THE LANDLORD'S GUIDE

# MANAGING INCOME AND EXPENSES

LandlordStudio

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# Why Tracking Income and Expenses is so Important

## Stay organized and understand your cash flow.

Understanding your cash flow through reports, or in the case of using Landlord Studio, through your dashboard, enables you to identify potential discrepancies as well as quickly and easily prove the solidity and trustworthiness of your income status. Proving you have a trustworthy stream of positive cash flow properties is essential if you want to take out new loans, or renegotiate old loans and scale your property portfolio.

## Maximize your tax deductibles.

Keeping careful records of all your income and expenses throughout the year, and keeping them properly organized will allow you to easily negotiate filing your taxes at the end of the year. Many of our users for example, simply generate reports through our system and send them over to their accountants, job done.

## File accurate claims

If you don't have detailed and accurate records, and you get audited by the IRS you could find that your claims are not honored and you have to pay additional money which you would otherwise be able to claim on your tax return.

## How Much can you Deduct as a Landlord?

According to the IRS, if you actively participated in the management of your rental property, you may be able to deduct up to $25,000  against your income each year.

However, let's say your property brings in $20,000 but you spend $30,000 on it that year.

In this scenario, you may be able to deduct $25,000 from your current tax year and then carry over and "recapture" the remaining $5,000 in the following year. If you continue to have losses of more than $25,000 then you can continue to carry over the losses beyond that amount year after year.

For more detailed information read the [IRS Publication 925: Passive Activity and At-Risk Rules]

To claim any tax deductibles on your property it needs to fall under the category of rental property.

There are strict guidelines outlining what is and isn't a rental. These state that you cannot spend more than 14 days - or 10% of the time it is rented - in your rental property, whichever is higher.

For example, you rent it out for 200 days of the year. You are allowed to spend up to 20 days in your property. If you spend more than this then your property is counted as a permanent residence and you cannot claim rental expenses back on it.

# Non-Passive vs. Active Passive vs. Passive

When you have an investment property you will fit into one of these three tax categories. Each allows you different rights in terms of tax deductions.

## Non-passive

This is when you run a suite of properties and/ or are engaged in non-passive real estate investments. For example, you engage in property development, construction, acquisition or leasing and operation on a professional level.

This means property is your business, it makes up a majority of your personal income and is how you spend the majority of your time - if this is the case you may qualify for a non-passive status.

We advise you to consult a tax professional if you believe this may be the case.

## Passive Income

Most rental properties count as passive income. Passive income is managing your properties or real estate investments that do not take up the majority of your time.

Passive income is then divided into two further classifications. Active-passive and completely passive.

The difference between active-passive and completely passive is simply the amount of time and engagement you spend managing your rental. If you own a rental and you have them managed by somebody else, you are taking a completely passive stance.

This is the easiest way to run your portfolio, however, it’s not necessarily the best or most profitable way - plus you miss out on some exciting tax breaks. As such, you likely want to be regarded as active-passive.

Active-passive means you are actively involved in the management of your property.

Using [property management software like Landlord Studio] means this has never been easier.

## Completely Passive

As an inactive, participant you can only deduct passive losses against passive income.

For example, you collect $6,000 in rent in a year from your property.

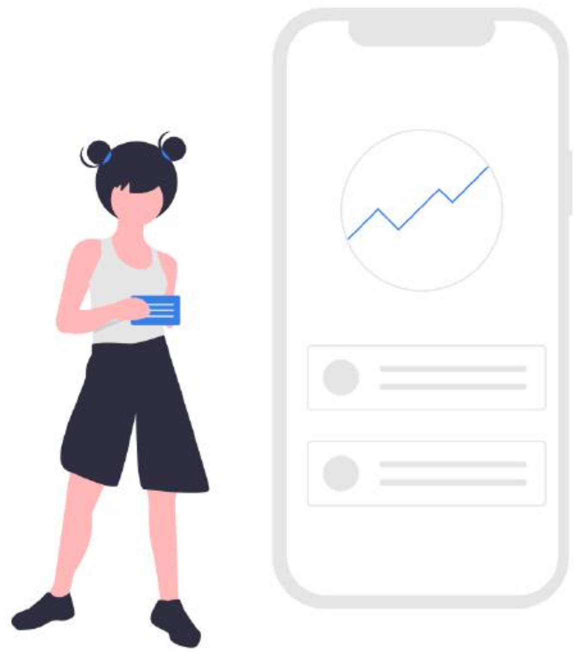
You rack up $7,000 in expenses and deductibles.

You would then report an excess loss of $1,000 - which would be your taxable income for that property. You can carry this loss over to your next tax year - but can only be applied to the passive income from your rental property.

## Active Passive

If you are an active participant in your property - for example, you use property management software like Landlord Studio to manage it yourself - then you may be able to deduct your losses from your personal income, up to the $25,000 limit. Losses exceeding that cap have to carry over into the next year.

Note that this amount can change based on income and marital status, potentially down to zero, so be sure to read the linked IRS guidance and/or consult with a professional.



# Most Important Tax Deductible Categories

All your expenses should be carefully recorded in your accounts so that you can accurately calculate your profit or loss. This is vital to determine the strength of an investment as well as for tax purposes.

To help reduce issues the IRS defines different expense categories to aid in itemization:

- Advertising;
- Auto and Travel Expenses;
- Cleaning and Maintenance;
- Commissions;
- Insurance;
- Legal and Other Professional Fees;
- Management Fees;
- Mortgage Interest Paid to Banks, etc.;
- Other Interest;
- Repairs;
- Supplies;
- Taxed;
- Utilities;
- Depreciation Expenses;
- Other.

