STESSA

Rental Property Tax Guide

2019 EDITION

Overview

Introduction

This guide gives rental property owners tax strategies to minimize next year's bill and tips for preparing and understanding 2018 tax filings.

The first part of effective tax strategy and planning is understanding that when you file your tax returns each year, you're simply reporting the results (income, losses, etc.) of your activities from the prior year. Once the year ends, while there are a few things that can be done, most of your results are already set in stone and you will pay tax based on those results.

That means you need to be taking a proactive approach to tax strategy and planning by implementing strategies and taking the right actions throughout the year so you'll end up with favorable results come tax filing season.

This guide is designed to give rental property owners tax strategies you can implement now to minimize next year's tax bill. You'll also come away with a more precise and nuanced understanding of your 2018 tax filing.

The Basics

Before we get too granular, let's cover some of the basic real estate tax strategies that have served rental property owners well for decades.

RECORDKEEPING

While it isn't necessarily a tax strategy, the importance of keeping organized, detailed, and up to date records cannot be understated. Doing so will allow you to see how much income your rentals are bringing in at any given time, and also allows you to project future income and expenses. This is key in determining the amount of estimated tax payments you'll need to make, your tax bracket and the tax strategies that make the most sense for you. Luckily you have this guide and Stessa to help keep your accounting records up to date.

TAX CUTS & JOBS ACT CHANGE

HELOC INTEREST

The Tax Cuts & Jobs Act no longer allows you to deduct interest from a home equity line of credit (HELOC) unless it was used to acquire a residence or substantially improve a residence.

However, if you use a HELOC to fund your rental business, the interest will be tax deductible if you elect to "treat the debt secured by your residence as not secured by your residence." It sounds confusing but of course makes perfect sense to the IRS, because the interest tracing rules allow you to deduct interest if used for business purposes.

COMMON TAX DEDUCTIBLE EXPENSES

Below is a table of the most common tax deductible expenses you'll want to track throughout the year.

Advertising/Marketing	Repairs and Maintenance
Leasing Commissions	Insurance
Professional Fees (Legal, Accounting, etc.)	Property Management Fees
Interest (Mortgage & Other)	Supplies
Taxes (Property & Other)	Utilities (Oil, Gas, Electric, Water, Phone, etc.)
Depreciation	Home Office Expenses
Business Mileage	Travel Expenses
Education & Training	Snow Removal, Landscaping, Pest Control, etc.
Bank Fees	HOA Fees
Employees and Independent Contractors	Business Meals (50% deductible)

Establishing a Home Office

As a rental property owner you can dedicate a room, or a portion of a room, to a home office to secure a home office deduction.

Having a home office also allows you to deduct local transportation expenses. Without a home office, a trip from your home to the business site will be considered a personal expense. With the home office, the same trip will be considered a business expense.

REQUIREMENTS AND BEST PRACTICES

Note that if you work off site, which is often the case for real estate investors, you can still deduct the home office if it is the location you handle your administrative work (i.e. bookkeeping).

IRS Rev. Proc. 2013-13 allows for a "safe harbor" deduction for anyone with an established home office. The deduction is $5 per sqft of the home office annually.

Alternatively, you can use the actual expense method which allows you to deduct a portion of your actual home expenses. Divide the square footage of your home office by the total square footage of your home to get the ratio.

Per IRC § 280A, a home office must be used:

(1) regularly and exclusively as the principal place of business; ***and***

(2) regularly and exclusively as a place to meet or deal with patients, clients, or customers in the normal course or trade of business.

Then multiply the ratio by the total amount of expenses that relate to your entire home, to arrive at the deductible amount for your home office.

Note that any expenses related solely to your home office (e.g. an office chair) will be 100% deductible if you use the actual expense method.

In order to substantiate a home office, you'll want to put together a small folder including the following:

- A statement as to what you use your home office for
- A floor plan showing where the home office is located in your home
- Pictures of your home office

EXAMPLE: HOME OFFICE DEDUCTION

If your home office is 100 square feet and your entire home is 1,000 square feet then you can deduct 10% (100/1,000) of the expenses that relate to your entire home.

HOME OFFICE		HOME		DEDUCTION
100 sq ft	/	**1000 sq ft**	=	**10% deduction on all home expenses**

If you plan to use the actual expense method you'll want to track all the expenses that relate to your entire home including but not limited to:

Utilities (Oil, Gas, Electric, Water, Phone, etc.)	Mortgage Interest (Not Principal)
Homeowner's Insurance	Internet
Landscaping	Office Supplies
Office Furniture	

Entity Selection

As a rental property owner, you'll most likely use a business entity to hold your investments. This is done largely for asset protection purposes rather than tax purposes as most are considered "pass-through" entities that don't pay tax at the entity level. Instead, the income/losses flow through to your personal tax return (Form 1040) and are taxed based on your personal circumstances.

Before we jump into the most common entities that real estate investors use, it is important to note that you should almost never put rental real estate in an S or C Corporation.

These are corporate entities that are taxed at the entity level and often incur negative tax consequences when assets are transferred out of the entity for estate planning or other reasons.

SINGLE MEMBER LLC (SMLLC)

An SMLLC is the most common type of entity for individual real estate investors.

You should almost never put rental real estate in an S or C Corporation.

SMLLCs are separate from the owner for legal purposes, but disregarded for tax purposes.

This means that the rental activity in the SMLLC is reported directly on your Schedule E as if you owned the property directly under your name.

When using an SMLLC it is important to treat it like a real business and have business bank accounts, credit cards, etc. that are separate from your personal accounts.

MULTI MEMBER LLC (MMLLC)

Investors often use an MMLLC when multiple individuals invest in rental real estate together. MMLLCs are generally taxed as partnerships and you'll receive your portion of the reported income or losses on a Schedule K-1.

The K-1 amounts are then reported on your personal tax returns (Form 1040) and you'll pay tax based on your personal circumstances.

