Tax Primer for Servicemembers with Residential Rental Property

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I shall never use profanity, except in discussing house rent and taxes.[1]

I. Introduction

With the recent economic downturn and the housing crisis,[2] more American homeowners face falling home values and an inability to sell their property at a profit.[3] Servicemembers, in particular, are often unable to build adequate home equity because of frequent requirements to move or deploy. To avoid a significant financial loss from a short-term home sale, some military homeowners choose to convert their homes into rental properties rather than sell them. Other servicemembers deliberately purchase rental properties near their various duty stations as a long-term investment plan.[4] As the number of prospective military landlords grows in the future, attorneys in charge of installation tax centers must have a solid understanding of the tax issues related to residential rental property.[5]

This paper aims to give legal assistance attorneys and officers-in-charge (OICs) of tax centers an overview of the basic federal income tax implications of residential rental property. Part II of this primer concentrates on reporting rental income and expenses and how to properly account for each on Schedule E of the landlord's IRS Form 1040. Part III addresses the benefits of depreciating rental property and capital improvements made during the life of a rental. Part IV discusses the limits on what landlords can deduct in any given year. Finally, Part V concentrates on the sale of rental homes and describes the new limits imposed by Internal Revenue Code § 121 when a landlord sells his investment.

II. Rental Income and Expenses

A. What Is Rental Income?

Rental income is most conveniently defined as payment for the use or occupation of a piece of property,[6] but it also encompasses *any* benefits received from the rental property.[7] This includes both current[8] and advance[9] rent payments from tenants but generally excludes security deposits.[10] Rental income also includes any number of other payments that a landlord

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[1] MARK TWAIN, EUROPE AND ELSEWHERE 15 (1923).

[2] Phil Izzo, *Economists See No Growth Until 2nd Half of 2009*, WALL ST. J., Nov. 13, 2008, *available at* http://online.wsj.com/article/SB122651067485621191.html.

[3] The Office of Federal Housing Enterprise Oversight (OFHEO), http://www.ofheo.gov/hpi.aspx?Nav=275 (last visited Feb. 26, 2009).

[4] Barbara H. Pietrowski, *Make Rental Property Part of Your Retirement Plan*, ARMY TIMES, http://www.armytimes.com/money/financial_advice/ONLINE.INVEST.RENTALPROPERTY/ (last visited Mar. 6, 2009).

[5] Residential rental property is defined as real property with buildings or structures, where eighty percent or more of the property's annual gross rental income comes from dwelling units. INTERNAL REVENUE SERV., PUB. 946, HOW TO DEPRECIATE PROP. 32 (2007) [hereinafter IRS PUB. 946].

[6] I.R.C. § 61 (2006). Gross income includes all income from whatever source derived. This may include rent paid by a tenant, services provided in lieu of rent, or any other benefit the landlord receives for use of the property. *See* Comm'r v. Glenshaw Glass, 348 U.S. 426 (1955) (All income, whether traceable to labor, to capital, or to mere good fortune are gains that fall within broad sweep of gross income in I.R.C. § 61, unless expressly excluded by Congress).

[7] Treas. Reg. § 1.61-8a (2008); INTERNAL REVENUE SERV., PUB. 527, RESIDENTIAL RENTAL HOMES 3 (2008) [hereinafter IRS PUB. 527].

[8] Current rents are payments or services provided to the landlord for a contemporaneous rental period (usually the current month), and they must be reported when received. IRS PUB. 527, *supra* note 7, at 3.

[9] Advance rent payments are payments for future use of the property. A common example of advance rent payment occurs when the landlord demands payment of first and last month's rent upon signing the lease. The last month's rent is an advance payment and is not generally refundable to the tenant. Any advance rental payments are reported as income in the year received, not the future tax year covered by the payment. I.R.C. § 451 (2006).

[10] IRS PUB. 527, *supra* note 7, at 3; JEFFERY HELEWITZ, A GUIDE TO FEDERAL TAXATION 49 (2005).

may receive in the ordinary course of a tenancy, even though the landlord may not think of them as rent.[11] Once a landlord accounts for his total rental income, he must report it to the Internal Revenue Service (IRS) in the year he received, or constructively received, the payments.[12] For example, if the landlord accepts rent payments for December 2008 and January 2009 in December, the landlord must report both payments as part of his taxable income in 2008 because he received the payments within that tax year.

Security deposits, on the other hand, may not necessarily be taxable income.[13] The landlord's obligation to report a security deposit as income hinges on how the landlord ultimately treats the deposit.[14] If the landlord intends to return the security deposit to the tenant at the end of the lease, then the deposit is not income.[15] The landlord is merely safeguarding the money to ensure the tenant lives up to his obligations under the lease and does not receive any benefit from the deposit.[16] If the landlord keeps part of the security deposit because the tenant breached the lease, he must report only the retained amount as income.[17] Because many landlords have differing views of what constitutes a security deposit, tax preparers must always ask whether the landlord intends to return the deposit.[18]

At the end of the tax year, the landlord must report all actual and constructive rental income using an IRS Form 1040 Schedule E, Supplemental Income and Loss Form.[19] The landlord may list up to three rental properties on each Schedule E, with each property listed separately by location. He must identify each property consistently throughout the schedule, as either property A, B, or C. If the landlord owns more than three rental properties, he should use additional schedules to report and adjust his total rental income. However, as the landlord acquires increasing numbers of rental properties, the IRS may classify his rental earnings as business, rather than as supplemental, income.[20]

After listing actual and constructive rent on the Schedule E, the landlord may offset the income with deductions for rental expenses and depreciation, and then he must report the net rental income to the IRS.[21] As a consequence of this adjustment on the Schedule E, many landlords collecting thousands of dollars in rent may wind up with no rental income or even losses used to offset their other income.[22] This potential for negative rental income is a significant financial advantage for landlords, and it is imperative that tax center OICs thoroughly understand how to adjust income through expenses and depreciation to assist clients.

B. Rental Expenses—What Can the Landlord Deduct?

A landlord who intends to deduct his rental expenses on a Schedule E must keep track of all "ordinary and necessary expenses paid or incurred during the taxable year."[23] The three most significant expenses landlords incur as part of their

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[11] If the tenant pays to cancel the lease, that payment is considered rent in the tax year when the cancellation payment is received. IRS PUB. 527, *supra* note 7, at 3. If there are any insurance proceeds for the loss of rental income because of fire or other casualty, those proceeds are considered rental income. 26 C.F.R. 1.123-1 (2005). Additionally, any non-monetary benefits that the landlord receives will be included as rent. This includes a tenant paying the landlord's deductable expenses and any property or services received in lieu of rent payments. Treas. Reg. § 1.61-8(c) (2008).

[12] I.R.C. § 451 (2006); *see id.* § 441. Taxable income is computed based on the accounting method the taxpayer regularly uses to compute his income. *Id.* For most landlords, this is the cash basis method, under which income is reported when received or constructively received.

[13] IRS PUB. 527, *supra* note 7, at 3.

[14] For example, if the security deposit consists of first and last month's rent, then it is actually a current and advance payment, and it is considered rental income in the year that it is received. I.R.C. § 451.

[15] IRS PUB. 527, *supra* note 7, at 3.

[16] However, some states statutorily require landlords to put security deposits into an interest earning account, which may generate additional reportable rental income. *See* VA. CODE ANN. § 55-248.15:1 (2007).

[17] This amount is reported as income in the tax year the money is retained, as opposed to the year in which the deposit was originally received. IRS PUB. 527, *supra* note 7, at 3.

[18] This issue, and many others, can be resolved by using a separate rental income questionnaire for those tax payers who have residential rental property. *See infra* Appendix A.

[19] *See infra* Appendix B.

[20] If landlord is renting residential property as a business venture, a Schedule C should be filed rather than a Schedule E. *See* discussion *infra* Appendix G.

[21] *See infra* Appendix B.

[22] *See* discussion *infra* Part IV.B.

[23] I.R.C. § 62(a)(4) (2006); *id.* § 212. Ordinary and necessary expenses are those expenses that are common and accepted in the taxpayer's business or trade. They must be reasonable in amount and bear a reasonable relation to the management of the property. Bingham's Trust v. Comm'r, 325 U.S. 365 (1945).

rental activity are mortgage interest, real estate taxes, and insurance. The lender holding the mortgage must report each of these items to the landlord and IRS at the end of the tax year on an IRS Form 1098, Mortgage Interest Statement.[24] Tax center OICs and those working in installation tax centers should always request this document when assisting a landlord with residential rental property.[25] If the landlord used the home exclusively as a rental property for the entire year, the preparer may transfer these expenses directly from the Form 1098 to the landlord's Schedule E.[26] The landlord may deduct all his mortgage interest for the rental property as an expense.[27] Conversely, if the landlord paid any points on the loan, that expense must be prorated over the mortgage term.[28] The landlord may also deduct any insurance on the rental home as an expense for that tax year.[29] Finally, the landlord may deduct real estate taxes on the property as an expense. If the landlord paid his property taxes into an escrow account, as required by many lenders, his Form 1098 will usually list his annual real estate taxes.[30] After these large expenses are accounted for, the landlord should continue to list his expenses by category on the Schedule E.[31]

Military landlords often find themselves stationed far from their rental property. Consequently, many of these landlords use property managers to assist in finding suitable tenants, collecting monthly rent payments, and carrying out the day-to-day business of managing a property. Landlords may deduct management fees for these services as an expense.[32] Additionally, if the landlord checks on the rental property during the tax year, he may deduct his "ordinary and necessary auto and travel expenses,"[33] including 50% of his meal expenses when traveling away from home.[34] If the landlord's primary purpose for the trip is to "collect rental income or to manage, conserve or maintain the rental property,"[35] he may deduct either (1) his actual travel expenses, or (2) the standard mileage rate when calculating this expense.[36] However, if the landlord fails to maintain records substantiating his travel expenses, the IRS may deny the deduction.[37] This deduction is particularly confusing for many military landlords, and tax center OICs should be thoroughly familiar with the limits on auto and travel expenses.[38]

Another issue that frequently arises when reporting rental expenses is the proper accounting for repairs. Many landlords have difficulty distinguishing between repairs and improvements. A repair "keeps the rental property in good operating condition" and "does not materially add to the value of [the] property or substantially prolong its life."[39] Examples of repairs

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[24] IRS PUB. 527, *supra* note 7, at 4.

