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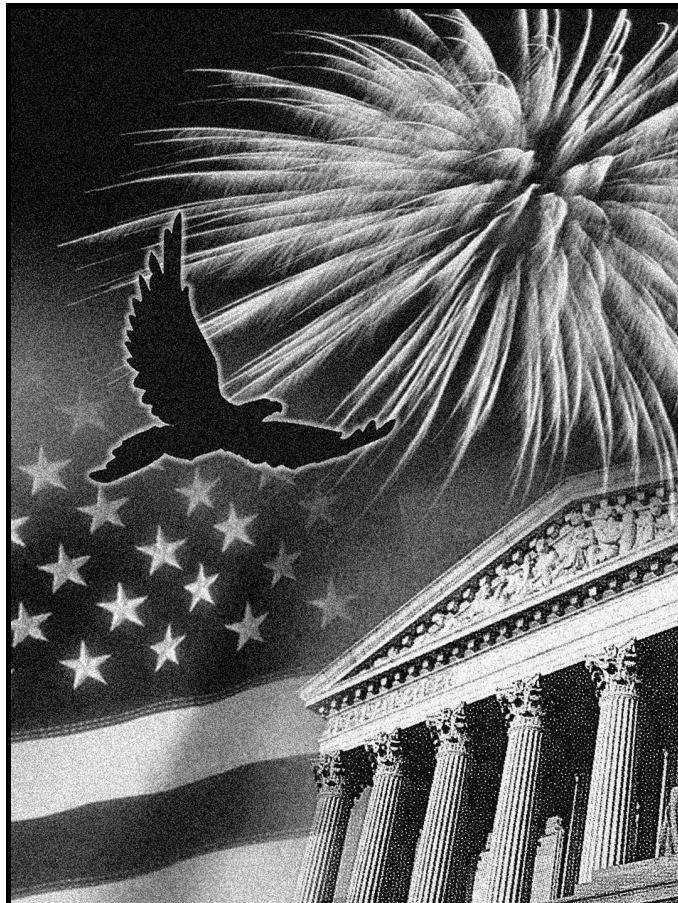
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# Residential Rental Property

## (Including Rental of Vacation Homes)

For use in preparing

**2008** Returns



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## Contents

<b>What's New</b> . . . . .	<b>1</b>
<b>Reminder</b> . . . . .	<b>2</b>
<b>Introduction</b> . . . . .	<b>2</b>
<b>1. Rental Income and Expenses (If No Personal Use of Dwelling)</b> . . . . .	<b>3</b>
Rental Income . . . . .	3
Rental Expenses . . . . .	3
<b>2. Depreciation of Rental Property</b> . . . . .	<b>6</b>
The Basics . . . . .	6
Claiming the Special Depreciation Allowance . . . . .	8
MACRS Depreciation . . . . .	8
Claiming the Correct Amount of Depreciation . . . . .	11
<b>3. Reporting Rental Income, Expenses, and Losses</b> . . . . .	<b>12</b>
Which Forms To Use . . . . .	12
Limits on Rental Losses . . . . .	13
At-Risk Rules . . . . .	13
Passive Activity Limits . . . . .	13
Casualties and Thefts . . . . .	14
Illustrated Example . . . . .	14
<b>4. Special Situations</b> . . . . .	<b>16</b>
Condominiums . . . . .	16
Cooperatives . . . . .	16
Property Changed to Rental Use . . . . .	16
Renting Part of Property . . . . .	17
Not Rented for Profit . . . . .	17
Illustrated Example . . . . .	17
<b>5. Personal Use of Dwelling Unit (Including Vacation Home)</b> . . . . .	<b>21</b>
What Is a Day of Personal Use . . . . .	21
Dwelling Unit Used as a Home . . . . .	21
Figuring Rental Income and Deductions . . . . .	22
Reporting Income and Deductions . . . . .	23
Illustrated Example . . . . .	23
Worksheet 5-1 . . . . .	26
<b>6. How To Get Tax Help</b> . . . . .	<b>28</b>
<b>Index</b> . . . . .	<b>29</b>

## What's New

**Tax-free exchange of rental property used for personal purposes.** Beginning March 10, 2008, you may qualify for a tax-free exchange (a like-kind or section 1031 exchange) of one piece of rental property you own for a similar piece of rental property, even if you have used the rental property for personal purposes. You must meet the following criteria.

- You own the rental property for at least 24 months before the exchange.
- During the 2 years before the exchange you rent the property to another person at a fair rental price for 14 days or more.
- Your personal use of the rental property during each of the two years before the exchange does not exceed the greater of 14 days or 10% of the number of days the property is rented.

For information on like-kind exchanges, see Publication 544, chapter 1.

**Additional first-year depreciation for certain MACRS property.** You can elect a 50% special depreciation allowance (in addition to your regular MACRS depreciation deduction) if you place in service during 2008 certain property with a recovery period of 20 years or less. See Publication 946, chapter 3, for more information.

**Special depreciation allowance for taxpayers affected by May 4, 2007, Kansas storms.** You can take a special depreciation allowance for qualified property affected by May 4, 2007, Kansas storms. See *Special Depreciation Allowance* on page 12 of Publication 4492-A for more information.

**Change to special depreciation allowance for GO Zone.** For property placed in service after December 31, 2007, the deadline on construction of property eligible for the special depreciation allowance in the Gulf Opportunity Zone (GO Zone) has been waived.

**Special depreciation allowance for qualified property in federally declared disaster areas.** You can take a special depreciation allowance for qualified disaster assistance property placed in service after December 31, 2007, with respect to disasters declared after that date. See Publication 946 for more information.

**Expensing of qualified expenses allowed in federally declared disaster areas.** You can deduct, rather than capitalize, qualified disaster expenses paid or incurred after December 31, 2007, with respect to disasters declared after that date. See Publication 535 for more information.

**Deduction for qualified disaster clean-up costs in a Midwestern disaster area.** You can deduct, rather than capitalize, 50% of qualified disaster recovery assistance clean-up costs paid or incurred on or after the applicable disaster date, and before January 1, 2011. Refer to Publication 4492-B to see if your rental property is in a qualifying area and for details on the deduction.

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## Reminder

**Photographs of missing children.** The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-5678) if you recognize a child.

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## Introduction

Do you own a second house that you rent out all the time? Do you own a vacation home that you rent out when you or your family isn't using it?

These are two common types of residential rental activities discussed in this publication. Generally, all rental income must be reported on your tax return, but there are differences in the expenses you are allowed to deduct and in the way the rental activity is reported on your return.

First, this publication will look at the rental-for-profit activity in which there is no personal use of the property. We will look at types of income and when each is reported, and at types of expenses and which are deductible.

Chapter 2 discusses depreciation as it applies to your rental real estate activity—what property can be depreciated and how to figure it.

Chapter 3 covers the actual reporting of your rental income and deductions, including casualties and thefts, limitations on losses, and claiming the correct amount of depreciation.

Special rental situations are grouped together in chapter 4. These include condominiums and cooperatives, property changed to rental use, renting only part of your property, and a not-for-profit rental activity.

Finally, in chapter 5, we will look at the rules for rental income and expenses when there is also personal use of the dwelling unit, such as a vacation home.

**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, see 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, see Publication 523, *Selling Your Home*.

**Comments and suggestions.** We welcome your comments about this publication and your suggestions for future editions.

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## Useful Items

You may want to see:

### Publication

- 463** Travel, Entertainment, Gift, and Car Expenses
- 523** Selling Your Home
- 534** Depreciating Property Placed in Service Before 1987
- 535** Business Expenses
- 544** Sales and Other Dispositions of Assets
- 547** Casualties, Disasters, and Thefts
- 551** Basis of Assets
- 925** Passive Activity and At-Risk Rules
- 946** How To Depreciate Property
- 4492-A** Information for Taxpayers Affected by the May 7, 2007, Kansas Storms and Tornadoes
- 4492-B** Information for Affected Taxpayers in the Midwestern Disaster Areas

### 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
- 8582** Passive Activity Loss Limitations
- Schedule E (Form 1040)** Supplemental Income and Loss

See chapter 6, *How To Get Tax Help*, for information about getting these publications and forms.

# 1.

## Rental Income and Expenses (If No Personal Use of Dwelling)

This chapter discusses the various types of rental income and expenses for a residential rental activity with no personal use of the dwelling. Generally, each year you will report all income and deduct all out-of-pocket expenses in full. The deduction to recover the cost of your rental property—depreciation—is taken over a prescribed number of years, and is discussed in chapter 2.



*If your rental income is from property you also use personally or rent to someone at less than a fair rental price, first read the information in chapter 5.*

### Rental Income

Generally, you 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 rental payments, there are other amounts that may be rental income.

### When To Report

When you report rental income on your tax return generally depends on whether you are a cash basis taxpayer or use an accrual method. Most individual taxpayers use the cash method.

**Cash method.** You are a cash basis taxpayer if you report income on your return in the year you actually or constructively receive it, regardless of when it was earned. You constructively receive income when it is made available to you, for example, by being credited to your bank account.

**Accrual method.** If you are an accrual basis taxpayer, you generally report income when you earn it, rather than when you receive it. You generally deduct your expenses when you incur them, rather than when you pay them.

**More information.** See Publication 538, Accounting Periods and Methods, for more information about when you constructively receive income and accrual methods of accounting.

### Types of Income

The following are common types of rental income.

**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.** On March 18, 2008, you signed a 10-year lease to rent your property. During 2008, you received \$9,600 for the first year's rent and \$9,600 as rent for the last year of the lease. You must include \$19,200 in your rental income in the first year.

**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 rental expenses, those payments are rental income. Because you are including this amount in income, you can also deduct the expenses if they are deductible rental expenses. For more information, see *Rental Expenses* beginning on this page.

**Example 1.** Your tenant pays the water and sewage bill for your rental property and deducts the amount from the normal rent payment. Under the terms of the lease, your tenant does not have to pay this bill. Include the utility bill paid by the tenant and any amount received as a rent payment in your rental income. You can deduct the utility payment made by your tenant 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 the repair bill paid by the tenant and any amount received as a rent payment in your rental income. You can deduct the repair payment made by your tenant as a rental expense.

**Property or services.** If you receive property or services as rent, instead of money, 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 house 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 deduct that same amount as a rental expense for painting your property.

**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.

### Other Sources of Rental Income

**Lease with option to buy.** If the rental agreement gives your tenant the right to buy your

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

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

**Rental of property also used as your home.** If you rent property that you also use as your home and you rent it fewer than 15 days during the tax year, do not include the rent you receive in your income and do not deduct rental expenses. However, you can deduct on Schedule A (Form 1040) the interest, taxes, and casualty and theft losses that are allowed for nonrental property. See the paragraph below for another way to deduct real estate taxes in 2008. Also, see chapter 5, *Personal Use of Dwelling Unit (Including Vacation Home)*.

**Adding real estate taxes to standard deduction.** If you are not able to itemize deductions on your 2008 tax return, you may be able to deduct all or part of the real estate tax you paid on property held for personal use. Take the deduction (limited to \$500 (\$1,000 if married filing jointly)) on Form 1040, line 40. See the Form 1040 instructions for line 39c.

### Rental Expenses

Generally, the expenses of renting your property, such as maintenance, insurance, taxes, and interest, can be deducted from your rental income.

**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 chapter 5, *Personal Use of Dwelling Unit (Including Vacation Home)*.

**Part interest.** If you own a part interest in rental property, you can deduct expenses you paid according to your percentage of ownership.

**Example.** Roger owns a one-half undivided interest in a rental house. Last year he paid \$968 for necessary repairs on the property. Roger can deduct \$484 (50% × \$968) as a rental expense. He is entitled to reimbursement for the remaining half from the co-owner.

### When To Deduct

You generally deduct your rental expenses in the year you pay them.

If you use the accrual method, see Publication 538 for more information.

### Types of Expenses

Listed below are the most common rental expenses.

- Advertising.
- Cleaning and maintenance.
- Commissions.

- Depreciation.
- Insurance.
- Interest.
- Legal fees.
- Local transportation expenses.
- Points.
- Rental payments.
- Repairs.
- Tax return preparation fees.
- Taxes.
- Travel expenses.
- Utilities.

Some of these expenses, as well as other less common ones, are discussed below.

**Depreciation.** You can begin to depreciate rental property when it is ready and available for rent. See *Placed in Service* under *When Does Depreciation Begin and End* in chapter 2.

**Insurance premiums paid in advance.** If you pay an insurance premium for more than 1 year in advance, for each year of coverage 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. See Publication 535, chapter 6, for information on deductible premiums.

**Interest expense.** You can deduct mortgage interest you pay on your rental property. Chapter 4 of Publication 535 explains mortgage interest in detail.

**Expenses paid to obtain a mortgage.** Certain 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. However, you can amortize them over the life of the mortgage. See Publication 535, chapter 8, for information about amortization.

**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 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 Schedule E (Form 1040), line 13. 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, enter "See attached."

**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 nondepreciable capital expenditures, and must be added to the basis of your property. However, you can deduct local benefit taxes that are for maintaining, repairing, or paying interest charges for the benefits.

**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. For 2008, the standard mileage rate for each mile of business use is:

- 50½ cents per mile for the period January 1 through June 30, 2008, and
- 58½ cents per mile for the period July 1 through December 31, 2008.

For more information, see chapter 4 of Publication 463.



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 Form 4562, Part V, and attach it to your tax return.

**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.

**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.

**Rental of 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.

**Tax return preparation fees.** You can deduct, as a rental expense, the part of tax return preparation fees you paid to prepare Schedule E, Part I. For example, on your 2008 Schedule E you can deduct fees paid in 2008 to prepare Part I of your 2007 Schedule E. You can also deduct, as a rental expense, any expense (other than federal taxes and penalties) you paid to resolve a tax underpayment related to your rental activities.

**Travel expenses.** You can deduct the ordinary and necessary expenses of traveling away from home if the primary purpose of the trip is to collect rental income or to manage, conserve, or maintain your rental property. You must properly allocate your expenses between rental and nonrental activities. You cannot deduct the cost of traveling away from home if the primary purpose of the trip is to improve the property. The cost of improvements is recovered by taking depreciation. For information on travel expenses, see chapter 1 of Publication 463.



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

**Uncollected rent.** If you are a cash basis taxpayer, do not deduct uncollected rent. Because you have not included it in your income, it is not deductible.

If you use an accrual method, report income when you earn it. If you are unable to collect the rent, you may be able to deduct it as a business bad debt. See chapter 10 of Publication 535 for more information about business bad debts.

**Vacant rental property.** If you hold property for rental purposes, you may be able to deduct your ordinary and necessary expenses (including depreciation) 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.

**Vacant while listed for sale.** 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.

## Points

The term "points" is often used to describe some of the charges paid, or treated as paid, by a borrower to take out a loan or a mortgage. These charges are also called loan origination fees, maximum loan charges, or premium charges. Any of these charges (points) that are solely for the use of money are interest. Because points are prepaid interest, you generally cannot deduct the full amount in the year paid, but must deduct the interest over the term of the loan.

The method used to figure the amount of points you can deduct each year follows the original issue discount (OID) rules. In this case, points are equivalent to OID, which is the difference between:

- The amount borrowed (redemption price at maturity, or principal), and
- The proceeds (issue price).

