enter the rental portion of depreciation of the dwelling unit	______	
c.	Add lines 6a and 6b	______	
d.	**Allowable excess casualty and theft losses and depreciation.** Enter the smaller of line 5 or line 6c		______
7a.	**Operating expenses to be carried over to next year.** Subtract line 4d from line 4c		______
b.	**Excess casualty and theft losses and depreciation to be carried over to next year.** Subtract line 6d from line 6c		______

Enter the amounts on **lines 2e, 4d, and 6d** on the appropriate lines of Schedule E (Form 1040), Part I.

Worksheet Instructions

Follow these instructions for the worksheet above. If you were unable to deduct all your expenses last year, because of the rental income limit, add these unused amounts to your expenses for this year.

Line 2a. Figure the mortgage interest on the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the unit. **Do not** include interest on a loan that did not benefit the dwelling unit. For example, **do not** include interest on a home equity loan used to buy, build, or improve the dwelling unit, or to refinance such a loan. Enter the rental portion of this interest on line 2a of the worksheet.

Line 2c. Figure the casualty and theft losses related to the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the dwelling unit. To do this, complete Section A of Form 4684, treating the losses as personal losses. On line 17 of Form 4684, enter 10% of your adjusted gross income figured **without** your rental income and expenses from the dwelling unit. Enter the rental portion of the result from line 18 of Form 4684 on line 2c of this worksheet.

Note. Do **not** file this Form 4684 or use it to figure your personal losses on Schedule A. Instead, figure the personal portion on a separate Form 4684.

Line 2d. Enter the total of your rental expenses that are directly related only to the rental activity. These include interest on loans used for rental activities other than to buy, build, or improve the dwelling unit. Also include rental agency fees, advertising, office supplies, and depreciation on office equipment used in your rental activity.

Line 4b. On line 2a, you entered the rental portion of the mortgage interest you could deduct on Schedule A if you had not rented out the dwelling unit. Enter on line 4b of this worksheet the rental portion of the mortgage interest you could not deduct on Schedule A because it is **more than** the limit on home mortgage interest. **Do not** include interest on a loan that did not benefit the dwelling unit (as explained in the line 2a instructions).

Line 6a. To find the rental portion of excess casualty and theft losses, use the Form 4684 you prepared for line 2c of this worksheet.

A.	Enter the amount from line 10 of Form 4684	______
B.	Enter the rental portion of **A**	______
C.	Enter the amount from line 2c of this worksheet	______
D.	Subtract **C** from **B.** Enter the result here and on line 6a of this worksheet	______

Allocating the limited deduction. If you cannot deduct all of the amount on line 4c or 6c this year, you can allocate the allowable deduction in any way you wish among the expenses included on line 4c or 6c. Enter the amount you allocate to each expense on the appropriate line of Schedule E, Part I.

Modified Accelerated Cost Recovery System (MACRS)

In general, the modified accelerated cost recovery system (MACRS) applies to tangible property placed in service during 1998.

MACRS consists of two systems that determine how you depreciate your property. The main system is called the ***General Depreciation System (GDS)***. The second system is called the ***Alternative Depreciation System (ADS).*** GDS is used to figure your depreciation deduction for property used in most rental activities, unless you elect ADS.

To figure your MACRS deduction, you need to know the following information about your property:

1) Its recovery period,
2) Its placed-in-service date, and
3) Its depreciable basis.

Personal home changed to rental use. You must use MACRS to figure the depreciation on property used as your home and changed to rental property in 1998.

Excluded property. You cannot use MACRS for certain personal property placed in service before 1987 (before August 1, 1986, if election made) that is transferred after 1986 (after July 31, 1986, if election made). However, you generally must use MACRS to designate property you or a related party used before 1987, or that you acquired from a related party, if the property had previously been depreciated under ACRS and the MACRS deduction would be less than the deduction under ACRS.

In addition, you may elect to exclude certain property from the application of MACRS.

Table 3. **MACRS Recovery Periods for Property Used in Rental Activities**

Type of Property	MACRS Recovery Period To Use: General Depreciation System	MACRS Recovery Period To Use: Alternative Depreciation System
Computers and their peripheral equipment	5 years	5 years
Office machinery, such as: Typewriters, Calculators, Copiers	5 years	6 years
Automobiles	5 years	5 years
Light trucks	5 years	5 years
Office furniture and equipment, such as: Desks, Files	7 years	10 years
Appliances, such as: Stoves, Refrigerators	7 years	12 years
Carpets	7 years	12 years
Furniture used in rental property	7 years	12 years
Any property that does not have a class life and that has not been designated by law as being in any other class	7 years	12 years
Roads	15 years	20 years
Shrubbery	15 years	20 years
Fences	15 years	20 years
Residential rental property (buildings or structures) and structural components such as furnaces, water pipes, venting, etc.	27.5 years	40 years
Improvements and additions, such as a new roof	The recovery period of the property to which the addition or improvement is made, determined as if the property were placed in service at the same time as the improvement or addition.	

Property that does not come under MACRS must be depreciated under ACRS or one of the other methods of depreciation, such as straight line or declining balance. See Publication 534 for more information.

Recovery Periods Under GDS

Each item of property that can be depreciated is assigned to a property class. The recovery period of the property depends on the class the property is in. The property classes are:

- 3–year property,
- 5–year property,
- 7–year property,
- 10–year property,
- 15–year property,
- 20–year property,
- Nonresidential real property, and
- Residential rental property.

The class to which property is assigned is determined by its class life. Class lives and recovery periods for most assets are listed in *Appendix B* in Publication 946.

Under GDS, property that you placed in service during 1998 in your rental activities generally falls into one of the following classes. Also see *Table 3*.

1) ***5–year property.*** This class includes computers and peripheral equipment, office machinery (typewriters, calculators, copiers, etc.), automobiles, and light trucks.

   Depreciation on automobiles, certain computers, and cellular telephones is limited. See chapter 4 of Publication 946.

2) ***7–year property.*** This class includes office furniture and equipment (desks, files, etc.), and appliances, carpets, furniture, etc., used in residential rental property. This class also includes any property that does not have a class life and that has not been designated by law as being in any other class.

3) ***15–year property.*** This class includes roads and shrubbery (if depreciable).