When using an MMLLC it is important to treat it like a real business and have business bank accounts, credit cards, etc. that are separate from your personal accounts. Also, prior to starting the MMLLC, you'll want to discuss profit/loss splits, capital contributions, and how to handle unreimbursed partnership expenses with your partners. Be sure to document this carefully in the operating agreement.

The K-1 amounts are then reported on your personal tax returns (Form 1040) and you'll pay tax based on your personal circumstances.

Travel Expenses

In general, business travel must be considered both "ordinary and necessary" to be tax-deductible. Ordinary means it is common and accepted within the trade or business. Necessary means it is helpful and appropriate for the trade or business.

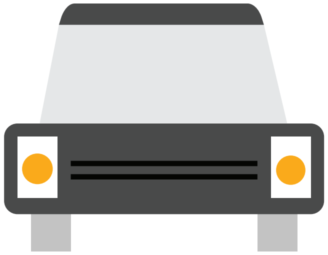
As a real estate investor, you'll likely travel to and from your rental properties, other business locations, new markets, and education related events. While most of these activities are ordinary and necessary, it is important to understand the various rules for deducting travel expenses.

LOCAL TRAVEL

Most rental property owners routinely travel to and from rental properties located within driving distance. You might also travel to the bank, the hardware store, or to meet with your broker, your attorney, and so on.

If you established a home office, these miles are considered business miles and are tax deductible within your "tax home."

If you established a home office, rental property-related driving is considered business mileage and is tax deductible within your "tax home."



An IRS-compliant mileage log includes:

- **Odometer reading as of Jan 1**
- **Odometer reading as of Dec 31**

For each business trip:

- **The date**
- **The purpose**
- **The amount of miles**
- **Locations**

Your "tax home" is considered the geographic location (i.e. city or locality) where you have an established rental business.

There are generally two ways you can deduct these trips:

1) Using the actual expense method, or

2) The standard mileage deduction.

Both methods require you to keep an IRS-compliant mileage log.

Remembering to log the trip each time you drive somewhere for business can be a challenge. Use an automatic mileage tracking app like MileIQ in tandem with Stessa's mileage expense feature to make sure you're not missing any deductible miles.

STANDARD MILEAGE RATE

The standard mileage rate is the simplest way to deduct local travel expenses because it requires the least amount of tracking. Simply take the amount of miles you drove for business and multiply it by the standard mileage rate to get your deduction. **The standard deduction for 2018 is 54.5 cents per mile for 2018 and 58 cents per mile for 2019.**

The only actual expenses you can deduct under this method, in addition to the mileage, are parking fees, tolls, interest on a car loan, and personal property tax on the vehicle.

EXAMPLE: ACTUAL EXPENSE METHOD

You drive a total of 10,000 miles in 2018. 6,700 are business miles. Your business percentage for the vehicle is 67% (6,700/10,000). After tallying up all the expenses related to your vehicle, the total is $8,000 for the year. You can deduct $5,360 for 2018 ($8,000 x 67%).

BUSINESS MILES / TOTAL MILES

(6700 / 10,000)

x

VEHICLE EXPENSE

$8,000

=

ACTUAL EXPENSE DEDUCTION

$5,360

In order to use the standard mileage rate, you must use it in the first year you use your vehicle for business purposes, otherwise you can only use the actual expense method. However, you can later switch to the actual expense method, and back again, so it's generally best to start with the standard mileage rate.

ACTUAL EXPENSE METHOD

Under the actual expense method, you can deduct a portion of your actual expenses from operating your vehicle. These expenses include, but are not limited to:

Lease Payments	Car Washing
Interest on Car Loans	Tolls and Parking Fees
Gas and Oil	Other Fees (e.g. Registration Fees)
Repairs and Maintenance	Depreciation
Insurance	

NOTE

Tickets and violations are NOT tax deductible.

Your deduction is based on the percentage of actual miles driven that you used your vehicle for business. This percentage is determined by dividing the amount of miles you drove for business by the total miles you drove for the year (business miles/total business and personal miles). You will also need to keep records (e.g. receipts) of all other auto expenses throughout the year.

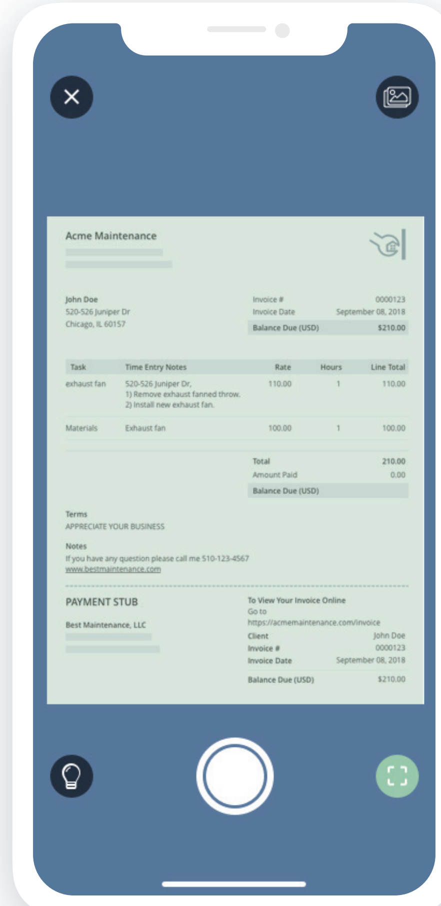
Stessa's mobile app can help with this as it includes OCR and machine learning to capture and automatically categorize receipts for free.

TRAVEL TO NEW MARKETS

Travel expenses are treated a bit differently when traveling to a new market outside of your tax home.

Travel expenses incurred to research and evaluate any new property that you eventually purchase outside of your tax home, will be added to the basis of the property and depreciated over 27.5 years. Once you purchase a rental property in the new geographic area, additional new travel to the same area to evaluate other potential acquisitions becomes tax deductible as a business expense.