The first step is to determine whether your total OID (which you may have on bonds or other investments in addition to the mortgage loan), including the OID resulting from the points, is insignificant or *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 OID.** The OID is *de minimis* if it is less than one-fourth of 1% (.0025) of the stated redemption price at maturity (principal amount of the loan) multiplied by the number of full years from the date of original issue to maturity (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.

- On a constant-yield basis over the term of the loan.
- On a straight line basis over the term of the loan.
- In proportion to stated interest payments.
- In its entirety at maturity of the loan.

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

**Example.** Carol Madison took out a \$100,000 mortgage loan on January 1, 2008, to buy a house she will use as a rental during 2008. The loan is to be repaid over 30 years. During 2008 Carol paid \$10,000 of mortgage interest (stated interest) to the lender. When the loan was made, she paid \$1,500 in points to the lender. The points reduced the principal amount of the loan from \$100,000 to \$98,500, resulting in \$1,500 of OID. Carol determines that the points (OID) she 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 . . . . .	× 30
Multiplied by . . . . .	× .0025
<b>De minimis amount</b> . . . . .	<u>\$ 7,500</u>

The points (OID) she paid (\$1,500) are less than the *de minimis* amount (\$7,500). Therefore, Carol has *de minimis* OID and she can choose one of the four ways discussed earlier to figure the amount she can deduct each year. Under the straight line method, she can deduct \$50 each year for 30 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. If you paid points on the loan, the issue price generally is the difference between the principal and the points.
2. Multiply the result in (1) by the yield to maturity (defined below).
3. Subtract any qualified stated interest payments (defined below) from the result in (2). This is the OID you can deduct in the first year.

**Yield to maturity (YTM).** This rate 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).** In general, this is the stated interest that is unconditionally payable in cash or property (other than another loan of the issuer) at least annually over the term of the loan at a fixed rate.

**Example—Year 1.** The facts are the same as in the previous example. The yield to maturity on Carol's loan is 10.2467%, compounded annually.

She figured the amount of points (OID) she could deduct in 2008 as follows.

Principal amount of the loan . . . . .	\$100,000
Minus: Points (OID) . . . . .	– 1,500
Issue price of the loan . . . . .	<u>\$ 98,500</u>
Multiplied by: YTM . . . . .	× .102467
Total . . . . .	10,093
Minus: QSI . . . . .	– 10,000
<b>Points (OID) deductible in 2008</b>	<u>\$ 93</u>

To figure your deduction in any subsequent year, you start with the adjusted issue price. To get the adjusted issue price, add to the issue price figured in Year 1 any OID previously deducted. Then follow steps (2) and (3) above.

**Example—Year 2.** Carol figured the deduction for 2009 as follows.

Issue price . . . . .	\$98,500
Plus: Points (OID) deducted in 2008 . . . . .	+ 93
Adjusted issue price . . . . .	<u>\$98,593</u>
Multiplied by: YTM . . . . .	× .102467
Total . . . . .	10,103
Minus: QSI . . . . .	– 10,000
<b>Points (OID) deductible in 2009</b>	<u>\$ 103</u>

**Loan or mortgage ends.** If your loan or mortgage ends, you may be able to deduct any remaining points (OID) in the tax 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.

## Repairs and Improvements

You can deduct the cost of repairs to your rental property, but you cannot deduct the cost of improvements. The cost of improvements is recovered by taking depreciation (see chapter 2).

**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 1-1 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.

**Example.** You repair a small section on one corner of the roof of a rental house. You deduct the cost of the repair as a rental expense. However, if you completely replace the roof, the new roof is an improvement because it increases the value and lengthens the life of the property. You depreciate the cost of the new roof.



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.

Table 1-1. 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.

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

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## 2.

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# Depreciation of Rental Property

You recover the cost of income producing property through yearly tax deductions. You do this by depreciating the property; that is, by deducting some of the cost each year on your tax return.

Three basic factors determine how much depreciation you can deduct: (1) your basis in the property, (2) the recovery period for the property, and (3) the depreciation method used. You cannot simply deduct your mortgage or principal payments, or the cost of furniture, fixtures and equipment, 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 *Which Forms To Use* in chapter 3. Also see Publication 946.

**Section 179 deduction.** The section 179 deduction is a means of recovering part or all of the cost of certain qualifying property in the year you place the property in service. This deduction is not allowed for property used in connection with residential rental property. See chapter 2 of Publication 946.

**Alternative minimum tax (AMT).** Using a method of accelerated depreciation may affect your being subject to the alternative minimum tax. Accelerated depreciation allows you to deduct more depreciation earlier in the recovery period than you could deduct using a straight line method (same deduction each year).

The prescribed depreciation methods for rental real estate are not accelerated, so the depreciation deduction is not adjusted for the AMT. However, accelerated methods are generally used for other property connected with rental activities (for example, appliances and wall-to-wall carpeting).

To find out if you are subject to the AMT, see the Instructions for Form 6251, *Alternative Minimum Tax—Individuals*.

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## The Basics

The following section discusses the information you will need to have about the rental property and the decisions to be made before figuring your depreciation deduction.

### What Rental Property Can Be Depreciated

You can depreciate your property if it meets all the following requirements.

- You own the property.
- You use the property in your business or income-producing activity (such as rental property).
- The property has a determinable useful life.
- The property is expected to last more than 1 year.

**Property you own.** To claim depreciation, you usually must be the owner of the property. You are considered as owning property even if it is subject to a debt.

**Rented property.** Generally, if you pay rent for property, you cannot depreciate that property. Usually, only the owner can depreciate it. However, if you make permanent improvements to leased property, you may be able to depreciate the improvements. See *Additions or Improvements to property*, later in this chapter, under *Recovery Periods Under GDS*.

**Cooperative apartments.** If you are a tenant-stockholder in a cooperative housing corporation and rent your cooperative apartment to others, you can deduct depreciation on your stock in the corporation. See chapter 4.

**Property having a determinable useful life.** To be depreciable, your property must have a determinable useful life. This means that it must be something that wears out, decays, gets used up, becomes obsolete, or loses its value from natural causes.

### What Rental Property Cannot Be Depreciated

Certain property cannot be depreciated. This includes land and certain excepted property.

**Land.** You cannot depreciate the cost of land because land generally does not wear out, become obsolete, or get used up. But if it does, the loss is accounted for upon disposition. The costs of clearing, grading, planting, and landscaping are usually all part of the cost of land and cannot be depreciated.

Although you cannot depreciate land, you can depreciate certain land preparation costs, such as landscaping costs, incurred in preparing land for business use. These costs must be so closely associated with other depreciable property that you can determine a life for them along with the life of the associated property.

**Example.** You built a new house to use as a rental and paid for grading, clearing, seeding, and planting bushes and trees. Some of the bushes and trees were planted right next to the house, while others were planted around the outer border of the lot. If you replace the house, you would have to destroy the bushes and trees right next to it. These bushes and trees are closely associated with the house, so they have a determinable useful life. Therefore, you can depreciate them. Add your other land preparation costs to the basis of your land because they have no determinable life and you cannot depreciate them.

**Excepted property.** Even if the property meets all the requirements listed on this page

under *What Rental Property Can Be Depreciated*, you cannot depreciate the following property.

- Property placed in service and disposed of (or taken out of business use) in the same year.
- Equipment used to build capital improvements. You must add otherwise allowable depreciation on the equipment during the period of construction to the basis of your improvements.

For more information, see Publication 946, chapter 1.

### When Does Depreciation Begin and End

You begin to depreciate your rental property when you place it in service for the production of income. You stop depreciating it either when you have fully recovered your cost or other basis, or when you retire it from service, whichever happens first.

#### Placed in Service

You place property in service in a rental activity when it is ready and available for a specific use in that activity. Even if you are not using the property, it is in service when it is ready and available for its specific use.

**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 installed and 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 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.

**Conversion to business use.** If you place property in service in a personal activity, you cannot claim depreciation. However, if you change the property's use to business or the production of income, you can begin to depreciate it at the time of the change. You place the property in service for business or income-producing use on the date of the change.

**Example.** You bought a home and used it as your personal home several years before you converted it to rental property. Although its specific use was personal and no depreciation was allowable, you placed the home in service when you began using it as your home. You can begin to claim depreciation in the year you converted it to rental property because at that time its use changed to the production of income.

## Idle Property

Continue to claim a deduction for depreciation on property used in your rental activity even if it is temporarily idle (not in use). For example, if you must make repairs after a tenant moves out, you still depreciate the rental property during the time it is not available for rent.

## Cost or Other Basis Fully Recovered

You must stop depreciating property when the total of your yearly depreciation deductions equals your cost or other basis of your property. For this purpose, your yearly depreciation deductions include any depreciation that you were allowed to claim, even if you did not claim it. See *Basis of Depreciable Property* on this page.

## Retired From Service

You stop depreciating property when you retire it from service, even if you have not fully recovered its cost or other basis. You retire property from service when you permanently withdraw it from use in a trade or business or from use in the production of income because of any of the following events.

- You sell or exchange the property.
- You convert the property to personal use.
- You abandon the property.
- The property is destroyed.

## Depreciation Methods

Generally, you must use the Modified Accelerated Cost Recovery System (MACRS) to depreciate residential rental property placed in service after 1986.

If you placed rental property in service before 1987, you are using one of the following methods.

- ACRS (Accelerated Cost Recovery System) for property placed in service after 1980 but before 1987.
- Straight line or declining balance method over the useful life of property placed in service before 1981.

**Rental property placed in service before 2008.** Continue to use the same method of figuring depreciation that you used in the past.

**Use of real property changed.** Generally, you must use MACRS to depreciate real property that you acquired for personal use before 1987 and changed to business or income-producing use after 1986. This includes

your residence that you changed to rental use. See *Property Owned or Used in 1986* in Publication 946, chapter 1, for those situations in which MACRS is not allowed.

**Improvements made after 1986.** Treat an improvement made after 1986 to property you placed in service before 1987 as separate depreciable property. Therefore, you can depreciate that improvement as separate property under MACRS if it is the type of property that otherwise qualifies for MACRS depreciation. For more information about improvements, see *Additions or improvements to property*, later in this chapter under *Recovery Periods Under GDS*.



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

## Basis of Depreciable Property

The 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.

If you depreciate your property under MACRS, you may also have to reduce your basis by certain deductions and credits with respect to the property.

Basis and adjusted basis are explained in the following discussions.



*If you used the property for personal purposes before changing it to rental use, its basis for depreciation 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 in chapter 4.*

## Cost Basis

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

- Sales tax charged on the purchase (but see *Exception* below),
- Freight charges to obtain the property, and
- Installation and testing charges.

**Exception.** If you deducted state and local general sales taxes as an itemized deduction on Schedule A (Form 1040), do not include those sales taxes as part of your cost basis. Such taxes were deductible before 1987 and after 2003.

**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 and Original Issue Discount (OID)* 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 and the seller does not reimburse you, 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 your basis in the property.

**Settlement fees and other costs.** The following settlement fees and closing costs that are for buying the property are part of your basis in the property.

- Abstract fees.
- Charges for installing utility services.
- Legal fees.
- Recording fees.
- Surveys.
- Transfer taxes.
- Title insurance.
- 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.

The following are settlement fees and closing costs you cannot include in your basis in the property.

1. Fire insurance premiums.
2. Rent or other charges relating to occupancy of the property before closing.
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 remaining to 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.

**Separating cost of 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 their assessed values for real estate tax purposes.

**Example.** You buy a house and land for \$200,000. 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 \$160,000, of which \$136,000 was for the house and \$24,000 was for the land.

You can allocate 85% ( $\$136,000 \div \$160,000$ ) of the purchase price to the house and 15% ( $\$24,000 \div \$160,000$ ) of the purchase price to the land.

Your basis in the house is \$170,000 (85% of \$200,000) and your basis in the land is \$30,000 (15% of \$200,000).

## Basis Other Than Cost

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

To figure your property's basis for depreciation, you may have to make certain adjustments (increases and decreases) to the basis of the property for events occurring between the time you acquired the property and the time you placed it in service for business or the production of income. 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. These include the following.

- The cost of any additions or improvements made before placing your property into service as a rental that have a useful life of more than 1 year.
- Amounts spent after a casualty to restore the damaged property.
- The cost of extending utility service lines to the property.
- Legal fees, such as the cost of defending and perfecting title, or settling zoning issues.

**Additions or improvements.** Add to the basis of your property the amount an addition or improvement actually cost you, including any amount you borrowed to make the addition or

improvement. This includes all direct costs, such as material and labor, but not your own labor. It also includes all expenses related to the addition or 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 additions or improvements made after you place the property in service in your rental activity. For information on depreciating additions or improvements, see *Additions or improvements to property*, later in this chapter, under *Recovery Periods Under GDS*.



*The cost of landscaping improvements is usually treated as an addition to the basis of the land, which is not depreciable. However, see What Rental Property Cannot 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 its cost, 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.

However, you can deduct as taxes charges or assessments for maintenance, repairs, or interest charges related to the improvements. Do not add them to your basis in the property.

**Deducting vs. capitalizing costs.** Do not add to your basis costs you can deduct 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 capitalize include carrying charges, such as interest and taxes, that you must pay to own property.

For more information about deducting or capitalizing costs and how to make the election, see *Carrying Charges* in Publication 535, chapter 7.

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

- Insurance or other payment you receive as the result of a casualty or theft loss.
- Casualty loss not covered by insurance for which you took a deduction.
- Amount(s) you receive for granting an easement.
- Residential energy credit you were allowed before 1986, or after 2005, if you added the cost of the energy items to the basis of your home.
- Exclusion from income of subsidies for energy conservation measures.

- Special depreciation allowance claimed on qualified property.
- Depreciation you deducted, or could have deducted, on your tax returns under the method of depreciation you chose. If you did not deduct enough or deducted too much in any year, see *Depreciation under Decreases to Basis* in Publication 551.

If your rental property was previously used as your main home, you must also decrease the basis by the following.

- Gain you postponed from the sale of your main home before May 7, 1997, if the replacement home was converted to your rental property.
- District of Columbia first-time homebuyer credit allowed on the purchase of your main home after August 4, 1997.
- Amount of qualified principal residence indebtedness discharged on or after January 1, 2007.

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## Claiming the Special Depreciation Allowance

For 2008, your residential rental property may qualify for a special 30% or 50% depreciation allowance. This allowance is figured before you figure your regular depreciation deduction.

Among other qualifications, this property must be located in the New York Liberty Zone, the Gulf Opportunity Zone, the Kansas disaster area, or other federally declared disaster areas. See Publication 946, chapter 3, for details. Also see the Instructions for Form 4562, *Line 14*.

If you qualify for, but choose not to take, a special depreciation allowance, you must attach a statement to your return. The details of this election are in Publication 946, chapter 3, and the Instructions for Form 4562, *Line 14*.

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## MACRS Depreciation

Most business and investment property placed in service after 1986 is depreciated using MACRS.

This section explains how to determine which MACRS depreciation system applies to your property. It also discusses other information you need to know before you can figure depreciation under MACRS. This information includes the property's:

- Recovery class,
- Applicable recovery period,
- Convention,
- Placed-in-service date,
- Basis for depreciation, and
- Depreciation method.



## Depreciation Systems

MACRS consists of two systems that determine how you depreciate your property—the General Depreciation System (GDS) and the Alternative Depreciation System (ADS). Generally, you must use GDS for property used in most rental activities, unless you elect ADS.