Another important item to include is to track the interest on any loans. You need to track the monthly amount that you owe, payment due dates, any changes in interest rates, and the amount of time until the loan is paid off in its entirety.

# The Top 9 Tax Deductions for Landlords:

1. Interest
2. Depreciation
3. Repairs
4. Personal Property
5. Pass-through Tax Deduction
6. Travel
7. Employee and Independent Contractors
8. Insurance
9. Legal and Professional Services

## 1. Interest

Interest is a major deductible for many landlords. The key reason it's such an important deduction is that, while you can't deduct your mortgage payments themselves, you can deduct the interest payments for mortgage loans used to acquire or improve a rental.

Another common example of an interest payment is the interest paid on credit cards used for goods or services related to rental property activity.

Depending on the size of your loans this could easily add up to tens of thousands of dollars over the lifetime of the property.

## 2. Depreciation for rental property

Another major deductible for landlords in the US is property depreciation. Property depreciation allows you to deduct the value of the house against your taxable income.

There are a couple of conditions for this, however. The first is that you must spread the deductible cost over 27.5 years.

The second consideration is that the value of the land can't be depreciated only the property itself.

We go into greater detail about property depreciation later on in this ebook.

## 3. Repairs

Work done on the property which is deemed as an improvement is not deductible for landlords. However, the cost of maintenance and repairs to the property are fully deductible in the year in which they occur.

You have to be careful not to deduct what the IRS determines as improvements as maintenance. So we again go into greater detail about what is seen as an improvement by the IRS vs. maintenance later in the Ebook. However, as a quick guideline, you can work on the principle that a replacement is almost always an improvement and not a repair, at least for tax deduction purposes.

To obtain the best tax deduction results then you should patch, mend, or fix things instead of replacing them. This can often be a little counter-intuitive as a replacement might work out cheaper, however, you might not be able to deduct it so it will cost you more.

A few examples of deductible maintenance and repair costs include:

- Repainting.
- Fixing guttering.
- Fixing floors.
- Plastering.
- Replacing a broken window.
- Cleaning.

## 4. Personal Property

Personal property, such as furniture or whiteware that is used in rental activity can also be deducted. This deduction comes under the de minimis safe harbor deduction and is allowable for property costing up to $2,500.

Examples of personal property include:

- Furniture used in a furnished apartment.
- Appliances (eg. fridge, oven, washing machine).
- Any supplied gardening equipment.

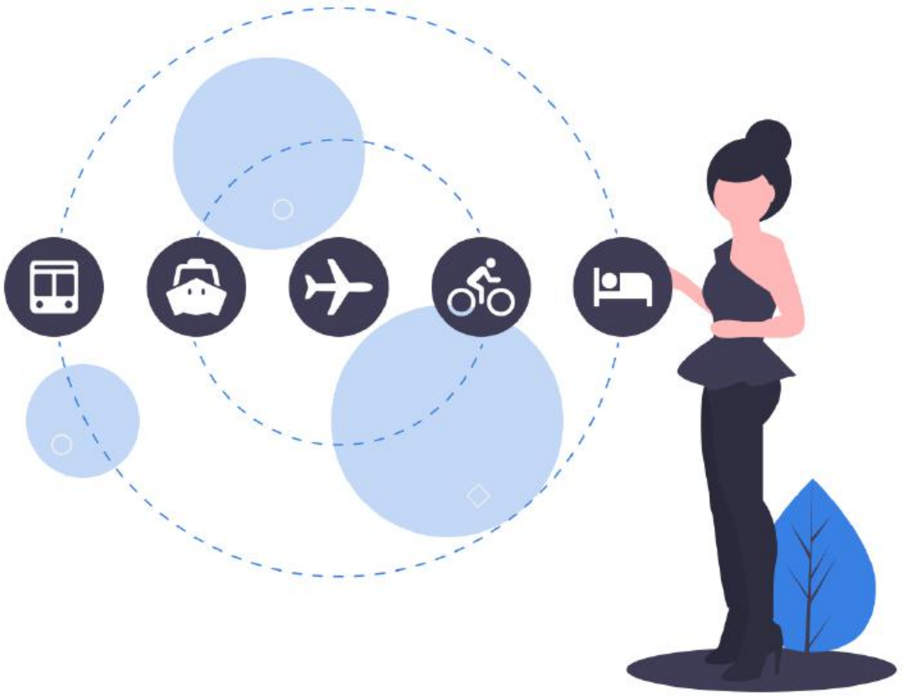
We explore safe harbors later on in the ebook.

## 5. Passthrough tax deduction

Pass-through tax deduction is a special income tax deduction rather than a rental property-specific deduction and was established as part of the Tax Cuts and Jobs Act.

Again, we explore this in more detail later in the ebook.

## 6. Travel



Landlords are entitled to a tax deduction for travel related to their rental activity. In the main, this means deducting mileage for any driving done for the purposes of managing your rental property. For example, driving to the property for a routine property inspection.

It's worth pointing out though that you cannot deduct any travel expenses to a property that are done for the purposes of improving the property. These costs, just like improvement costs need to be added to a property's tax basis and depreciated over many years.

To deduct your driving expense you can do one of two things. Either:

- deduct your actual expenses (gasoline, upkeep, repairs), or
- use the standard mileage rate (check the IRS website for current rates).

* You must use the standard mileage rate in the first year you use a car for your rental activity to be qualified to use this rate going forward.

To take advantage of this deduction, you need to carefully and precisely track and monitor your traveling as the IRS closely scrutinizes travel deductions especially any deductions made for overnight travel. To stay within the law (and avoid unwanted attention from the IRS), you need to properly document your long-distance travel expenses.

