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Vera Coulter

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TAX ASPECTS OF RENTAL PROPERTY

By VERA COULTER, Los Angeles Chapter, ASWA

Rental income, of course, must be reported for income tax purposes. The interesting questions are when must it be reported and what deductions can be taken against it.

Let us first consider the question of when rental income should be reported. If a taxpayer is on a cash basis, rental income is reported as received. If a taxpayer is on an accrual basis, it must be reported as it accrues unless collection is not expected. Even on an accrual basis, rental income received in advance must be reported in the year in which received. If property is leased and the taxpayer receives two year's rent in advance, the entire amount must be reported as income in the year in which it was received. If, on the other hand, a taxpayer receives a deposit to secure performance under the lease, he would not receive taxable income even though he has temporary use of the money.

A landlord need not report as income any improvements made by a lessee either at the time the improvements are made or at the termination of the lease unless the improvements are in lieu of rent. If a lessor rents a piece of land and receives yearly rentals and in addition the tenant builds a building which will belong to the lessor in fifty years at the termination of the lease, the lessor reports only the yearly rent as income. There will be no profit from the building improvements until the building is sold. But should the lessor say "Don't pay me any rent, but build a building which will be mine at the end of a certain time", he is in a different position. In this case the lessor must report as ordinary income the entire fair market value of the building in the year it is completed.

Now let us turn to the question of deductions, a subject which seems to have universal appeal. All of the expenses directly connected with the rented property are deductible and are deductible directly from the income of the property. To be technical, the expenses are deductible from gross income to arrive at adjusted gross income. This is important if a taxpayer wishes to use the standard deduction in lieu of itemizing his deductions on

his return, inasmuch as he may deduct these expenses from gross income and also take the standard deduction. Depreciation, repairs and other expenses are deducted to arrive at net rental income. It is interesting to consider what some of the other expenses may include. Among them are:

Travel expense incurred in looking after income producing property.

Attorney's or accountant's fees paid for services rendered in obtaining adjustment of local real estate tax on business property.

Expenses paid or incurred by the taxpayer in connection with the determination, collection, or refund of any tax related to business property.

Fees for keeping books of income producing property.

Suppose a taxpayer owns an apartment building, lives in one unit and rents the three other units. What deductions can he take? He may deduct all expenses pertaining directly to the rented units plus three fourths of any general expenses applying to all units. Thus if he is renting furnished apartments, he may deduct in full the depreciation on the furniture in the apartments rented, but may deduct only three fourths of the depreciation on the building. Such items as interest and taxes are deductible whether they are business expenses or personal expenses, but only the business portion of these expenses may be deducted from the rental income. The personal portion is deductible only if deductions are itemized. Should the taxpayer sell the apartment house, he must split the sales price and expenses connected with the sale into business (three fourths) and personal (one fourth). The cost of the property would then be computed separately with depreciation on the building being deducted only from that portion allocated to business. It is possible to end up with a profit on the business portion and a loss on the personal portion of the sale.

Getting back to expenses, if insurance premiums are paid in advance for more than one year, the Tax Court has always held that only a pro rata part is deductible in each year whether the taxpayer is on a cash or an accrual basis. However in a

recent case, *Waldheim Realty and Investment Company v. Commissioner of Internal Revenue*,¹ the Court of Appeals reversed the decision of the Tax Court. In so doing the Court ruled:

“We do not believe that any substantial distortion of the taxpayer’s income resulted from the method in which it handled its deductions for insurance expense. Taxpayer deducted the insurance premium in the year paid. This is the usual and ordinary way for a cash basis taxpayer to handle business expenses. To require the taxpayer to treat insurance payments upon an accrual basis would, as the Supreme Court states in *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281 create ‘a divided and inconsistent method of accounting not properly to be denominated either a cash or an accrual system’.”

Depreciation is a subject in itself, but a few items may be of special interest in connection with rental property. A lessor should be careful not to include a phrase which states that the property must be returned to him in as good a condition as when rented as such a statement may cause disallowance of the depreciation allowance. When a taxpayer purchases property which he plans to rent, he must have a basis for allocating the cost between land and buildings since only the buildings may be depreciated. An appraisal report or property tax bills may be used for this purpose. The purchaser may want to consider the possibility of using accelerated depreciation. This subject is too involved to take up here, but it should be considered.

The question arises as to whether an item should be capitalized and recovered through depreciation or whether it should be taken as a current expense. Expenditures should be capitalized if any of the following conditions are met:

- 1—The expenditure improves the asset beyond its original condition.
- 2—The expenditure fits the asset for some new use.
- 3—The expenditure will prolong the life of the asset beyond its original life.

In addition, the replacement of major parts of a building must be capitalized. If a roof is replaced, the cost must be capitalized and recovered through depreci-

ation. If the roof is simply repaired the expenditure may be deducted as repair expense.