### Excluded Property

You cannot use MACRS for certain personal property (such as furniture or appliances) placed in service in your rental property in 2008 if it had been previously placed in service before 1987 when MACRS became effective.

Generally, personal property is excluded from MACRS if you (or a person related to you) owned or used it in 1986 or if your tenant is a person (or someone related to the person) who owned or used it in 1986. However, the property is not excluded if your 2008 deduction under MACRS (using a half-year convention) is less than the deduction you would have under ACRS. For more information, see *What Method Can You Use To Depreciate Your Property?* in Publication 946, chapter 1.

### Electing ADS

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

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 and nonresidential real property.

For property placed in service during 2008, you elect to use ADS by entering the depreciation on Form 4562, Part III, line 20.

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

### Property Classes Under GDS

Each item of property that can be depreciated under MACRS is assigned to a property class, determined by its class life. The property class generally determines the depreciation method, recovery period, and convention. The property classes under GDS 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.

Under MACRS, property that you placed in service during 2008 in your rental activities generally falls into one of the following classes.

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

This class also includes appliances, carpeting, furniture, etc., used in a residential rental real estate activity.

Depreciation on automobiles, certain computers, and cellular telephones is limited. See chapter 5 of Publication 946.

- **7-year property.** This class includes office furniture and equipment (desks, file cabinets, etc.). 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.
- **15-year property.** This class includes roads, fences, and shrubbery (if depreciable).
- **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. 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.



The other property 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.

## Recovery Periods Under GDS

The recovery period of property is the number of years over which you recover its cost or other basis. The recovery periods are generally longer under ADS than GDS.

The recovery period of property depends on its property class. Under GDS, the recovery period of an asset is generally the same as its property class.

Class lives and recovery periods for most assets are listed in *Appendix B* of Publication 946. See Table 2-1 for recovery periods of property commonly used in residential rental activities.

**Qualified Indian reservation property.** Shorter recovery periods are provided under MACRS for qualified Indian reservation property placed in service on Indian reservations. For more information, see chapter 4 of Publication 946.

**Additions or improvements to property.** Treat additions or improvements you make to

Table 2-1. **MACRS Recovery Periods for Property Used in Rental Activities**

Keep for Your Records



Type of Property	MACRS Recovery Period	
	General Depreciation System	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
Appliances, such as:		
Stoves		
Refrigerators . . . . .	5 years	9 years
Carpets . . . . .	5 years	9 years
Furniture used in rental property . . . . .	5 years	9 years
Office furniture and equipment, such as:		
Desks		
Files . . . . .	7 years	10 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, waterpipes, venting, etc. . . . .	27.5 years	40 years
Additions and improvements, such as a new roof . . . . .	The same recovery period as that 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 addition or improvement.	

your depreciable rental property as separate property items for depreciation purposes.

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

The recovery period for an addition or improvement to property begins on the later of:

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

**Example.** You own a residential rental house that you have been renting since 1986 and depreciating under ACRS. You built an addition onto the house and placed it in service in 2008. You must use MACRS for the addition. Under GDS, the addition is depreciated as residential rental property over 27.5 years.

## Conventions

A convention is a method established under MACRS to set the beginning and end of the recovery period. The convention you use determines the number of months for which you can claim depreciation in the year you place property in service and in the year you dispose of the property.

**Mid-month convention.** A mid-month convention is used for all residential rental property and nonresidential real property. Under this convention, you treat all property placed in service, or disposed of, during any month as placed in service, or disposed of, at the midpoint of that month.

**Mid-quarter convention.** A mid-quarter convention must be used if the mid-month convention does not apply and the total depreciable basis of MACRS property placed in service in the last 3 months of a tax year (excluding nonresidential real property, residential rental property, and property placed in service and disposed of in the same year) is more than 40% of the total basis of all such property you place in service during the year.

Under this convention, you treat all property placed in service, or disposed of, during any quarter of a tax year as placed in service, or disposed of, at the midpoint of the quarter.

**Example.** During the tax year, Tom Martin purchased the following items to use in his rental property. He elects not to claim the special depreciation allowance, discussed earlier.

- A dishwasher for \$400 that he placed in service in January.
- Used furniture for \$100 that he placed in service in September.
- A refrigerator for \$800 that 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 \$1,300. The \$800 basis of the refrigerator placed in service during the last 3 months of his tax year exceeds \$520 ( $40\% \times \$1,300$ ). Tom

must use the mid-quarter convention instead of the half-year convention for all three items.

**Half-year convention.** The half-year convention is used if neither the mid-quarter convention nor the mid-month convention applies. Under this convention, you treat all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, at the midpoint of that tax year.

If this convention applies, you deduct a half year of depreciation for the first year and the last year that you depreciate the property. You deduct a full year of depreciation for any other year during the recovery period.

## Figuring Your Depreciation Deduction

You can figure your MACRS depreciation deduction in one of two ways. The deduction is substantially the same both ways. You can either:

- Actually compute the deduction using the depreciation method and convention that apply over the recovery period of the property, or
- Use the percentage from the MACRS percentage tables, shown later.

In this publication we will use the percentage tables. For instructions on how to compute the deduction, see chapter 4 of Publication 946.

**Residential rental property.** You must use the straight line method and a mid-month convention for residential rental property. In the first year that you claim depreciation for residential rental property, you can claim depreciation only for the number of months the property is in use, and you must use the mid-month convention (explained under *Conventions*, earlier on this page).

**5-, 7-, or 15-year property.** For property in the 5- or 7-year class, use the 200% declining balance method and a half-year convention. However, in limited cases you must use the mid-quarter convention, if it applies. For property in the 15-year class, use the 150% declining balance method and a half-year convention.

You can also choose to use the 150% declining balance method for property in the 5- or 7-year class. The choice to use the 150% 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 make this election on Form 4562. In Part III, column (f), enter "150 DB." Once you make this election, you cannot change to another method.

If you use either the 200% or 150% declining balance method, you figure your deduction using the straight line method in the first tax year that the straight line method gives you an equal or 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 Part III, column (f), enter "S/L."

Once you make this election, you cannot change to another method.

## MACRS Percentage Tables

You can use the percentages in Table 2-2 (on the next page) to compute annual depreciation under MACRS. The tables show the percentages for the first few years or until the change to the straight line method is made. See *Appendix A* of Publication 946 for complete tables. The percentages in Tables 2-2a, 2-2b, and 2-2c make the change from declining balance to straight line in the year that straight line will give a larger deduction.

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 percentage tables.** You must apply the table rates to your property's unadjusted basis (defined below) each year of the recovery period.

Once you begin using a percentage 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 reason other than (1) or (2), 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 on this page under *Figuring Your Depreciation Deduction*. See *Figuring the Deduction Without Using the Tables* in Publication 946, chapter 4.

**Unadjusted basis.** This is the same basis you would use to figure gain on a sale (see *Basis of Depreciable Property* earlier), but without reducing your original basis by any MACRS depreciation taken in earlier years.

However, you do reduce your original basis by other amounts claimed on the property, including:

- Any amortization,
- Any section 179 deduction, and
- Any special depreciation allowance.

For more information, see Publication 946, chapter 4.

**Tables 2-2a, 2-2b, and 2-2c.** The percentages in these tables take into account the half-year and mid-quarter conventions. Use Table 2-2a for 5-year property, Table 2-2b for 7-year property, and Table 2-2c for 15-year property. Use the percentage in the second column (half-year convention) unless you are required to 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.

Table 2-2. Optional MACRS GDS Percentage Tables

a. MACRS 5-Year Property (200% DB)

Year	Half-year convention	Mid-quarter convention			
		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

b. MACRS 7-Year Property (200% DB)

Year	Half-year convention	Mid-quarter convention			
		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	8.85	8.73
7	8.93	8.75	8.87	8.86	8.73

c. MACRS 15-Year Property (150% DB)

Year	Half-year convention	Mid-quarter convention			
		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
7	5.90	5.90	5.91	5.90	5.90
8	5.90	5.91	5.90	5.90	5.90

d. Residential Rental Property (27.5-year S/L with mid-month convention)

	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

you are required to use the mid-quarter convention to figure depreciation on both the stove and refrigerator.

Because you placed the refrigerator in service in October, you use the fourth quarter column of Table 2-2a and find the depreciation percentage for Year 1 is 5%. Your depreciation deduction for the refrigerator is \$50 (\$1,000 × .05).

Because you placed the stove in service in June, you use the second quarter column of Table 2-2a and find the depreciation percentage for Year 1 is 25%. For that year, your depreciation deduction for the stove is \$150 (\$600 × .25).

**Table 2-2d.** 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. Continue to use the same row (month) under the column for the appropriate year.

**Example.** You purchased a single family rental house for \$185,000 and placed it in service on February 8. The sales contract showed that the building cost \$160,000 and the land cost \$25,000. Your basis for depreciation is its original cost, \$160,000. Using Table 2-2d, you find that the percentage for property placed in service in February of Year 1 is 3.182%. That year's depreciation deduction is \$5,091 (\$160,000 × .03182).

## Figuring MACRS Depreciation Under ADS

Table 2-1, earlier, shows the ADS recovery periods for property used in rental activities.

See *Appendix B* in Publication 946 for other property. If your property is not listed in *Appendix B*, it is considered to have no class life. Under ADS, personal property with no class life is depreciated using a recovery period of 12 years.

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

## Claiming the Correct Amount of Depreciation

You should claim the correct amount of depreciation each tax year. If you did not claim all the depreciation you were entitled to deduct, you must still reduce your basis in the property by the full amount of depreciation that you could have deducted. For more information, see *Depreciation under Decreases to Basis* in Publication 551.

If you deducted an incorrect amount of depreciation for property in any year, you may be able to make a correction by filing Form 1040X, Amended U.S. Individual Income Tax Return. If you are not allowed to make the correction on an

**Example 1.** You purchased a stove and refrigerator and placed them in service in June. Your basis in the stove is \$600 and your basis in the refrigerator is \$1,000. Both are 5-year property. Using the half-year convention column in Table 2-2a, the depreciation percentage for Year 1 is 20%. For that year your depreciation deduction is \$120 (\$600 × .20) for the stove and \$200 (\$1,000 × .20) for the refrigerator.

For Year 2, the depreciation percentage is 32%. That year's depreciation deduction will be

\$192 (\$600 × .32) for the stove and \$320 (\$1,000 × .32) for the refrigerator.

**Example 2.** Assume the same facts as in *Example 1*, except you buy the refrigerator in October instead of June. Since the refrigerator was placed in service in the last 3 months of the tax year, and its basis (\$1,000) is more than 40% of the total basis of all property placed in service during the year (\$1,600 × .40 = \$640),

amended return, you can change your accounting method to claim the correct amount of depreciation.

**Filing an amended return.** You can file an amended return to correct the amount of depreciation claimed for any property in any of the following situations.

- You claimed the incorrect amount because of a mathematical error made in any year.
- You claimed the incorrect amount because of a posting error made in any year.
- You have not adopted a method of accounting for property placed in service by you in tax years ending after December 29, 2003.
- You claimed the incorrect amount on property placed in service by you in tax years ending before December 30, 2003.

Generally, you adopt a method of accounting for depreciation by using a permissible method of determining depreciation when you file your first tax return for the property used in your rental activity. This also occurs when you use the same impermissible method of determining depreciation (for example, using the wrong MACRS recovery period) in two or more consecutively filed tax returns.

If an amended return is allowed, you must file it by the later of the following dates.

- 3 years from the date you filed your original return for the year in which you did not deduct the correct amount. A return filed before an unextended due date is considered filed on that due date.
- 2 years from the time you paid your tax for that year.

**Changing your accounting method.** To change your accounting method, you generally must file Form 3115, Application for Change in Accounting Method, to get the consent of the IRS. In some instances, that consent is automatic. For more information, see *Changing Your Accounting Method* in Publication 946, chapter 1.

## 3. Reporting Rental Income, Expenses, and Losses

Figuring the net income or loss for a residential rental activity may involve more than just listing the income and deductions on Schedule E

(Form 1040). First, there are those activities which do not qualify to use Schedule E.

Then there are the limitations which may need to be applied if you have a net loss on Schedule E. There are two: (1) the limitation based on the amount of investment you have at risk in your rental activity, and (2) the special limits imposed on passive activities.

You may also have a loss (or gain) related to your rental property from a casualty or theft. This is considered separately from the income and expense information on Schedule E.

## Which Forms To Use

The basic form for reporting residential rental income and expenses is Schedule E. However, do not use that schedule to report a not-for-profit activity. See *Not Rented For Profit*, in chapter 4. There are also other rental situations in which forms other than Schedule E would be used.

### Schedule C (Form 1040)

Generally, Schedule C is used when you materially participate in your residential rental activity.

**Providing substantial services.** If you provide substantial 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, Profit or Loss From Business, or Schedule C-EZ, Net Profit From Business. Use Form 1065, U.S. Return of Partnership Income, if your rental activity is a partnership (including a partnership with your spouse). Substantial services do not include the furnishing of heat and light, cleaning of public areas, trash collection, etc. For information, see Publication 334, Tax Guide for Small Business. Also, you may have to pay self-employment tax on your rental income using Schedule SE (Form 1040), Self-Employment Tax. For a discussion of "substantial services," see *Real Estate Rents* in Publication 334, chapter 5.

**Qualified joint venture.** If you and your spouse each materially participate (see *Material participation* on this page) as the only members of a jointly owned and operated rental real estate business, and you file a joint return for the tax year, you can make a joint election to be treated as a qualified joint venture instead of a partnership.

If you make this election, instead of filing Schedule E or Form 1065, you and your spouse must each file a separate Schedule C or C-EZ reporting the appropriate share of income and deductions. Rental real estate income generally is not included in net earnings from self-employment subject to self-employment tax and generally is subject to the passive loss limitation rules. Electing qualified joint venture status and using the Schedule C or C-EZ does not alter the application of the self-employment tax or the passive loss limitation rules.

If you and your spouse filed a Form 1065 for the year prior to the election, the partnership terminates at the end of the tax year immediately preceding the year the election takes effect.

**Real estate professional.** If you meet the qualifications discussed on this page, report

your rental income and expenses on Schedule C or C-EZ (or Form 1065 if a partnership). Use Schedule SE to figure your self-employment tax. Also, complete line 43 of Schedule E.

You qualify as a real estate professional for the tax year if you meet both of the following requirements.

- More than half of the personal services you perform in all trades or businesses during the tax year are performed in real property trades or businesses in which you materially participate.
- You perform more than 750 hours of services during the tax year in real property trades or businesses in which you materially participate.

For purposes of meeting these qualifications, each interest in rental real estate is a separate activity, unless you elect to treat all your interests in rental real estate as one activity.

Do not count personal services you perform as an employee in real property trades or businesses unless you are a 5% owner of your employer. You are a 5% owner if you own (or are considered to own) more than 5% of your employer's outstanding stock, or capital or profits interest.

Do not count your spouse's personal services to determine whether you met the requirements listed above. However, you can count your spouse's participation in an activity in determining if you materially participated.

**Real property trades or businesses.** A real property trade or business is a trade or business that does any of the following with real property.

- Develops or redevelops it.
- Constructs or reconstructs it.
- Acquires it.
- Converts it.
- Rents or leases it.
- Operates or manages it.
- Brokers it.