You should record the following details:

- The beginning address and the ending address.
- The total mileage of the trip - It doesn't hurt to note the beginning and ending mileage recorded in your car for each trip.
- Write down a business description detailing who you met with and the purpose of the travel.

You can easily do this using Landlord Studio's built-in mileage tracker.

## 7. Employees and independent contractors

You can deduct the wages of anyone employed to perform services for your rental activity. Examples of an independent contractors include electricians or plumbers; whilst an employee is someone like a resident manager.

## 8. Insurance

All the Insurance premiums you pay for your rental property, including, fire, theft, and flood insurance as well as any landlord liability insurance can be deducted. On top of this, if you have employees involved in the management of your property you can deduct the cost of their health and workers' compensation insurance.

## 9. Legal and professional services

The final item on our list is the cost of legal and professional services. This can include fees paid to attorneys or accountants, as well as costs associated with the creation of legal documents and property management. Landlord Studio property management software falls under this category

To make the most out of your deductions and take full advantage of the annual deductible allowance of $25,000 you need to carefully track your income and expenses. The most efficient way to manage this is to use a designated software such as Landlord Studio.

Landlord Studio allows you to track your income and expenses at an organization, property, and unit level. On top of this, connect your bank accounts and use our smart scan feature to quickly enter receipt details using your camera.

## Is Your Expenditure a Repair or Improvement?

After a property is in service, you'll need to determine whether each repair, maintenance, or renovation expenditure you incur should be classified as a regular expense or a capital improvement. Capital improvements are depreciated over the life of the capitalized asset (unless you can apply 100% bonus depreciation). Most landlords prefer to classify these costs as regular repair and maintenance expenses in order to maximize current year deductions and minimize depreciation recapture.

Repairs and maintenance are generally one-time expenses that are incurred to keep your property habitable. To give you an idea of costs that qualify as repairs, we've listed common examples below:

- Painting
- Fixing an AC unit or leaky plumbing
- Patching holes in the wall
- Replacing a small part of the flooring or roof
- Replacing cabinet doors

- Repairing appliances
- Inspection costs
- Replacing broken parts

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

Examples that constitute capital improvements include:

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

Determining whether your expenditure is a repair or improvement is not as straightforward as it may seem. First, you need to identify the Unit of Property that the expenditure affects. There are nine Units of Property: the building structure, HVAC systems, plumbing systems, electrical system, escalators, elevators, fire protection and alarm systems, security systems, and gas distribution systems.

You must then apply the De Minimis Safe Harbor, the Routine Maintenance Safe Harbor, or the Safe Harbor for Small Taxpayers.

If your expenditure fails all of the tests associated with those three safe harbors, you will move on to the Betterment, Adaption, Restoration tests. After working your way through these safe harbors and tests, you'll know whether your expenditure qualifies as a repair or is considered a capital improvement that must be depreciated.

## Below is a high-level overview of the Betterment, Adaption, Restoration tests.

An expenditure will fall under a Betterment if:

- it ameliorates a "material condition or defect" in the Unit of Property (UOP) that existed before it was acquired,
- it is for a "material addition" to the UOP,
- it materially increases the size or capacity of the UOP,
- it materially increases the productivity, efficiency, or strength of the UOP.

"Material" in the case of Betterments generally means 30%, though there is no bright-line test. Thus, if you buy a 10 unit apartment complex and replace 2 HVAC units, you will have replaced 20% of the HVAC system.

While the HVAC replacements will be too expensive for any of the three safe harbors previously discussed, they do not materially improve the UOP and therefore can be deducted.

Expenditure will be a Restoration if it replaces a major component or substantial structural part of a UOP or rebuilds the UOP to like-new condition. As with the Materiality threshold for Betterments, 30% is the accepted definition of the terms "major" or "substantial". However, the regulations make no mention of a numerical threshold.

An expenditure is an Adaptation if a UOP is modified to serve a new and different use not consistent with the original ordinary use.

# Rental Property Depreciation and Amortization

Rental Property depreciation is one of the biggest and most important deductions for landlords and buy and hold real estate investors because it reduces taxable income but not cash flow. As a result, depreciation is often referred to as a "phantom" expense.

Every asset that is used in business has a useful life of which its cost must be depreciated over. **Residential rental property has a 27.5-year useful life while commercial property has a useful life of 39 years**. So, if you buy residential rental property, you'd slowly deduct the cost of the building over a period of 27.5 years.

Notice how we said the "cost of the building" above. When you purchase a rental property, you must allocate the purchase price among the property's building and land. Land is not depreciated, thus any value allocated to land is not deductible via depreciation. But you would be able to deduct, via depreciation, the value associated with the building over 27.5 years.

There are two critical points to understand about depreciation:

1. It is mandated by the IRS that you take it; and
2. You don't have to "come out of pocket" each year to claim your depreciation expense.

On the first point above, many landlords and buy and hold real estate investors don't want to take depreciation due to the depreciation recapture tax imposed upon liquidation of the rental real estate. However, the IRS will impose the tax on the depreciation that you have taken or the depreciation that you should have taken even if you didn't take depreciation. You are required to take depreciation as a landlord. No ifs ands or buts about it.

On the second point, understand that depreciation is meant to track the property's deterioration over time. Because you paid for the property upfront, you will receive a nice tax deduction each year that you don't have to continually expend money to claim. Think of it as a nice "thank you for providing housing" from the IRS.

Amortization works similar to depreciation but is used to track the intangible costs of acquiring property, such as loan costs. Loan costs are any costs incurred to obtain the loan and the amortization period will be equal to the loan's amortization period.