4) ***Residential rental property.*** This class includes any real property that is a rental building or structure (including a mobile home) for which 80% or more of the gross rental income for the tax year is from dwelling units. A dwelling unit is a house or an apartment used to provide living accommodations in a building or structure. It does not include a unit in a hotel, motel, inn, or other establishment where more than half of the units are used on a transient basis. If you live in any part of the building or structure, the gross rental income includes the fair rental value of the part you live in. Residential rental property is depreciated over ***27.5 years.***

CAUTION *The other recovery classes do not generally apply to property used in rental activities. These classes are not discussed in this publication. See Publication 946 for more information.*

Qualified Indian reservation property. For the applicable recovery period for qualified Indian reservation property, see Publication 946.

Additions or improvements to property. Treat depreciable additions or improvements you make to any property as separate property items for depreciation purposes. The recovery period for an addition or improvement to property begins on the later of:

1) The date the addition or improvement is placed in service, or
2) The date the property to which the addition or improvement was made is placed in service.

The class and recovery period of the addition or improvement is the one that would apply to the underlying property if it were placed in service at the same time as the addition or improvement.

Example. You own a residential rental house that you have been renting out since 1980 and that you are depreciating under ACRS. If you put an addition onto the house, and you place the improvement in service after 1986, you use MACRS for the addition. Under MACRS, the addition would be depreciated as residential rental property.

Placed-in-Service Date

You can begin to depreciate property when you place it in service in your trade or business or for the production of income. Property is considered placed in service in a rental activity when it is ready and available for a specific use in that activity.

Example 1. On November 22 of last year, you purchased a dishwasher for your rental property. The appliance was delivered on December 7, but was not installed and ready for use until January 3 of this year. Because the dishwasher was not ready for use last year, it is not considered placed in service until this year.

If the appliance had been ready for use when it was delivered in December of last year, it would have been considered placed in service in December, even if it was not actually used until this year.

Example 2. On April 6, you purchased a house to use as residential rental property. You made extensive repairs to the house and had it ready for rent on July 5. You began to advertise the house for rent in July and actually rented it out beginning September 1. The house is considered placed in service in July when it was ready and available for rent. You can begin to depreciate the house in July.

Example 3. You moved from your home in July. During August and September you made several repairs to the house. On October 1, you listed the property for rent with a real estate company, which rented it on December 1. The property is considered placed in service on October 1, the date when it was available for rent.

Depreciable Basis

The depreciable basis of property used in a rental activity is generally its adjusted basis when you place it in service in that activity. This is its cost or other basis when you acquired it, adjusted for certain items occurring before you place it in service in the rental activity. Basis and adjusted basis are explained in the following discussions.

However, if you used the property for personal purposes before changing it to rental use, its depreciable basis is the lesser of its adjusted basis or its fair market value when you change it to rental use. See *Basis of Property Changed to Rental Use,* later.

Cost Basis

The basis of property you buy is usually its cost. The cost is the amount you pay for it in cash or in other property or services. Your cost also includes amounts you pay for:

- Sales tax charged on the purchase,
- Freight charges to obtain the property, and
- Installation and testing charges.

Loans with low or no interest. If you buy property on any time-payment plan that charges little or no interest, the basis of your property is your stated purchase price, less the amount considered to be unstated interest. See *Unstated Interest* in Publication 537, *Installment Sales.*

Real property. If you buy real property, such as a building and land, certain fees and other expenses you pay are part of your cost basis in the property.

Real estate taxes. If you buy real property and agree to pay real estate taxes on it that were owed by the seller, the taxes you pay are treated as part of your basis in the property. You cannot deduct them as taxes paid.

If you reimburse the seller for real estate taxes the seller paid for you, you can usually deduct that amount. Do not include that amount in the basis of the property.

Settlement fees and other costs. Settlement fees and closing costs that are for buying the property are part of your basis in the property. These include:

- Abstract fees,
- Charges for installing utility services,
- Legal fees,
- Recording fees,
- Surveys,
- Transfer taxes,
- Title insurance, and
- Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

Some settlement fees and closing costs you ***cannot*** include in the basis of the property are:

1) Fire insurance premiums,
2) Rent or other charges relating to occupancy of the property before closing, and
3) Charges connected with getting or refinancing a loan, such as:
   a) Points (discount points, loan origination fees),
   b) Mortgage insurance premiums,
   c) Loan assumption fees,
   d) Cost of a credit report, and
   e) Fees for an appraisal required by a lender.

Also, do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

Assumption of a mortgage. If you buy property and become liable for an existing mortgage on the property, your basis is the amount you pay for the property plus the amount that still must be paid on the mortgage.

Example. You buy a building for $60,000 cash and assume a mortgage of $240,000 on it. Your basis is $300,000.

Land and buildings. If you buy buildings and your cost includes the cost of the land on which they stand, you must divide the cost between the land and the buildings to figure the basis for depreciation of the buildings. The part of the cost that you allocate to each asset is the ratio of the fair market value of that asset to the fair market value of the whole property at the time you buy it.

If you are not certain of the fair market values of the land and the buildings, you can divide the cost between them based on the assessed values for real estate tax purposes.

Example. You buy a house and land for $100,000. The purchase contract does not specify how much of the purchase price is for the house and how much is for the land.

The latest real estate tax assessment on the property was based on an assessed value of $80,000, of which $68,000 is for the house and $12,000 is for the land.

You can allocate 85% ($68,000 ÷ $80,000) of the purchase price to the house and 15% ($12,000 ÷ $80,000) of the purchase price to the land.

Your basis in the house is $85,000 (85% of $100,000) and your basis in the land is $15,000 (15% of $100,000).

Basis Other Than Cost

There are many times when you cannot use cost as a basis. You cannot use cost as a basis for property that you received:

- In return for services you performed,
- In an exchange for other property,
- As a gift,
- From your spouse, or from your former spouse as the result of a divorce, or
- As an inheritance.

If you received property in one of these ways, see Publication 551 for information on how to figure your basis.

Adjusted Basis

Before you can figure allowable depreciation, you may have to make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

Increases to basis. You must increase the basis of any property by the cost of all items properly added to a capital account. This includes:

- The cost of any improvements having a useful life of more than one year,
- Amounts spent after a casualty to restore the damaged property,
- The cost of extending utility service lines to the property, and
- Legal fees, such as the cost of defending and perfecting title.