**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 Schedule E for information about making this choice.

**Material participation.** Generally, you materially participated in an activity for the tax year if you were involved in its operations on a regular, continuous, and substantial basis during the year. For details, see Publication 925 or the instructions for Schedule C.

**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.

## Schedule E (Form 1040)

If you rent buildings, rooms, or apartments, and provide only heat and light, trash collection, etc., you normally report your rental income and expenses on Schedule E, Part I.

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.

On Schedule E, page 1, line 20, enter the depreciation you are claiming for each property. To find out if you need to attach Form 4562, see Form 4562, below.

If you have a loss from your rental real estate activity, you also may need to complete one or both of the following forms.

- Form 6198, At-Risk Limitations. See *At-Risk Rules* on this page. Also see Publication 925.
- Form 8582, Passive Activity Loss Limitations. See *Passive Activity Limits* on this page.

Page 2 of Schedule E 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. Also, include the amount from line 26 (Part I) in the "Total income or (loss)" on line 41 (Part V).

**Form 4562.** You must complete and attach Form 4562 for rental activities only if you are claiming:

- Depreciation, including the special depreciation allowance, on property placed in service during 2008;
- Depreciation on listed property (such as a car), regardless of when it was placed in service; or
- Any other car expenses, including the standard mileage rate or lease expenses.

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

See Publication 946 for information on preparing Form 4562.

## Limits on Rental Losses

If you have a loss from your rental real estate activity, two sets of rules may limit the amount of

loss you can deduct. You must consider these rules in the order shown below. Both are discussed in this section.

1. At-risk rules. These rules are applied first if there is investment in your rental real estate activity for which you are not at risk. This applies only if the real property was placed in service after 1986.
2. Passive activity limits. Generally, rental real estate activities are considered passive activities and losses are not deductible unless you have income from other passive activities to offset them. However, there are exceptions.

## At-Risk Rules

You may be subject to the at-risk rules if you have:

- A loss from an activity carried on as a trade or business or for the production of income, and
- Amounts invested in the activity for which you are not fully at risk.

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. Any loss that is disallowed because of the at-risk limits is treated as a deduction from the same activity in the next tax year. See Publication 925 for a discussion of the at-risk rules.

**Form 6198.** If you are subject to the at-risk rules, file Form 6198, At-Risk Limitations, with your tax return.

## Passive Activity Limits

Generally, all rental real estate 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. For a discussion of activities that are not considered rental activities, see *Rental Activities* in Publication 925.

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. Two exceptions to the rules for figuring passive activity limits are discussed on this page.

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

**Form 8582.** You may have to complete Form 8582 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*, later in this chapter, to determine if you must complete Form 8582.

If you are required to complete Form 8582 and are also subject to the at-risk rules, include the amount from Form 6198, line 21 (deductible loss) in column (b) of Form 8582, Worksheet 1 or 3, as required.

## Exception for Personal Use of Dwelling Unit

If you used the rental property as a home during the year, any income, deductions, gain, or loss allocable to such use shall not be taken into account for purposes of the passive activity loss limitation. Instead, follow the rules explained in chapter 5, *Personal Use of Dwelling Unit (Including Vacation Home)*.

## Exception for Rental Real Estate With Active Participation

If you or your spouse actively participated in a passive rental real estate activity, you can deduct up to \$25,000 of loss from the activity from your nonpassive income. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities. Similarly, you can offset credits from the activity against the tax on up to \$25,000 of nonpassive income after taking into account any losses allowed under this exception.

**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.



*The special allowance is not available if you were married, lived with your spouse at any time during the year, and are filing a separate return.*

**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 or arranged for others to provide services (such as repairs) in a significant and *bona fide* sense. Management decisions that may count as active participation include approving new tenants, deciding on rental terms, approving expenditures, and other similar decisions.

**Example.** Mike is single and 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 was 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 made or contracted out by Mike.

Although the rental loss is 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.** The maximum special allowance is:

- \$25,000 for single individuals and married individuals filing a joint return for the tax year,
- \$12,500 for married individuals who file separate returns for the tax year and lived apart from their spouses at all times during the tax year, and
- \$25,000 for a qualifying estate reduced by the special allowance for which the surviving spouse qualified.

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

Generally, if your MAGI is \$150,000 or more (\$75,000 or more if you are married filing separately), there is no special allowance.

**Modified adjusted gross income (MAGI).** This is your adjusted gross income from Form 1040, line 38, or Form 1040NR, line 36, figured without taking into account:

1. The taxable amount of social security or equivalent tier 1 railroad retirement benefits,
2. The deduction allowed for contributions to IRAs or certain other qualified retirement plans,
3. The exclusion from income of interest from Series EE and I U.S. savings bonds used to pay higher educational expenses,
4. The exclusion of amounts received under an employer's adoption assistance program,
5. Any passive activity income or loss included on Form 8582,
6. Any rental real estate loss allowed to real estate professionals,
7. Any overall loss from a publicly traded partnership (see *Publicly Traded Partnerships (PTPs)* in the Instructions for Form 8582),
8. The deduction allowed for one-half of self-employment tax,
9. The deduction allowed for interest paid on student loans,
10. The deduction for qualified tuition and related fees, and
11. The domestic production activities deduction (see the Instructions for Form 8903).

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

- Your only passive activities were rental real estate activities in which you actively participated.
- Your overall net loss from these activities is \$25,000 or less (\$12,500 or less if married filing separately).
- If married filing separately, you lived apart from your spouse all year.
- You have no prior year unallowed losses from these activities.
- You have no current or prior year unallowed credits from passive activities.
- Your MAGI is \$100,000 or less (\$50,000 or less if married filing separately and you lived apart from your spouse all year).
- 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. On line 23 of your Schedule E, enter each rental real estate loss shown on on line 22.

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.

## Casualties and Thefts

As a result of a casualty or theft, you may have a loss related to your rental property. You may be able to deduct the loss on your income tax return.

**Casualty.** This is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. Such events include a storm, fire, or earthquake.

**Theft.** This is defined as the unlawful taking and removing of your money or property with the intent to deprive you of it.

**Gain from casualty or theft.** It is also possible to have a gain from a casualty or theft if you receive money, including insurance, that is more than your adjusted basis in the property. Generally, you must report this gain. However, under certain circumstances, you may defer paying tax by choosing to postpone reporting the gain. To do this, you generally must buy replacement property within 2 years after the close of the first tax year in which any part of your gain is realized. Generally, the replacement period is 5 years for property located in disaster areas. The cost of the replacement property must be equal to or more than the net insurance or other payment you received.

**More information.** For information on business and nonbusiness casualty and theft losses, see Publication 547.

**How to report.** If you had a casualty or theft that involved property used in your rental activity, figure the net gain or loss in Section B of Form 4684, Casualties and Thefts. Follow the Instructions for Form 4684 for where to carry your net gain or loss.

## Illustrated Example

In February 2003, Marie Pfister bought a rental house for \$135,000 (house \$120,000 and land \$15,000) and immediately began renting it out. In 2008, she rented it all 12 months for a monthly rental fee of \$800. In addition to her rental income of \$9,600 (12 x \$800), Marie had the following expenses.

Mortgage interest . . . . .	\$8,000
Fire insurance (1-year policy) . . . . .	250
Miscellaneous repairs . . . . .	400
Real estate taxes imposed and paid . . . . .	500
Maintenance . . . . .	200

Marie depreciates the residential rental property under MACRS GDS. This means using the straight line method over a recovery period of 27.5 years.

She uses Table 2-2d to find her depreciation percentage. Because she placed the property in service in February 2003, she continues to use that row of Table 2-2d. For year 6, the rate is 3.636%.

Marie figures her net rental income or loss for the house as follows:

Total rental income received (\$800 x 12) . . . . .	\$9,600
Minus: Expenses	
Mortgage interest . . . . .	\$8,000
Fire insurance . . . . .	250
Miscellaneous repairs . . . . .	400
Real estate taxes . . . . .	500
Maintenance . . . . .	200
Total expenses . . . . .	<u>-9,350</u>
Balance . . . . .	250
Minus: Depreciation (\$120,000 x 3.636) . . . . .	<u>-4,363</u>
<b>Net rental loss for house . . . . .</b>	<b><u>\$4,113</u></b>

Marie had a net loss for the year. Because she actively participated in her passive rental real estate activity and her loss was less than \$25,000, she can deduct the loss on her return. Marie also meets all of the requirements for not having to file Form 8582. She uses Schedule E, Part I, to report her rental income and expenses. She enters her income, expenses, and depreciation for the house in the column for Property A and enters her loss on line 23. Marie's Schedule E is shown next. Form 4562 is not required. See Publication 946 for information on how to prepare Form 4562.

**SCHEDULE E  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service (99)

**Supplemental Income and Loss**

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

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

OMB No. 1545-0074

**2008**

Attachment  
Sequence No. **13**

Name(s) shown on return

Marie Pfister

Your social security number

444 : 00 : 8888

**Part I Income or Loss From Rental Real Estate and Royalties** Note. If you are in the business of renting personal property, use Schedule C or C-EZ (see page E-3). If you are an individual, report farm rental income or loss from Form 4835 on page 2, line 40.

1	List the type and address of each rental real estate property:	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:	
			Yes	No
A	Rental house 444 Maple Ave, Anywhere, WI 55555	• 14 days or • 10% of the total days rented at fair rental value? (See page E-3)	A	✓
B			B	
C			C	

Income:	Properties			Totals (Add columns A, B, and C.)
	A	B	C	
3 Rents received . . . . .	3 9,600			3 9,600
4 Royalties received . . . . .	4			4
<b>Expenses:</b>				
5 Advertising . . . . .	5			
6 Auto and travel (see page E-4) . . . . .	6			
7 Cleaning and maintenance. . . . .	7 200			
8 Commissions . . . . .	8			
9 Insurance . . . . .	9 250			
10 Legal and other professional fees . . . . .	10			
11 Management fees. . . . .	11			
12 Mortgage interest paid to banks, etc. (see page E-5) . . . . .	12 8,000			12 8,000
13 Other interest . . . . .	13			
14 Repairs . . . . .	14 400			
15 Supplies . . . . .	15			
16 Taxes. . . . .	16 500			
17 Utilities . . . . .	17			
18 Other (list) ▶ . . . . .	18			
19 Add lines 5 through 18 . . . . .	19 9,350			19 9,350
20 Depreciation expense or depletion (see page E-5) . . . . .	20 4,363			20 4,363
21 Total expenses. Add lines 19 and 20 . . . . .	21 13,713			
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-5 to find out if you must file Form 6198 . . . . .	22 (4,113)			
23 Deductible rental real estate loss. <b>Caution.</b> Your rental real estate loss on line 22 may be limited. See page E-5 to find out if you must file Form 8582. Real estate professionals <b>must</b> complete line 43 on page 2 . . . . .	23 ( 4,113 )	( )	( )	
24 <b>Income.</b> Add positive amounts shown on line 22. <b>Do not</b> include any losses . . . . .	24			24
25 <b>Losses.</b> Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here.	25 ( 4,113 )			25 ( 4,113 )
26 <b>Total rental real estate and royalty income or (loss).</b> Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2 . . . . .	26 (4,113)			26 (4,113)

For Paperwork Reduction Act Notice, see page E-8 of the instructions.

Cat. No. 11344L

Schedule E (Form 1040) 2008

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## 4.

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# Special Situations

This chapter discusses some rental real estate activities that are subject to additional rules.

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## Condominiums

A condominium is most often a dwelling unit in a multi-unit building, but can also take other forms, such as a townhouse or garden apartment.

If you own a condominium, you also own a share of the common elements, 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.

Special rules apply if you rent your condominium to others. You can deduct as rental expenses all the expenses discussed in chapters 1 and 2. In addition, you can deduct any dues or assessments paid for maintenance of the common elements.

You cannot deduct special assessments you pay to a condominium management corporation for improvements. However, you may be able to recover your share of the cost of any improvement by taking depreciation.

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## Cooperatives

If you live in a cooperative, you do not own your apartment. Instead, a corporation owns the apartments and you are a tenant-stockholder in the cooperative housing corporation. If you rent your apartment to others, you usually can deduct, as a rental expense, all the maintenance fees you pay to the cooperative housing corporation.

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.

## Depreciation

You will be depreciating your stock in the corporation rather than the apartment itself. Figure your depreciation deduction as follows.

1. Figure the depreciation for all the depreciable real property owned by the corporation. (Depreciation methods are discussed in chapter 2 of this publication and Publication 946.) If you bought your cooperative stock after its first offering, figure the depreciable basis of this property as follows.

- a. Multiply your cost per share by the total number of outstanding shares.
  - b. Add to the amount figured in (a) any mortgage debt on the property on the date you bought the stock.
  - c. Subtract from the amount figured in (b) any mortgage debt that is not for the depreciable real property, such as the part for the land.
2. Subtract from the amount figured in (1) any depreciation for space owned by the corporation that can be rented but cannot be lived in by tenant-stockholders.
  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 result of (2) by the percentage you figured in (3). This is your depreciation on the stock.

Your depreciation deduction for the year cannot be more than the part of your adjusted basis (defined in chapter 2) in the stock of the corporation that is allocable to your rental property.

**Payments added to capital account.** Payments earmarked for a capital asset or improvement, or otherwise charged to the corporation's capital account are added to the basis of your stock in the corporation. 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.

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 manner.

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.

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## 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 the beginning of your tax year, you must divide yearly expenses, such as 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 include the home mortgage interest, qualified mortgage insurance premiums, and real estate tax expenses for the part of the year the property was held for personal use as an itemized deduction on Schedule A (Form 1040). If you are unable to itemize your deductions, there is a new option for deducting real estate tax (see below).

**Example.** Your tax year is the 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.

When figuring depreciation, treat the property as placed in service on June 1.

**Adding real estate taxes to standard deduction.** If you are not able to itemize your deductions on your 2008 tax return, you may be able to deduct all or part of the real estate tax you paid on property held for personal use. Take the deduction (limited to \$500 (\$1,000 if married filing jointly)) on Form 1040, line 40. See the Form 1040 instructions for line 39c.

## Basis of Property Changed to Rental Use

When you change property you held for personal use to rental use (for example, you rent your former home), the basis for depreciation will be the lesser of fair market value or adjusted basis on the date of conversion.

**Fair market value.** This is the price at which the property would change hands between a willing buyer and a willing 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 additions or improvements since you acquired it, minus deductions for any casualty or theft losses claimed on earlier years' income tax returns and other decreases to basis. For other increases and decreases to basis, see *Adjusted Basis* in chapter 1.

**Example.** Several years ago you built your home for \$140,000 on a lot that cost you \$14,000. Before changing the property to rental use this year, you added \$28,000 of permanent improvements to the house and claimed a \$3,500 casualty loss deduction for damage to the house. Part of the improvements qualified for a \$500 residential energy credit, which you



claimed on your 2006 tax return. 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 its use was \$164,000 (\$140,000 + \$28,000 – \$3,500 – \$500).

On the date of the change in use, your property had a fair market value of \$168,000, of which \$21,000 was for the land and \$147,000 was for the house.

The basis for depreciation on the house is the fair market value on the date of the change (\$147,000), because it is less than your adjusted basis (\$164,000).

## Cooperatives

If you change your cooperative apartment to rental use, figure your allowable depreciation as explained earlier. The basis of all the depreciable real property owned by the cooperative housing corporation is the smaller of the following amounts.