## What is Depreciation Recapture and How Does it Work on Rental Properties?

Depreciation recapture is a process put in place by the IRS to recapture some of the deducted value of the property when you sell it. According to these rules, the amount deducted over time through depreciation is treated as capital gains which are taxed at a specific depreciation recapture rate when the property is sold.

In 2019, depreciation recapture on gains related to the sale of the property was capped at a maximum of 25%. The rest will be taxed at the long-term capital gains rate according to your income level. If you're a higher-income taxpayer, you may also be on the hook for a 3.8% net investment income tax.

Let's run through a simple example.

You buy a property for $100,000. You use it as a rental property for 10 years. You claim a deduction of $3,636 each year the property is in service.

The property then sells after 10 years for $150,000. Upon the sale of the property, you will need to pay capital gains tax on the profit. In this scenario, because you depreciated the property for 10 years you would make a profit of $50,000 plus the $3,636 x 10 years, making a total taxable capital gain of $86,360

This taxable gain would then be subject to two different tax rates. $36,360 would be subject to the depreciation recapture rate of up to 25% and the remaining $50,000 would be subject to your long-term capital gains rate of 0%, 15%, or 20% depending on your income level.

Depreciation recapture is reported on Internal Revenue Service (IRS) Form 4797.

## Depreciation Recapture When you Sell a Rental Property for a Loss

You might be looking at a loss if you have to sell a rental home in a down market or have just had to put more money into a property than it is worth. If you do make a loss when selling your property depreciation recapture doesn't apply. However, you need to make sure you have correctly worked out your net gain or loss.

To determine if you have a tax gain or loss, you will need to compare the property's sale price to its tax basis. The tax basis is generally your original purchase price, plus the cost of improvements (not counting expenses you've deducted as repairs and maintenance), minus any depreciation deductions you claimed while you owned it.

For example, you bought a property for $200,000 depreciated $58,000 over 8 years and then sold the property for $150,000. This might look like a big loss, however, it would be an $8,000 gain which would be subject to depreciation recapture.

## Can you Avoid Depreciation Recapture?

It might seem reasonable that if you were to avoid claiming depreciation you could avoid the recapture tax hit. However, this strategy doesn't work because tax law requires that recapture be calculated on depreciation that was "allowed or allowable," according to Internal Revenue Code section 1250(b)(3).

In other words, you were entitled to claim depreciation even if you didn't, so the IRS treats the situation as though you had. From a tax-planning perspective, taxpayers should generally claim depreciation on the property to get the currently associated tax deduction because they'll have to pay tax on the gain due to the depreciation anyway when they eventually sell.

What you can do however is delay capital gains by taking advantage of Section 1031 of the IRS tax code. Commonly referred to as a 1031 exchange, this section allows investors to defer paying taxes when they sell investment real estate, instead, they are allowed to reinvest the proceeds from the sale in a real estate investment of equal or greater value. You should always contact a 1031 exchange specialist before selling your current property.

## Calculating Building and Land Values

When you purchase a rental property, only a portion of the property's cost can be depreciated. Specifically, the value allocated to land cannot be depreciated. Of course, this means that each time a landlord or buy and hold real estate investor purchases a new property, they must calculate the building and land values.

Luckily, this isn't too difficult to do. To calculate the building and land value, the simplest method is to calculate the "improvement ratio" by examining the property tax card from the assessor database.

Without going through the steps required to calculate the building and land value, you'll make the rookie mistake of reporting the full purchase price as the building's basis. And don't just come up with a random percentage to allocate your building and land values by.

We see many landlords make the mistake of allocating 15% or 20% of the purchase price to land. This could land you in hot water in expensive markets such as San Francisco or New York City because you'd be allocating too much value to the building and, as a result, your annual depreciation expense will be much higher than it should be.

## Cost Segregation Studies and Should Use Them?

A cost segregation study is an act of allocating the cost of a property among the property's various components that make up the property. The benefit that cost segregation studies provide for landlords and buy and hold real estate investors is that they allow you to depreciate your properties over accelerated schedules. Normally, landlords will depreciate the cost of rental property over 27.5 years and commercial property over 39 years.

However, landlords that have a cost segregation study performed on their rental real estate will be able to allocate the cost between 5, 7, 15, and 27.5-year property. This means that the costs allocated to 5-year property are depreciated over 5 years instead of 27.5 years, 7-year property is depreciated over 7 years, and so on.

Cost segregation studies often result in allocating 20-30% of the purchase price to 5, 7, and 15-year property. This can result in a huge boost of annual depreciation expense as illustrated below:

A rental property with a value of $500,000 will typically have $18,181 in annual depreciation ($500,000/27.5).

However, if you were to perform a cost segregation study, you might break that $500,000 down in the following manner:

- 5-year property = $60,000
- 15-year property = $40,000
- 27.5-year property = $400,000

This value allocation will result in a first-year depreciation of $42,565 (200% declining balance for 5-year and 150% declining balance for 15-year).