[25] If the landlord pays mortgage interest to a lender other than a financial institution or does not receive a Form 1098, he is required to maintain a record of the interest paid to the lender and should report the interest payments on line 13 (other interest), rather than line 12 (mortgage interest) on the Schedule E. IRS INSTRUCTIONS FOR SCHEDULE E (FORM 1040), SUPPLEMENTAL INCOME AND LOSS, at E-5 (2008) [hereinafter IRS INSTRUCTIONS FOR SCHEDULE E].

[26] If the home was not exclusively used as a rental property during that tax year, expenses must be apportioned between personal use and the rental use. Only the proportion related to rental use may be deducted as a rental expense. *See* discussion *infra* Part IV.A.

[27] I.R.C. §163 (2006). However, the landlord may not deduct any pre-paid interest as an expense. Ordinary interest paid on the mortgage should be entered in block 12 (mortgage interests paid to banks) of the Schedule E.

[28] Moore v. Comm'r, T.C. Memo 1994-503. Points will be placed in block 13 (other interest) of the Schedule E.

[29] I.R.C. § 62(a)(4); *id.* § 212. Insurance includes premiums for mortgage insurance, fire and casualty insurance, or any other ordinary or necessary insurance expenses required to maintain the rental home. The sum of these premiums should be entered in block 9 (insurance) of the Schedule E.

[30] Some landlords may also provide documents from their local tax assessor to substantiate the amount of real estate taxes paid on the rental property during the tax year. The total amount paid in real estate taxes should be listed on line 16 (taxes) of the Schedule E.

[31] *See infra* Appendix B.

[32] IRS PUB. 527, *supra* note 7, at 3. The landlord should report this expense on line 11 (management fees) of the Schedule E. If the landlord incurs any additional expenses by advertising the rental property, or as a commission to another party, he may also report these expenses on lines 5 (advertising) and 8 (commissions) of the Schedule E, respectively.

[33] INTERNAL REVENUE SERV., PUB. 463, TRAVEL, ENTM'T, GIFTS, AND CAR EXPENSES 4 (2008) [hereinafter IRS PUB. 463].

[34] However, all deductable travel expenses must relate solely to the rental activity. For example, Sergeant Smith spends $600 to fly to Austin, Texas, to see his mother and $70 to rent a car for his visit. He also chooses to check up on his rental property located near Fort Hood, Texas, during the visit. He will not be permitted to deduct the cost of his entire trip as a business expense. He is only permitted to deduct the round-trip mileage from Austin to the rental home at Fort Hood, plus fifty percent of his meal expenses during the trip to check on the property. The remainder of his expenses are personal or family-related.

[35] IRS PUB. 527, *supra* note 7, at 4.

[36] This amount is reported on line 6 (auto & travel) of the Schedule E. The standard mileage rate is listed each year in the instructions for the Schedule E.

[37] *See* Burton v. Comm'r, T.C. Memo 1991-12 (1991) (disallowing auto and travel expenses when petitioners could not present travel logs or other evidence to corroborate their testimony regarding such trips).

[38] *See* IRS PUB. 463, *supra* note 33.

[39] IRS PUB. 527, *supra* note 7, at 5.

include the fixing of a clogged sink or the replacement of a broken window pane. An improvement, on the other hand, "adds to the value of the property, prolongs its useful life, or adapts the property to new uses."[40] Finishing the basement on a rental home to expand its livable space is an example of an improvement.

Confusion over repairs and improvements often occurs when an item falls squarely into both categories. If the landlord replaces the roof on the rental home, it extends the useful life of the rental and adds value to the property. As such, a new roof would generally constitute an improvement. However, if the landlord only replaces part of the roof because it is leaking, the new roofing materials and labor are a necessary expense needed to keep the rental home in good operating condition. In each scenario, the landlord pays for exactly the same type of materials and labor, so he may be unable to distinguish whether the expense incurred represents an improvement cost or a deductable repair.[41] When the potential for confusion exists, it is "necessary to take into consideration the purpose for which an expenditure is made in order to determine whether such expenditure is capital in nature or constitutes a necessary expense."[42]

While most deductions on the Schedule E are self-explanatory, some are relatively vague and may be ripe for abuse by unscrupulous landlords.[43] Tax preparers can prevent much of this fraud by inspecting landlords' supporting documents.[44] Landlords must maintain records to substantiate their rental income and deductions each year.[45] If the landlord presents insufficient records, the preparer should ask him how he incurred his expenses and ask for supporting documents. Finally, it is always important to remember that landlords may never deduct the value of their own labor as an expense.[46]

III. Depreciation—How It Helps the Landlord

Depreciation is possibly the greatest tax benefit afforded to landlords. It permits landlords to recover the cost of wear and tear on their residential rental property through yearly tax deductions.[47] Using the dwelling as a rental home decreases the value of the asset for tax purposes, even though the fair market value of the home stays the same or even increases over time.[48] Using the Modified Accelerated Cost Recovery System (MACRS),[49] the useful life of a residential rental property is twenty-seven and a half years, and the value of this asset notionally drops each year during that period. If the landlord is the owner of the property[50] and meets all the criteria to depreciate the asset, he can deduct this depreciation on his Schedule E.[51]

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[40] *Id.*

[41] Repairs are deducted as an expense on line 15 (repairs) of the Schedule E. The cost of improvements to the rental home are not deductable expenses, but the cost may be recovered by taking depreciation on the improvements. *See* discussion *infra* Part III.B and Appendix C.

[42] Campbell v. Comm'r, T.C. Summ. Op. 2002-117 (2002) (allowing removal and replacement of roofing materials as a deductible expense when the only purpose was to prevent existing leakage and keep the rental home in operating condition and not to prolong the life of the property, increase its value, or make it adaptable for another use). Allowable repairs may be deducted as an expense on line 15 (repairs) of the Schedule E.

[43] For example, the supplies expense (line 5 of the Schedule E) is not defined in IRS Pub. 527 and is not specifically addressed in the IRS instructions for the Schedule E. Accordingly, landlords must fall back on the overarching principle that only "ordinary and necessary expenses" for operation of the rental property are deductable. *See* Bingham's Trust v. Comm'r, 325 U.S. 365 (1945).

[44] Installation tax centers operate under the IRS Volunteer Income Tax Assistance (VITA) program and help military taxpayers prepare individual tax returns in conjunction with Army Regulation 27-3, paragraph 3-6i. U.S. DEP'T OF ARMY, REG. 27-3, THE ARMY LEGAL ASSISTANCE PROGRAM para. 3-6i (21 Feb. 1996). Tax returns prepared as part of the VITA program are considered self-prepared by the taxpayer. However, VITA preparers and supervising attorneys may not knowingly assist taxpayers in preparing or filing erroneous or fraudulent tax documents.

[45] I.R.C. § 6001 (2006); Shelton v. Comm'r, T.C. Summ. Op. 2002-9 (2002).

[46] Rental Property and the Tax Gap, http://www.irs.gov/newsroom/article/0,,id=172596,00.html (last visited Nov. 17, 2009); *see generally* Burton v. Comm'r, T.C. Memo 1991-12 (1991) (explaining petitioner could not deduct his "children's help" as an expense because any amounts paid to the children are expenses that are personal in nature and not deductible).

[47] IRS PUB. 946, *supra* note 5, at 3.

[48] I.R.C. § 167.

[49] *Id.* § 168. Taxpayers must use MACRS to depreciate residential rental property placed in service after 31 December 1986. Homes placed into service prior to 1 January 1987 use the Accelerated Cost Recovery System (ACRS) depreciation method instead of the MACRS method. Further information about using ACRS is contained in IRS Pub. 534. INTERNAL REVENUE SERV., PUB. 534, DEPRECIATING PROP. PLACED IN SERVICE PRIOR TO 1987 (Nov. 1995).

[50] The taxpayer is still considered the owner of the property even if it is subject to a lien or debt. IRS PUB. 946, *supra* note 5, at 4.

[51] Landlords often may not claim the full depreciation deduction for a tax year in which they used a rental home for personal use. *See* discussion *infra* Part IV.A.