Perhaps surprisingly, travel expenses incurred to evaluate property in a new market in which you don't eventually purchase a property are not immediately deductible. These are considered start-up expenses that can only be deducted after purchasing your first property in the new geographic area.



Stessa's mobile app can help keep records of receipts and expenses throughout the year.

What Types of Travel Expenses are Deductible?

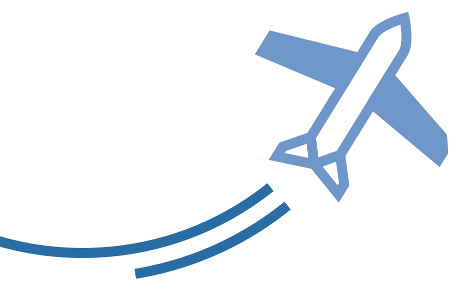
TRANSPORTATION

Transportation to and from the business destination is tax deductible.

This includes but is not limited to airfare, train and bus tickets, car expenses (see page 11).

Other transportation costs that are deductible include:

- Expenses for travel to and from the airport (i.e. taxi, bus, etc.)
- From the lodging area (i.e. hotel, Airbnb, etc.) to the business location (i.e. potential rental property, conference center, etc.)
- Rental cars



LODGING

Lodging expenses (i.e. hotel, Airbnb, etc.) on overnight stays that are required for sleep or rest are deductible.

- Other Expenses
- Meals outside of your tax home are 50% tax deductible
- Dry cleaning
- Phone
- Tips
- Other ordinary and necessary business travel expenses

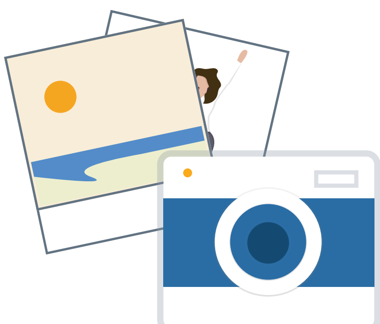
TAX CUTS & JOBS ACT CHANGE

Entertainment is no longer tax deductible under The Tax Cuts and Jobs Act.

MIXING PERSONAL & BUSINESS TRAVEL

When you mix business travel with personal travel, some of the expenses (i.e. airfare) may still be tax deductible if the trip was **primarily** for business purposes. In general this means you should be spending more than half of the total number of days you're traveling on business activities versus personal activities. A day is considered a business day if you spend four or more hours on business activities.

It's important to note, however, that lodging expenses, meals, and other expenses incurred during days primarily dedicated to non-business purposes, are not tax deductible. In addition, any travel expenses for a spouse (or child) that isn't traveling for a "bona fide" business purpose is not tax deductible.



Also keep in mind that if the trip is primarily for personal purposes, travel to and from the destination (i.e. airfare) are not tax deductible but business expenses incurred during the same trip are deductible.

EXAMPLE: BUSINESS & PERSONAL TRAVEL

You go on a seven day business trip to visit your out-of-state investment portfolio and spend five days on business and the other two at the beach.

Because the trip was primarly for business purposes, the entire round-trip airfare, plus lodging, meals and related expenses for the five business days are tax deductible. However, the lodging, meals, and other expenses from the two personal days are not deductible.

Real Estate Tax Strategies

This section looks at real estate tax strategies that will ensure you're paying as little tax on your rental income as possible.

Now that we covered the basics, let's dive into some nitty gritty real estate tax strategies that will ensure you're paying as little tax on your rental income as possible.

THE IMPORTANCE OF DATE PLACED IN SERVICE

When you first purchase a rental property it will be considered "placed in service" on day one if there's an existing tenant in the property. If there's no existing tenant, then the property is assumed to be not yet in service.

To place a property into service, you must meet two requirements: (1) the property must be ready for use; and (2) the property must be available for use.

Generally, your rental is ready for use when the city or locality of your rental property will conservatively issue a Certificate of Occupancy. The rental property is considered available for use once it's advertised for rent.

Rental property investors will often purchase a property vacant and in need of significant renovations before it's ready to rent. Any renovation costs incurred before you place the property in service must be capitalized and depreciated, generally over 27.5 years, regardless of whether or not they are actual capital improvements or simply repair and maintenance expenses.

The key point here is that costs that are capitalized and then depreciated are recovered over several years and then are subject to depreciation recapture (a 25% tax when you sell the property). Regular repair and maintenance expenses are fully deductible in the year incurred and are not subject to depreciation recapture.

The way to successfully manage this distinction from a tax perspective is to complete the minimum amount of work necessary to get the property ready for lease, then immediately advertise it for rent.

As mentioned above, the definition of ready for lease will be determined by the building codes in your locality, but is typically when sheetrock is on the walls and the flooring is finished. In other words, if the property is habitable and no longer dangerous, it's probably also ready for lease.

Once the property is in service you can finish the renovation and deduct some of the costs as repair and maintenance expenses in the current year. Other start up costs such as appliances, which are normally considered capital improvements, become deductible in the current year under the de minimis safe harbor provision of the tax code.

Note that some renovation costs will always be considered capital improvements regardless of whether or not a property has already been placed in service (e.g. replacing the entire roof).

PRO TIP **As a best practice, you'll want to get in the habit of itemizing your invoices so that you, or your accountant, can more easily categorize these items as repair and maintenance expenses or capital improvements. Itemized invoices are also helpful in determining whether expenses might qualify under one of the safe harbors mentioned in the next section or for 100% bonus depreciation.**

EXAMPLES OF RENOVATION ITEMS & WHEN TO COMPLETE:

Before you place the property in service:

- Fixing structural issues (e.g. cracks in the foundation)
- Replacing an entire roof, floor, bathroom, kitchen, or plumbing system
- Adding a deck or new HVAC system

After you place the property in service:

- Painting
- Installing appliances
- Replacing a doorknob or window
- Repairing an existing plumbing system
- Other minor repairs

Capital Improvements vs. Repairs & Maintenance Expenses

For most rental property owners, classifying repair and maintenance expenses as regular repairs will maximize current year deductions and minimze depreciation recapture.