- The fair market value of the property on the date you change your apartment to rental use. This is considered to be the same as the corporation's adjusted basis minus straight line depreciation, unless this value is unrealistic.
- The corporation's adjusted basis in the property on that date. Do not subtract depreciation when figuring the corporation's adjusted basis.

If you bought the stock after its first offering, the corporation's adjusted basis in the property is the amount figured in (1) under *Depreciation* (under *Cooperative*, near the beginning of this chapter). The fair market value of the property is considered to be the same as the corporation's adjusted basis figured in this way minus straight line depreciation, unless the value is unrealistic.

## Figuring the Depreciation Deduction

To figure the deduction, use the depreciation system in effect when you convert your residence to rental use. Generally, that will be MACRS for any conversion after 1986. Treat the property as placed in service on the conversion date.

**Example.** Your converted residence (see previous example) was available for rent on August 1. Using Table 2-2d (see chapter 2), the percentage for Year 1 beginning in August is 1.364% and the depreciation deduction for Year 1 is \$2,005 (\$147,000 × .01364).

## 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 the expenses related to the part of the property used for rental purposes, such as home mortgage interest, qualified mortgage insurance premiums, and real estate taxes, as rental expenses on Schedule E (Form 1040). You can also deduct as rental expenses a portion of other expenses that normally are nondeductible personal expenses, such as expenses for electricity, or painting the outside of the house.

There is no change in the types of expenses deductible for the personal-use part of your property. Generally, these expenses may be deducted only if you itemize your deductions on Schedule A. For an exception, see *Adding real estate taxes to standard deduction under Property Changed to Rental Use*.

You cannot deduct any part of the cost of the first 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. For example, 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 on the part of the house used for rental purposes as well as on the furniture and equipment you use for rental 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. The two most common methods for dividing an expense are (1) the number of rooms in your home, and (2) 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 that you cannot deduct.

**Duplex.** A common situation is the duplex where you live in one unit and rent out the other. Certain expenses apply to the entire property, such as mortgage interest and real estate taxes, and must be split to determine rental and personal expenses.

**Example.** You own a duplex and live in one half, renting the other half. Both units are approximately the same size. Last year, you paid a total of \$10,000 mortgage interest and \$2,000 real estate taxes for the entire property. You can deduct \$5,000 mortgage interest and \$1,000 real estate taxes on Schedule E, and if you itemize your deductions, you can deduct the

other \$5,000 mortgage interest and \$1,000 real estate taxes on Schedule A.

## 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 deduct a loss or carry forward to the next year any rental expenses that are more than your rental income for the year.

**Where to report.** Report your not-for-profit rental income on Form 1040 or 1040NR, line 21. For example, if you are filing Form 1040, you can include your mortgage interest and any qualified mortgage insurance premiums (if you use the property as your main home or second home), real estate taxes, and casualty losses on the appropriate lines of Schedule A if you itemize your deductions.

Claim your other rental expenses, subject to the rules explained in chapter 1 of Publication 535, as miscellaneous itemized deductions on Schedule A (Form 1040), line 23, (Schedule A (Form 1040NR), line 11). You can deduct these expenses only if they, together with certain other miscellaneous itemized deductions, total more than 2% of your adjusted gross income.

**Presumption of profit.** 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.

**Postponing decision.** If you are starting your rental activity and do not have 3 years showing a profit, you can elect to have the presumption made after you have the 5 years of experience required by the test. You may choose to postpone the decision of whether the rental is for profit by filing Form 5213. You must file Form 5213 within 3 years after the due date of your return (determined without extensions) for the year in which you first carried on the activity or, if earlier, within 60 days after receiving written notice from the Internal Revenue Service proposing to disallow deductions attributable to the activity.

**More information.** For more information about the rules for an activity not engaged in for profit, see *Not-for-Profit Activities* in chapter 1 of Publication 535.

## Illustrated Example—Property Changed to Rental Use

In January, Eileen Johnson 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. Eileen selected a tenant and started renting the house on February 1. Eileen charges \$750 a month for rent and collects it herself. Eileen also received a \$750 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 rental 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 . . . . .	1,200

Eileen 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 include the balance of the allowable taxes and mortgage interest on Schedule A if she itemizes. She cannot deduct the balance of the fire insurance because it is a personal expense.

Eileen bought this house in 1983 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, Eileen added several improvements to the house. She figures her adjusted basis as follows:

Improvements	Cost
House . . . . .	\$25,000
Remodeled kitchen . . . . .	4,200
Recreation room . . . . .	5,800
New roof . . . . .	1,600
Patio and deck . . . . .	<u>2,400</u>
<b>Adjusted basis</b> . . . . .	<b><u>\$39,000</u></b>

On February 1, when Eileen changed her house to rental property, the property had a fair market value of \$152,000. Of this amount, \$35,000 was for the land and \$117,000 was for the house.

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

As specified for residential rental property, Eileen must use the straight line method of depreciation over the GDS or ADS recovery period. She chooses the GDS recovery period of 27.5 years.

She uses Table 2-2d to find her depreciation percentage. Since she placed the property in service in February, the percentage is 3.182%.

On April 1, Eileen bought a new dishwasher for the rental property at a cost of \$425. The dishwasher is personal property used in a rental real estate activity, which has a 5-year recovery period. She uses Table 2-2a to find the percentage for Year 1 under "Half-year convention" (20%) to figure her depreciation deduction.

On May 1, Eileen paid \$4,000 to have a furnace installed in the house. The furnace is residential rental property. Because she placed the property in service in May, the percentage from Table 2-2d is 2.273%.

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

Total rental income received (\$750 × 11) . . . . .	\$8,250
Minus: Expenses	
Mortgage interest (\$1,800 × <sup>11</sup> / <sub>12</sub> ) . . . . .	\$1,650
Fire insurance (\$100 × <sup>11</sup> / <sub>12</sub> ) . . . . .	92
Miscellaneous repairs . . . . .	297
Real estate taxes (\$1,200 × <sup>11</sup> / <sub>12</sub> ) . . . . .	<u>1,100</u>
Total expenses . . . . .	<u>3,139</u>
Balance . . . . .	\$5,111
Minus: Depreciation	
House (\$39,000 × .03182) . . . . .	\$1,241
Dishwasher (\$425 × .20) . . . . .	85
Furnace (\$4,000 × .02273) . . . . .	<u>91</u>
Total depreciation . . . . .	<u>1,417</u>
<b>Net rental income for house</b>	<b><u>\$3,694</u></b>

Eileen uses Schedule E, Part I, to report her rental income and expenses. She enters her rental income, expenses, and depreciation for the house in the column for Property A. Since all property was placed in service this year, Eileen must use Form 4562 to figure the depreciation. Eileen's Schedule E and Form 4562 are shown next. See the Instructions for Form 4562 for more information on preparing the form.

**SCHEDULE E  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service (99)

**Supplemental Income and Loss**

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

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

OMB No. 1545-0074

**2008**

Attachment  
Sequence No. **13**

Name(s) shown on return

Eileen Johnson

Your social security number

123 : 00 : 4567

**Part I Income or Loss From Rental Real Estate and Royalties** Note. If you are in the business of renting personal property, use Schedule C or C-EZ (see page E-3). If you are an individual, report farm rental income or loss from Form 4835 on page 2, line 40.

<b>1</b>	List the type and address of each rental real estate property:	<b>2</b>	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:	<b>Yes</b>	<b>No</b>
<b>A</b>	Brick House 123 Main Street, Hometown, MN 56200		<ul style="list-style-type: none"> <li>• 14 days or</li> <li>• 10% of the total days rented at fair rental value?</li> </ul> (See page E-3)	<b>A</b>	✓
<b>B</b>				<b>B</b>	
<b>C</b>				<b>C</b>	

Income:	Properties			Totals (Add columns A, B, and C.)
	A	B	C	
<b>3</b> Rents received . . . . .	<b>3</b> 8,250			<b>3</b> 8,250
<b>4</b> Royalties received . . . . .	<b>4</b>			<b>4</b>
<b>Expenses:</b>				
<b>5</b> Advertising . . . . .	<b>5</b>			
<b>6</b> Auto and travel (see page E-4) . . . . .	<b>6</b>			
<b>7</b> Cleaning and maintenance. . . . .	<b>7</b>			
<b>8</b> Commissions . . . . .	<b>8</b>			
<b>9</b> Insurance . . . . .	<b>9</b> 92			
<b>10</b> Legal and other professional fees . . . . .	<b>10</b>			
<b>11</b> Management fees. . . . .	<b>11</b>			
<b>12</b> Mortgage interest paid to banks, etc. (see page E-5) . . . . .	<b>12</b> 1,650			<b>12</b> 1,650
<b>13</b> Other interest . . . . .	<b>13</b>			
<b>14</b> Repairs . . . . .	<b>14</b> 297			
<b>15</b> Supplies . . . . .	<b>15</b>			
<b>16</b> Taxes. . . . .	<b>16</b> 1,100			
<b>17</b> Utilities . . . . .	<b>17</b>			
<b>18</b> Other (list) ▶ . . . . .	<b>18</b>			
<b>19</b> Add lines 5 through 18 . . . . .	<b>19</b> 3,139			<b>19</b> 3,139
<b>20</b> Depreciation expense or depletion (see page E-5) . . . . .	<b>20</b> 1,417			<b>20</b> 1,417
<b>21</b> Total expenses. Add lines 19 and 20	<b>21</b> 4,556			
<b>22</b> 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-5 to find out if you must file Form 6198 . . . . .	<b>22</b> 3,694			
<b>23</b> Deductible rental real estate loss. <b>Caution.</b> Your rental real estate loss on line 22 may be limited. See page E-5 to find out if you must file Form 8582. Real estate professionals <b>must</b> complete line 43 on page 2 . . . . .	<b>23</b> ( ) ( ) ( )			
<b>24</b> <b>Income.</b> Add positive amounts shown on line 22. <b>Do not</b> include any losses . . . . .	<b>24</b>			<b>24</b> 3,694
<b>25</b> <b>Losses.</b> Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here.	<b>25</b>			<b>25</b> ( )
<b>26</b> <b>Total rental real estate and royalty income or (loss).</b> Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2 . . . . .	<b>26</b>			<b>26</b> 3,694

**Depreciation and Amortization**  
**(Including Information on Listed Property)**

▶ See separate instructions. ▶ Attach to your tax return.

Name(s) shown on return Eileen Johnson	Business or activity to which this form relates Rental house	Identifying number 123-00-4567
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**Part I Election To Expense Certain Property Under Section 179**  
**Note: If you have any listed property, complete Part V before you complete Part I.**

1 Maximum amount. See the instructions for a higher limit for certain businesses . . . . .	<b>1</b>	\$250,000
2 Total cost of section 179 property placed in service (see instructions) . . . . .	<b>2</b>	
3 Threshold cost of section 179 property before reduction in limitation (see instructions) . . . . .	<b>3</b>	\$800,000
4 Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0- . . . . .	<b>4</b>	
5 Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions . . . . .	<b>5</b>	
<b>6</b>		
(a) Description of property	(b) Cost (business use only)	(c) Elected cost
<b>7</b>		
7 Listed property. Enter the amount from line 29 . . . . .	<b>7</b>	
8 Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7 . . . . .	<b>8</b>	
9 Tentative deduction. Enter the <b>smaller</b> of line 5 or line 8. . . . .	<b>9</b>	
10 Carryover of disallowed deduction from line 13 of your 2007 Form 4562 . . . . .	<b>10</b>	
11 Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	<b>11</b>	
12 Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11 . . . . .	<b>12</b>	
13 Carryover of disallowed deduction to 2009. Add lines 9 and 10, less line 12 ▶	<b>13</b>	

**Note: Do not use Part II or Part III below for listed property. Instead, use Part V.**

**Part II Special Depreciation Allowance and Other Depreciation (Do not include listed property.) (See instructions.)**

14 Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see instructions) . . . . .	<b>14</b>	
15 Property subject to section 168(f)(1) election . . . . .	<b>15</b>	
16 Other depreciation (including ACRS) . . . . .	<b>16</b>	

**Part III MACRS Depreciation (Do not include listed property.) (See instructions.)**

**Section A**

17 MACRS deductions for assets placed in service in tax years beginning before 2008 . . . . .	<b>17</b>	
18 If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here <input type="checkbox"/> . . . . .		

**Section B—Assets Placed in Service During 2008 Tax Year Using the General Depreciation System**

(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
<b>19a</b> 3-year property						
<b>b</b> 5-year property		425	5 years	HY	200% DB	85
<b>c</b> 7-year property						
<b>d</b> 10-year property						
<b>e</b> 15-year property						
<b>f</b> 20-year property						
<b>g</b> 25-year property			25 yrs.		S/L	
<b>h</b> Residential rental property	2/2008	39,000	27.5 yrs.	MM	S/L	1,241
	5/2008	4,000	27.5 yrs.	MM	S/L	91
<b>i</b> Nonresidential real property			39 yrs.	MM	S/L	

**Section C—Assets Placed in Service During 2008 Tax Year Using the Alternative Depreciation System**

<b>20a</b> Class life						
<b>b</b> 12-year			12 yrs.		S/L	
<b>c</b> 40-year			40 yrs.	MM	S/L	

**Part IV Summary (See instructions.)**

21 Listed property. Enter amount from line 28 . . . . .	<b>21</b>	
22 <b>Total.</b> Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instr. . . . .	<b>22</b>	1,417
23 For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs . . . . .	<b>23</b>	

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## 5.

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# Personal Use of Dwelling Unit (Including Vacation Home)

In chapter 1, we looked at the rules for residential rental activities where the rental dwelling unit was separate from where you lived. In this chapter, we are looking at rental activities where the same dwelling unit is used both as your home (or is considered to be your home) and as a rental. This might be a vacation home or your main home, a recreational vehicle or a boat. In this case, expenses must be divided between rental use and personal use, and you will not be able to deduct rental expenses that are more than your rental income for that dwelling unit.

**Dwelling unit.** A dwelling unit includes a house, apartment, condominium, mobile home, boat, vacation home, or similar property. It also includes all structures or other property belonging to the dwelling unit. A dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities.

A dwelling unit does not include property (or part of the 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 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. This room is used solely as a hotel, motel, inn, or similar establishment and is not a dwelling unit.

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## What Is a Day of Personal Use

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

1. You or any other person who owns an interest in it, unless you rent it to another owner as his or her main home under a shared equity financing agreement (defined on this page). However, see *Exception for Use as Main Home Before or After Renting under Dwelling Unit Used As a Home*, later.
2. A member of your family or a member of the family of any other person who owns an interest in it, unless the family member uses the dwelling unit as his or her main

home and pays a fair rental price (defined on this page). Family includes only your spouse, brothers and sisters, half-brothers and half-sisters, 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 person or member of the family in (1) or (2) above has more than one home, his or her main home is ordinarily the one he or she 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 the 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 if you have days of personal use.

**Example 1.** You and your neighbor are co-owners of a condominium at the beach. Last year, you rented the unit to vacationers whenever possible. The unit was not used as a main home by anyone. Your neighbor used the unit for 2 weeks last year; you did not use it at all.

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 does not own any interest in this property. He uses it as his main home and pays you a fair rental price.

Your son’s use of the property is not personal use by you because your son is using it as his main home, he owns 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 cabin in the mountains to you. You each pay a fair rental price.