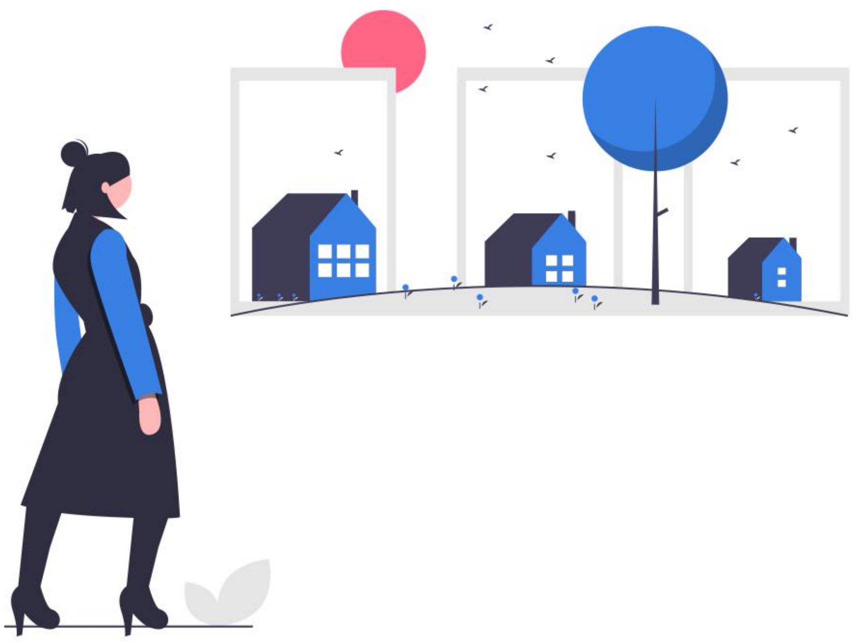
That's a $24,384 increase over our first-year depreciation without a cost segregation study. Most often this is used on multi-family and commercial properties to boost depreciation.

Single-family homes tend to not yield great results due to there being a lack of personal property and land improvements to allocate value to (i.e. one set of appliances versus ten sets of appliances in a 10-unit property).

Cost segregation studies are powerful, especially when combined with 100% bonus depreciation. Landlords and buy and hold real estate investors can almost entirely wipe out their tax bills by strategically utilizing cost segregation studies. However, be mindful of depreciation recapture upon the liquidation of your property especially if you had a cost segregation study performed on it.

You might be in for a rude surprise (also known as a big tax bill). That said, the time value of money on the increased cash flow due to the tax savings a cost segregation study can provide you generally outweigh any lingering concerns about the benefits.

Cost segregation studies are complicated and you should not try to complete one by yourself. Make sure to talk with a professional CPA or financial advisor if you'd like to have a cost segregation study performed to ensure this is the right strategy for you.



## 100% Bonus Depreciation and Why it Matters

Under the Tax Cuts and Jobs Act of 2017, bonus depreciation for property with a useful life of less than 20 years increased to 100%. This means that in any year you place property into service that has a useful life of less than 20 years, you can immediately expense the full cost.

Pairing 100% bonus depreciation with cost segregation studies yields powerful tax deductions. In the prior section, we worked through a simple example of how a cost segregation study could increase first year depreciation by $24,384. However, if we would have applied bonus depreciation to the 5-year and 15-year property, our first-year depreciation deduction would be $114,545!

That's due to being able to immediately and fully expense the value allocated to 5-year and 15-year property. We have seen landlords and buy and hold real estate investors wipe out their tax bill by combining cost segregation studies, 100% bonus depreciation, and the real estate professional status.

Assets that commonly qualify for 100% bonus depreciation include:

- Appliances
- Carpeting
- Tools
- Equipment
- Computers
- Software
- and Land improvements.

All good things are not without consequence, however. Read up on depreciation recapture and how that may affect your decision to take bonus depreciation and of course, consult a licensed tax professional to ensure you understand the full ramifications.

# Deferring Capital Gains Taxes with a 1031 Exchange

Real estate investors are often looking for the next investment and unless you are looking to cash out you can put off paying capital gains taxes thanks to Section 1031.

A 1031 exchange lets you sell your rental property and purchase a "like-kind" property without paying taxes on your capital gains at the time the exchange is made. You can execute 1031 exchanges as many times as you want, but when you eventually take the equity out of the property you will need to pay the full tax on the capital gains earned.

The simplest way to defer taxes is to swap one property for another. A more complicated strategy called a deferred exchange lets you sell a property and then acquire one or more like-kind replacement properties.

In this context, like-kind means another rental property. You cannot for example 1031 exchange a rental for a new holiday home. The main stipulation is that the property must be used for rental purposes and generate income.

You get 45 days from the date of the sale to identify potential replacement properties and you must close on the replacement property (or properties) within 180 days. If your tax return is due before that 180-day period, you must close sooner.

You can read this article to find out more about Capital Gains Taxes.

# Three Safe Harbors Every Landlord Should Know

There are three safe harbors related to repairs and maintenance that every landlord should know about.

Those three safe harbors are:

1. The De Minimis Safe Harbor
2. The Routine Maintenance Safe Harbor
3. The Safe Harbor for Small Taxpayers

## The De Minimis Safe Harbor

The **De Minimis Safe Harbor** is found under Reg. Sec. 1.263(a)-1(f). Landlords may use the De Minimis Safe Harbor to deduct up to $2,500 of the costs of tangible property used to produce or acquire rental real estate. This deduction limit is applied at the "invoice" level. Such tangible property includes materials and supplies as well as installation (labor) costs. The safe harbor does not apply to materials and supplies for use in manufacturing inventory; thus if you were to flip property, you cannot use the DMSH.

There is an anti-abuse rule which does not allow you to manipulate a transaction to ensure all costs related to the tangible property fall below the $2,500 threshold. For example, if an HVAC unit costs $4,000 for parts and labor, you cannot divide up the costs as the property must be looked at in the aggregate.

## The Routine Maintenance Safe Harbor

The **Routine Maintenance Safe Harbor** is found under Reg. Sec. 1.263(a)-3(i). There is no limit on the amount you can deduct under this safe harbor.

Routine Maintenance is work the landlord performs on a property to keep the building and each of the building's systems in operating condition. This generally includes inspecting and cleaning components of the building or structure and then replacing the damaged or worn parts.

In order for costs to count under the Routine Maintenance Safe Harbor, you must reasonably expect to perform such maintenance more than once every ten years (i.e. replacing carpet every 4-5 years).