Improvements. Add to the basis of your property the amount an improvement actually cost you, including any amount you borrowed to make the improvement. This includes all direct costs, such as material and labor, but not your own labor. It also includes all expenses related to the improvement.

For example, if you had an architect draw up plans for remodeling your property, the architect's fee is a part of the cost of the remodeling. Or, if you had your lot surveyed to put up a fence, the cost of the survey is a part of the cost of the fence.

Keep separate accounts for depreciable improvements made after you place the property in service in your rental activity. For information on depreciating improvements, see *Additions or improvements to property*, earlier, under *Recovery Periods Under GDS.*

CAUTION *The cost of landscaping improvements is usually treated as an addition to the basis of the land, which is not depreciable property. See* What can be depreciated, *earlier.*

Assessments for local improvements. Assessments for items which tend to increase the value of property, such as streets and sidewalks, must be added to the basis of the property. For example, if your city installs curbing on the street in front of your house, and assesses you and your neighbors for the cost of curbing, you must add the assessment to the basis of your property. Also add the cost of legal fees paid to obtain a decrease in an assessment levied against property to pay for local improvements. You cannot deduct these items as taxes or depreciate them.

Assessments for maintenance or repair or meeting interest charges are deductible as taxes. Do not add them to your basis in the property.

Deducting vs. capitalizing costs. You cannot add to your basis costs that are deductible as current expenses. However, there are certain costs you can choose either to deduct or to capitalize. If you capitalize these costs, include them in your basis. If you deduct them, do not include them in your basis.

The costs you may be able to choose to deduct or to capitalize include carrying charges, such as interest and taxes, that you must pay to own property.

For more information about deducting or capitalizing costs, see chapter 11 in Publication 535.

Decreases to basis. You must decrease the basis of your property by any items that represent a return of your cost. These include:

- The amount of any insurance or other payment you receive as the result of a casualty or theft loss,
- Any deductible casualty loss not covered by insurance,
- Any amount you receive for granting an easement,
- Any residential energy credit you were allowed before 1986, if you added the cost of the energy items to the basis of your home, and
- The amount of depreciation you could have deducted on your tax returns under the method of depreciation you selected. If you took less depreciation than you could have under the method you selected, you must decrease the basis by the amount you could have taken under that method.

  If you deducted more depreciation than you should have, you must decrease your basis by the amount you should have deducted, plus the part of the excess you deducted that actually lowered your tax liability for any year.

Basis of Property Changed to Rental Use

When you change property you held for personal use to rental use (for example, you rent out your former home), you figure the basis for depreciation using the lesser of fair market value or adjusted basis.

Fair market value. This is the price at which the property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all the relevant facts. Sales of similar property, on or about the same date, may be helpful in figuring the fair market value of the property.

Figuring the basis. The basis for depreciation is the lesser of:

- The fair market value of the property on the date you changed it to rental use, or
- Your adjusted basis on the date of the change—that is, your original cost or other basis of the property, plus the cost of permanent improvements or additions since you acquired it, minus deductions for any casualty or theft losses claimed on earlier years' income tax returns and other decreases to basis.

Example. Several years ago you built your home for $40,000 on a lot that cost you $4,000. Before changing the property to rental use last year, you added $8,000 of permanent improvements to the house and claimed a $1,000 deduction for a casualty loss to the house. Because land is not depreciable, you can only include the cost of the house when figuring the basis for depreciation.

The adjusted basis of the house at the time of the change in use was $47,000 ($40,000 + $8,000 − $1,000).

On the date of the change in use, your property had a fair market value of $48,000, of which $6,000 was for the land and $42,000 was for the house.

The basis for depreciation on the house is the fair market value at the date of the change ($42,000), because it is less than your adjusted basis ($47,000).

MACRS Depreciation Under GDS

You can figure your MACRS depreciation deduction under GDS in one of two ways. The deduction is substantially the same both ways. (The difference, if any, is slight.) You can either:

1) Actually compute the deduction using the depreciation method and convention that apply over the recovery period of the property, or
2) Use the percentage from the optional MACRS tables.

If you actually compute the deduction, the depreciation method you use depends on the class of the property.

5–, 7–, or 15–year property. For property in the 5– or 7–year class, you use the double (200%) declining balance method and a half-year convention. You must use the mid-quarter convention, if it applies. These conventions are explained later. For property in the 15–year class, you use the 150% declining balance method and a half-year convention.

You can also choose to use the 150% declining balance method and the ADS recovery period for property in the 5–, 7–, or 15–year class. See *MACRS Depreciation Under ADS*, later, for the ADS recovery periods. You make this election on Form 4562. In column (f), Part II, enter “150 DB.”

Change from either declining balance method to the straight line method in the first tax year that the straight line method gives you a larger deduction.

You can also choose to use the straight line method with a half-year or mid-quarter convention for 5–, 7–, or 15–year property. The choice to use the straight line method for one item in a class of property applies to all property in that class that is placed in service during the tax year of the election. You elect the straight line method on Form 4562. In column (f), Part II, enter “S/L.” Once you make this election, you cannot change to another method.

Residential rental property. You must use the straight line method and a mid-month convention (explained later) for residential rental property.

Declining Balance Method

To figure your MACRS deduction, first determine your declining balance rate from the table below. However, if you elect to use the 150% declining balance method for 5– or 7–year property, figure the declining balance rate by dividing 1.5 (150%) by the ADS recovery period for the property.

In the first tax year, multiply the adjusted basis of the property by the declining balance rate and apply the appropriate convention to figure your depreciation. In later years, use the following steps to figure your depreciation.

1) Adjust your basis by subtracting the amount of depreciation allowable for the earlier years.
2) Multiply your adjusted basis in (1) by the same rate used in the first year.

See *Conventions*, later, for information on depreciation in the year you dispose of property.

Declining balance rates. The following table shows the declining balance rate that applies for each class of property and the first year for which the straight line method will give a greater deduction. (The rates for 5– and 7–year property are based on the 200% declining balance method. The rate for 15–year property is based on the 150% declining balance method.)

Class	Declining Balance Rate	Year
5	40%	4th
7	28.57%	5th
15	10%	7th

Straight Line Method

To figure your MACRS deduction under the straight line method, you must figure a new depreciation rate for each tax year in the recovery period.

For any tax year, figure the straight line rate by dividing the number 1 by the years remaining in the recovery period at the beginning of the tax year. When figuring the number of years remaining, you must take into account the convention used in the first year. If the remaining recovery period at the beginning of the tax year is less than one year, the straight line rate for that tax year is 100%.