You are using your beach 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 cabin.

**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 Used for Repairs and Maintenance

Any day that you spend working substantially full time repairing and maintaining (not improving) 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.** Corey owns a cabin in the mountains that he rents for most of the year. He spends a week at the cabin with family members. Corey works on maintenance of the cabin 3 or 4 hours each day during the week and spends the rest of the time fishing, hiking, and relaxing. Corey’s family members, however, work substantially full time on the cabin each day during the week. The main purpose of being at the cabin that week is to do maintenance work. Therefore, the use of the cabin during the week by Corey and his family will not be considered personal use by Corey.

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## Dwelling Unit Used as a 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 *Figuring Rental Income and Deductions*, later in this chapter).

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 *What Is a Day of Personal Use*, earlier on this page.

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 use in applying (2) above. Instead, count it as a day of personal use in applying both (1) and (2) above (see *Example 3 under Fair rental price*, next). However, this rule does not apply when dividing expenses between rental and personal use (see *Dividing Expenses*, later, for details).

**Fair rental price.** A fair rental price for your property generally is the amount of rent 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 basement apartment at a fair rental price to college students during the regular school year. You rented to them on a 9-month lease (273 days). You figured 10% of the total days rented to others at a fair rental price is 27 days.

During June (30 days), your brothers stayed with you and lived in the basement apartment rent free.

Your basement apartment was used as a home because you used it for personal purposes for 30 days. Rent-free use by your brothers is considered personal use. Your personal use (30 days) is more than the greater of 14 days or 10% of the total days it was rented (27 days).

**Example 2.** You rented 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. You figured 10% of the total days rented to others at a fair rental price is 3 days.

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 27 days it was rented (3 days).

**Example 3.** You own a condominium apartment in a resort area. You rented it 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. You figured 10% of the total days rented to others at a fair rental price is 16 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 160 days it was rented (16 days).

## Exceptions to Use as a Home

Discussed below are exceptions to the rules for personal use of a rented dwelling unit.

### Exception for Minimal Rental Use

If you use the dwelling unit as a home and you rent it fewer than 15 days during the year, that period is not treated as rental activity. Do not include any of the rent in your income and do not deduct any of the rental expenses. See *Dwelling Unit Used as a Home*, earlier.

## Exception for Use as Main Home Before or After Renting

For purposes of determining whether a dwelling unit was used as a home, you may not have to count days you used the property as your main home before or after renting it or offering it for rent as days of personal use. Do not count them as days of personal use if:

- You rented or tried to rent the property for 12 or more consecutive months.
- 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.

However, this special rule does not apply when dividing expenses between rental and personal use. See *Property Changed to Rental Use* in chapter 4.

**Example 1.** On February 28, 2007, you moved out of the house you had lived in for 6 years because you accepted a job in another town. You rented your house at a fair rental price from March 15, 2007, to May 14, 2008 (14 months). On June 1, 2008, you moved back into your old house.

The days you used the house as your main home from January 1 to February 28, 2007, and from June 1 to December 31, 2008, are not counted as days of personal use. Therefore, you would use the rules in chapter 1 when figuring your rental income and expenses.

**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.

## Figuring Rental Income and Deductions

If you use a dwelling unit as a home during the year, how you figure your rental income and deductions depends on how many days the unit was rented at a fair rental price.

**Rented 15 days or more.** If you use a dwelling unit as a home and rent it 15 days or more during the year, include all your rental income in your income. See *Reporting Income and Deductions*, later in this chapter. 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, your deduction for certain rental expenses is limited.

## Dividing 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.

When dividing your expenses, follow these rules.

- 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.)
- Any day that the unit is available for rent but not actually rented is not a day of rental use.

**Example.** Your beach cottage was available for rent from June 1 through August 31 (92 days). Your family used 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 as follows.

- The cottage was used for rental a total of 85 days (92 – 7). The days it was available 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.
- You used the cottage for personal purposes for 14 days (the last 2 weeks in May).
- The total use of the cottage was 99 days (14 days personal use + 85 days rental use).
- 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 (8 days), 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 *Limit on Deductions*, next.

## Limit on Deductions

The rental activity discussed in this chapter—using the same dwelling unit for both rental and personal purposes—is not a passive activity. Instead, the limitation is based on the rental income from this activity.

If your rental expenses are more than your rental income, you cannot use the excess expenses to offset income from other sources. The excess can be carried forward to the next year and treated as rental expenses for the same

property. Any expenses carried forward to the next year will be subject to any limits that apply for that 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.

To figure your deductible rental expenses and any carryover to next year, use Worksheet 5-1 at the end of this chapter.

## Reporting Income and Deductions

When you use a dwelling unit both as a home and a rental unit, expenses must be divided between rental use and personal use, and you will not be able to deduct rental expenses that are more than your rental income for that dwelling unit.

Use Worksheet 5-1 to divide your expenses between rental and personal use. Follow the rules listed in chapter 3 to report your rental income and deductions. Personal expenses are not deductible except in the case of certain items such as mortgage interest and real estate taxes, which can be deducted if you itemize your personal deductions on Schedule A. See the instructions for Schedule A for more information on deducting these expenses. If you cannot itemize your deductions, see *Adding real estate taxes to standard deduction* in chapter 4.

## Illustrated Example

On June 1, Tim and Emily Donovan bought a vacation condominium to use as rental property. They began advertising in June that the property would be available for rent beginning July 1. The Donovans used the property for 10 days during June. They didn't have any tenants in July, so family and friends used it for the 15 days they weren't using the property themselves. On August 3, they began renting it for \$300 per week (a fair rental price) and rented it continuously through December 20. They had no tenants for the rest of December, so the Donovans used the property for the rest of the year.

They had the following costs associated with the vacation property for the 7 months they owned it.

Mortgage interest . . . . .	\$10,500
Real estate taxes . . . . .	300
Repairs . . . . .	400
Fire insurance . . . . .	120
Advertising . . . . .	150

The property was ready and available for rental use on July 1, so it was considered placed in service at that time. They figured \$1,200 depreciation for the 6 months it was available for rent.

## Completing Worksheet 5-1

The Donovans answer "Yes" to each of the questions at the top of Worksheet 5-1 and continue to Part I.

### Part I. Rental Use Percentage

**Line A.** The property was available for rent beginning July 1, so they enter the total number of days (184) from July 1 through December 31.

**Line B.** They had no tenants during the month of July or from December 21–31. They enter 42 days (31 days in July + 11 days in December).

**Line C.** Total days of rental use equals 142 (184 – 42).

**Line D.** Their days of personal use totaled 52 (10 days in June + 31 days in July + 11 days in December). They must include in their personal use any use by family and friends.

**Line E.** Total use of the property equals 194 days (142 + 52).

**Line F.** Rental use of the property is 73% (142 ÷ 194) of its total use for the year. In completing this worksheet, they will multiply any of their expenses that apply to both personal and rental use by 73% (.73).

### Part II. Allowable Rental Expenses

**Line 1.** The Donovans enter \$6,000 (20 weeks × \$300 per week), the total amount of rent they received for the year.

**Lines 2a–2e.** They enter \$7,665 (\$10,500 mortgage interest × .73) on line 2a and \$219 (\$300 real estate taxes × .73) on line 2b. On line 2d they enter the full \$150 spent on advertising because it is a direct rental expense that does not have to be divided. On line 2e, they enter \$8,034 (\$7,665 + \$219 + \$150).

Next, they enter the amounts from line 2a (\$7,665), line 2b (\$219), and line 2d (\$150) on the appropriate lines of Schedule E (see the illustrated form).

**Line 3.** Because \$6,000 minus \$8,034 is less than zero, the Donovans enter -0- on line 3. This shows that no additional rental expenses can be deducted on this year's return. They need to complete the rest of the worksheet to see what expenses can be carried over and deducted the following year if they have enough rental income.

**Lines 4a–4e.** The Donovans enter \$380 ((\$400 repairs + \$120 insurance) × .73) on lines 4a and 4d. They enter -0- on line 4e (the smaller of \$0 and \$380).

They do not make an entry on Schedule E for the direct expenses entered on line 4a because all of their rental income has been offset by the

expenses listed on lines 2a–2d. But see *Lines 7a–7b* below.

**Line 5.** They enter -0- on line 5.

**Lines 6a–6e.** The Donovans enter \$876 ((\$1,200 depreciation from 7/1 through 12/31) × .73) on lines 6b and 6d. Their entry on line 6e is -0-, the smaller of \$0 and \$876.

They do not make an entry on Schedule E for the depreciation listed on line 6b, again because all of their rental income has been offset. See *Lines 7a–7b* below.

### Part III. Carryover of Unallowed Expenses to Next Year

**Lines 7a–7b.** The Donovans enter \$380 (\$380 – \$0) on line 7a. On line 7b, they enter \$876 (\$876 – \$0). This means that they have operating expenses of \$380 and depreciation of \$876 to carry over to next year.

## Schedule E (Form 1040)

The Donovans have entered the rental portion of their deductible expenses from Worksheet 5-1 on the appropriate lines of Schedule E (Form 1040), as follows.

Line 5 . . . . .	\$ 150
Line 12 . . . . .	7,665
Line 16 . . . . .	219

**Line 19.** This is the total of lines 5 through 18.

**Line 20.** No entry is made because no depreciation deduction is allowed this year.

**Line 21.** This is the same as line 19 because there is no entry on line 20.

**Line 22.** The Donovans have a net loss of \$2,034 from this rental property. As instructed, they enter the amount in parentheses to show that it is a loss. Next, they read the instructions for Schedule E to see if they must file Form 6198. Since they are fully responsible for the investment in their vacation condominium, their investment is considered to be at-risk and they do not need to file Form 6198.

**Line 23.** To find out how much loss they can deduct, the Donovans refer to the instructions for Schedule E to see if they must file Form 8582. They determined that they can deduct the full loss shown on line 22 and that they meet all the criteria for not filing Form 8582 (see *Limits on Rental Losses* in chapter 3). Their line 23 entry is (2,034).

**Lines 25 and 26.** The Donovans do not have any other rental or royalty property, so they enter their \$2,034 loss on lines 25 and 26. They also enter the loss on line 17 of their Form 1040.



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

**PART I. Rental Use Percentage**

A. Total days available for rent at fair rental price . . . . .	A.	184	
B. Total days available for rent (line A) but not rented . . . . .	B.	42	
C. <b>Total days of rental use.</b> Subtract line B from line A . . . . .	C.	142	
D. <b>Total days of personal use</b> (including days rented at less than fair rental price) . . . . .	D.	52	
E. <b>Total use of the property.</b> Add lines C and D . . . . .	E.	194	
F. <b>Percentage of expenses allowed for rental.</b> Divide line C by line E . . . . .	F.	.73	

**PART II. Allowable Rental Expenses**

1. Enter rents received . . . . .			1. 6,000
2a. Enter the rental portion of deductible home mortgage interest and qualified mortgage insurance premiums (see instructions) . . . . .	2a.	7,665	
b. Enter the rental portion of real estate taxes . . . . .	b.	219	
c. Enter the rental portion of deductible casualty and theft losses (see instructions) . . . . .	c.		
d. Enter direct rental expenses (see instructions) . . . . .	d.	150	
e. <b>Fully deductible rental expenses.</b> Add lines 2a–2d. Enter here and on the appropriate lines on Schedule E (see instructions) . . . . .	2e.	8,034	
3. Subtract line 2e from line 1. If zero or less, enter -0- . . . . .	3.	0	
4a. Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities) . . . . .	4a.	380	
b. Enter the rental portion of excess mortgage interest and qualified mortgage insurance premiums (see instructions) . . . . .	b.		
c. Carryover of operating expenses from 2007 worksheet . . . . .	c.		
d. Add lines 4a–4c . . . . .	d.	380	
e. <b>Allowable expenses.</b> Enter the <b>smaller</b> of line 3 or line 4d (see instructions) . . . . .	4e.	0	
5. Subtract line 4e from line 3. If zero or less, enter -0- . . . . .	5.	0	
6a. Enter the rental portion of excess casualty and theft losses (see instructions) . . . . .	6a.		
b. Enter the rental portion of depreciation of the dwelling unit . . . . .	b.	876	
c. Carryover of excess casualty losses and depreciation from 2007 worksheet . . . . .	c.		
d. Add lines 6a–6c . . . . .	d.	876	
e. <b>Allowable excess casualty and theft losses and depreciation.</b> Enter the <b>smaller</b> of line 5 or line 6d (see instructions) . . . . .	6e.	0	

**PART III. Carryover of Unallowed Expenses to Next Year**

7a. <b>Operating expenses to be carried over to next year.</b> Subtract line 4e from line 4d . . . . .	7a.	380	
b. <b>Excess casualty and theft losses and depreciation to be carried over to next year.</b> Subtract line 6e from line 6d . . . . .	b.	876	



**SCHEDULE E  
(Form 1040)**

**Supplemental Income and Loss**  
(From rental real estate, royalties, partnerships,  
S corporations, estates, trusts, REMICs, etc.)

OMB No. 1545-0074

**2008**

Department of the Treasury  
Internal Revenue Service (99)

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

Attachment  
Sequence No. **13**

Name(s) shown on return *Tim and Emily Donovan*

Your social security number  
*666 00 777*

**Part I Income or Loss From Rental Real Estate and Royalties** Note. If you are in the business of renting personal property, use Schedule C or C-EZ (see page E-3). If you are an individual, report farm rental income or loss from Form 4835 on page 2, line 40.