This rule eliminates the replacement of larger components, such as roofs, windows, and tile/wood flooring. Landlords may not deduct costs under the Routine Maintenance Safe Harbor that qualify as Betterments or Restorations. Thus, major repairs and remodeling will not qualify, however, defects discovered during routine inspections will qualify.

## The Safe Harbor for Small Landlords

Found in Reg. Sec. 1.263(a)-3h, the **Safe Harbor for Small Landlords** allows real estate investors to deduct all of their repairs and maintenance on a property as long as the property's unadjusted basis is less than $1M and the total aggregate cost of the repairs, maintenance, and improvements for that property during the year were less than $10,000 or 2% of the unadjusted basis on the building, whichever is less.

This safe harbor is generally claimed in years in which properties did not incur large repair or maintenance expenses but did incur a large capital expenditure.

For example, assume you own a property with an unadjusted basis of $300,000. This property required $0 of repair and maintenance during the year but did require a replacement HVAC costing $4,000.

Because 2% of $300,000 is $6,000 and that is less than $10,000, $6,000 is the threshold that, if we stay under, we can deduct the cost of the HVAC in full. Because the HVAC cost only $4,000, and because our other maintenance and repairs

# About 20% Pass-through Tax Deduction

One of the major benefits for business owners in the 2017 Tax Cuts & Jobs Act is the pass-through business income deduction. Business owners that are sole proprietors, LLCs, and S-Corps with taxable income less than $157,500 ($315,000 if MFJ) will be able to deduct 20% of their qualified business income.

For example, if you have a business with a net operating income of $100,000 and W-2 wages of

$50,000, you will be able to deduct $20,000 from your net operating income ($100,000 x 20%).

For taxpayers with taxable incomes above these thresholds ($157,500 if single, $315,000 if married filing joint), things get a little more complicated as W-2 wage limitations come into play, and for service businesses (i.e. wholesalers, law firms, accountants, etc) this deduction is phased out between $157,500 - $207,500 for single taxpayers and $315,000 - $415,000 for married taxpayers.

Real estate investors and landlords need to understand how these new rules apply to rental real estate. The problem with rental real estate is that the taxable income is most often negative due to depreciation and amortization. In such cases, this will reduce the qualified business income you have available for the 20% pass-through deduction. If you invest in real estate syndicates or funds, you should also be aware of how the elections they make at the fund level affect your ability to claim or not claim the 20% pass-through deduction on your returns.

A major issue for landlords and buy and hold investors is whether their rental real estate activities rise to the level of a trade or business. Without rising to such a level, your rentals will not produce qualified business income. The challenge rests with whether a rental activity rises to the level of a trade or business under IRC Sec 162.

To make this analysis simpler, the IRS produced a safe harbor for landlords in January 2019. This safe harbor is detailed under Rev. Proc. 2019-7 and detailed how landlords can qualify their activities as a Sec 162 trade or business and qualify for the 20% pass-through deduction as a result.

## Are HOA Fees Tax Deductible?

You may have to pay HOA fees (homeowner association fees). Whether these fees are tax-deductible depends on whether or not you live in that property.

- If you live in your property year-round, then the HOA fees are not deductible as they are considered by the IRS as an assessment by a private entity as opposed to a business expense.

- If the property is a rental property HOA fees do become tax-deductible. In this scenario, the IRS sees these fees as property maintenance costs. You need to report HOA fees on your Schedule E (form 1040) when you submit your tax return.

- If you live in your property part of the year then it becomes a little more complicated. But in a simplified sense, you can deduct HOA fees for the portion of the time that it is rented. For example, you rent it out for 9 months of the year – then you can deduct 75% of the HOA fees.

## How To Report Your Rental Income and Expense

### About IRS form Schedule E

Schedule E is part of Form 1040. It is used to report the income and loss of supplemental income sources such as rental real estate, royalties, partnerships, and several other classifications.

This is income that is not earned through a business activity like employment.

Supplemental income is considered passive income, such as collecting rent. Of course, as a landlord, you know that rental income is anything but passive. However, passive is how the IRS sees it.

If you own a rental then, you need to file a supplemental income and loss form schedule E.

Get the most recent version from: https://www.irs.gov/forms-pubs/about-schedule-e-form-1040

Landlord Studio has these categories already preloaded for you and easily allows you to generate property-specific reports.

## A Complete Breakdown of the Schedule E Expense Categories

There are 15 expense categories on the Schedule E form. Some of these are fairly self-explanatory such as advertising expenses. However, other expense categories do require a little more explanation. Below we go through each of the categories to make sure you're using them correctly.

### Advertising

When searching for new tenants you will likely need to take action to market your property. Any out-of-pocket expenses for the purpose of advertising your property are deductible business expenses. These expenses include things like newspaper ads, yard signs, online listing costs, online ads, website expenses, etc.

### Auto and travel

This expense travel can make up a large deductible expense as you will likely need to travel between properties for business purposes – such as routine inspections or showing a listing. Auto and travel expenses include things like vehicle mileage (the Internal Revenue Service allows a deduction of $0.56 per mile in 2021), airfare, and half of the meals you purchase while traveling.

If your rental properties are local, this isn't likely to be a major expense, but if you own faraway vacation rentals, it could add up to a substantial deduction.

If you do deduct any travel expenses make sure to keep careful records, such as a mileage log, with the details and purpose of the travel as the IRS often chooses to closely scrutinize this expense, especially if it's substantial.

## Cleaning and maintenance

Cleaning and any routine maintenance costs that you pay for on your rental property can be deducted. Examples of expenses that fit within this category include gardening or lawn care, pest control, snow removal, pressure washing of the building exterior, etc. This includes the cost of labor as well as any supplies that were necessarily bought for this purpose.