Once your property is in service, you'll need to determine whether each repair and maintenance expense you incur should be classified as a regular expense or a capital improvement that must be capitalized and depreciated.

Most rental property owners will prefer to have as many of these costs as possible classified as regular repair and maintenance expenses in order to maximize current year deductions and minimize depreciation recapture.

Next, we'll examine the differences between these two classifications and explore some common examples of each. But before we do, we want to make you aware of three safe harbors that may prove useful in moving some expenses that would otherwise be classified as capital, into the regular expenses bucket:

- Safe Harbor for Small Taxpayers
- Routine Maintenance Safe Harbor
- De Minimis Safe Harbor

We won't go into all the details of these three safe harbors here, but the IRS official guidance on these safe harbors is required reading for rental property owners that want to maximize their current year deductions. You'll also learn quite a bit about how the IRS approaches capital improvements versus repairs & maintenance expenses.

REPAIRS AND MAINTENANCE

Repairs and maintenance are generally one time expenses that are incurred to keep your property habitable and in proper working condition.

EXAMPLES: COMMON REPAIR & MAINTENANCE EXPENSES

Include but are not limited to:

Painting

Fixing:

- an existing AC unit
- a faucet or toilet

Replacing:

- a few shingles on a roof
- a cabinet door
- a few planks or tiles on a floor
- a broken pipe

Costs incurred to:

- inspect, or clean part of the building structure and/or building system
- replace broken or worn out parts with comparable parts

CAPITAL IMPROVEMENTS

A capital improvement is an addition or change that increases a property's value, increases its useful life, or adapts it (or a component of the property) to new uses. These items fall under categories sometimes called betterments, restorations, and adaptations.

EXAMPLES: CAPITAL IMPROVEMENTS

- Additions (e.g. additional room, deck, pool, etc.)
- Renovating an entire room (e.g. kitchen)
- Installing central air conditioning, new plumbing system, etc.
- Replacing 30% or more of a building component (i.e. roof, windows, floors, electrical system, HVAC, etc.)

Depreciation

Depreciation is one of the most important deductions because it reduces taxable income but not cash flow.

Depreciation is one of the biggest and most important deductions for rental real estate investors because it reduces taxable income but not cash flow.

For many landlords, the most important part here will be determining a property's depreciable basis. The goal is to allocate as much of the property's purchase price to the building value as possible to maximize your depreciation expense since land is never depreciated. The portion allocated to the building will be depreciated over 27.5 years, per the IRS guidelines for residential income property.

While allocating 20% to land and 80% to the building is a common practice, under an audit you may have to substantiate why you chose these numbers. This is commonly done by finding the land versus building value on an appraisal or property tax card filed with the county. You can also use comparable land sales to make this determination or commission a cost segregation study or appraisal by a third-party professional. Should you decide to deviate from the county tax assessor's land versus building value ratio, you'll need to be prepared to support your determination in an audit with independent documentation prepared by a third-party professional.

COST SEGREGATION STUDIES & 100% BONUS DEPRECIATION

In a cost segregation study, certain costs previously classified as 27.5 year property, are instead classified as personal property or land improvements, with a shorter 5, 7, or 15-year rate of depreciation that uses accelerated methods to increase your near-term deductions. It sounds complicated but most tax accountants and some software will do the math for you.

Generally between 20-30% of the property's purchase price can be reclassified under these shorter class lives which can significantly increase a property's depreciation expense. Thanks to The Tax Cuts and Jobs Act, 5, 7, and 15-year property is now eligible for 100% bonus depreciation, which means its entire cost can be written off in the first year of ownership.

TAX CUTS & JOBS ACT CHANGE

5, 7, and 15-year property is now eligible for 100% bonus depreciation, which means its entire cost can be written off in the first year of ownership.

EXAMPLE: COST SEGREGATION

A building with a value of $100,000 will typically have $3,636 in annual depreciation ($100,000/27.5). However, if you were to commission a cost segregation study and find that 20% of the building's value can be reclassified as personal property or land improvements, you could then deduct $20,000 in 100% bonus depreciation, and enjoy another $2,909 in regular annual depreciation for a total depreciation deduction of $22,909 in the first year.

ANNUAL DEPRECIATION		100% BONUS DEPRECIATION		TOTAL DEPRECIATION DEDUCTION
$20,000	+	**$2,909**	=	**$22,909**

It's important to note that cost segregation studies make the most sense for landlords who are considered real estate professionals for tax purposes or expect to come in under the passive loss limits discussed below.

Cost segregation studies may also be worth considering if you consistently have net income from passive activities or a capital gain from the sale of a rental, since losses generated by rental properties can generally offset other passive income or gain from the sale of rental property.

Passive Losses, Passive Activity Limits & The Real Estate Professional Status

As a rental property owner, it's not uncommon for your properties to produce a net loss for tax purposes thanks to depreciation and other operating expenses. The treatment of these losses is often misunderstood by investors for various reasons, so we'll spend some time here to clear up common misconceptions.

Losses from rental property are considered passive losses and can generally only offset passive income.

Losses from rental property are considered passive losses and can generally only offset passive income (i.e. income from other rental properties or another business in which you do not materially participate, not including investments). If these passive losses exceed your passive income, they are suspended and carried forward indefinitely until future years, when you either have passive income or sell a property at a gain.

This is good news because a net loss (for tax purposes) means you aren't paying taxes on your rental income today, even if you have positive cash flow.

Generally, the only time passive losses will offset your ordinary income from a W-2 job or another trade or business is under one of the circumstances discussed below.