When preparing tax returns for rental property, landlords frequently misunderstand the usefulness of the depreciation deduction. Although landlords must report all their rental income, they do not have to use their rental expenses or depreciation to adjust this income.[52] Few landlords willingly give up their expense deductions, but a surprising number contemplate forfeiting their depreciation deduction. The decision not to depreciate a property is often made by inexperienced landlords who believe depreciating the property for tax purposes will somehow decrease the value of the home. This notion is incorrect. When a landlord claims this benefit on his tax return, it does not affect the fair market value of the property. Depreciation is merely an opportunity for a landlord to recover his investment in tangible property through a tax deduction.[53]

A second misunderstanding about depreciation relates to the sale of a home. When a landlord sells a rental property, his capital gain includes both the profit realized from the sale and the depreciation on the home during the period it was used as rental property.[54] Some landlords mistakenly believe that by declining to depreciate the rental home on their annual tax returns, the IRS will not compel them to account for depreciation upon the home's sale. In truth, when the landlord calculates his capital gain, he must always adjust the value of the home for any *allowable* depreciation.[55] For example, if a landlord sells his rental home in 2008 for a $20,000 profit, and could have depreciated the rental home by $10,000 on his tax returns during the rental period, he must declare a total of $30,000 as capital gain upon the sale, even if he did not actually claim the depreciation during each of those tax years. Accordingly, landlords should always claim the maximum amount of depreciation when allowed, because they will have to adjust their basis by the amount they *could have* deducted on the rental home.[56]

A. Depreciating the Rental Home

To depreciate any asset, the landlord must know three things: (1) the recovery period, (2) the date the asset was placed in service, and (3) the basis of the asset.[57] The recovery period for residential rental property under the MACRS general depreciation system (GDS) is always twenty-seven and a half years.[58] Next, the date the rental property was "placed in service" is the month the asset was "ready and available for a specific use."[59] Finally, the basis amount is usually either the cost of the rental property or its fair market value.[60] Once the landlord determines the rental home's basis, calculating the depreciation deduction is relatively easy because the landlord only needs to determine his basis amount once—when the home is placed into service.[61] Tax centers using TaxWise software[62] to electronically prepare returns should note that TaxWise will automatically calculate the landlord's depreciation once the preparer has entered all the relevant information for the rental property. Preparers calculating depreciation manually must use the IRS Form 4562 and the relevant depreciation tables to determine the depreciation deduction.[63]

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[52] As with other adjustments, deductions, and tax credits, the taxpayer may willingly choose to give up his allowable deductions, but if he does so, he will pay more taxes than similarly-situated landlords.

[53] IRS PUB. 946, *supra* note 5, at 3.

[54] I.R.C. § 1016(a)(2); *see* Samson v. United States, 144 F. Supp. 620 (D.C.N.Y. 1956) (finding taxpayer was permitted by statute to claim depreciation, and, therefore, his adjusted cost basis at sale should have reflected this allowable depreciation).

[55] I.R.C. § 1016(a)(2). Allowable depreciation is the amount the landlord is permitted to claim under the tax code. Compare the difference between "allowable" depreciation, "claimed" depreciation (the amount the landlord actually claims on his tax return), and "allowed" depreciation (the amount the IRS allowed the landlord to claim on his tax return). If the landlord only claimed $500 in depreciation and that depreciation deduction was approved by the IRS when he was permitted to claim $1000 in depreciation, then his allowable depreciation was $1000, even though his claimed/allowed depreciation was only $500.

[56] *Id.*

[57] IRS PUB. 527, *supra* note 7, at 6.

[58] *Id.* at 9.

[59] IRS PUB. 946, *supra* note 5, at 34. This will be a fact-specific determination based on each individual property, as some rental homes are available for rent in one month but remain vacant for several months before the landlord actually secures tenants. *Id.*

[60] IRS PUB. 527, *supra* note 7, at 7–8. However, basis may be determined by other means if the rental home was acquired as a gift from a former spouse as a result of divorce, by inheritance, or through a like-kind exchange under I.R.C. § 1031. INTERNAL REVENUE SERV., PUB. 551, BASIS OF ASSETS 10 (2002) [hereinafter IRS PUB. 551].

[61] IRS PUB. 551, *supra* note 60, at 2–3. Each subsequent year that the home remains a rental property, the basis will remain the same for purposes of depreciation calculations. The preparer should be able to readily determine the basis of the rental property by looking at the landlord's Schedule E and IRS Form 4562 from the prior year.

[62] TaxWise is tax and accounting software licensed to the IRS for use in all VITA programs and tax centers.

[63] *See* discussion *infra* Appendix E.

1. Determining Basis by Cost

The basis of an asset is usually its cost.[64] However, determining the cost basis for residential rental property is more complex than most other assets because it consists of two separate items: (1) the rental home, and (2) the parcel of land the home sits on.[65] The landlord may only depreciate the value of the rental home and any other structures on the property; he cannot depreciate the value of the land itself.[66] Most landlords purchase the land and residence together, and they often need help determining the cost of each asset separately. To do this, a landlord must know the property's total purchase price and the assessed value of the parcel of land.[67] After establishing these amounts, the landlord simply subtracts the land value from purchase price, and the remainder is his cost basis in the rental home.

2. Determining Basis by Fair Market Value

Many military landlords use the home as a personal residence before converting it to a rental property. In such cases, it's often more advantageous for the landlord to calculate his basis using the property's fair market value (FMV) at the time of conversion, rather than its cost at the time of purchase. However, the landlord may only use this method to determine his basis when the home's FMV is *less than* the home's adjusted basis.[68] For example, assume a landlord purchased a parcel of land for $30,000 (land value) and built a $200,000 home on the property. While living in the home, he made an additional $26,000 in improvements before converting it to a rental home. In this case, the landlord's adjusted basis in the rental home is $226,000. Now assume the FMV of the property at the time it's converted to a rental is $250,000, of which $35,000 is for the current land value and the remaining $215,000 is for the home. The landlord may use the home's FMV ($215,000) as his basis for depreciation instead of the property's cost ($200,000), because the FMV of the property is less than the landlord's adjusted basis of $226,000. It is important to note that, regardless of whether the landlord uses the cost basis method or FMV method to determine his basis in the rental property, he never includes the land's value in this determination. He can only consider the value of the residence and other structures on the land.[69]

3. Depreciation Limits and Additions

The landlord may depreciate the rental property each year for twenty-seven and a half years, until he fully recovers the home's basis.[70] However, depreciation ends early if the landlord retires the rental property from service, either by selling it or converting the property to personal use.[71] Furthermore, if the landlord uses the rental home as his personal residence for a portion of the year, he may be unable to deduct the full amount of his depreciation that particular year.[72]

In addition to normal depreciation for the rental home, some landlords are also eligible for a special depreciation allowance, which *increases* their depreciation deduction.[73] For example, certain landlords receive a special depreciation allowance for rental properties homes built within a qualified Liberty Zone[74] or Gulf Opportunity Zone.[75] Once the landlord

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[64] I.R.C. § 1012 (2006); IRS PUB. 551, *supra* note 60, at 2.

[65] IRS PUB. 527, *supra* note 7, at 7–8.

[66] *Id.* at 6. The landlord cannot depreciate land because it does not wear out, become obsolete, or get used up. *Id.*

[67] The purchase price is readily available on the property's sale documents or the HUD-1. The value of the land by itself, however, is rarely itemized in the sale documents, unless the landlord purchased the parcel without any structures on it. Instead, the land's value is most easily established through tax appraisal records from the local tax assessor. *See* Sample Land Appraisal document *infra* Appendix D.

[68] IRS PUB. 946, *supra* note 5, at 12.

[69] IRS PUB. 527, *supra* note 7, at 7–8.

[70] IRS PUB. 946, *supra* note 5, at 7.

[71] *Id.*

[72] Personal use is defined as fourteen or more days in the year or more than ten percent of the total days it was rented to others at a fair market price. IRS PUB. 527, *supra* note 7, at 21.

[73] IRS PUB. 946, *supra* note 5, at 24.

[74] I.R.C. § 1400L (2006). The Liberty Zone includes qualified properties in areas of New York City damaged, destroyed, or condemned as a result of the 11 September 2001 terrorist attacks.

[75] *Id.* § 1400N. The Gulf Opportunity Zone covers qualified properties in Mississippi, Alabama, and Louisiana declared hurricane disaster areas after Hurricanes Katrina, Rita, or Wilma.

determines his total depreciation on the rental home, he may also begin depreciating any capital improvements made to the rental property.[76]

B. Depreciating Capital Improvements

Even though landlords cannot deduct improvement costs for rental properties as an "expense" on their Schedule E, they can recover these costs through depreciation.[77] Landlords must always remember to depreciate each improvement separately from the rental property using the improvement's appropriate recovery period.[78] For example, if a landlord installs a new dishwasher in a rental home two years after placing the home into service, he can continue depreciating the rental property for the remaining twenty-five and a half years of its recovery period and can also begin depreciating the dishwasher as a second asset.

Most improvements to rental property fall into the five-year, seven-year, or fifteen-year recovery periods.[79] Interior improvements, such as the installation of appliances, carpets, or air conditioning units, have a five-year recovery period.[80] Thus, a landlord can depreciate the value of a new dishwasher over five years to recover the cost of the improvement. Office furniture, fixtures, and equipment that are not structural components of the home have a seven-year recovery period.[81] The landlord may depreciate any improvements made directly to the land or added to it, including trees, shrubs, fences, roads, sidewalks, and bridges, over a fifteen-year period.[82] Finally, any other additions or improvements made to the structure itself have the same recovery period as the home.[83] For example, a new roof will be depreciated over twenty-seven and a half years.