Multiply the adjusted basis of the property by the straight line rate. You must figure the depreciation for the first year using the convention that applies. (See *Conventions*, later.)

Example. For property with a 5–year recovery period, the straight line rate is 20% (1 divided by 5) for the first tax year. After you apply the half-year convention, the first year rate is 10% (20% divided by 2).

At the beginning of the second year, the remaining recovery period is $4\frac{1}{2}$ years because of the half-year convention. The straight line rate for the second year is 22.22% (1 divided by 4.5).

To figure your depreciation deduction for the second year:

1) Subtract the depreciation taken in the first year from the basis of the property, and
2) Multiply the remaining basis in (1) by 22.22%.

Residential rental property. In the first year that you claim depreciation for residential rental property, you can only claim depreciation for the number of months the property is in use, and you must use the mid-month convention (explained under *Conventions,* next).

Conventions

In the year that you place property in service or in the year that you dispose of property, you are allowed to claim depreciation for only part of the year. The part of the year (or convention) depends on the class of the property.

Use a half-year convention for property used in rental activities, other than residential rental property. (However, in certain circumstances, you must use a mid-quarter convention.) For residential rental property, use a mid-month convention in all situations.

Half-year convention. The half-year convention treats all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, in the middle of that tax year.

A half year of depreciation is allowable for the first year property is placed in service, regardless of when the property is placed in service during the tax year. For each of the remaining years of the recovery period, you will take a full year of depreciation. If you hold the property for the entire recovery period, a half year of depreciation is allowable for the year in which the recovery period ends. If you dispose of the property before the end of the recovery period, a half year of depreciation is allowable for the year of disposition.

Mid-quarter convention. Under a mid-quarter convention, all property placed in service, or disposed of, during any quarter of a tax year is treated as placed in service, or disposed of, in the middle of the quarter.

A mid-quarter convention must be used in certain circumstances for property used in rental activities, other than residential rental property. This convention applies if the total basis of such property that is placed in service in the last 3 months of a tax year is more than 40% of the total basis of all such property you place in service during the year.

Do not include in the total basis any property placed in service and disposed of during the same tax year.

Example. During the tax year, Tom Martin purchased the following items to use in his rental property:

- Dishwasher for $400, which he placed in service in January,
- Used furniture for $100, which he placed in service in September, and
- A refrigerator for $500, which he placed in service in October.

Tom uses the calendar year as his tax year. The total basis of all property placed in service that year is $1,000. The $500 basis of the refrigerator placed in service during the last 3 months of his tax year exceeds $400 (40% × $1,000). Tom must use the mid-quarter convention for all three items.

Mid-month convention. Under a mid-month convention, residential rental property placed in service, or disposed of, during any month is treated as placed in service, or disposed of, in the middle of that month.

Optional Tables

You can use the tables in *Table 4* to compute annual depreciation under MACRS. The tables show the percentages for the first 6 years. See *Appendix A* of Publication 946 for complete tables. The percentages in *Tables 4–A, 4–B*, and *4–C* make the change from declining balance to straight line in the year that straight line will yield a larger deduction. See *Declining Balance Method*, earlier.

If you elect to use the straight line method for 5–, 7–, or 15–year property, or the 150% declining balance method for 5– or 7–year property, use the tables in *Appendix A* of Publication 946.

How to use the tables. The following section explains how to use the optional tables.

Figure the depreciation deduction by multiplying your unadjusted basis in the property by the percentage shown in the appropriate table. Your ***unadjusted basis*** is your depreciable basis without reduction for depreciation previously claimed.

Once you begin using an optional table to figure depreciation, you must continue to use it for the entire recovery period unless there is an adjustment to the basis of your property for a reason other than:

1) Depreciation allowed or allowable, or
2) An addition or improvement that is depreciated as a separate item of property.

If there is an adjustment for any other reason (for example, because of a deductible casualty loss) you can no longer use the table. For the year of the adjustment and for the remaining recovery period, figure depreciation using the property's adjusted basis at the end of the year and the appropriate depreciation method, as explained earlier under *MACRS Depreciation Under GDS.*

Tables 4–A, 4–B, and 4–C. The percentages in these tables take into account the half-year and mid-quarter conventions. Use *Table 4–A* for 5–year property, *Table 4–B* for 7–year property, and *Table 4–C* for 15–year property. Use the percentage in the second column (half-year convention) unless you must use the mid-quarter convention (explained earlier). If you must use the mid-quarter convention, use the column that corresponds to the calendar year quarter in which you placed the property in service.

Example 1. You purchased a stove and refrigerator and placed them in service in February. Your basis in the stove is $300 and your basis in the refrigerator is $500. Both are 7–year property. Using the half-year convention column in *Table 4–B*, you find the depreciation percentage for year 1 is 14.29%. For that year your depreciation deduction is $43 ($300 × .1429) for the stove and $71 ($500 × .1429) for the refrigerator.

For year 2, you find your depreciation percentage is 24.49%. That year's depreciation deduction will be $73 ($300 × .2449) for the stove and $122 ($500 × .2449) for the refrigerator.

Example 2. Assume the same facts as in Example 1, except you buy the refrigerator in October instead of February. You must use the mid-quarter convention to figure depreciation on the stove and refrigerator. The refrigerator was placed in service in the last 3 months of the tax year, and its basis ($500) is more than 40% of the total basis of all property placed in service during the year ($800 × .40 = $320).

Because you placed the refrigerator in service in October, you use the fourth quarter column of *Table 4–B* and find that the depreciation percentage for year 1 is 3.57%. Your depreciation deduction for the refrigerator is $18 ($500 × .0357).

Because you placed the stove in service in February, you use the first quarter column of *Table 4–B* and find that the depreciation percentage for year 1 is 25%. For that year, your depreciation deduction for the stove is $75 ($300 × .25).

Table 4–D. Use this table for residential rental property. Find the row for the month that you placed the property in service. Use the percentages listed for that month to figure your depreciation deduction. The mid-month convention is taken into account in the percentages shown in the table.

Example. You purchased a single family rental house and placed it in service in February. Your basis in the house is $80,000. Using *Table 4–D*, you find that the percentage for property placed in service in February of year 1 is 3.182%. That year's depreciation deduction is $2,546 ($80,000 × .03182).