PASSIVE ACTIVITY LIMITS

Under the passive activity limits you can deduct up to $25,000 in passive losses against your ordinary income (e.g. W-2 wages) if your modified adjusted gross income (MAGI) is $100,000 or less. This deduction phases out $1 for every $2 of MAGI above $100,000 until $150,000 when it is completely phased out. Note: these limits apply to both those filing single or married filing joint.

In addition, in order to take losses against you ordinary income, you must materially participate in the activity by meeting one of the following seven tests:

1. You participated in the activity for more than 500 hours.
2. Your participation was substantially all the participation in the activity of all individuals for the tax year, including the participation of individuals who didn't own any interest in the activity.
3. You participated in the activity for more than 100 hours during the tax year, and you participated at least as much as any other individual (including individuals who didn't own any interest in the activity) for the year.
4. The activity is a significant participation activity, and you participated in all significant participation activities for more than 500 hours. A significant participation activity is any trade or business activity in which you participated for more than 100 hours during the year and in which you didn't materially participate under any of the material participation tests, other than this test.
5. You materially participated in the activity (other than by meeting this fifth test) for any 5 (whether or not consecutive) of the 10 immediately preceding tax years.
6. The activity is a personal service activity in which you materially participated for any 3 (whether or not consecutive) preceding tax years. An activity is a personal service activity if it involves the performance of personal services in the fields of health (including veterinary services), law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital isn't a material income-producing factor.

7. Based on all the facts and circumstances, you participated in the activity on a regular, continuous, and substantial basis during the year.

Note: these are the same tests used to establish material participation as a real estate professional discussed below.

EXAMPLE: MAGI & PASSIVE ACTIVITY LIMITS

Your MAGI is $100,000 for the year and your rental properties produce a net loss of $30,000. As long as you materially participate in your rental activities you'll be able to deduct $25,000 of this loss against your ordinary income. The remaining $5,000 will be carried forward.

Lets say, however, your MAGI was $125,000. In this case you can only deduct $12,500 of the loss because each dollar over $100,000 reduced the amount you could deduct by $0.50. If you're MAGI was over $150,000 then you can't deduct any of these losses against your ordinary income and the entire $30,000 is carried forward.

THE REAL ESTATE PROFESSIONAL STATUS

The real estate professional status historically allowed real estate investors to take unlimited rental losses against their ordinary income. This has now been limited to $250,000 in losses if single (and $500,000 if married) under the excess business loss limits introduced by the Tax Cuts & Jobs Act.

In order to qualify as a real estate professional you must spend at least 750 hours in a real estate trade or business and more than half your total working hours must be in a real estate trade or business.

Due to these requirements, many investors who work a full-time job or full-time in another business that is not real estate-related will have a hard time qualifying as a real estate professional.

That said, simply meeting the above requirements will not necessarily allow you to deduct your rental losses against your ordinary income. You must also materially participate in the rental activity using the same tests mentioned above, but is most commonly done by electing to aggregate all your rental properties as one activity and then working 500 or more hours in this single activity per year.

Note that if **one** spouse qualifies for the 750 hour test, both spouse's time on the rental properties count towards material participation, and losses can then be taken against either spouse's income. This is a great strategy for couples where one spouse works in a real estate trade or business, works only part-time, or not at all outside of your investment activities.

Note: In any year you elect to be treated as a real estate professional for tax purposes, you'll need to keep a log of all hours worked within a real estate trade or business.

TAX CUTS & JOBS ACT CHANGE

The real estate professional status has now been limited to $250,000 in losses if single (and $500,000 if married) under the excess business loss limits by the Tax Cuts & Jobs Act.

Capital Gains
Tax and Depreciation Recapture

- **If you hold property for less than a year before selling, gains are taxed at ordinary income rates up to 37%**
- **If you hold property for over a year, gains are taxed at the long-term capital gains rate of 15-20%**

For many real estate investors, the biggest tax bills will arrive upon the sale of your property. This is especially true when all goes according to plan and you're selling into a strong market while cap rates are low. Below we discuss what taxes you can expect to pay after the successful sale of a property and how best to mitigate them.

CAPITAL GAINS TAX

If you hold your property for less than a year before selling you'll have to pay tax at your ordinary income rates (up to 37%) on the gain. However, if you hold the property for over a year your gain will taxed at the long-term capital gains rate of 15%, or 20% if your income exceeds $425,801 if single or $479,001 if married.

DEPRECIATION RECAPTURE

The dark side of depreciation is depreciation recapture, which rears its claws upon sale of a depreciated asset. Depreciation recapture is the portion of your gain attributable to the depreciation you took on your property during prior years of ownership, also known as accumulated depreciation.

Depreciation recapture is taxed as ordinary income up to a maximum rate of 25%.

NET INVESTMENT INCOME TAX (NIIT)

You'll also face the Net Investment Income Tax (NIIT) of 3.8% if your income exceeds $200,000 if single or $250,000 if married. It's important to note that while the NIIT applies to both rental income and capital gains, those that closely follow this guide may not report any taxable rental income. Finally, if you meet the requirements to be considered a real estate professional for tax purposes, your real estate income is not subject to NIIT.

EXAMPLE: CAPITAL GAINS TAX AND DEPRECIATION RECAPTURE

You purchase a rental property in 2010 for $275,000 and later sell it in 2018 for $450,000. Each year your depreciation expense was $10,000 ($275,000 / 27.5) for a total of $80,000 in depreciation over 8 years. This lowered your adjusted basis in the property to $195,000 making your total gain on sale $255,000 ($450,000 - $195,000).

The $80,000 of gain from depreciation is taxed at 25% for a total of $20,000. The remaining gain of $175,000 is taxed at the long-term capital gains rate of 15% for a total of $26,250. Also, because your total income was above $200,000, the entire gain of $255,000 is subject to the 3.8 NIIT for a total of $9,690. When you add this all up your total tax upon sale is $55,940 or nearly 22% of the total gain. You may also be liable for state taxes, depending on your geography.

