Ready for Tax Season?

written by JARGAL OYUNBILEG

Read the following Q&A to be on your top tax game this year.

With the tax-filing deadline fast approaching, I thought the most useful column for readers would be a compilation of frequently asked questions from landlord-taxpayers. So, without further ado ...

Q. A tenant in my building went though a trying time. He wasn't able to pay rent for a time period and recently vacated the unit. I lost a few months of rental income and incurred expenses during and after his move. Can I deduct the expenses and loss of rent on my tax return?

A. In most cases, the answer is no. Most landlords use cash-basis reporting, which means income is reported in the year the money is received. Therefore, if money from rent did not come in, then no money was lost to deduct on the tax return.

However, some landlords report rental income as the money is due, rather than when they actually collect the rent. In this situation, deduction of unpaid rent is possible for accrual-based taxpayers.

If the cash-basis taxpayer mistakenly reports the uncollected rent as income, then amending the return to correct the mistake is an option. Keep in mind, though, that sometimes it's not worth the incurred costs to amend a tax return.

Q. After a long-term tenant moved out, it took four months to fill the vacancy. Can I deduct expenses that incurred during the vacancy?

A. Expenses directly related to the rental property—as long as the property was available for rent—are usually deductible during a vacancy. Maintain organized and thorough records just in case you need to prove that the property was on the market for rent.

Improvements do not fit into this category, however. Improvements are capitalized and deducted through depreciation over the lifetime of the asset.

Q. A friend told me about the section 179 deduction, in which a property owner can deduct 100 percent of the eligible cost of assets in the year of purchase. Why are carpets and cabinets not deductible in the first year of use?

A. Section 179 is an election to deduct cost of eligible property in the year of purchase and/or service. This election is not available to some taxpayers, even though the assets they placed in service may be qualifying assets. For example, estates and trusts cannot use this election, nor can owners of residential rental properties.

Not everything is lost though. Bonus depreciation is available to rental property owners, which is currently 50% of the cost of the eligible assets.

Additionally, the De Minimis Safe Harbor Election allows taxpayers to expense tangible property that costs up to $2,500. This is only available if the taxpayer makes the election by submitting her timely filed returns and required statement in the year the De Minimis tangible property is expensed. This election is an annual election, not a one-time election.

Q. I own four multi-unit rental properties. Before I retired, I had a full-time non-real estate career. My income was significantly high, so I was not able to deduct loses related to my rental properties over the years, which have accrued over time. Since my retirement early last year, I've been managing my rental properties full time. Can I deduct the carried forward suspended losses now?

A. Let's refresh the basics of rental activities and varying tax treatment of losses.

Renting real estate is generally considered a passive activity. Loss from passive activity can only offset income received from passive activity. Any excess is suspended and carried forward until there is passive income to offset, or the property is disposed in its entirety.

There are two exceptions where the loss can become deductible: active participation and material participation.

In the case of active participation, a taxpayer must meet the active participation requirements (this is the easiest exception to qualify for). Up to $25,000 loss is allowed for deduction from actively managed (by owner) rental activity. However, this deduction is reduced when the taxpayer's adjusted gross income (AGI) exceeds

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Suspended passive activity losses are generally released and deducted partially or fully when there is income from passive activities to offset against; when there is income from former passive activities; or when the property is fully disposed.

In the first situation, the taxpayer has income from other passive activities (three of his four buildings), so the suspended loss is released to offset the passive income. Any excess is carried forward. In the second situation, when the properties are grouped as one activity and there is net rental income from the same properties, the suspended loss can be released to offset to the extent of the income. Any excess can be carried forward. In the third situation, when the taxpayer materially participated 750 hours on each of his buildings, all the suspended losses from the former passive activity is released.

Q. My wife and I own a two-unit building with our son. My wife and I live in the lower unit and my son lives in the upper unit. We pay 100% of the mortgage and property taxes. On the tax return, do we allocate the amount of mortgage interest and property taxes incurred during the year, based on our ownership percentage of the property (in this case 50/50), or do we get to deduct the amount that we actually paid during the year?

A. Whoever is on the title (whether full ownership or 50/50) and paying the mortgage interest and property taxes gets to take the deduction. In this situation, the parents are 50% owners and pay 100% of the costs, which means they get to deduct the costs fully on their return. One cannot deduct mortgage interest and property taxes that are imposed on someone else, even if that person is a family member.

However, if the parents and son split the costs per their ownership interest, they would deduct based on their prorate share of the costs on their tax return.

In another scenario, if the son were the sole titleholder of the property, and the parents covered 100% of the costs, then those payments would be considered a gift to their son (hint: gift tax return reporting requirement).

Q. I co-own a three-unit building and live in one of the units. The mortgage interest statement shows only my co-owner's name. Since I paid my proportionate share of the mortgage, I claimed the deduction on my tax return. To my surprise, I recently received a notice from the IRS disallowing my mortgage interest deduction. How do we resolve this?

A. This is commonplace and happens when the 1098 form is sent to only one owner. We recommend that this taxpayer deduct his portion of the interest paid during the year on Schedule A of his tax return, on the line stating: "Home Mortgage Interest not reported to you on form 1098."

This column is not an authoritative or a reliable source of information to use for your tax compliance. Please consult with your paid tax specialist to get answers to your specific questions. Additionally, the information in this article may become out-of-date if there is tax reform in the future.

Jargal Oyunbileg is a CPA at Shwiff, Levy & Polo, LLP and can be contacted at jargal@yousrvc.com.

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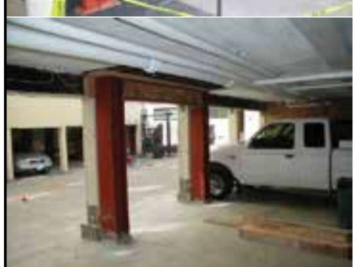

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Contact
Bishwendu K. Paul, S.E., M. Eng.
UC Berkeley Alumni
Structural Lic. No. S003093
(510) 601-1065
(415) 835-6754
bk@esiengineers.com
www.esiengineers.com