MACRS Depreciation Under ADS

If you choose, you can use the ADS method for most property. Under ADS, you use the straight line method of depreciation.

Table 3 shows the recovery periods for property used in rental activities that you depreciate under ADS.

See *Appendix B* in Publication 946 for other property. If your property is not listed, it is considered to have no class life.

Use the mid-month convention for residential rental property. For all other property, use the half-year or mid-quarter convention.

Election. You choose to use ADS by entering the depreciation on line 16, Part II of Form 4562.

The election of ADS for one item in a class of property generally applies to all property in that class that is placed in service during the tax year of the election. However, the election applies on a property-by-property basis for residential rental property.

Once you choose to use ADS, you cannot change your election.

Casualties and Thefts

As a result of a casualty or theft, you may have a loss related to your property. You may be able to deduct the loss on your federal income tax return. For information on casualty and theft losses (business and nonbusiness), see Publication 547.

Casualty. Damage to, destruction or loss of property is a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

Theft. The unlawful taking and removing of your money or property with the intent to deprive you of it is a theft.

Gain from casualty or theft. When you have a casualty to, or theft of, your property and you receive money, including insurance, that is more than your adjusted basis in the property, you generally must report the gain. However, under certain circumstances, you may defer the payment of tax by choosing to postpone reporting the gain. To do this, you must generally buy replacement property within 2 years after the close of the first tax year in which any part of your gain is realized. The cost of the replacement property must be equal to or more than the net insurance or other payment you received. For more information, see Publication 547.

Table 4. **Optional MACRS Tables**

Table 4-A. **MACRS 5-Year Property**

	Half-year convention	Mid-quarter convention			
Year		**First quarter**	**Second quarter**	**Third quarter**	**Fourth quarter**
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00	26.00	30.00	34.00	38.00
3	19.20	15.60	18.00	20.40	22.80
4	11.52	11.01	11.37	12.24	13.68
5	11.52	11.01	11.37	11.30	10.94
6	5.76	1.38	4.26	7.06	9.58

Table 4-B. **MACRS 7-Year Property**

	Half-year convention	Mid-quarter convention			
Year		**First quarter**	**Second quarter**	**Third quarter**	**Fourth quarter**
1	14.29%	25.00%	17.85%	10.71%	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06
5	8.93	8.75	8.87	9.30	10.04
6	8.92	8.74	8.87	8.35	8.73

Table 4-C. **MACRS 15-Year Property**

	Half-year convention	Mid-quarter convention			
Year		**First quarter**	**Second quarter**	**Third quarter**	**Fourth quarter**
1	5.00%	8.75%	6.25%	3.75%	1.25%
2	9.50	9.13	9.38	9.63	9.88
3	8.55	8.21	8.44	8.66	8.89
4	7.70	7.39	7.59	7.80	8.00
5	6.93	6.65	6.83	7.02	7.20
6	6.23	5.99	6.15	6.31	6.48

Table 4-D. **Residential Rental Property (27.5-year)**

	Use the row for the month of the taxable year placed in service.					
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
Jan.	3.485%	3.636%	3.636%	3.636%	3.636%	3.636%
Feb.	3.182	3.636	3.636	3.636	3.636	3.636
March	2.879	3.636	3.636	3.636	3.636	3.636
Apr.	2.576	3.636	3.636	3.636	3.636	3.636
May	2.273	3.636	3.636	3.636	3.636	3.636
June	1.970	3.636	3.636	3.636	3.636	3.636
July	1.667	3.636	3.636	3.636	3.636	3.636
Aug.	1.364	3.636	3.636	3.636	3.636	3.636
Sept.	1.061	3.636	3.636	3.636	3.636	3.636
Oct.	0.758	3.636	3.636	3.636	3.636	3.636
Nov.	0.455	3.636	3.636	3.636	3.636	3.636
Dec.	0.152	3.636	3.636	3.636	3.636	3.636

How to report. If you had a casualty or theft that involved property used in your rental activity, you figure the net gain or loss in Section B of **Form 4684**, *Casualties and Thefts.* Also, you may have to report the net gain or loss from Form 4684 on **Form 4797,** *Sales of Business Property.* (Follow the instructions for Form 4684.)

Limits on Rental Losses

Rental real estate activities are generally considered passive activities, and the amount of loss you can deduct is limited. Generally, you cannot deduct losses from rental real estate activities unless you have income from other passive activities. See *Passive Activity Limits*, later.

Losses from passive activities are first subject to the at-risk rules. At-risk rules limit the amount of deductible losses from holding most real property placed in service after 1986.

Exception. If your rental losses are less than $25,000 ($12,500 if married filing separately), the passive activity limits probably do not apply to you. See *Losses From Rental Real Estate Activities,* later.

Property used as a home. If you used the rental property as a home during the year, the passive activity rules do not apply to that home. Instead, you must follow the rules explained earlier under *Personal Use of Vacation Home or Dwelling Unit*.

At-Risk Rules

The at-risk rules place a limit on the amount you can deduct as losses from activities often described as tax shelters. Losses from holding real property (other than mineral property) placed in service before 1987 are not subject to the at-risk rules.

Generally, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount you have at risk in the activity at the end of the tax year. You are considered at risk in an activity to the extent of cash and the adjusted basis of other property you contributed to the activity and certain amounts borrowed for use in the activity. See Publication 925 for more information.

Passive Activity Limits

In general, all rental activities (except those meeting the exception for real estate professionals, below) are passive activities. For this purpose, a rental activity is an activity from which you receive income mainly for the use of tangible property, rather than for services.

Passive activity rules. Deductions for losses from passive activities are limited. You generally cannot offset income, other than passive income, with losses from passive activities. Nor can you offset taxes on income, other than passive income, with credits resulting from passive activities. Any excess loss or credit is carried forward to the next tax year.

For a detailed discussion of these rules, see Publication 925.

You may have to complete **Form 8582,** *Passive Activity Loss Limitations*, to figure the amount of any passive activity loss for the current tax year for all activities and the amount of the passive activity loss allowed on your tax return. See *Form 8582 not required,* under *Losses From Rental Real Estate Activities,* later, to determine whether you have to complete Form 8582.

Exception for Real Estate Professionals

Rental activities in which you ***materially participated*** during the year are not passive activities if for that year you were a real estate professional. Losses from these activities are not limited by the passive activity rules.