## Commissions

Commissions are generally considered a business expense. As such they are normally deductible. If at any point in time you pay a commission to someone this can be expensed here. This might include a commission for someone to find you a tenant to fill a vacancy for example.

However, this does not include any commissions you might have paid to a real estate agent when buying a property.

## Insurance

Maintaining an insurance policy on your rental property is just good business. As such there are very few real estate investors that don't have at least one policy per property. You may also have additional insurance policies for things like flood protection if the property is in a flood zone.

Regardless of the type or number of policies you have, insurance premiums are deductible as a rental property business expense.

## Legal and other professional fees

Legal and professional fees aren't just for worst-case scenarios such as managing an eviction. There are various other more standard reasons you might employ a lawyer or professional service to help deal with your investment property. A few examples include hiring a lawyer to oversee paperwork such as new lease documents, any fees you might have paid to get your taxes prepared, your CPA costs, and if you use a property management software like Landlord Studio, these fees can be deducted here too.

These are all considered operating expenses and should be deducted as such. You cannot, however, deduct legal fees used to defend the title of your property or recover and improve the property.

## Management fees

Property management fees are generally between 8%-12% of your monthly rental income. Thankfully, if you do hire a property management service their fees are generally deductible.

## Mortgage interest

Leveraging through loans to invest in property is a tried and tested way to build wealth through real estate. The mortgage that you take out will likely make up a large expenditure for your business.

For investment properties, any investment property owner can use their mortgage interest as a business expense on IRS Schedule E.

It's important to note it is only the interest that is deductible, not the mortgage payment itself. So, when recording your expenses it's a good idea to track the interest separately.

## Other interest

You can also deduct the interest from other loans. This includes interest on credit cards as well. As long as the expenses were incurred in actions taken to make improvements or repairs to the property.

Additionally, you can deduct interest from loans from non-bank lenders. Generally speaking, if you have interest on a loan but don't receive a Form 1098 mortgage interest statement you can report this interest as a deductible expense under this category.

## Repairs

The cost of making repairs to a property is deductible under this section. Examples of repairs might be repairing broken plumbing, fixing a broken cupboard door, etc.

It's important to note that you can't deduct the cost of any improvements made to the property. Improvements might be anything from a loft conversion or new conservatory, to replacing (rather than repairing) kitchen appliances, etc. Instead, capital improvements need to be added to your cost basis and depreciated.

There are some grey areas when it comes to determining what is a repair and what is an improvement so it's worth discussing this with your CPA to make sure you categorize these expenses properly.

A good rule of thumb is that a repair is necessary to keep the property in good working order but doesn't increase its market value, while a capital improvement is a modification that adds significantly to the fair market value of the property.

It's also worth pointing out that all deductible rental property expenses (repairs and otherwise) must be ordinary and necessary. If you needed to spend $100 to repair the tap on the kitchen sink but instead you spend $500 replacing the sink it might not qualify as a deductible expense.

## Supplies

This is a pretty broad category. It normally refers to any office equipment you might have purchased to help you manage your property or any other supplies that are to be used exclusively for your rental properties.

An example of this could be notepads, or if you self-manage you might purchase a toolset for use in the properties maintenance.

### Taxes

Any property taxes that you might pay to your local government can be recorded under this section of the Schedule E form as a deductible expense. You can also deduct any taxes or fees associated with being allowed to rent out the property, such as local licensing fees or occupancy taxes.

### Utilities

All landlords handle utilities differently. Some will pass the expenses on to their tenants, some will simply have their tenants set up their own connections or move the bills into their name when they move in. However, if you choose to cover things like gas electric, water, heating, AC, or internet for your tenants you can deduct these as utility expenses.

If your tenant agrees to reimburse you at a later date you can continue to file it as a deduction, but you would need to then record the reimbursement as income.

### Depreciation expense or depletion

Properties (not the land itself) are seen as assets with a value that reduces over the period of your ownership due to wear and tear. As such, they can be depreciated over 27.5 years and deducted against your taxes.

You can start claiming depreciation as soon as your property is ready for rent – this generally means when you start advertising for your tenants. It is important to make sure you claim the maximum amount of depreciation you are entitled to because the IRS will reclaim some of the depreciated value through a process called depreciation recapture when you eventually sell the property.

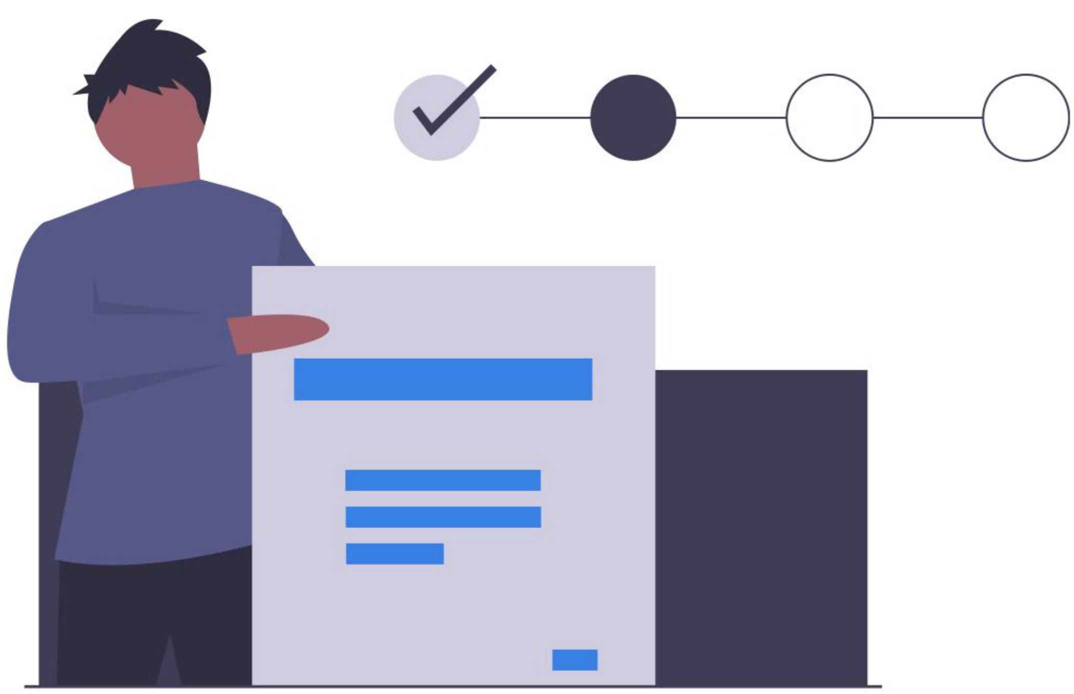
You can also depreciate the value of equipment used in the management of the property or improvements made to the property.