Once the landlord has calculated the depreciation for improvements, he can add it to his depreciation on the home. He can then subtract the total depreciation amount from his rental income on Schedule E.[84] Adjusting rental income by subtracting rental expenses and depreciation often results in a negative amount or "loss." Losses often help landlords because they can be used to offset other income.[85] However, certain situations may limit whether the landlord can fully use this negative rental income in any given year.

IV. Limits on the Landlord's Rental Deductions

There are two circumstances when a landlord may not deduct the full extent of his expenses or depreciation. First, if a landlord uses the home as his private residence for more than fourteen days during the year, he must limit his deductions to the amount of his rental income for that year.[86] Second, if the landlord exceeds the passive activity loss limit, his losses for that year are phased out as his modified adjusted gross income (MAGI) increases.[87] These topics frequently appear when preparing rental returns, and tax center OICs must have a strong grasp of the underlying rules to explain these concepts.

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[76] IRS PUB. 527, *supra* note 7, at 5.

[77] *Id.*

[78] *Id.* at 10–11. As with rental homes, landlords must complete Form 4862 and use the MACRS method for depreciating the asset after determining the asset's basis, recovery period, and the date placed in service.

[79] *Id.* at 10.

[80] IRS PUB. 946, *supra* note 5, at 31.

[81] *Id.*

[82] *Id.* at 32.

[83] IRS PUB. 527, *supra* note 7, at 9.

[84] *See infra* Appendix E.

[85] I.R.C. § 469(i) (2006).

[86] *Id.* § 280A.

[87] *Id.* § 469.

A. Limitations Created by Personal Use of the Rental Home

If a landlord uses a home for personal use, his rental deductions (*i.e.*, expenses and depreciation) may not exceed his rental income.[88] In determining what the landlord can deduct, he must first apportion his expenses between his personal and the rental use of the home.[89] The landlord may only deduct the mortgage interest, real estate taxes, casualty losses, and any other rental expenses *unrelated* to his personal use of the home.[90] If there is any rental income remaining after these initial deductions, the landlord may also deduct his depreciation and other expenses, up to the amount of the remaining rental income.[91] The landlord cannot report negative rental income (losses) in any year in which he personally used the rental home. However, he can carry over any unused expenses to the next tax year if the sole reason he was unable to use them in the current tax year was due to the personal use rule.[92]

For example, assume CPT Jones lived in her home and used it as a personal residence for the first six months of 2008 before converting it into a rental home. Captain Jones must apportion her expenses between her personal use of the home and the rental activity. She may offset her 2008 rental income with the rental activity's portion (fifty percent) of the annual mortgage interest and property taxes, as well as all other rental expenses unrelated to her personal use of the home.[93] If there is any rental income left over after deducting these expenses, CPT Jones may then deduct her depreciation, up to the amount of remaining rental income. She cannot claim a loss in 2008; however, she can carry forward the losses she cannot deduct to 2009, because the sole reason her loss must be disallowed is related to her personal use of the home in 2008.[94]

These same limitations also apply to landlords who only rent out a portion of their home. In such cases, the landlord must apportion his expenses between the percentage of property retained for personal use and the percentage of the home rented to tenants.[95] A landlord must report all of his rental income and may only deduct a pro rata portion of the home's expenses.[96]

B. Passive Activity Loss Limits

Passive activity loss limits may also cap the amount of rental losses a landlord can use to offset his income in any given year. There are two types of passive activities: (1) a business or trade in which the taxpayer does not "materially participate"[97] and (2) ownership of residential rental property, so long as the landlord is not a real estate professional.[98] Most military landlords incur negative rental income or "passive losses" after deducting expenses and depreciation from their rental income. Under the general passive activity rules, taxpayers may not use passive losses to offset their earned income or

[88] *Id.* § 280A. This is most likely to occur in the first tax year in which the landlord converts the home into a rental property.

[89] IRS PUB. 527, *supra* note 7, at 22.

[90] *Id.*; IRS INSTRUCTION FOR SCHEDULE E, *supra* note 25, at E-3.

[91] IRS PUB. 527, *supra* note 7, at 22–23.

[92] *Id.*

[93] Such expenses might include advertising expenses and any amounts she paid to the property manager to handle the rental home.

[94] After accounting for her rental income and expenses, CPT Jones may then treat the expenses incurred solely from her personal use of the home (i.e., the remaining fifty percent of her mortgage interest, property taxes, and insurance) as an individual expense. She may list these expenses on her Schedule A, if she itemizes her personal deductions. *Id.* at 23.

[95] I.R.C. § 280A (2006); IRS PUB. 527, *supra* note 7, at 21.

[96] IRS PUB. 527, *supra* note 7, at 22. For example, if the landlord rents three of the nine rooms in his home, then one-third of his annual mortgage interest is a rental expense and two-thirds of the mortgage interest is a personal expense.

[97] I.R.C. § 469(c)(1). Passive activities became a very narrow category under the Tax Reform Act of 1986. Although a taxpayer does not materially participate in creating income or losses when purchasing stocks or mutual funds, winning the lottery, or earning interest on a bank account, these activities are still not considered passive activities. There are only two activities that create passive income. Also, note that any gains resulting from the sale of a passive activity is also considered passive income. Treas. Reg. § 1.469-2T(c)(2) (2008).

[98] I.R.C. § 469(c)(2). Real estate professionals materially participate in the business of renting homes. In general, a real estate professional spends half of his professional time and at least 750 hours per year engaged in the real property trade and business, and, therefore, materially participates in the trade or business and does not create passive income. IRS PUB. 527, *supra* note 7, at 12.

other non-passive investments.[99] However, a special rule permits landlords to use their rental losses to offset up to $25,000 of their other *non-passive* income.[100]

This rule creates a significant tax advantage for landlords who own at least a ten percent interest in the rental property, who "actively participate"[101] in the rental activity, and who have a MAGI of $100,000 or less.[102] If a landlord does not own the requisite percentage of the property or actively participate in the rental activity, he may not take advantage of this rule. However, if his MAGI exceeds $100,000, this tax benefit is only phased-out.[103] The landlord may still be able to use his rental losses to offset his income, although he may not be entitled to use the entire loss that tax year. For example, assume COL Fullhouse and his spouse have a MAGI of $130,000. They own a rental property and actively participated in managing that property. Due to their income level and the MAGI phase-out rules, their passive activity loss allowance is only $10,000 instead of the full $25,000 allowance.[104] If their rental loss on the property is $12,000, they may only use $10,000 of this loss to offset their gross income this tax year, and they will have to roll over the remaining $2,000 loss to a subsequent tax year.[105]

These rules for passive activity losses and personal use of the rental home are important because landlords often believe they are entitled to deduct all their expenses from the rental home and use any losses to offset their wages and income. Familiarity with these two limits can help OICs more thoroughly explain why a client cannot deduct all his rental expenses or losses in a given year. Explaining how these amounts roll over can also help appease landlords, who come to realize that their rental losses are not barred, only deferred to a future tax year.

V. Time to Sell the Investment—What Should the Landlord Know?

At some point, the military landlord may sell his rental property, leading to numerous new tax concerns. As with any home or capital asset, the profits from the sale of a rental home are subject to capital gains tax.[106] Accordingly, tax center OICs must understand how to properly account for capital gains from the sale of rental real estate.

A. Capital Gains from Sale of a Rental Home

When a landlord sells a rental property, he must report his capital gains on an IRS Form 4797, Sales of Business Property.[107] Because rental property is a depreciable asset, the landlord must also use the property's *allowable* depreciation to calculate his capital gain.[108] Whether or not the landlord actually chose to deduct depreciation in the tax years the home served as a rental, he must still account for depreciation at the time of sale.[109] This is called depreciation recapture. Accounting for depreciation when the home is sold prevents the landlord from receiving a tax benefit twice—first during the rental period and again upon sale. Depreciation recapture is why it is so important for the landlord to depreciate the home on

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[99] I.R.C. § 469(b). Whenever passive losses exceed passive income, the losses must be carried forward to the next tax year.

[100] *Id.* However, the special allowance is reduced to $12,500 for landlords who lived apart from their spouse for the entire year and have a filing status of "married filing separately." If the landlord's filing status is "married filing separately" but he lived with his spouse during the year, he may not use the allowance at all. *Id.*

[101] Active participation means that the landlord or his spouse made "management decisions about the rental property in a significant and bona fide sense." This active participation might include deciding on lease terms, approving new tenants, approving repair decisions, or other similar decisions. INTERNAL REVENUE SERV., PUB. 925, PASSIVE ACTIVITY AND AT-RISK RULES 3 (2008) [hereinafter IRS PUB. 925].

[102] IRS PUB. 527, *supra* note 7, at 13–14.

[103] I.R.C. § 469(i) (2006). If the taxpayer's MAGI is $100,000 or less, the loss allowance limit is $25,000. This allowance is phased out by fifty percent of the amount that the taxpayer's MAGI exceeds $100,000 up to a MAGI of $150,000. No loss is allowed in years when the taxpayer's MAGI exceeds $150,000. IRS PUB. 925, *supra* note 101, at 4.

[104] I.R.C. § § 469(i). If the landlord's MAGI is $130,000, his special allowance limit is $10,000 ($130,000 MAGI - $100,000 MAGI limit = $30,000; $30,000 x 50% = $15,000; $25,000 PAL allowance - $15,000 = $10,000 allowance). IRS PUB. 925, *supra* note 101, at 4.