For this purpose, each interest you have in a rental real estate activity is a separate activity, unless you choose to treat all interests in rental real estate activities as one activity.

If you were a real estate professional for 1998, complete line 42 of Schedule E (Form 1040).

Real estate professional. You were a real estate professional if, during the year, the time you spent performing services in real property trades or businesses in which you materially participated was:

1) More than half of the time you spent performing personal services in all trades or businesses, and
2) More than 750 hours.

A real property trade or business is one that develops, redevelops, constructs, reconstructs, acquires, converts, rents, operates, manages, leases, or sells real property.

Services you performed as an employee are not treated as performed in a real property trade or business, unless you own more than 5% of the stock (or more than 5% of the capital or profits interest) in the employer.

If you file a joint return, one spouse must separately meet both of the above conditions, without taking into account services performed by the other spouse.

Material participation. Generally, you materially participated in an activity for the tax year if you were involved in the operations of it on a regular, continuous, and substantial basis during the year. For more information, see section 1.469–5T of the Income Tax Regulations.

Participating spouse. If you are married, determine whether you materially participated in an activity by also counting any participation in the activity by your spouse during the year. Do this even if your spouse owns no interest in the activity or files a separate return for the year.

Choice to treat all interests as one activity. If you were a real estate professional and had more than one rental real estate interest during the year, you can choose to treat all the interests as one activity. You can make this choice for any year that you qualify as a real estate professional. If you forgo making the choice for one year, you can still make it for a later year.

If you make the choice, it is binding for the tax year you make it and for any later year that you are a real estate professional. This is true even if you are not a real estate professional in any intervening year. (For that year, the exception for real estate professionals will not apply in determining whether your activity is subject to the passive activity rules.)

See the instructions for line 23 of Schedule E (Form 1040) for information about making this choice.

Losses From Rental Real Estate Activities

If you ***actively participated*** in a passive rental real estate activity, you may be able to deduct up to $25,000 of loss from the activity from nonpassive income. This special allowance cannot be more than $12,500 if you were married, file a separate return, and lived apart from your spouse at all times during the year. It is not available if you were married, file a separate return, and did not live apart from your spouse at all times during the year.

The maximum amount of the special allowance is reduced if your modified adjusted gross income is more than $100,000 ($50,000 if married filing separately).

Example. Jane is single and has $40,000 in wages, $2,000 of passive income from a limited partnership, and $3,500 of passive loss from a rental real estate activity in which she actively participated. $2,000 of Jane's $3,500 loss offsets her passive income. The remaining $1,500 loss can be deducted from her $40,000 wages.

Active participation. You actively participated in a rental real estate activity if you (and your spouse) owned at least 10% of the rental property and you made management decisions in a significant and bona fide sense. Management decisions include approving new tenants, deciding on rental terms, approving expenditures, and similar decisions.

Example. Mike, a bachelor, had the following income and losses during the tax year:

Salary	$42,300
Dividends	300
Interest	1,400
Rental loss	(4,000)

The rental loss resulted from the rental of a house Mike owned. Mike had advertised and rented the house to the current tenant himself. He also collected the rents, which usually came by mail. All repairs were either done or contracted out by Mike.

Even though the rental loss is a loss from a passive activity, because Mike actively participated in the rental property management, he can use the entire $4,000 loss to offset his other income.

Maximum special allowance. If your modified adjusted gross income is $100,000 or less ($50,000 or less if married filing separately), you can deduct your loss up to $25,000 ($12,500 if married filing separately). If your modified adjusted gross income is more than $100,000 (more than $50,000 if married filing separately), this special allowance is limited to 50% of the difference between $150,000 ($75,000 if married filing separately) and your modified adjusted gross income.

Generally, there is no relief from the passive activity loss limits if your modified adjusted gross income is $150,000 or more ($75,000 or more if married filing separately).

Modified adjusted gross income. This is your adjusted gross income from line 33, Form 1040, figured without taking into account:

1) Any passive income or loss or any loss allowable by reason of the exception for real estate professionals discussed earlier,
2) Taxable social security or equivalent tier 1 railroad retirement benefits,
3) Deductible contributions to an IRA or certain other qualified retirement plans,
4) The deduction for one-half of self-employment tax,
5) The exclusion allowed for employer-provided adoption benefits, and
6) The exclusion allowed for qualified U.S. savings bond interest used to pay higher education expenses.

Form 8582 not required. Do not complete Form 8582 if you meet all of the following conditions.

1) Your only passive activities were rental real estate activities in which you actively participated.
2) Your overall net loss from these activities is $25,000 or less ($12,500 or less if married filing separately).
3) You do not have any prior year unallowed losses from any passive activities.
4) If married filing separately, you lived apart from your spouse all year.
5) You have no current or prior year unallowed credits from passive activities.
6) Your modified adjusted gross income is $100,000 or less ($50,000 or less if married filing separately).
7) You do not hold any interest in a rental real estate activity as a limited partner or as a beneficiary of an estate or a trust.

If you meet all of the conditions listed above, your rental real estate activities are not limited by the passive activity rules and you do not have to complete Form 8582. Enter each rental real estate loss from line 22 of Schedule E (Form 1040) on line 23 of Schedule E.

If you do not meet all of the conditions listed above, see the instructions for Form 8582 to find out if you must complete and attach that form to your tax return.

How To Report Rental Income and Expenses

If you rent out buildings, rooms, or apartments, and provide only heat and light, trash collection, etc., you normally report your rental income and expenses in Part I of Schedule E (Form 1040). However, do not use that schedule to report a not-for-profit activity. See *Not Rented For Profit* under *Rental Expenses,* earlier.

If you provide significant services that are primarily for your tenant's convenience, such as regular cleaning, changing linen, or maid service, you report your rental income and expenses on Schedule C (Form 1040), *Profit or Loss From Business* or Schedule C–EZ, *Net Profit From Business*. Significant services do not include the furnishing of heat and light, cleaning of public areas, trash collection, etc. For information, see Publication 334. You also may have to pay self-employment tax on your rental income. See Publication 533.

Schedule E (Form 1040)

Use Part I of Schedule E (Form 1040) to report your rental income and expenses. List your total income, expenses, and depreciation for each rental property. Be sure to answer the question on line 2.