<b>1</b>	List the type and address of each rental real estate property:	<b>2</b>	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:	<b>Yes</b>	<b>No</b>
<b>A</b>	<i>Vacation condo 333 Oak Ave., Somewhere, GA 66666</i>		• 14 days or • 10% of the total days rented at fair rental value? (See page E-3)	<input checked="" type="checkbox"/>	
<b>B</b>					
<b>C</b>					

	Properties			Totals (Add columns A, B, and C.)
	A	B	C	
<b>3</b> Rents received . . . . .	<b>3</b> 6,000			<b>3</b> 6,000
<b>4</b> Royalties received . . . . .	<b>4</b>			<b>4</b>
<b>Expenses:</b>				
<b>5</b> Advertising . . . . .	<b>5</b> 150			
<b>6</b> Auto and travel (see page E-4) . . . . .	<b>6</b>			
<b>7</b> Cleaning and maintenance . . . . .	<b>7</b>			
<b>8</b> Commissions . . . . .	<b>8</b>			
<b>9</b> Insurance . . . . .	<b>9</b>			
<b>10</b> Legal and other professional fees . . . . .	<b>10</b>			
<b>11</b> Management fees . . . . .	<b>11</b>			
<b>12</b> Mortgage interest paid to banks, etc. (see page E-5) . . . . .	<b>12</b> 7,665			<b>12</b> 7,665
<b>13</b> Other interest . . . . .	<b>13</b>			
<b>14</b> Repairs . . . . .	<b>14</b>			
<b>15</b> Supplies . . . . .	<b>15</b>			
<b>16</b> Taxes . . . . .	<b>16</b> 219			
<b>17</b> Utilities . . . . .	<b>17</b>			
<b>18</b> Other (list) ▶ . . . . .	<b>18</b>			
<b>19</b> Add lines 5 through 18 . . . . .	<b>19</b> 8,034			<b>19</b> 8,034
<b>20</b> Depreciation expense or depletion (see page E-5) . . . . .	<b>20</b>			<b>20</b>
<b>21</b> Total expenses. Add lines 19 and 20 . . . . .	<b>21</b> 8,034			
<b>22</b> 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-5 to find out if you must file Form 6198 . . . . .	<b>22</b> (2,034)			
<b>23</b> Deductible rental real estate loss. <b>Caution.</b> Your rental real estate loss on line 22 may be limited. See page E-5 to find out if you must file Form 8582. Real estate professionals <b>must</b> complete line 43 on page 2 . . . . .	<b>23</b> ( 2,034 )			
<b>24</b> <b>Income.</b> Add positive amounts shown on line 22. <b>Do not</b> include any losses . . . . .	<b>24</b>			<b>24</b>
<b>25</b> <b>Losses.</b> Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here.	<b>25</b> ( 2,034 )			
<b>26</b> <b>Total rental real estate and royalty income or (loss).</b> Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2 . . . . .	<b>26</b> (2,034)			



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

**PART I. Rental Use Percentage**

- |   |    |       |
|---|----|-------|
| A. Total days available for rent at fair rental price . . . . .                                       | A. | _____ |
| B. Total days available for rent (line A) but not rented . . . . .                                    | B. | _____ |
| C. <b>Total days of rental use.</b> Subtract line B from line A . . . . .                             | C. | _____ |
| D. <b>Total days of personal use</b> (including days rented at less than fair rental price) . . . . . | D. | _____ |
| E. <b>Total use of the property.</b> Add lines C and D . . . . .                                      | E. | _____ |
| F. <b>Percentage of expenses allowed for rental.</b> Divide line C by line E . . . . .                | F. | _____ |

**PART II. Allowable Rental Expenses**

- |   |     |       |
|---|-----|-------|
| 1. Enter rents received . . . . .   | 1.  | _____ |
| 2a. Enter the rental portion of deductible home mortgage interest and qualified mortgage insurance premiums (see instructions) . . . . .                      | 2a. | _____ |
| b. Enter the rental portion of real estate taxes . . . . .  | b.  | _____ |
| c. Enter the rental portion of deductible casualty and theft losses (see instructions) . . . . .  | c.  | _____ |
| d. Enter direct rental expenses (see instructions) . . . . .  | d.  | _____ |
| e. <b>Fully deductible rental expenses.</b> Add lines 2a–2d. Enter here and on the appropriate lines on Schedule E (see instructions) . . . . .               | 2e. | _____ |
| 3. Subtract line 2e from line 1. If zero or less, enter -0- . . . . .   | 3.  | _____ |
| 4a. Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities) . . . . . | 4a. | _____ |
| b. Enter the rental portion of excess mortgage interest and qualified mortgage insurance premiums (see instructions) . . . . .                                | b.  | _____ |
| c. Carryover of operating expenses from 2007 worksheet . . . . .  | c.  | _____ |
| d. Add lines 4a–4c . . . . .  | d.  | _____ |
| e. <b>Allowable expenses.</b> Enter the <b>smaller</b> of line 3 or line 4d (see instructions) . . . . .  | 4e. | _____ |
| 5. Subtract line 4e from line 3. If zero or less, enter -0- . . . . .   | 5.  | _____ |
| 6a. Enter the rental portion of excess casualty and theft losses (see instructions) . . . . .   | 6a. | _____ |
| b. Enter the rental portion of depreciation of the dwelling unit . . . . .  | b.  | _____ |
| c. Carryover of excess casualty losses and depreciation from 2007 worksheet . . . . .   | c.  | _____ |
| d. Add lines 6a–6c . . . . .  | d.  | _____ |
| e. <b>Allowable excess casualty and theft losses and depreciation.</b> Enter the <b>smaller</b> of line 5 or line 6d (see instructions) . . . . .             | 6e. | _____ |

**PART III. Carryover of Unallowed Expenses to Next Year**

- |  |     |       |
|--|-----|-------|
| 7a. <b>Operating expenses to be carried over to next year.</b> Subtract line 4e from line 4d . . . . .                               | 7a. | _____ |
| b. <b>Excess casualty and theft losses and depreciation to be carried over to next year.</b> Subtract line 6e from line 6d . . . . . | b.  | _____ |



**Caution.** Use the percentage determined in Part I, line F, to figure the rental portions to enter on lines 2a–2c, 4a–4b, and 6a–6b of Part II.

**Line 2a.** Figure the mortgage interest on the dwelling unit that you could deduct on Schedule A (as if you were itemizing your deductions) 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 pay off credit cards or other personal loans, buy a car, or pay college tuition. Include interest on a loan used to buy, build, or improve the dwelling unit, or to refinance such a loan. Include the rental portion of this interest in the total you enter on line 2a of the worksheet.

Figure the qualified mortgage insurance premiums on the dwelling unit that you could deduct on line 13 of Schedule A, if you had not rented the unit. See page A-4 of the Schedule A instructions. However, figure your adjusted gross income (Form 1040, line 38) without your rental income and expenses from the dwelling unit. See *Line 4b* below to deduct the part of the qualified mortgage insurance premiums not allowed because of the adjusted gross income limit. Include the rental portion of the amount from Schedule A, line 13, in the total you enter on line 2a of the worksheet.

**Note.** Do not file this Schedule A or use it to figure the amount to deduct on line 13 of that schedule. Instead, figure the personal portion on a separate Schedule A. If you have deducted mortgage interest or qualified mortgage insurance premiums on the dwelling unit on other forms, such as Schedule C or F, remember to reduce your Schedule A deduction by that amount.

**Line 2c.** Figure the casualty and theft losses related to the dwelling unit that you could deduct on Schedule A if you had not rented the dwelling unit. To do this, complete Section A of Form 4684, Casualties and Thefts, treating the losses as personal losses. If any of the loss is due to a federally declared disaster, see the Instructions for Form 4684. On Form 4684, line 22, 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 Form 4684, line 24, 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 2e.** You can deduct the amounts on lines 2a, 2b, 2c, and 2d as rental expenses on Schedule E even if your rental expenses are more than your rental income. Enter the amounts on lines 2a, 2b, 2c, and 2d on the appropriate lines of Schedule E.

**Line 4b.** On line 2a, you entered the rental portion of the mortgage interest and qualified mortgage insurance premiums you could deduct on Schedule A if you had not rented the dwelling unit. If you had additional mortgage interest and qualified mortgage insurance premiums that would not be deductible on Schedule A because of limits imposed on them, enter on line 4b of this worksheet the rental portion of those excess amounts. Do not include interest on a loan that did not benefit the dwelling unit (as explained in the line 2a instructions).

**Line 4e.** You can deduct the amounts on lines 4a, 4b, and 4c as rental expenses on Schedule E only to the extent they are not more than the amount on line 4e.\*

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

**Line 6e.** You can deduct the amounts on lines 6a, 6b, and 6c as rental expenses on Schedule E only to the extent they are not more than the amount on line 6e.\*

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

## 6.

# How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

**Contacting your Taxpayer Advocate.** The Taxpayer Advocate Service (TAS) is an independent organization within the IRS whose employees assist taxpayers who are experiencing economic harm, who are seeking help in resolving tax problems that have not been resolved through normal channels, or who believe that an IRS system or procedure is not working as it should.

You can contact the TAS by calling the TAS toll-free case intake line at 1-877-777-4778 or TTY/TDD 1-800-829-4059 to see if you are eligible for assistance. You can also call or write your local taxpayer advocate, whose phone number and address are listed in your local telephone directory and in Publication 1546, Taxpayer Advocate Service—Your Voice at the IRS. You can file Form 911, Request for Taxpayer Advocate Service Assistance (And Application for Taxpayer Assistance Order), or ask an IRS employee to complete it on your behalf. For more information, go to [www.irs.gov/advocate](http://www.irs.gov/advocate).

**Low Income Taxpayer Clinics (LITCs).** LITCs are independent organizations that provide low income taxpayers with representation in federal tax controversies with the IRS for free or for a nominal charge. The clinics also provide tax education and outreach for taxpayers who speak English as a second language. Publication 4134, Low Income Taxpayer Clinic List, provides information on clinics in your area. It is available at [www.irs.gov](http://www.irs.gov) or your local IRS office.

**Free tax services.** To find out what services are available, get Publication 910, IRS Guide to Free Tax Services. It contains lists of free tax information sources, including publications, services, and free tax education and assistance programs. It also has an index of over 100 TeleTax topics (recorded tax information) you can listen to on your telephone.

Accessible versions of IRS published products are available on request in a variety of alternative formats for people with disabilities.

**Free help with your return.** Free help in preparing your return is available nationwide from IRS-trained volunteers. The Volunteer Income Tax Assistance (VITA) program is designed to help low-income taxpayers and the Tax Counseling for the Elderly (TCE) program is designed to assist taxpayers age 60 and older with their tax returns. Many VITA sites offer free electronic filing and all volunteers will let you know about credits and deductions you may be entitled to claim. To find the nearest VITA or TCE site, call 1-800-829-1040.

As part of the TCE program, AARP offers the Tax-Aide counseling program. To find the nearest AARP Tax-Aide site, call 1-888-227-7669 or visit AARP's website at [www.aarp.org/money/taxaide](http://www.aarp.org/money/taxaide).

For more information on these programs, go to [www.irs.gov](http://www.irs.gov) and enter keyword "VITA" in the upper right-hand corner.



**Internet.** You can access the IRS website at [www.irs.gov](http://www.irs.gov) 24 hours a day, 7 days a week to:

- *E-file* your return. Find out about commercial tax preparation and *e-file* services available free to eligible taxpayers.
- Check the status of your 2008 refund. Go to [www.irs.gov](http://www.irs.gov) and click on *Where's My Refund*. Wait at least 72 hours after the IRS acknowledges receipt of your e-filed return, or 3 to 4 weeks after mailing a paper return. If you filed Form 8379 with your return, wait 14 weeks (11 weeks if you filed electronically). Have your 2008 tax return available so you can provide your social security number, your filing status, and the exact whole dollar amount of your refund.
- Download forms, instructions, and publications.
- Order IRS products online.
- Research your tax questions online.
- Search publications online by topic or keyword.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Figure your withholding allowances using the withholding calculator online at [www.irs.gov/individuals](http://www.irs.gov/individuals).
- Determine if Form 6251 must be filed by using our Alternative Minimum Tax (AMT) Assistant.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.



**Phone.** Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call 1-800-829-3676 to order current-year forms, instructions, and publications, and prior-year forms and instructions. You should receive your order within 10 days.
- *Asking tax questions.* Call the IRS with your tax questions at 1-800-829-1040.
- *Solving problems.* You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to [www.irs.gov/localcontacts](http://www.irs.gov/localcontacts) or look in the

phone book under *United States Government, Internal Revenue Service*.

- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call 1-800-829-4477 to listen to pre-recorded messages covering various tax topics.
- *Refund information.* To check the status of your 2008 refund, call 1-800-829-1954 during business hours or 1-800-829-4477 (automated refund information 24 hours a day, 7 days a week). Wait at least 72 hours after the IRS acknowledges receipt of your e-filed return, or 3 to 4 weeks after mailing a paper return. If you filed Form 8379 with your return, wait 14 weeks (11 weeks if you filed electronically). Have your 2008 tax return available so you can provide your social security number, your filing status, and the exact whole dollar amount of your refund. Refunds are sent out weekly on Fridays. If you check the status of your refund and are not given the date it will be issued, please wait until the next week before checking back.
- *Other refund information.* To check the status of a prior year refund or amended return refund, call 1-800-829-1954.

**Evaluating the quality of our telephone services.** To ensure IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to listen in on or record random telephone calls. Another is to ask some callers to complete a short survey at the end of the call.



**Walk-in.** Many products and services are available on a walk-in basis.

- *Products.* You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- *Services.* You can walk in to your local Taxpayer Assistance Center every business day for personal, face-to-face tax help. An employee can explain IRS letters, request adjustments to your tax account, or help you set up a payment plan. If you need to resolve a tax problem, have questions about how the tax law applies to your individual tax return, or you are more comfortable talking with someone in person, visit your local Taxpayer Assistance Center where you can spread out your records and talk with an IRS representative face-to-face. No appointment is necessary—just walk in. If you prefer, you

can call your local Center and leave a message requesting an appointment to resolve a tax account issue. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. If you have an ongoing, complex tax account problem or a special need, such as a disability, an appointment can be requested. All other issues will be handled without an appointment. To find the number of your local office, go to [www.irs.gov/localcontacts](http://www.irs.gov/localcontacts) or look in the phone book under *United States Government, Internal Revenue Service*.



**Mail.** You can send your order for forms, instructions, and publications to the address below. You should receive a response within 10 days after your request is received.

Internal Revenue Service  
1201 N. Mitsubishi Motorway  
Bloomington, IL 61705-6613



**DVD for tax products.** You can order Publication 1796, IRS Tax Products DVD, and obtain:

- Current-year forms, instructions, and publications.

- Prior-year forms, instructions, and publications.
- Tax Map: an electronic research tool and finding aid.
- Tax law frequently asked questions.
- Tax Topics from the IRS telephone response system.
- Internal Revenue Code—Title 26 of the U.S. Code.
- Fill-in, print, and save features for most tax forms.
- Internal Revenue Bulletins.
- Toll-free and email technical support.
- Two releases during the year.
  - The first release will ship the beginning of January 2009.
  - The final release will ship the beginning of March 2009.

Purchase the DVD from National Technical Information Service (NTIS) at [www.irs.gov/cdorders](http://www.irs.gov/cdorders) for \$30 (no handling fee) or call 1-877-233-6767 toll free to buy the DVD for \$30 (plus a \$6 handling fee).



**Small Business Resource Guide 2009.** This online guide is a must for every small business owner or any taxpayer about to start a business. This year's guide includes:

- Helpful information, such as how to prepare a business plan, find financing for your business, and much more.
- All the business tax forms, instructions, and publications needed to successfully manage a business.
- Tax law changes for 2009.
- Tax Map: an electronic research tool and finding aid.
- Web links to various government agencies, business associations, and IRS organizations.
- “Rate the Product” survey—your opportunity to suggest changes for future editions.
- A site map of the guide to help you navigate the pages with ease.
- An interactive “Teens in Biz” module that gives practical tips for teens about starting their own business, creating a business plan, and filing taxes.

The information is updated during the year. Visit [www.irs.gov](http://www.irs.gov) and enter keyword “SBRG” in the upper right-hand corner for more information.

## Index



To help us develop a more useful index, please let us know if you have ideas for index entries. See “Comments and Suggestions” in the “Introduction” for the ways you can reach us.