MITIGATING TAXES UPON SALE

As you can see from the example above, the tax upon sale can be substantial. Luckily there are some things you can do to defer and/or reduce this tax liability.

TAX LOSS HARVESTING

In general, capital gains can be offset by capital losses. Tax loss harvesting is simply the selling of capital assets (e.g. stocks or other real estate) at a loss to offset your capital gain.

This most likely makes sense if you invested in stock, rental property, or another capital asset with a fair market value that has now fallen below its adjusted basis (purchase price) and is unlikely to recover.

1031 EXCHANGES

1031 Exchanges allow you to defer both the capital gains tax and depreciation recapture from the sale of a property and invest the proceeds into another "like-kind" property, often called "trading up". While you ultimately have to pay tax at some point down the line, with the notable exception of inheritance, this allows you to use the entire proceeds to purchase a new property, thereby increasing the size of your portfolio at a faster pace that would otherwise be possible if you were paying capital gains taxes upon each sale.

It's important to note that 1031 exchanges have a very strict timeline that needs to be followed and generally require the assistance of a qualified intermediary (QI).

1031 Exchanges allow you to defer both the capital gains tax and depreciation recapture from the sale of a property and invest the proceeds into another "like-kind" property, often called "trading up".

OPPORTUNITY FUNDS

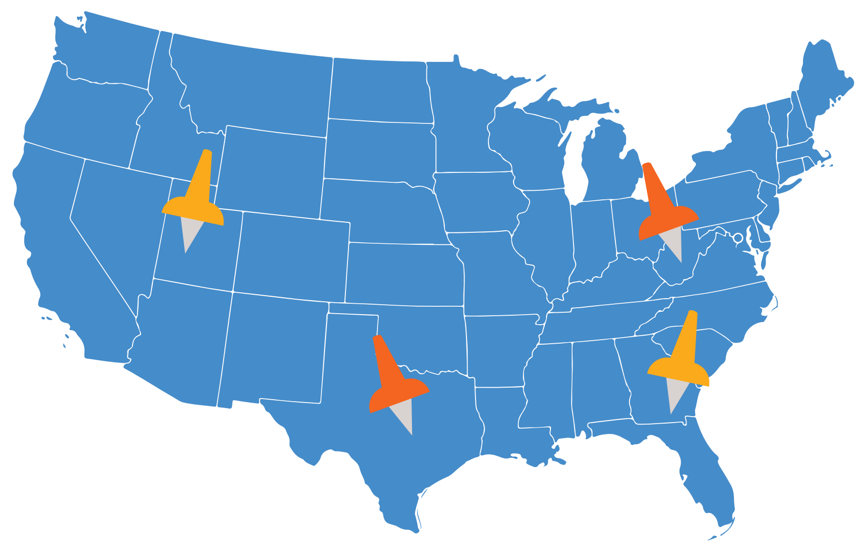
Introduced by the Tax Cuts and Jobs Act, Opportunity Funds allow you defer and reduce the capital gains tax from the sale of any capital asset. Unlike a 1031 exchange, you only have to redeploy the capital gain, not the entire sales proceeds.

If you invest the capital gains in an Opportunity Fund within 180 days and hold it for 5 years you'll reduce your original taxable capital gain tax liability by 10%. If you hold it for an additional 2 years, the original gain liability is reduced by another 5%. If you then hold your investment for another 3 years, the new capital gain from the Opportunity Fund itself becomes fully tax exempt.

In order to take full advantage of the tax benefits that Opportunity Funds offer you'll need to invest by December 31, 2019. That's because you'll have to pay tax on the majority of the original capital gain in 2026, regardless of whether or not you continue to hold your investment in the fund.

TAX CUTS & JOBS ACT CHANGE

Opportunity Funds allow you to defer and reduce the capital gains tax from the sale of any capital asset.



EXAMPLE: OPPORTUNITY FUNDS

You purchase a $100,000 property in 2010.

In 2019 you sell the property for $200,000 and roll the $100,000 capital gain into an Opportunity Fund within 180 days. In 5 years, your taxable capital gain of $100,000 invested in the Opportunity Fund is reduced by $10,000. And in 7 years it is reduced by another 5%, reducing your original taxable capital gain by a cumulative total of $15,000. This means you will only pay capital gains tax on $85,000 of your original $100,000 gain.

You continue to hold the investment for another 3 years. During this time, your $100,000 investment in the Opportunity Fund appreciates to $150,000. Because you held the investment for 10 years, the tax on your $50,000 gain from the Opportunity Fund investment is completely eliminated.

It's important to note here that the tax benefit related to reductions in the original capital gains liability is modest at best, so rental property owners will need to carefully weigh the pros and cons of 1031 exchanges versus Opportunity Fund investments. It's likely that an Opportunity Fund investment will only be preferable to a 1031 exchange for rental property owners when they expect the Opportunity Fund investment to significantly outperform the rental property market over the next 10 years.

INSTALLMENT SALES

An installment sale, sometimes called seller or owner financing, allows you to sell your property to a buyer and receive payments over a predetermined number of years. This spreads out your capital gains tax over several years and gives you an additional return in the form of interest.

EXAMPLE: INSTALLMENT SALES

You purchase a property in 2010 for $30,000 and want to sell for $110,000 in 2018. Your AGI is $180,000 and this $80,000 capital gain will increase your AGI to $260,000, causing you to pay an additional 3.8% net investment income tax. Your CPA suggests selling this property using an installment sale to avoid the 3.8% tax.