If you have more than three rental or royalty properties, complete and attach as many Schedules E as are needed to list the properties. Complete lines 1 and 2 for each property. However, fill in the “Totals” column on only one Schedule E. The figures in the “Totals” column on that Schedule E should be the combined totals of all Schedules E.

Page 2 of Schedule E (Form 1040) is used to report income or loss from partnerships, S corporations, estates, trusts, and real estate mortgage investment conduits. If you need to use page 2 of Schedule E, use page 2 of the same Schedule E you used to enter the combined totals in Part I.

On page 1, line 20 of Schedule E (Form 1040), enter the depreciation you are claiming. You must complete and attach Form 4562 for rental activities only if you are claiming:

- Depreciation on property placed in service during 1998,
- Depreciation on any property that is listed property (such as a car), regardless of when it was placed in service, or
- Any car expenses (actual or the standard mileage rate).

Otherwise, figure your depreciation on your own worksheet. You do not have to attach these computations to your return.

Example 1. On January 1, Eileen Johnson bought a townhouse and placed it in service as residential rental property. She receives $1,100 a month rental income. Her rental expenses for the year are as follows:

Mortgage interest	$5,000
Fire insurance (1–year policy)	200
Fee paid to real estate company for collecting monthly rent	572
General repairs	175
Real estate taxes imposed and paid	800

Eileen's basis for depreciation of the townhouse is $65,000. She is using the MACRS method with a 27.5–year recovery period. On April 1, Eileen bought a new dishwasher for the rental property at a cost of $425. She uses the MACRS method with a 7–year recovery period.

Eileen uses the percentage for January in *Table 4–D* to figure her depreciation deduction for the townhouse. She uses the percentage under “Half-year convention” in *Table 4–B* to figure her depreciation deduction for the dishwasher. She must report the depreciation on Form 4562.

Eileen figures her net rental income or loss for the townhouse as follows:

Total rental income received ($1,100 × 12)		$13,200
Minus: Expenses		
Mortgage interest	$5,000	
Fire insurance (1–year policy)	200	
Rent collection fee	572	
General repairs	175	
Real estate taxes	800	
Total expenses		6,747
Balance		$ 6,453
Minus: Depreciation		
On townhouse ($65,000 × 3.485%)	$2,265	
On dishwasher ($425 × 14.29%)	61	
Total depreciation		2,326
Net rental income for townhouse		$ 4,127

Eileen uses Part I of Schedule E (Form 1040) to report her rental income and expenses. She enters her income, expenses, and depreciation for the townhouse in the column for Property A. She uses Form 4562 to figure and report her depreciation. Eileen's Schedule E (Form 1040) is shown later.

Example 2. In January, Mary Smith bought a condominium apartment to live in. Instead of selling the house she had been living in, she decided to change it to rental property. Mary selected a tenant and started renting the house on February 1. Mary charges $550 a month for rent and collects it herself. Mary received a $550 security deposit from her tenant. Because she plans to return it to her tenant at the end of the lease, she does not include it in her income. Her house expenses for the year are as follows:

Mortgage interest	$1,800
Fire insurance (1–year policy)	100
Miscellaneous repairs (after renting)	297
Real estate taxes imposed and paid	800

Mary must divide the real estate taxes, mortgage interest, and fire insurance between the personal use of the property and the rental use of the property. She can deduct eleven-twelfths of these expenses as rental expenses. She can deduct the balance of the allowable taxes and mortgage interest on Schedule A (Form 1040) if she itemizes her deductions. She cannot deduct the balance of the fire insurance because it is a personal expense.

Mary bought this house in 1979 for $35,000. Her property tax was based on assessed values of $10,000 for the land and $25,000 for the house. Before changing it to rental property, Mary added several improvements to the house. She figures her adjusted basis as follows:

Improvement	**Cost**
House	$25,000
Remodeled kitchen	4,200
Recreation room	5,800
New roof	1,600
Patio and deck	2,400
Adjusted basis	$39,000

On February 1, when Mary changed her house to rental property, the property had a fair market value of $92,000. Of this amount, $20,000 was for the land and $72,000 was for the house.

Because Mary's adjusted basis is less than the fair market value on the date of the change, Mary uses $39,000 as her basis for depreciation.

Because the house is residential rental property, she must use the straight line method of depreciation over either the GDS recovery period or the ADS recovery period. She chooses the GDS recovery period of 27.5 years.

She uses *Table 4–D* to find her depreciation percentage. Because she placed the property in service in February, she finds the percentage to be 3.182%.

On May 1, Mary paid $2,000 to have a furnace installed in the house. The furnace is residential rental property. Because she placed the property in service in May, she finds the percentage to be 2.273% from *Table 4–D*.

Mary figures her net rental gain or loss for the house in the following way:

Total rental income received ($550 × 11)		$6,050
Minus: Expenses		
Mortgage interest ($1,800 × $^{11}/_{12}$)	$1,650	
Fire insurance ($100 × $^{11}/_{12}$)	92	
Miscellaneous repairs	297	
Real estate taxes ($800 × $^{11}/_{12}$)	733	
Total expenses		2,772
Balance		$3,278
Minus: Depreciation		
On house ($39,000 × 3.182%)	$1,241	
On furnace ($2,000 × 2.273%)	45	
Total depreciation		1,286
Net rental gain for house		$1,992

Mary uses Part I of Schedule E (Form 1040) to report her rental income and expenses. She enters her income, expenses, and depreciation for the house in the column for Property A. She uses Form 4562 to figure and report her depreciation. Mary's Schedule E (Form 1040) and Form 4562 are shown later.

SCHEDULE E (Form 1040)

Department of the Treasury
Internal Revenue Service

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

► **Attach to Form 1040 or Form 1041.** ► **See Instructions for Schedule E (Form 1040).**

OMB No. 1545-0074

1998

Attachment Sequence No. **13**

Name(s) shown on return: Eileen Johnson

Your social security number: 112 00 2334

Part I **Income or Loss From Rental Real Estate and Royalties** **Note:** *Report income and expenses from your business of renting personal property on **Schedule C** or **C-EZ** (see page E-1). Report farm rental income or loss from **Form 4835** on page 2, line 39.*

1	Show the kind and location of each **rental real estate property:**
A	Townhouse 4444 Timber Lane, Anytown, UT 84000
B	
C	

2 For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of:
- 14 days, **or**
- 10% of the total days rented at fair rental value?