### Other (list)

If there are any further expenses you have that are related to the owning, maintaining, or management of the property you can list them under the Other section.

If you aren't 100% sure something is deductible, it's wise to seek help from a qualified tax professional.

You can now instantly generate a Schedule E report using Landlord Studio.



## Using Landlord Studio to Track your Rental Expenses

Landlord Studio is designed to make it easier than ever to not only store relevant documents and record your rental income, but also to keep track of and organize all property-related expenses.

Additionally, You can set recurring expenses, create rent reminder emails, smart scan receipts and let us not forget the professional reports that landlords can generate instantly.

Do away with your excel spreadsheets and boxes of receipts. Instead, let Landlord Studio look after all your bookkeeping needs.

## Smart Scan Receipts

The Smart Scan allows users to take a picture of their receipts using their device camera. The software automatically reads the details of the receipt and enters it into the system for you and then saves the image against the entered expense for future reference.

Find out more about income and expense tracking with Landlord Studio →

## Reconciling from your Bank Account

Another feature we developed upon popular user request. This feature allows you to connect your bank accounts to your Landlord Studio account. You can then access your bank account transactions and reconcile income and expense transactions inside the app.

For example, you pay $100 for property maintenance. Open the app, go to bank feeds, tap on the outgoing expense, hit reconcile, select the relevant property, and save.

Find out more about our bank feeds feature →

## Manually Enter Expenses

Alternatively, you can enter your expense details manually. This can be done for any expense. However, it is particularly important for the two following reasons: creating recurring expenses in the app, and creating expenses that are payable by the tenant.

## Set up Recurring Expenses

For recurring expenses such as mortgage payments, so that you don't have to enter them every month you can set it to automatically recur saving you time and removing any potential human error.

## Payable By Tenants

Not all of the property's expenses are the landlord's responsibilities. Some expenses will need to be passed onto the tenant. For example, any damage that goes beyond normal wear and tear would be a tenant's responsibility.

What expenses can and can't be passed onto tenants varies from state to state and from country to country so please check with your local laws and regulations. Using our system you can mark tenant payable expenses allowing you to track them separately as well as automatically generate invoices and receipts and email them to your tenants.

## Generating Reports

Of course, all this tracking of income and expenses is only as good as the data and reports that you can get out of it at the end.

We have a number of professional reports available across devices. Popular reports include our:

- Income Expense Report
- Rent Ledger
- Schedule E Report (for US users).

Manage expenses on an Organization, Property, or even individual unit level.

It's important you have the correct segmentation of your expenses. We allow you to organize expenses on an organization, property and even a unit level.

Find out more about our professional reports →

### Online Rent Collection

Using Landlord Studio your tenants can pay their rent directly into your bank account through our tenant portal. Additionally, they can view upcoming and historical payments for increased clarity of payments and set up automatic payments so that they never forget the rent ever again. All payments collected through the system will be automatically reconciled in our accounting system against the relevant property.

Find out more about Online Rent Collection →

### Available on Any Device

A key benefit of Landlord Studio over other software on the market or even over your trusty spreadsheet is that users are able to access their account on any device. This means you can update your accounts anywhere at any time.

You can snap a picture of your receipt in the hardware store parking lot and have your accounting done before your seatbelt is even on.

## Final Words

Using this knowledge it becomes possible to maximize the number of expenses that you claim against your taxable income. Many of these rules explored in this document are specifically designed to enable property investors of any size to build a profitable investment portfolio.

However, it is imperative that you keep proper, and well organized documentation of your income and expenses so that you can file an accurate tax return at the end of each year. Additionally, important documentation like leases or property inspections should be stored safely for future reference. The easiest way to do all this, to stay organized and efficiently manage your property's income and expenses is using a rental property-specific software such as Landlord Studio.

As a final note, it is recommended that you consult a tax professional to check your rental status as well as the eligibility of the expenses that you want to claim against your income.

Hopefully, this information has proved valuable to you and will help you move forward with the management of your properties, better equipped (and dare we even suggest excited?) to tackle your taxes.

# RESOURCES / DISCLAIMER

- https://www.irs.gov/forms-pubs/about-publication-925
- https://www.irs.gov/forms-pubs/about-publication-527
- https://www.thestreet.com/personal-finance/taxes/mortgage-interest-deduction-14816851
- https://www.irs.gov/publications/p925#en_US_2017_publink1000104571
- https://www.irs.gov/businesses/small-businesses-self-employed/tangible-property-final-regulations
- https://www.irs.gov/pub/irs-pdf/i1040se.pdf
- https://www.landlordstudio.com

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