<p><b>A</b></p> <p><b>Accelerated Cost Recovery System (ACRS)</b> (<i>See also</i> Modified Accelerated Cost Recovery System (MACRS)) ..... <u>8</u></p> <p>Effective date ..... <u>7</u></p> <p><b>Accounting methods:</b></p> <p>Accrual method ..... <u>3</u></p> <p>Cash method ..... <u>3</u></p> <p>Change of method ..... <u>12</u></p> <p>Constructive receipt of income ..... <u>3</u></p> <p><b>Accrual method taxpayers</b> ..... <u>3</u></p> <p><b>ACRS (Accelerated Cost Recovery System):</b></p> <p>Effective date ..... <u>7</u></p> <p><b>Active participation</b> ..... <u>13</u></p> <p><b>Activities not for profit</b> ..... <u>17</u></p> <p><b>Additions to property</b> (<i>See also</i> Improvements) ..... <u>9</u></p> <p>Basis ..... <u>8</u></p> <p>MACRS recovery period ..... <u>9</u></p> <p><b>Adjusted basis:</b></p> <p>MACRS depreciation ..... <u>8</u></p> <p><b>Adjusted gross income (AGI):</b></p> <p>Modified (<i>See</i> Modified adjusted gross income (MAGI))</p> <p><b>Advance rent</b> ..... <u>3</u></p> <p>Security deposits ..... <u>3</u></p> <p><b>Advertising</b> ..... <u>3</u></p>	<p><b>Allocation of expenses:</b></p> <p>Change of property to rental use ..... <u>16</u></p> <p>How to divide expenses ..... <u>22</u></p> <p>Part of property rented ..... <u>17</u></p> <p>Personal use of rental property ..... <u>3, 21</u></p> <p><b>Alternative Depreciation System (ADS):</b></p> <p>Election of ..... <u>9</u></p> <p>MACRS ..... <u>8, 11</u></p> <p><b>Alternative minimum tax (AMT):</b></p> <p>Accelerated depreciation methods ..... <u>6</u></p> <p><b>Amended returns</b> ..... <u>12</u></p> <p><b>Apartments:</b></p> <p>Basement apartments ..... <u>22</u></p> <p>Dwelling units ..... <u>21</u></p> <p><b>Appraisal fees</b> ..... <u>7</u></p> <p><b>Assessments for maintenance</b> ..... <u>8</u></p> <p><b>Assessments, local</b> (<i>See</i> Local assessments)</p> <p><b>Assistance</b> (<i>See</i> Tax help)</p> <p><b>Assumption of mortgage</b> ..... <u>7</u></p> <p><b>Attorneys' fees</b> ..... <u>7, 8</u></p> <p><b>Automobiles:</b></p> <p>MACRS recovery periods ..... <u>9</u></p>	<p><b>B</b></p> <p><b>Basis:</b></p> <p>Adjusted basis ..... <u>8</u></p> <p>Assessments for local improvements ..... <u>8</u></p> <p>Basis other than cost ..... <u>8</u></p> <p>Cost basis ..... <u>7</u></p> <p>Decreases to ..... <u>8</u></p> <p>Deductions:</p> <p>Capitalization of costs vs. .... <u>8</u></p> <p>Not greater than basis ..... <u>7</u></p> <p>Fair market value ..... <u>16</u></p> <p>Increases to ..... <u>8</u></p> <p>MACRS depreciable basis ..... <u>7</u></p> <p>Property changed to rental use ..... <u>16</u></p> <hr/> <p><b>C</b></p> <p><b>Capital expenditures:</b></p> <p>Deductions vs. effect on basis ..... <u>8</u></p> <p>Improvements ..... <u>5</u></p> <p>Local benefit taxes ..... <u>4</u></p> <p>Mortgages, payments to obtain ..... <u>4</u></p> <p><b>Cars:</b></p> <p>MACRS recovery periods ..... <u>9</u></p> <p><b>Cash method taxpayers</b> ..... <u>3</u></p> <p><b>Casualty losses</b> ..... <u>14</u></p>	<p><b>Change of accounting method</b> ..... <u>12</u></p> <p><b>Charitable contributions:</b></p> <p>Use of property ..... <u>21</u></p> <p><b>Cleaning and maintenance</b> ..... <u>3</u></p> <p><b>Closing costs</b> ..... <u>7</u></p> <p><b>Comments on publication</b> ..... <u>2</u></p> <p><b>Commissions</b> ..... <u>3</u></p> <p><b>Computers:</b></p> <p>MACRS recovery periods ..... <u>9</u></p> <p><b>Condominiums</b> ..... <u>16, 21</u></p> <p><b>Constructive receipt of income</b> ..... <u>3</u></p> <p><b>Cooperative housing</b> ..... <u>6, 16, 21</u></p> <p><b>Cost basis</b> ..... <u>7</u></p> <p><b>Credit reports</b> ..... <u>7</u></p> <p><b>Credits:</b></p> <p>Residential energy credit before 1986 ..... <u>8</u></p> <hr/> <p><b>D</b></p> <p><b>Days of personal use</b> ..... <u>21</u></p> <p><b>Days used for repairs and maintenance</b> ..... <u>21</u></p> <p><b>Deductions</b> (<i>See also</i> Rental expenses) ..... <u>3</u></p> <p>Capitalizing costs vs. effect on basis ..... <u>8</u></p> <p>Depreciation (<i>See</i> Depreciation)</p>
--	--	---	--

<b>Deductions (Cont.)</b>	<b>Form 4797:</b>	Charges connected with getting or refinancing, cost basis	<b>Placed-in-service date</b>
Limitations on	Sales of business property	..... 7	..... 6
Passive activity losses (See Passive activity)	..... 14	Low or no interest	<b>Points</b>
<b>Depreciation</b>	<b>Form 8582:</b>	Origination fees	..... 4, 7
Alternative Depreciation System (ADS) (See Modified Accelerated Cost Recovery System (MACRS))	Passive activity losses	<b>Local assessments</b>	<b>Pre-rental expenses</b>
Basis (See Basis)	..... 13, 14	..... 8	..... 4
Change of accounting method	<b>Free tax services</b>	<b>Losses (See Gains and losses)</b>	<b>Principal residence (See Home)</b>
..... 12	..... 28	.....	<b>Profit, property not rented for</b>
Change of property to rental use	<b>G</b>	<b>M</b>	..... 17
..... 16	<b>Gains and losses:</b>	<b>Minimal rental use exception</b>	<b>Property changed to rental use</b>
Claiming correct amount of	At-risk rules	..... 22	..... 16
..... 11	Casualty and theft losses	<b>Missing children, photographs of</b>	Basis
Declining balance method	..... 14	..... 2	..... 16
..... 7	Limits on rental losses	<b>Modified Accelerated Cost Recovery System (MACRS)</b>	<b>R</b>
Duration of property expected to last more than one year	..... 13	Additions or improvements to property	<b>Real estate professionals</b>
..... 6	Passive activity losses	Adjusted basis	..... 12
Eligible property	..... 13	Alternative Depreciation System (ADS)	<b>Real estate taxes</b>
..... 6	Rental real estate activities	Basis other than cost	..... 7
First-year expensing	..... 13	Conventions	<b>Real property trades or businesses</b>
..... 6	Sale of rental property	Cost basis	..... 12
MACRS (See Modified Accelerated Cost Recovery System (MACRS))	..... 2, 14	Depreciable basis	<b>Recordkeeping requirements:</b>
Methods	<b>General depreciation system (GDS) (See Modified Accelerated Cost Recovery System (MACRS))</b>	Effective date	Travel and transportation expenses
..... 7, 10	.....	Excluded property	..... 4
Ownership of property	<b>H</b>	General Depreciation System (GDS)	<b>Recovery periods</b>
..... 6	<b>Help (See Tax help)</b>	..... 8, 9, 10	..... 9
Rental expense	<b>Home:</b>	Nonresidential rental property	<b>Rent</b>
..... 4	Main home	Property used in rental activities (Table 2-1)	..... 7
Rented property	..... 21	Recovery periods	Advance rent
Section 179 deduction	Use as rental property (See Use of home)	Residential rental property	..... 3
..... 6	.....	Special depreciation allowances	Fair price
Special depreciation allowances	<b>I</b>	<b>Modified adjusted gross income (MAGI)</b>	..... 21
..... 8	<b>Improvements (See also Repairs)</b>	..... 14	<b>Rental expenses</b>
Straight line method	Assessments for local improvements	<b>More information (See Tax help)</b>	Advertising
..... 7	..... 8	<b>Mortgages</b>	Allocation between rental and personal uses
Useful life	Basis	Assumption of, cost basis	..... 22
..... 6	..... 8	Change of property to rental use	Change of property to rental use
Vacant rental property	Depreciation of rented property	End of, OID	..... 16
..... 4	..... 6	Interest	Cleaning and maintenance
<b>Discount, bonds and notes issued at (See Original issue discount (OID))</b>	MACRS recovery period	Mortgage insurance premiums	..... 3
.....	..... 9	Part of property rented	Commissions
<b>Dividing of expenses (See Allocation of expenses)</b>	<b>Indian reservation property</b>	..... 17	..... 3
.....	..... 9	<b>Nonresidential real property</b>	Depreciation
<b>Dwelling units:</b>	<b>Insurance</b>	..... 9	..... 4
Definition	Casualty or theft loss payments	<b>Not-for-profit activities</b>	Dwelling unit used as home
..... 21	..... 8	..... 17	..... 21
Fair rental price	Change of property to rental use	<b>O</b>	Equipment rental
..... 21	..... 16	<b>Original issue discount (OID)</b>	..... 4
Personal use of	Fire insurance premiums, cost basis	..... 4-5	Home, property also used as
..... 21	..... 7	<b>Nonresidential real property</b>	Improvements
.....	Part of property rented	..... 9	..... 5
<b>E</b>	Premiums paid in advance	<b>Not-for-profit activities</b>	Insurance
<b>Easements</b>	..... 4	..... 17	..... 4
..... 8	Title insurance, cost basis	<b>Original issue discount (OID)</b>	Interest payments
<b>Equipment rental expense</b>	..... 7	..... 4-5	..... 4
..... 4	<b>Interest payments (See also Mortgages)</b>	<b>P</b>	Local transportation expenses
<b>Expenses (See Rental expenses)</b>	..... 4	<b>Part interest:</b>	..... 4
.....	Loan origination fees	Expenses	Part of property rented
<b>F</b>	..... 4	..... 3	..... 17
<b>Fair market value (FMV)</b>	Rental expenses	<b>Passive activity:</b>	Points
..... 16	..... 4	Maximum special allowance	..... 4
<b>Fair rental price</b>	<b>L</b>	..... 14	Pre-rental expenses
..... 21, 22	<b>Land:</b>	<b>Personal property:</b>	..... 4
<b>Fees:</b>	Cost basis	Rental income from	Rental payments
Loan origination fees	..... 7	..... 3	..... 4, 5
Points (See Points)	Depreciation	<b>Personal use of rental property (See also Property changed to rental use)</b>	Repairs
Settlement fees and other costs	..... 6	..... 16, 21	..... 4, 5
..... 7	<b>Leases:</b>	<b>O</b>	Sale of property
Tax return preparation fees	Cancellation payments	<b>Original issue discount (OID)</b>	..... 4
..... 4	..... 3	..... 4-5	Tax return preparation fees
<b>First-year expensing</b>	Equipment leasing	<b>Part interest:</b>	..... 4
..... 6	..... 4	Expenses	Taxes
<b>Form 1040:</b>	<b>Limits:</b>	Income	..... 3
Not rented for profit income	Passive activity losses and credits	..... 3	Tenant, paid by
..... 17	..... 13	<b>Passive activity:</b>	..... 3
Part of property rented	Rental expense deductions	Maximum special allowance	Travel expenses
..... 17	..... 22	..... 14	..... 4
Rental income and expenses	Rental losses	<b>Personal property:</b>	Utilities
..... 12	..... 13	Rental income from	..... 4
Schedule E	<b>Loans:</b>	..... 3	Vacant rental property
..... 13	Assumption fees	<b>Nonresidential real property</b>	..... 4
<b>Form 1098:</b>	..... 7	..... 9	<b>Rental income:</b>
Mortgage interest	<b>Form 4684:</b>	<b>Not-for-profit activities</b>	Advance rent
..... 4	Casualties and thefts	..... 17	..... 3
.....	..... 14	<b>Original issue discount (OID)</b>	Cancellation of lease payments
.....	.....	..... 4-5	..... 3
.....	.....	<b>Part interest:</b>	Dwelling unit used as home
.....	.....	Expenses	..... 21
.....	.....	Income	Lease with option to buy
.....	.....	..... 3	..... 3
.....	.....	<b>Passive activity:</b>	Minimal rental use exception
.....	.....	Maximum special allowance	..... 22
.....	.....	..... 14	Not rented for profit
.....	.....	<b>Personal property:</b>	..... 17
.....	.....	Rental income from	Part interest
.....	.....	..... 3	..... 3
.....	.....	<b>Personal use of rental property (See also Property changed to rental use)</b>	Property received from tenant
.....	.....	..... 16, 21	..... 3
.....	.....	.....	Reporting
.....	.....	.....	..... 3, 12
.....	.....	.....	Security deposit
.....	.....	.....	..... 3

<b>Rental income:</b> <i>(Cont.)</i>					
Services received from tenant	3				
Uncollected rent	4				
Used as home	3				
<b>Rental losses</b> <i>(See also</i> Gains and losses; Passive activity)	13				
<b>Repairs</b> <i>(See also</i> Improvements)	4, 5				
Assessments for maintenance	8				
Personal use of rental property exception for days used for repairs and maintenance	21				
<hr/>					
<b>S</b>					
<b>Sale of property:</b>					
Expenses	4				
Gain or loss	2, 14				
Main home	2				
<b>Section 179 deductions</b>	6				
<b>Security deposits</b>	3				
<b>Settlement fees</b>	7				
		<b>Shared equity financing agreements</b>	21		
		<b>Special depreciation allowances</b>	8		
		<b>Spouse:</b>			
		Material participation	13		
		<b>Standard mileage rates</b>	4		
		<b>Suggestions for publication</b>	2		
		<b>Surveys</b>	7		
		<hr/>			
		<b>T</b>			
		<b>Tables and figures:</b>			
		Improvements, examples of (Table 1-1)	5		
		MACRS optional tables (Table 2-2d)	11		
		MACRS optional tables (Tables 2-2a, 2-2b, and 2-2c)	10		
		MACRS recovery periods for property used in rental activities (Table 2-1)	9		
		<b>Tax credits:</b>			
		Residential energy credit allowed before 1986, effect on basis	8		
		<b>Tax help</b>	28		
		<b>Tax return preparation fees</b>	4		
		<b>Taxes:</b>			
		Deduction of	4		
		Local benefit taxes	4		
		Real estate taxes	7		
		Transfer taxes	7		
		<b>Taxpayer Advocate</b>	28		
		<b>Theft losses</b>	14		
		<b>Title insurance</b>	7		
		<b>Transfer taxes</b>	7		
		<b>Travel and transportation expenses:</b>			
		Local transportation expenses	4		
		Recordkeeping	4		
		Rental expenses	4		
		Standard mileage rate	4		
		<b>TTY/TDD information</b>	28		
		<hr/>			
		<b>U</b>			
		<b>Uncollected rent:</b>			
		Income	4		
		<b>Use of home:</b>			
		Before or after renting	22		
		Change to rental use	16		
		Days of personal use	21		
		Fair rental price	21		
		Minimal rental use exception	22		
		Passive activity rules exception	13		
		Personal use as dwelling unit	21		
		<b>Utilities</b>	4, 8		
		<hr/>			
		<b>V</b>			
		<b>Vacant rental property</b>	4		
		<b>Vacation homes:</b>			
		Dividing of expenses	22		
		Dwelling unit	21		
		Fair rental price	21		
		Minimal rental use exception	22		
		Personal use of	21		
		<b>Valuation:</b>			
		Fair market value	16		
		<hr/>			