(See page E-1.)

	Yes	No
A		√
B		
C		

		Properties A	Properties B	Properties C		Totals (Add columns A, B, and C.)
Income:						
3 Rents received	3	13,200			3	13,200
4 Royalties received	4				4	
Expenses:						
5 Advertising	5					
6 Auto and travel (see page E-2)	6					
7 Cleaning and maintenance	7					
8 Commissions	8					
9 Insurance	9	200				
10 Legal and other professional fees	10					
11 Management fees	11	572				
12 Mortgage interest paid to banks, etc. (see page E-2)	12	5,000			12	5,000
13 Other interest	13					
14 Repairs	14	175				
15 Supplies	15					
16 Taxes	16	800				
17 Utilities	17					
18 Other (list) ►	18					
19 Add lines 5 through 18	19	6,747			19	6,747
20 Depreciation expense or depletion (see page E-3)	20	2,326			20	2,326
21 Total expenses. Add lines 19 and 20	21	9,073				
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-3 to find out if you must file **Form 6198**	22	4,127				
23 Deductible rental real estate loss. **Caution:** *Your rental real estate loss on line 22 may be limited. See page E-3 to find out if you must file **Form 8582**. Real estate professionals must complete line 42 on page 2*	23	( )	( )	( )		

24 **Income.** Add positive amounts shown on line 22. **Do not** include any losses	24	4,127
25 **Losses.** Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here	25	( )
26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 39 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 40 on page 2	26	4,127

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11344L **Schedule E (Form 1040) 1998**

SCHEDULE E (Form 1040)

Department of the Treasury
Internal Revenue Service

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule E (Form 1040).

OMB No. 1545-0074

1998

Attachment Sequence No. 13

Name(s) shown on return: Mary Smith

Your social security number: 123 00 4567

Part I **Income or Loss From Rental Real Estate and Royalties** **Note:** *Report income and expenses from your business of renting personal property on* ***Schedule C*** *or* ***C-EZ*** *(see page E-1). Report farm rental income or loss from* ***Form 4835*** *on page 2, line 39.*

	1 Show the kind and location of each **rental real estate property:**
A	Brick House 123 Main Street, Hometown, MN 56200
B	
C	

2 For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of:
- 14 days, **or**
- 10% of the total days rented at fair rental value?

(See page E-1.)

	Yes	No
A		√
B		
C		

		Properties A	Properties B	Properties C	Totals (Add columns A, B, and C.)
Income:					
3 Rents received	3	6,050			3 6,050
4 Royalties received	4				4
Expenses:					
5 Advertising	5				
6 Auto and travel (see page E-2)	6				
7 Cleaning and maintenance	7				
8 Commissions	8				
9 Insurance	9	92			
10 Legal and other professional fees	10				
11 Management fees	11				
12 Mortgage interest paid to banks, etc. (see page E-2)	12	1,650			12 1,650
13 Other interest	13				
14 Repairs	14	297			
15 Supplies	15				
16 Taxes	16	733			
17 Utilities	17				
18 Other (list) ▶	18				
19 Add lines 5 through 18	19	2,772			19 2,772
20 Depreciation expense or depletion (see page E-3)	20	1,286			20 1,286
21 Total expenses. Add lines 19 and 20	21	4,058			
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-3 to find out if you must file **Form 6198**	22	1,992			
23 Deductible rental real estate loss. **Caution:** *Your rental real estate loss on line 22 may be limited. See page E-3 to find out if you must file* ***Form 8582****. Real estate professionals must complete line 42 on page 2*	23	( )	( )	( )	

24 **Income.** Add positive amounts shown on line 22. **Do not** include any losses	24 1,992
25 **Losses.** Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here	25 ( )
26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 39 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 40 on page 2	26 1,992

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11344L **Schedule E (Form 1040) 1998**

Form **4562**

Department of the Treasury
Internal Revenue Service

Depreciation and Amortization
(Including Information on Listed Property)

► **See separate instructions.** ► **Attach this form to your return.**

OMB No. 1545-0172

1998

Attachment Sequence No. **67**

Name(s) shown on return	Business or activity to which this form relates	**Identifying number**
Mary Smith	Rental of house	123-00-4567

Part I **Election To Expense Certain Tangible Property (Section 179) (Note:** *If you have any "listed property," complete Part V before you complete Part I.***)**

1	Maximum dollar limitation. If an enterprise zone business, see page 2 of the instructions	1	$18,500
2	Total cost of section 179 property placed in service. See page 2 of the instructions	2	
3	Threshold cost of section 179 property before reduction in limitation	3	$200,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 2 of the instructions	5	

	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
6			
7	Listed property. Enter amount from line 27	7	

8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	
9	Tentative deduction. Enter the smaller of line 5 or line 8	9	
10	Carryover of disallowed deduction from 1997. See page 3 of the instructions	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	
13	Carryover of disallowed deduction to 1999. Add lines 9 and 10, less line 12 ►	13	

Note: *Do not use Part II or Part III below for listed property (automobiles, certain other vehicles, cellular telephones, certain computers, or property used for entertainment, recreation, or amusement). Instead, use Part V for listed property.*

Part II **MACRS Depreciation For Assets Placed in Service ONLY During Your 1998 Tax Year (Do Not Include Listed Property.)**

Section A—General Asset Account Election

14 If you are making the election under section 168(i)(4) to group any assets placed in service during the tax year into one or more general asset accounts, check this box. See page 3 of the instructions ► ☐

Section B—General Depreciation System (GDS) (See page 3 of the instructions.)

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
15a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property	2-98	39,000	27.5 yrs.	MM	S/L	1,241
	5-98	2,000	27.5 yrs.	MM	S/L	45
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Section C—Alternative Depreciation System (ADS) (See page 5 of the instructions.)

16a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part III **Other Depreciation (Do Not Include Listed Property.)** (See page 6 of the instructions.)

17	GDS and ADS deductions for assets placed in service in tax years beginning before 1998	17	
18	Property subject to section 168(f)(1) election	18	
19	ACRS and other depreciation	19	

Part IV **Summary** (See page 6 of the instructions.)

20	Listed property. Enter amount from line 26	20	
21	**Total.** Add deductions on line 12, lines 15 and 16 in column (g), and lines 17 through 20. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	21	1,286
22	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	22	

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 12906N Form **4562** (1998)

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