[105] IRS PUB. 925, *supra* note 101, at 4.

[106] I.R.C. § 61.

[107] INTERNAL REVENUE SERV., PUB. 544, SALES AND OTHER DISPOSITIONS OF ASSETS (2007) [hereinafter IRS PUB. 544]. Although capital gains are reported on a Schedule D, sales of rental property must be calculated on an IRS Form 4797 first because the rental home is a depreciable asset. *See infra* Appendix F.

[108] INTERNAL REVENUE SERV., PUB. 523, SELLING YOUR HOME 16 (2008) [hereinafter IRS PUB. 523]; IRS PUB. 544, *supra* note 107, at 4.

[109] I.R.C. § 1016(a)(2).

his annual tax returns. If he fails to deduct the allowable depreciation each year, he will have to pay capital gains tax on a benefit he willingly chose to give up.[110]

B. Using the Section 121 Exclusion for Capital Gains

When a homeowner sells or exchanges a principal residence, the homeowner is only required to report the sale when his capital gain is more than $250,000.[111] This benefit, often referred to as the section 121 exclusion, can be used for a home sale every two years,[112] as long the owner used the home as his principal residence for at least two years in the five-year period preceding the sale.[113] Military homeowners receive an added benefit under section 121 because they can suspend this two-year "use test" for up to ten years while serving on active duty.[114] Thus, a servicemember using the home as his primary residence for two years during a five-year period can suspend disposition for *up to ten years* and still use the section 121 exception to exclude his capital gain from taxation.[115]

Prior to 2009, this rule also applied to landlords. As long as the landlord met both the ownership and use tests, he could use section 121 to exclude part of his capital gains from the sale of a rental home.[116] The landlord was still required to pay capital gains tax on an amount equal to depreciation on the rental home,[117] but he could exclude the remaining profit, as long as his total gain fell below $250,000.[118]

This exclusion helped many military landlords, because they could use property as an investment and build equity in the property over time. Toward the end of the investment, the landlord could convert the rental home back into his primary residence to meet the "use test" before selling it and excluding the majority of his capital gains from taxation. For example, assume SFC Turner lived in his home for twenty months and then leased it to tenants for thirty-six months while stationed out-of-state. To benefit from the section 121 exclusion, SFC Turner merely had to convert the home back to his primary residence at the end of the rental period for an additional four months before selling it.[119] If successful in meeting the section 121 use and ownership tests, SFC Turner only paid capital gains tax on the amount equal to the depreciation of the home over the thirty-six-month rental period.[120]

Unfortunately for landlords, section 3092 of the Housing and Recovery Act (HERA) of 2008 drastically amended this portion of the Code.[121] Section 121 now limits this exclusion to "qualified use" of a home.[122] To use the section 121 exclusion, homeowners must still meet both the ownership and use tests, but if they do not fulfill the requirements of both

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[110] *See* Jones v. Comm'r, 72 F.2d 114 (8th Cir. 1934) (Tax commissioner permitted to deduct $13,227.50 from taxpayer's sale price to account for allowable depreciation, even though taxpayer never claimed depreciation); *see also* Samson v. United States, 144 F. Supp. 620 (2nd Cir. 1956) (holding that taxpayer was permitted by statute to claim depreciation, his adjusted cost basis upon sale should reflect this allowable depreciation).

[111] I.R.C. § 121. The exclusion increases to $500,000 for taxpayers who are married and filing jointly. Any gain in excess of these limits must be reported as income.

[112] *Id.* § 121(b)(3).

[113] *Id.* § 121(a). This "use test" does not require the homeowner to reside in the home for two consecutive years, but it does require the homeowner to reside in the home for at least twenty-four months (or 720 days) in a sixty-month period immediately preceding the sale.

[114] *Id.* § 121(d)(9).

[115] For example, assume that Mr. Young, a civilian, buys a home in May 2004, and uses it as his principle residence until May 2006 (two years). He may use section 121 to exclude up to $250,000 of capital gains from the home's sale, as long as he sells the home by May 2009. If he sells the home after May 2009, he must pay capital gains tax on all the profit from the sale because he did not satisfy the "use test" under section 121. In other words, he did not use the home as his primary residence for two of the five years preceding the sale. However, if Staff Sergeant Young, an active duty Soldier, purchases the same home in May 2004 and lives in it for the next two years, he may wait until May 2019 to sell the home (May 2009 plus the ten-year suspension), as long as he remains on active duty for that entire suspended period and is stationed at least fifty miles away from the home.

[116] IRS PUB. 523, *supra* note 108, at 10.

[117] *Id*. at 16.

[118] *Id.*

[119] This example assumes the landlord only sold one home within a two-year period.

[120] I.R.C. § 1016(a)(2); IRS PUB. 523, *supra* note 108, at 16.

[121] Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289 § 3092, 122 Stat. 289, 3092.

[122] I.R.C. § 121(b)(5) (2009). Qualified use is defined as use as a primary residence. All other uses, including rental properties, are deemed non-qualified use. *Id.*

tests *before* converting the property to a rental, they cannot take full advantage of the section 121 exclusion.[123] Instead, the landlord must allocate capital gains from the sale between the rental use and the personal use, and the portion of the home's capital gain equal to the non-qualified use (e.g., rental use) will no longer be excludable under section 121.[124]

In the example above, SFC Turner would still meet the ownership and use tests under section 121 because he owned and used the home as his primary residence for two of the five years preceding the sale. However, SFC Turner would not meet the use test *prior* to converting the home to a rental. Instead, to meet the use test, he had to use it as his primary residence for an additional four months. Because of the amendment to section 121, SFC Turner must now apportion his gains from the sale between the rental use and his personal use.[125]

Although Congress expressly added similar ten-year disposition language to the new version of section 121,[126] it will be increasingly difficult for many military landlords to take advantage of this exception as deployments supporting the Global War on Terrorism continue. This loophole only benefits those military landlords who can use the home as their primary residence for at least twenty-four months prior to converting the property into a rental.[127]

The recent change to section 121 is likely to have a considerable impact on military landlords who only convert their homes into rental properties when required to deploy or move pursuant to military orders. Often these servicemembers do not have the choice to remain in a home for twenty-four months before conversion. The prior version of section 121 recognized this problem and built in the ten-year disposition exception to accommodate military homeowners. That version permitted military landlords to exclude their entire capital gain (less depreciation), just like non-transient homeowners, as long as they resumed living in the home long enough to meet the use test. Now, military landlords who have been forced to convert their homes to rentals because of military orders are lumped into the same category as landlords who rent property as a business enterprise. This is unfortunate because many military landlords must convert their homes out of financial and military necessity rather than for commercial reasons.

With the frequency of deployments and permanent change of station (PCS) moves, the new requirement in section 121 may become an exceptionally difficult hurdle for the average military landlord to overcome, and it may force more servicemembers to remain tenants, rather than become homeowners and landlords themselves. Additionally, because of the change in the law, purchasing a home early in a servicemember's military career may no longer be a wise investment strategy if the home cannot be used as a primary residence for at least twenty-four months prior to conversion. The longer the home remains a rental, the greater the taxable capital gains will be when the home is sold.

VII. Conclusion

Because so many servicemembers own rental homes, legal assistance attorneys and tax center OICs must understand how to use the Schedule E to account for income, expenses, and depreciation on residential rental property. This primer addressed these basic concepts and discussed how a landlord's personal use of a rental home can significantly limit his rental deductions. The article also explained the passive activity loss rules and the advantage they afford many landlords seeking to offset their non-passive income. Finally, the primer described how depreciation affects capital gains upon the sale of a rental home, as well as how the amended section 121 will impact military landlords. Knowledge of these issues should make preparing tax returns for residential rental property much easier and help legal assistance attorneys anticipate the tax questions and needs of their landlord clients.

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[123] *See* Nat'l Ass'n of Realtors, New Rules for Taxing Gain When a Second Home Is Converted to a Principal Residence: Changes to the $500,000 Exclusion, http://www.realtor.org/government_affairs/gapublic/hr_3221_key_provisions (follow "View some examples that illustrate the application of this new rule" hyperlink provided under "Modification of $250,000/$500,000 Exclusion") (last visited Nov. 17, 2009); *see also* Exeter, Tax Fee Exclusion on the Sale of Primary Residence May be Significantly Reduced Under Certain Circumstances, http://www.exeter1031.com/article_changes_to_section_121.aspx (last visited Jan. 19, 2009).

[124] I.R.C. § 121(b)(5).

[125] I.R.C. § 121. In this example, the property was used as a rental property for three-fifths of the time the landlord owned the property. This is a non-qualified use, so three-fifths of the profit realized from the home's sale will now be *taxable* capital gains. Prior to 2009, the landlord would have had to pay capital gains tax only on the amount equal to his depreciation. Now he must pay capital gains tax on the depreciation *and* three-fifths of the profit from the sale.

[126] I.R.C. § 121(d)(9) (2006).

[127] I.R.C. § 121(b)(5)(C)(ii)(II).