You find a buyer and sell them the property for $110,000. They put $10,000 down and finance the remaining $100,000 over a period of 10 years, plus 6% interest. Each year, $7,273 out of the $10,000 payment is considered a capital gain and the other $2,727 is your return of principal. You'll pay $1,091 in capital gains tax but no tax on the return of principal. The interest you receive will be taxed at your ordinary tax rate and you'll avoid the NIIT in the current year

USING COST SEGREGATION TO OFFSET CAPITAL GAINS

When you sell a property, current and suspended passive losses can be used to offset the gain from sale. If you don't have enough current or suspended losses to offset this capital gain, you can purchase a new property and use a cost segregation study to create current passive losses that can offset the gain. It's actually not as complicated as it sounds, so let's explore an example.

EXAMPLE: INSTALLMENT SALES

You sell a property for a $100,000 capital gain and have no current or suspended passive losses to help offset the gain. You decide to purchase a new property for $500,000 and have a third-party company perform a cost segregation study. They determine that about 20% ($100,000) of the property can be depreciated using 100% first-year bonus depreciation.

This increase in depreciation expense causes your current losses to exceed $100,000 and allows you to offset the entire capital gain from sale.

Key Tax Issues for Short-Term Rentals

With the increasing popularity of short-term rentals thanks to Airbnb, VRBO, and other vacation rental platforms, it's important to understand some of the tax issues related to owning and operating short-term rentals.

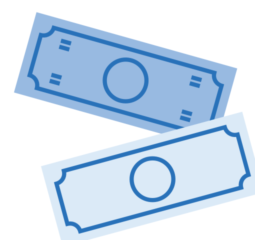
RENTING YOUR PRIMARY RESIDENCE OR VACATION HOME

For the purposes of this section, we assume you and/or your relatives stay at your vacation home for the greater of 14 days a year or 10% of the days rented. If you and/or you relatives use the vacation home for fewer than this number of days per year, then according to the IRS, your vacation home is a rental property instead of a residence.

14 Days or Less

If you rent out your primary residence or vacation home for 14 days or less throughout the year you do not have to pay taxes on the income. Because your income isn't taxable, you also can't deduct your expenses.

If you rent your primary residence or vacation home for more than 15 days, then you must report your income on Schedule E of your tax return.



15 Days or More

However, your expenses are only deductible to the extent of your income. Any remaining expenses will be carried forward to offset income from this activity in future years.

Renting Out a Room in Your House

If you rent out a room in your house you can deduct 100% of your rental expenses including advertising fees, rental agency fees and commissions, insurance, cleaning, depreciation, repairs and other expenses related directly to the rental of that room.

You can also deduct a portion of the expenses related to your entire home (i.e. mortgage interest, insurance, etc.) However, these are prorated based on both how long the room was rented and the square footage ratio of the room to the entire home.

EXAMPLE: SHORT TERM RENTAL

You have a three bedroom house and rent out one of the rooms. If you rent this room for 95 days out of the year, its rental usage is about 26% (95/365). Because you only rented [illegible] of your house for 26% of the year, you can only deduct 8.67% of the expenses that relate to your entire home (i.e. mortgage interest).

If the expenses related to your entire home total $15,000 then you can only deduct $1,300 (8.67% x $15,000). However any direct rental expenses (i.e. advertising fees) are 100% deductible.

CONSEQUENCES OF TREATING YOUR SHORT-TERM RENTAL AS A BED & BREAKFAST

In general your short-term rentals are reported as passive rental activities on Schedule E of your tax return unless you provide “substantial services” to your guests. Substantial services include services found in a hotel or bed & breakfast such as providing meals, daily cleaning, maid services, travel arrangements, vehicles or bikes, and other services commonly found in a hotel.

Note that merely providing light amenities like soap or towels is unlikely to rise to the level of “substantial services” because it doesn’t make up 10-15% of the total rent paid by your guest.

However, if you do provide substantial services to your guests, your short-term rental activity is no longer considered a passive rental activity. Instead it is considered an active business, reported on Schedule C, and becomes subject to the dreaded self-employment tax of 15.3% on top of your ordinary income tax liability.

20% Pass-Through Deduction

TAX CUTS & JOBS ACT CHANGE

The 20% pass-through deduction allows certain business owners to deduct 20% of qualified business income if taxable income is below $157,500 if single or $315,000 if married.

The Tax Cuts & Jobs Act of 2017 introduced a new 20% pass-through deduction allowing certain business owners to deduct 20% of qualified business income if your taxable income is below $157,500 if single or $315,000 if married. Should your taxable income be above these thresholds, a complicated calculation will be used to determine the amount of this deduction. Luckily your tax professional or tax software will handle that for you.

SAFE HARBOR FOR LANDLORDS

If you still have taxable income from your rental properties after following the strategies explored in this guide, you may qualify for the 20% pass-through deduction under the following safe harbor, which requires that ALL conditions are met:

- The property is held directly by the individual or through a disregarded entity by the individual or passthrough entity seeking the pass-through deduction (e.g. a person who owns a single-member LLC that holds a rental property qualifies).

- Commercial and residential real estate may not be part of the same enterprise.
- Separate books and records are maintained to reflect income and expenses for each rental real estate activity or enterprise (a separate real estate enterprise may constitute multiple properties as long as it is all commercial or all residential).
- 250+ hours of rental services are performed for the enterprise (see detail below).
- You maintain contemporaneous records, including time reports or similar documents, regarding: a) hours of all services performed, b) description of all services performed, c) dates on which such services are performed, and d) who performed the services.

Rental services include advertising to rent, negotiating and executing leases, verifying tenant applications, collection of rent, daily operation and maintenance, management of the real estate, purchase of materials, and supervision of employees and independent contractors. Services performed by owners or employees, agents, or contractors all count toward the 250 hours.

Note that even if your rentals don't meet the criteria for the above safe harbor, that doesn't necessarily mean they won't qualify for the 20% pass-through deduction. Regardless of whether your activity qualifies for the described safe harbor, if you plan on taking this deduction, you'll have to issue Form 1099 for all independent contractors to which you paid over $600 during the year.