If a taxpayer decides to rent a house in which he previously lived, expenses may be deductible from the time he puts the house up for rent, even though he does not succeed in renting the house and eventually sells it. The basis for depreciation of a house previously used as a residence is the adjusted basis of the house at date of conversion or the fair market value at the date of conversion whichever is lower. For example, suppose a taxpayer owned a house which cost \$15,000 (excluding the value of the land). After ten years he converted it to rental property at a time when the fair market value of the house was \$12,000. The house had an estimated life of 20 years when converted. Depreciation on cost would be \$750 per year, but on the fair market value would be \$600 per year. The amount of depreciation allowable would be \$600. If the house had cost \$10,000, depreciation on cost would be \$500 annually and since this is the lower figure, \$500 would be the amount of allowable depreciation.

If after converting the house into business property, taxpayer decides to sell, any gain is taxable. Value of the property at date of conversion has no effect upon the amount of the gain. However, should the property be sold at a loss, the loss is limited to that which occurred after the property was converted to business property.

Since the adjusted cost is the basis for gain and the adjusted cost or the adjusted fair market value at date of conversion, whichever is the lower, is the basis for loss, it is possible to have neither gain nor loss when selling rental property which was converted from a residence. In the example on page 12, had the selling price been \$21,000, there would have been neither loss nor gain since the basis for gain would be \$23,200 and that for loss \$20,200.

Rental property is a Section 1231 asset since it is property used in trade or business. It is therefore subject to the provisions applicable to Section 1231 assets, which in general allows gains to be treated as capital gains and losses as ordinary losses.

The law permits the deduction of losses which arise from fire, storm, shipwreck or other casualty. This deduction is allowed whether the property is personal

¹*Waldheim Realty and Investment Company, Petitioner v. Commissioner of Internal Revenue, Respondent*. CA-8-No. 15,651, 6/4/57 (rev'g. and rem'g. TC-25TC 1216; Dec. 21,617) 245 Fed. (2d) 823. (57-2 USTC #9717, CCH)

or business property. There is a difference in the treatment of business property, however. Since a casualty is an event due to some sudden, unexpected or unusual cause, damages by termites to a residence would be disallowed (unless the termites were unusually fast eaters), but damages to business property by termites is allowed.

If a residence burns down, and there is no insurance coverage, the casualty loss will be limited to the fair market value of the house at the time of the fire, if this basis is lower than the adjusted cost. But if rental property is completely destroyed by fire, the owner will be entitled to deduct the adjusted basis of the property, less salvage value and less insurance received.

If only part of the property is destroyed and the remaining property is not discarded, the following formula may be used for computing the deductible loss:

$$\frac{\text{Actual value before loss} - \text{Actual value after loss}}{\text{Adjusted basis} \times \frac{\text{Actual value before loss}}{\text{Actual value before loss}}} = \text{Loss}$$

Rental income and expenses pertaining thereto are reported on Schedule G.-Income from Rents and Royalties, Form 1040

Example:

Cost—		
Land	\$10,000	
Bldg.	15,000	\$25,000
		<hr/>
Depreciation,		
3 yrs. @ \$600		
per year		1,800
		<hr/>
		\$23,200
Selling price		16,000
		<hr/>
Loss		\$7,200

—U.S. Individual Income Tax Return. Depreciation of rental property is to be explained on Schedule I.-Explanation of Deduction for Depreciation Claimed in Schedule G and repairs and other expenses should be itemized on an attached list. The net rental income is combined with other income and is included in adjusted gross income by being reported on Page 1 of Form 1040.

Accountants should impress upon their clients the importance of good records in support of deductions claimed for rental properties. The taxpayer should be encouraged to preserve appraisals, invoices for expenditures, cancelled checks, and any other pertinent memoranda. Often-time property owners conclude a sale or disposition of properties without adequate knowledge of proper accounting for such transactions because they fail to consult an accountant. An accountant can render more effective service to the client when consulted prior to the consummation of such transactions, and is in a better position to advise tax treatment of the transaction most favorable to the taxpayer rather than after the event has occurred.

Fair Market Value at Conversion—

Land	\$10,000	
Bldg.	12,000	\$22,000
		<hr/>
Depreciation,		
3 yrs. @ \$600		
per year		1,800
		<hr/>
		\$20,200
Selling price		16,000
		<hr/>
Deductible		\$4,200
Loss		

(Continued from page 9)
amendment does. The title of the resolution reads:

“Proposing an amendment to the Constitution of the United States relative to equal rights for men and women.”

Next, she wants both sexes to have their rights, nothing more and nothing less. These rights we spell out as being equality under the Constitution, nothing more or nothing less.

Although both AWSCPA and ASWA are on record as supporting Equal Rights legislation, which is introduced in each session of Congress, many members are quite vague as to what the broad problems are. This information is being published in a series of articles so that members of the two societies may become better informed.

*Mary F. Hall, Legislative Chairman,
AWSCPA*