Appendix A

Rental Questionnaire

1. How many rental properties do you own or partially own? _____

2. Where is your rental property located? (If you own multiple properties, make sure to identify each property consistently thoughout this questionnaire as property A, B, or C)

   Property A: ____

   Property B: ____

   Property C: ____

3. Did you live in any of these properties <u>during</u> 2009? ☐ Yes ☐ No

4. If so, which property? And when did you reside there? ________________________________

5. Did you receive a **security deposit** on any of your property(s) in 2009? ☐ Yes ☐ No

6. What did your security deposit consist of?

   ☐ First and last month's rent

   ☐ A fixed dollar amount I intend to return to the tenant at the end of the rental period (after deducting damages)

   ☐ Other _________________

7. How much **annual rent** did you receive on your rental property in 2009?

   Property A ______________ Property B _______________Property C________________

8. Did you receive any **"payments in kind"** in lieu of rent? (Example: Your tenant paid for a plumber to make repairs and deducted that amount from his monthly rent) ☐ Yes ☐ No

9. If you received payments in kind, how much were they? ___________________________

10. Did you bring your IRS Form 1098 with you today? ☐ Yes ☐ No

11. How much **mortgage interest** did you pay on each rental property?

    Property A ______________ Property B _______________Property C________________

12. Did you pay any **other interest** (points) on any rental property? ☐ Yes ☐ No

13. How much did you **pay in property taxes** on each rental property?

    Property A ______________ Property B _______________Property C________________

14. How much did you pay in **insurance** on each property? (e.g. Homeowner's, fire, casualty)

    Property A ______________ Property B _______________Property C________________

15. Did you **actively manage** the property yourself (find or approve tenants, make or approve repairs, etc)? ☐ Yes ☐ No

16. Did you also use a **property manager** to assist you with your property? ☐ Yes ☐ No

17. If so, which property did you use your property manager(s) for? ☐ A ☐ B ☐ C

18. How much did you pay the property manager in 2008? _________________

19. Did you pay a **commission** to anyone else? ☐ Yes ☐ No

20. Did you have any additional expenses for **advertising** the property? ☐ Yes ☐ No

21. Did you pay any necessary **utilities** for your rental property (gas, electric, etc)? ☐ Yes ☐ No

22. Did you pay for any **cleaning or maintenance** for the property? ☐ Yes ☐ No

23. Did you pay for any **legal or professional fees** related to the property? ☐ Yes ☐ No

24. Did you do any **travel** solely to check on your rental property? ☐ Yes ☐ No

25. Did you pay for any **repairs** to the rental property? (A repair fixes something that is inoperable and does not add any additional value to the home. For example, fixing a leaky toilet is a repair.) ☐ Yes ☐ No

26. If so, how much were your repairs? ____

27. Did you make any **improvements** on the rental property this year? (An improvement adds value to the home. For example, adding dishwasher, putting on a new roof) ☐ Yes ☐ No

28. If so, what improvements did you make and how much did they cost? _________________________

29. Did you sell your rental home this year? ☐ Yes ☐ No

30. Did you bring last year's tax return? ☐ Yes ☐ No

31. Do you have any special concerns or questions about your rental property? ☐ Yes ☐ No

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PLEASE REMEMBER TO BRING THE FOLLOWING ITEMS TO YOUR TAX APPOINTMENT

- Form 1098
- Tax/land appraisal document (if this is the first year you rented the property out)
- Receipts or documents for your expenses
- Receipts or documents showing how much rent you collected
- Last year's tax return

Appendix B

Schedule E

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

2009

Attachment Sequence No. **13**

Name(s) shown on return | Your social security number

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: • 14 days **or** • 10% of the total days rented at fair rental value? (See page E-3)		Yes	No
A			A		
B			B		
C			C		

Income:		Properties A	Properties B	Properties C		Totals (Add columns A, B, and C.)
3	Rents received	3				3
4	Royalties received	4				4
Expenses:						
5	Advertising	5				
6	Auto and travel (see page E-4)	6				
7	Cleaning and maintenance	7				
8	Commissions	8				
9	Insurance	9				
10	Legal and other professional fees	10				
11	Management fees	11				
12	Mortgage interest paid to banks, etc. (see page E-5)	12				12
13	Other interest	13				
14	Repairs	14				
15	Supplies	15				
16	Taxes	16				
17	Utilities	17				
18	Other (list) ►	18				
19	Add lines 5 through 18	19				19
20	Depreciation expense or depletion (see page E-5)	20				20
21	Total expenses. Add lines 19 and 20	21				
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				
23	Deductible rental real estate loss. **Caution.** 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 **must** complete line 43 on page 2	23	( )	( )	( )	
24	**Income.** Add positive amounts shown on line 22. **Do not** include any losses					24
25	**Losses.** Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here					25 ( )
26	**Total rental real estate and royalty income or (loss).** Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 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

For Paperwork Reduction Act Notice, see page E-8 of the instructions. Cat. No. 11344L **Schedule E (Form 1040) 2009**

Appendix C

Repairs versus Improvements

Repairs
A repair keeps the rental property in good operating condition and does not materially add to the value of the property or substantially prolong its life. Repairs usually entail fixing a broken or faulty item that already exists in the home to bring it back to its prior working condition.

Improvements
An improvement adds to the value of the property, prolongs its useful life, or adapts the property to new uses. Improvements usually involve replacing an existing item with a more up-to-date item or installing something that did not previously exist in the home.

REPAIR	IMPROVEMENT
Fixing broken slats in hardwood floor	Replacing worn carpet with hardwood floors
Replacing a broken mirror	Installing a mirrored medicine cabinet
Re-hanging a towel bar in the bathroom	Installing a towel bar in the bathroom
Replacing missing tiles on kitchen counter	Replacing the entire countertop
Unclogging pipes under the sink	Installing a garbage disposal under the sink
Replacing faulty power cord on the dryer	Replacing dryer
Cleaning lint-clogged dryer duct	Adding outside air vent for dryer duct
Replacing batteries in fire detectors	Installing fire detectors
Replacing light bulbs in fixtures	Adding lights to outside of the home
Repair call from air-conditioner repairman	Replacing the air-conditioner
Fixing torn screens on windows	Screening in a back porch
Fixing hinge on cupboard door	Painting cupboards
Removing torn drapes	Installing mini-blinds
Removing a dead tree	Planting flowers
Fixing jets on hot tub	Adding a swimming pool

Appendix D

Sample Land Appraisal

6523

This is NOT a Tax Statement

2008 Notice Of Appraised Value

Do Not Pay From This Notice

TAX APPRAISAL DISTRICT
OF BELL COUNTY
PO BOX 390
BELTON, TX 76513-0390
Phone: (254) 939-5841

DATE OF NOTICE: May 1, 2008

Property ID: [redacted]
Ownership %: [redacted]
Ref ID2: [redacted]
DBA:
Legal: [redacted]

[redacted]

Legal Acres:
Situs: [redacted]
Appraiser: [redacted]
OWNER ID: [redacted]

Dear Property Owner,
We have appraised the property listed above for the tax year 2008. As of January 1, our appraisal is outlined below.

Appraisal Information	Last Year - 2007	Proposed - 2008
Structure & Improvement Market Value	194,228	196,141
Market Value of Non Ag/Timber Land	24,888	24,888
Market Value of Ag/Timber Land	0	0
Market Value of Personal Property/Minerals	0	0
Total Market Value	219,116	221,029
Productivity Value of Ag/Timber Land	0	0
Appraised Value * (Possible Homestead Limitations, see asterisk below)	219,116	221,029
Homestead Cap Value excluding Non-Homsite Value (i.e. Ag, Commercial)	219,116	221,029
Exemptions		

2007 Taxable Value	Taxing Unit	2008 Proposed Assessed Value	2008 Exemption Amount	2008 Taxable Value	2007 Tax Rate	2008 Estimated Taxes	2008 Freeze Year and Tax Ceiling**
219,116	BELL COUNTY	221,029	0	221,029	0.379500	838.81	
219,116	CENTRAL TEXAS COLLEGE	221,029	0	221,029	0.142000	313.86	
219,116	BELL COUNTY ROAD	221,029	0	221,029	0.029500	65.20	
219,116	KILLEEN ISD	221,029	0	221,029	1.141190	2,522.36	
219,116	CITY OF HARKER HTS	221,029	0	221,029	0.679600	1,502.11	
219,116	CLEARWATER U.W.C.D.	221,029	0	221,029	0.004000	8.84	

Total Estimated Tax: $5,251.18

The Texas Legislature does not set the amount of your local taxes. Your property tax burden is decided by your locally elected officials and all inquiries concerning your taxes should be directed to those officials.

The above tax estimates use last year's tax rates for the taxing units shown. The governing body of each unit (school board, county commissioners, and so forth) decides whether property taxes increase. The appraisal district only determines your property value. The taxing units will set tax rates later this year.

* Your residence homestead is protected from future appraisal value increases in excess of 10% per year from the date of the last appraisal PLUS the value of any new improvements.

** If you are 65 years of age or older and received the $10,000 school tax exemption on your home last year from the school listed above, your school taxes for this year will not be higher than when you first received the exemption on this home. If you are disabled and received the $10,000 school tax exemption on your home last year from the school listed above, your school taxes for this year will not be higher than the 2003 taxes or the first year you received the exemption, whichever is later. If your county, city, or junior college has approved a limitation on your taxes in the preceding year, your county, city, or junior college taxes will not be higher than the first year your county, city, or junior college approved the limitation or the first year you qualified for the limitation. If you improved your property (by adding rooms or buildings), your school, county, city, or junior college ceiling may increase for these improvements. If you are a surviving spouse, age 55 or older, you may be eligible to retain the school, county, city, or junior college tax ceiling.