Rental property owners are generally not required to file or send 1099s to independent contractors unless you plan to take the 20% pass-through deduction, provide substantial services to guests, or qualify as a real estate professional for tax purposes.

Rental property owners are generally not required to file or send 1099s to independent contractors unless you plan to take the 20% pass-through deduction, provide substantial services to guests, or qualify as a real estate professional for tax purposes.

Casualty Losses

A casualty loss is considered a "sudden, unexpected or unusual event" that causes property damage or loss. These events commonly include:

- Hurricanes
- Accidents
- Earthquakes
- Vandalism
- Fires
- Floods
- Volcanic Eruptions
- Terrorist Attacks

If one of your rental properties is completely destroyed in one of the above scenarios, the amount of the loss you can claim is equal to your adjusted basis in the property.

If you receive a reimbursement from your insurance company for exactly the amount of your property's adjusted basis, then you recognize no gain or loss. If the reimbursement is more than your adjusted basis, then you must recognize a gain. If it is less, then you recognize a loss in the amount of the difference.

In the event of a gain, the good news is that you can avoid recognizing a gain by simply reinvesting the proceeds into a property that is "similar or related in service or use". You have two years from the end of the tax period in which the gain was received to find a suitable replacement.

EXAMPLE: CASUALTY LOSSES

Your rental property has an adjusted basis of $114,000 in 2018. A wild fire strikes, completely destroying the property.

In Scenario A, the insurance company cuts you a check for $114,000. No loss or gain is recognized. In Scenario B, the insurance company cuts you a check of $126,000, the property's fair market value (FMV). You would have to recognize a gain of $12,000.

However, you purchase a similar replacement property that cost $126,000 in 2019. In this case, you do not have to recognize the gain, but your basis in the new property would be $114,000, the adjusted basis of the original property.

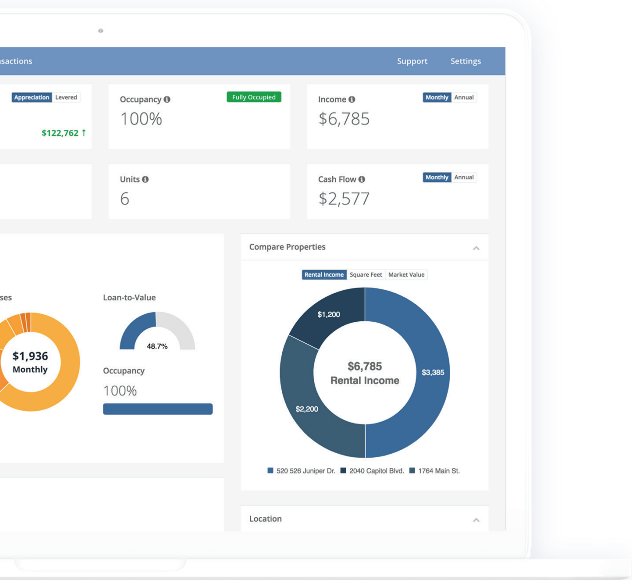
This guide should equip most rental property owners with basic tax strategies needed to minimize next year's tax bill. It's also a great source of ideas and possible scenarios to explore with your CPA. This is not an exhaustive list of all available real estate tax strategies and there may be additional actions you can take to further reduce your tax liability.

For more information on how the strategies discussed in this guide might apply to your specific situation, and tax compliance in general, we recommend consulting directly with your CPA. Also see the official guidance provided by the IRS, other tax content developed by Stessa, and further resources available via The Real Estate CPA.

While reasonable efforts were taken to furnish accurate and up-to-date information, we do not warrant that the information contained in and made available through this guide is 100% accurate, complete, and error-free. We assume no liability or responsibility for any errors or omissions in this guide.

Meet Stessa

AUTOMATIC TRACKING & REPORTING FOR RENTAL OWNERS



Make tax time a breeze

Get time-saving tools that make reporting painless and help maximize your deductions--from tax-ready financials to end-of-year performance statements.

Save time on income & expense tracking

Link your bank accounts to Stessa and transactions update in real-time. Categorize transactions into tax-ready categories for easy reporting.

Get key performance metrics in one dashboard

View your entire portfolio in one streamlined report that automatically calculates key metrics and provides a clear picture of your investments.

Stay organized with receipt capture

Keep track of and scan receipts right from the phone app. Stessa automatically reads, categorizes and stores them for you - no more data entry!

Keep your data safe with bank-grade security

Designed from the ground up with multiple layers of security. Stessa uses bank-grade encryption to keep your financial data safe and secure.

Built by rental investors for rental investors

Stessa was built from the ground up with rental investors in mind. We take care of all the tedious tracking and reporting details so you don't have to.

Stessa gives the millions of real estate investors with single-family rentals and multifamily buildings a powerful new way to track, manage, and communicate the performance of their real estate assets. Tracking rental property finances and monitoring performance used to be time-consuming and tedious. Now, Stessa's smart income and expense tracking technology makes it effortless, automating the busy work and saving property owners valuable time. Get a current view of how your portfolio is performing, and get the insights you need to make decisions without the manual spreadsheet updates.

How It Works

Take a few minutes to add your properties, link your bank accounts and everything updates in real-time. ***To learn more get started with a free account, go to Stessa.com.***

THE REAL ESTATE CPA

This content was created by Stessa in partnership with The Real Estate CPA.

Thomas Castelli, CPA is a Tax Strategist and real estate investor who helps other real estate investors keep more of their hard-earned dollars in their pockets, and out of the government's.

The Real Estate CPA is a 100% virtual accounting firm that helps individual real estate investors, syndicates, and private equity funds save thousands in taxes and grow their business with outsourced accounting and CFO services. While traditional CPAs will take on clients across numerous industries and become "generalists," we only service real estate investors or business owners in the real estate industry. We eat, breathe, and live real estate!

STESSA

THE REAL ESTATE CPA