Contact the appraisal office if you disagree with this year's proposed value for your property or if you have any problem with the property description or address information. If the problem cannot be resolved, you have the right to appeal to the appraisal review board (ARB).
To appeal, you must file a written protest with the ARB before the deadline date:

Deadline for filing a protest: [redacted]
Location of Hearings:
ARB will begin hearings:

Enclosed is a protest form to send the appraisal district office if you intend to appear and present evidence before the ARB. The ARB will notify you of the date, time, and place of your scheduled hearing. Also enclosed is information to help you in preparing your protest. You do not need to use the enclosed form to file your protest. You may protest by letter, if it includes your name, your property's description, and your reason for protesting.

If you have any questions or need more information, please contact the appraisal district office at (254) 939-5841 or at the address shown above.

Sincerely,

MARVIN HAHN
Chief Appraiser

Appendix E

Depreciation

It is essential that landlords not only take advantage of depreciation but also understand that they can depreciate both the rental home and any capital improvements to the home. If the landlord makes improvements to the home, he must depreciate each asset separately, because the recovery periods vary based on the property's classification. While TaxWise will automatically calculate these depreciation deductions, preparers and OICs should also know how to manually calculate these deductions. To do this, the preparer must use the IRS Form 4562, Depreciation and Amortization, and the depreciation tables in IRS Publication 946, both of which are available at the end of this appendix.

Depreciating the rental home

To manually calculate depreciation on the rental home, the landlord needs to know two things: (1) when he placed the home into service and (2) the property's basis.[128] All the information necessary to calculate the home's depreciation deduction is entered on IRS Form 4562, line 19h (residential rental property).[129] First, the landlord must enter the month and year the home was placed into service in column (b). This date is significant because depreciation begins the month the home is placed into service and uses a straight-line method over the useful life of the property.[130] Next, the landlord must enter the property's basis in column (c). The remaining information required for the depreciation calculation, including the recovery period (27.5 years), convention (mid-month), and depreciation method (straight-line), is already pre-printed in Form 4562 because that information remains constant when depreciating residential rental property.

In column (g), the landlord must use all the information in the prior columns to calculate that year's allowable depreciation deduction on the rental home. To do this, he must look in the 27.5-year depreciation table and find the appropriate percentage for the month and year when the home was placed in service. The table already accounts for the mid-month convention, so the landlord simply multiplies the appropriate percentage from the table by the basis of the home to find his depreciation deduction.

To illustrate how this process works, assume the landlord placed a home into service in July 2009 and the home's basis is $200,000. Using the 27.5 year depreciation table, the landlord determines the appropriate depreciation percentage for the home is 1.67% (July, year 1). He then multiplies this percentage by the home's basis ($200,000), and the landlord's depreciation amount for that tax year comes to $3,340. The landlord places this amount in column (g). Once this is complete, the landlord can calculate depreciation on any improvements to the home.

Depreciating improvements to the rental home

To manually calculate depreciation for an improvement using the IRS Form 4562, the landlord must know five things: (1) when he made the improvement, (2) its basis, (3) the proper recovery period, (3) the appropriate convention, and (5) the method of depreciation. The landlord must enter all this information on line 19 of Form 4562 and place it on the appropriate sub-line for each improvement's property classification/recovery period.[131] For, example replacing a dishwasher has a recovery period of five years, so that improvement is classified as a "5-year property" and its depreciation will be calculated on line 19(b).

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[128] *See* discussion *infra* Part III. The landlord determines the rental home's basis through either the cost method or the fair market value method.

[129] Line 19h is where most landlords will depreciate their residential rental home using the General Depreciation System (GDS). However, landlords are permitted to depreciate the rental home using using the Alternative Depreciation System (ADS), and will place this amount on line 20a. The resulting difference between the two calculations is negligible, however, whichever method the landlord chooses when he places the home in service must be used throughout the entire period the home is used as a rental property.

[130] I.R.C. § 168 (2006)

[131] The landlord determines the property classification by the recovery period for the improvement. The length of the recovery period and the property classification are identical.

Once the landlord determines the property's classification, he must enter the improvement's basis in column (c). In column (d), the landlord lists the applicable recovery period for the improvement.[132] In column (e), the landlord selects either the mid-quarter or half-year convention.[133] If the landlord uses the depreciation tables, he places "straight-line" method in column (f). Finally, in column (g), the landlord will use all the information in the prior columns to calculate the allowable depreciation deduction for that tax year.

To illustrate how to calculate the depreciation deduction for an improvement, assume the landlord added a $500 dishwasher to the rental home in May 2008, and that was his only improvement. A dishwasher has a five-year recovery period, so the landlord will place all his information on line 19b ("5-year property"). In column (c) he will list "$500" as his basis in the dishwasher; in column (d) he will place "5-year" as the recovery period; in column (e) the landlord will place "MQ" for mid-quarter; and in column (f) he will place "S/L" for straight-line method.

To calculate the total in column (g), the landlord must look up the appropriate depreciation percentage in the 5-year depreciation table. The dishwasher was put into service in May (second quarter) of 2008 (year 1), so the applicable depreciation percentage is 17.85%. Multiply this percentage by the asset's basis ($500), and the result is an $89.25 depreciation deduction for the dishwasher. The landlord places this amount in column (g).

Once the landlord has calculated the deprecation on both the rental home and all improvements, he must add these amounts together to determine his total allowable depreciation for that tax year. The landlord enters this sum on line 22 of Form 4562, before transferring that amount to his Schedule E.

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[132] Most improvements to rental property fall into 5-year, 15-year, or 27.5-year property. Interior improvements to the rental property have a 5-year recovery period. Improvements made directly to the land have a 15-year recovery period. Additions or improvements to the actual structure have a 27.5-year recovery period. IRS PUB. 527, *supra* note 7, at 9.

[133] Normally, the landlord will use the mid-quarter convention. However, if the asset is placed in service between October and December of the tax year and constitutes more than 40% of the total basis of all assets placed in service that year, the landlord must use the half-year convention instead. For example, if the landlord puts a $500 dishwasher in the rental home in August and a $900 refrigerator in the home in October, he will use the mid-quarter conversion for the dishwasher and the half-year convention for the refrigerator. (The $900 basis of the refrigerator is more than 40% of the total basis of all the assets placed in service that year. His total basis between both assets was $1,400, and the refrigerator was 64% of that basis.) IRS PUB. 527, *supra* note 7, at 10.

	Use the row for the month the taxable year was placed in service					
	YEAR 1	YEARS 2-9	YEARS 10, 12, 14, 16, 18, 20, 22, 24, 26	YEARS 11, 13, 15, 17, 19, 21, 23, 25, 27	YEAR 28	YEAR 29
JAN	3.49%	3.36%	3.64%	3.64%	1.97%	
FEB	3.18%	3.36%	3.64%	3.64%	2.27%	
MAR	2.88%	3.36%	3.64%	3.64%	2.58%	
APR	2.58%	3.36%	3.64%	3.64%	2.88%	
MAY	2.27%	3.36%	3.64%	3.64%	3.18%	
JUN	1.97%	3.36%	3.64%	3.64%	3.49%	
JUL	1.67%	3.36%	3.64%	3.64%	3.64%	0.15%
AUG	1.36%	3.36%	3.64%	3.64%	3.64%	0.46%
SEP	1.06%	3.36%	3.64%	3.64%	3.64%	0.76%
OCT	0.76%	3.36%	3.64%	3.64%	3.64%	1.06%
NOV	0.46%	3.36%	3.64%	3.64%	3.64%	1.36%
DEC	0.15%	3.36%	3.64%	3.64%	3.64%	1.67%

Table 1. Residential Rental Property (Mid-month Convention) Straight-line–27.5 years

YEAR	Half-Year Convention	Mid-Quarter Convention			
		1st Qtr	2nd Qtr	3rd Qtr	4th Qtr
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00%	26.00%	30.00%	34.00%	38.00%
3	19.20%	15.60%	18.00%	20.40%	22.80%
4	11.52%	11.01%	11.37%	12.24%	13.68%
5	11.52%	11.01%	11.37%	11.30%	10.94%
6	5.76%	1.38%	4.26%	7.06%	9.58%

Table 2. 5-year property (Half-year and Mid-month Convention)

YEAR	Half-Year Convention	Mid-Quarter Convention			
		1st Qtr	2nd Qtr	3rd Qtr	4th Qtr
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%	8.85%	8.73%
8	4.46%	1.09%	3.34%	5.53%	7.64%

Table 3. 7-year property (Half-year and Mid-month Convention)

YEAR	Half-Year Convention	Mid-Quarter Convention			
		1st Qtr	2nd Qtr	3rd Qtr	4th Qtr
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%	5.91%	5.90%
9	5.91%	5.90%	5.91%	5.90%	5.90%
10	5.90%	5.91%	5.90%	5.91%	5.91%
11	5.91%	5.90%	5.91%	5.90%	5.90%
12	5.90%	5.91%	5.90%	5.91%	5.91%
13	5.91%	5.90%	5.91%	5.90%	5.90%
14	5.90%	5.91%	5.90%	5.91%	5.91%
15	5.91%	5.90%	5.91%	5.90%	5.90%
16	2.95%	0.74%	2.21%	3.69%	5.17%

Table 4. 15-year property (Half-year and Mid-month Convention)

Appendix F

Sale of Home

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

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

OMB No. 1545-0184

2009

Attachment Sequence No. 27

Name(s) shown on return | Identifying number

1	Enter the gross proceeds from sales or exchanges reported to you for 2009 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)	1	

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)

2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 43	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	
	Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
	Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)	9	

Part II Ordinary Gains and Losses (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 35 and 42a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a	If the loss on line 11 includes a loss from Form 4684, line 39, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2009)

Appendix G

Advice for Tax Center OICs

While many servicemembers have simple returns, the more complex and time-consuming returns OICs and tax preparers encounter involve residential rental properties. In my own experience as a tax center OIC, I developed four lessons on how to successfully assist landlords with their returns.

Recordkeeping: Training the Landlord

It is crucial to train landlords to take care of their records. I frequently referred to my most challenging landlords as "shoebox" clients because they would often stuff every receipt pertaining to their rental property into an envelope or shoebox and expect the preparer to sort everything out just days or weeks before their tax returns were due. Allowing landlords to continue this inadequate and often incomplete recordkeeping method is unacceptable and only sets the landlord up for future failures.

To take a deduction for expenses or depreciation on his Schedule E, the landlord must meet the "adequate records requirement."[134] Consequently, it is vital that military landlords maintain accurate and complete records of their rental income and expenses each year. Landlords can withstand their burden by maintaining an account book, log, expense statement, trip sheet, or similar record that, together with his receipts, is sufficient to establish his expenditures.[135]

If a landlord uses a property manager, he should request an itemized list of all income and expenditures from the property manager at the end of each tax year. This will assist in preparing his Schedule E and minimize the amount of paperwork required to substantiate the information on the form. If the landlord manages the property himself, he should keep a continuous log or record throughout the year as he incurs expenses. This record can be as simple as a spreadsheet attached to his receipts and cancelled checks. Additionally, maintaining expense records in the same order as they are listed on the Schedule E is helpful when preparing the landlord's taxes. Using a spreadsheet with the landlord's expenses grouped by category eases the burden of sorting a shoebox full of receipts at the end of the tax year.

As with any other legal assistance client, the attorney helping the landlord should always prepare the client to adequately handle his own legal affairs. By providing some simple recordkeeping tips, attorneys and tax preparers can help these military landlords become more organized for future tax years and leave them more prepared to defend their expenditures in the event of an audit.

Is it supplemental income or a rental business?

Some military landlords seem to "collect" homes every time they PCS. While owning a handful of rental homes is not unusual, there comes a point when the landlord is running a business. It is the OIC's responsibility to tell the landlord when this situation occurs, as his tax returns go beyond the scope of legal services provided under the Army's tax assistance program.

As discussed at the beginning of this primer, the more investment properties the landlord owns, the more likely the IRS is to classify his activities as a rental business, rather than individual investment income. The line where a particular landlord changes from a passive investor to a real estate professional may be blurry and difficult to ascertain. However, there are a number of questions a tax center OIC can ask that may reveal whether the landlord is "materially participating" in creating the rental income and thereby creating business income.[136] Some of these questions include the following: How many rental properties does the landlord own? What percentage of the landlord's income comes from his rental properties? How many hours a month does the landlord spend managing his rental activities? Is there anyone else who spends more time managing the properties than the landlord? Does the landlord provide services primarily for his tenant's convenience (changing linens, regular cleaning, or maid service)?

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[134] IRS PUB. 946, *supra* note 5, at 65.

[135] *Id.*

[136] Treas. Reg. § 1.469T (2008).

The landlord is "materially participating" in the creation of rental income if he participates in the rental activity for more than 500 hours per year, if his participation constitutes nearly all the management of the property, or when he participates for more than 100 hours a year, with no other individual managing the property more than him.[137] If the landlord is merely doing routine work customarily done by homeowners or investors, such as studying and reviewing financial statements or preparing documents that summarize his expenses and income, then his activities do not constitute material participation.[138] But, if the landlord actively manages rental properties and/or becomes involved on a regular, continuous, and substantial basis, he is no longer creating passive income.[139]

Proof of "the extent of the [landlord's] participation in [the rental] activity can be established by any reasonable means," including time reports, logs, appointment books, calendars, or narrative summaries.[140] If the landlord is materially participating in the rental activity, he is no longer eligible for the $25,000 special allowance under the passive activity rules, and he must account for his rental income using an IRS Form 1040 Schedule C, Profit and Loss from Business, rather than on a Schedule E.

Additionally, if the landlord is running a business, his tax returns go beyond the scope of the Army's tax assistance program. Although legal assistance attorneys can help with the rental of a client's principal residence and other real property, they are prohibited from assisting clients with private business activities.[141] If a landlord's rental activities amount to running a business, the OIC must inform him that the tax assistance program is unable to prepare his return.[142] Often the OIC can delicately relay this information to the landlord by informing him that it is best to have a tax professional assist in comprehensive tax planning and preparation when so many rental properties are involved. However, some military landlords will insist on having the installation tax center prepare their returns because they have historically done them there. If all else fails, the OIC can simply explain that Army regulations prohibit tax centers from preparing a Schedule C for any clients other than Family Child Care (FCC) providers.[143]

Using a rental income intake form

One of the easiest ways tax center OICs can screen prospective issues with military landlords is through a rental property questionnaire. In addition to the tax center's normal intake form,[144] this form helps the tax preparer assist landlords by posing key questions about the rental property. For example, the questionnaire should discuss the issue of security deposits and whether these are refundable deposits (non-income) or advance rental payments (rental income). Using a standardized questionnaire ensures that all tax preparers address these issues each time they begin helping a new landlord.

Using a rental intake form also assists the preparer in completing the landlord's Schedule E more efficiently because it forces the landlord to organize his income and expenses prior to his tax preparation appointment. When using a questionnaire, tax preparers often find that they can sort through the landlord's supporting documents much quicker and determine if the landlord is missing any items. It also serves as a checklist for the landlord and ensures that he brings all of his required documents to the tax preparation appointment.

Supervise and advise

Finally, it is always important to closely supervise preparers when they prepare rental returns. Some landlords attempt to pressure preparers into completing the Schedule E incorrectly or accounting for expenses that are inaccurate or fraudulent. As the OIC, it is your responsibility to step in and protect the preparers in your tax center from these pressures.

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[137] Treas. Reg. § 1.469T (2008).

[138] *Id.*

[139] IRS PUB. 527, *supra* note 7, at 12; *see* Schwalbach v. Comm., 111 T.C. 215 (1998) (determining that rental income received by dentist from leasing a building to a dental practice in which he materially participated is not a passive activity).

[140] Treas. Reg. § 1.469T (2008).

[141] U.S. DEP'T OF ARMY, REG. 27-3, THE ARMY LEGAL ASSISTANCE PROGRAM para. 3-6c (21 Feb. 1996).

[142] *Id.* para. 3-8a(2).

[143] *Id.*

[144] IRS FORM 13614, INTAKE/INTERVIEW AND QUALITY CONTROL SHEET, or its equivalent.

Attorneys may not advise a landlord to take a deduction or exclude items from their rental income unless that attorney believes there is a reasonable expectation it will be substantiated and is not fraudulent.[145] These same requirements apply to tax preparers working under the attorney's supervision.[146]

While the preparers often know more about tax law than the average landlord merely by virtue of their VITA training, their role does not include giving tax advice. A properly trained team of tax preparers should willingly restate the law and show the landlord their underlying sources. However, if there is any significant debate over whether the tax code permits certain deductions, the tax center OIC must always get involved in that discussion. If the landlord disagrees with the attorney's interpretation of the law, the OIC can contact the faculty at The Judge Advocate General's Legal Center and School for clarification of the law. However, under no circumstances should the OIC assist in creating false documents or provide reckless or grossly incompetent legal advice on tax matters.

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[145] Treas. Circ. 230 (Apr. 2008).

[146] U.S. DEP'T OF ARMY, REG. 27-26, RULES OF PROFESSIONAL CONDUCT FOR LAWYERS app. B (1 May 1992).

Appendix H

Resources for Tax Center OICs

IRS Publications

- IRS Pub. 3, Armed Forces' Tax Guide
- IRS Pub. 17, Your Federal Income Tax
- IRS Pub. 463, Travel, Entertainment, Gift, and Car Expenses
- IRS Pub. 523, Selling your home
- IRS Pub. 527, Residential Rental Property
- IRS Pub. 534, Depreciating Rental Property Placed in Service before 1987
- IRS Pub. 550, Investment Income and Expenses
- IRS Pub. 551, Basis of Assets
- IRS Pub. 544, Sales and Dispositions of Other Assets
- IRS Pub. 925, Passive Activity and At-risk Rules
- IRS Pub. 946, How to Depreciate Property

Articles

- Bill Bischoff*, So You Want to be a Landlord?* (http://www.smartmoney.com)
- Stephen Fishman, *Ten Reasons Landlords Pay Too Much* (http://www.forbes.com)
- Benny L. Kass, *Tax Rules Vary in Sale of Rental Property* (http://www.washingtonpost.com)
- William Perez, *Rental Income and Expenses: Tips for Schedule E* (http://www.about.com)

Books

- Stephen Fishman, *Every Landlord's Tax Deduction Guide* (2005)

Other resources

- IRS Tax Topic 414, Rental Income and Expense
- IRS Tax Topic 415, Renting Residential and Vacation Property
- IRS Tax Topic 704, Depreciation