PacificCPE

COURSE

34302B

Landlords: Operating Expenses and Repairs

Two of the most frequently encountered — and frequently mishandled — deduction areas for landlords are operating expenses and repairs. This course takes a practical look at what qualifies as a deductible operating expense and how to draw the line between repairs and improvements, a distinction with real tax consequences. Tax professionals working with rental clients will come away with the clarity needed to apply these rules correctly, avoid costly misclassifications, and make sure clients are capturing every deduction they're entitled to.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

Start Course ↓

Final Exam Copy ↓

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall expenses that are deductible by landlords.
- Recognize the proper tax treatment for repairs and improvements.
- Recall safe harbors available to landlords for expense deductibility.

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Chapter 1: DEDUCTING YOUR OPERATING EXPENSES

Chapter Objective

After completing this chapter, you should be able to:

- Recall expenses that are deductible by landlords.

This chapter covers the basic rules for deducting operating expenses you incur from your residential rental activities. These expenses are the bread-and-butter expenses virtually every landlord has for things like repairs, management fees, and advertising.

REQUIREMENTS FOR DEDUCTING OPERATING EXPENSES

Because so many different kinds of operating expenses exist, the tax code couldn't possibly list them all. Instead, the code gives you the definition of an operating expense, and it's up to you to make sure the expenditures you deduct meet the requirements. If they do, they'll qualify as deductible operating expenses. To qualify, the expense must be:

- Ordinary and necessary
- Current
- Directly related to your rental activity, and
- Reasonable in amount. (I.R.C. § 162.)

Ordinary and Necessary

The first requirement is that the expense must be ordinary and necessary, which means that the expense is common and "helpful and appropriate" for your activity. (*Welch v. Helvering*, 290 U.S. 111 (1933).) The expense doesn't have to be indispensable to be necessary; it only has to help your rental activity in some way—even if it's minor. A one-time expenditure can be ordinary and necessary.

It's usually fairly easy to figure out whether an expense passes the ordinary and necessary test. Many of the most common types of landlord operating expenses are listed on IRS Schedule E, including:

- Advertising your rental units
- Auto and travel expenses you or your staff incur
- Cleaning and maintenance
- Commissions you pay to rental brokers, if you use them

- Insurance, such as property and commercial general liability insurance, and part of your automobile insurance if you use your car for rental activities
- Legal and other professional fees, such as accounting fees
- Management fees, should you decide to hire a management company to handle day-to-day operations
- Mortgage interest paid to banks or other financial institutions
- Other interest expenses, such as interest on a credit card you use to buy items for your rental activity
- Repairs
- Supplies to clean and refurbish your rental property
- Taxes, and
- Utilities.

This list the IRS created is by no means exhaustive. In addition to the items listed, you might also have deductible operating expenses for such things as office rent, equipment rental, publications and subscriptions (including the cost of this course!), education expenses, postage, software, payments to independent contractors, membership fees for landlord associations, and so on.

Generally, the IRS won't second-guess your claim that an expense is ordinary and necessary, unless the item or service clearly has no legitimate business purpose. You won't be allowed to deduct off-the-wall or clearly ridiculous expenses.

Example

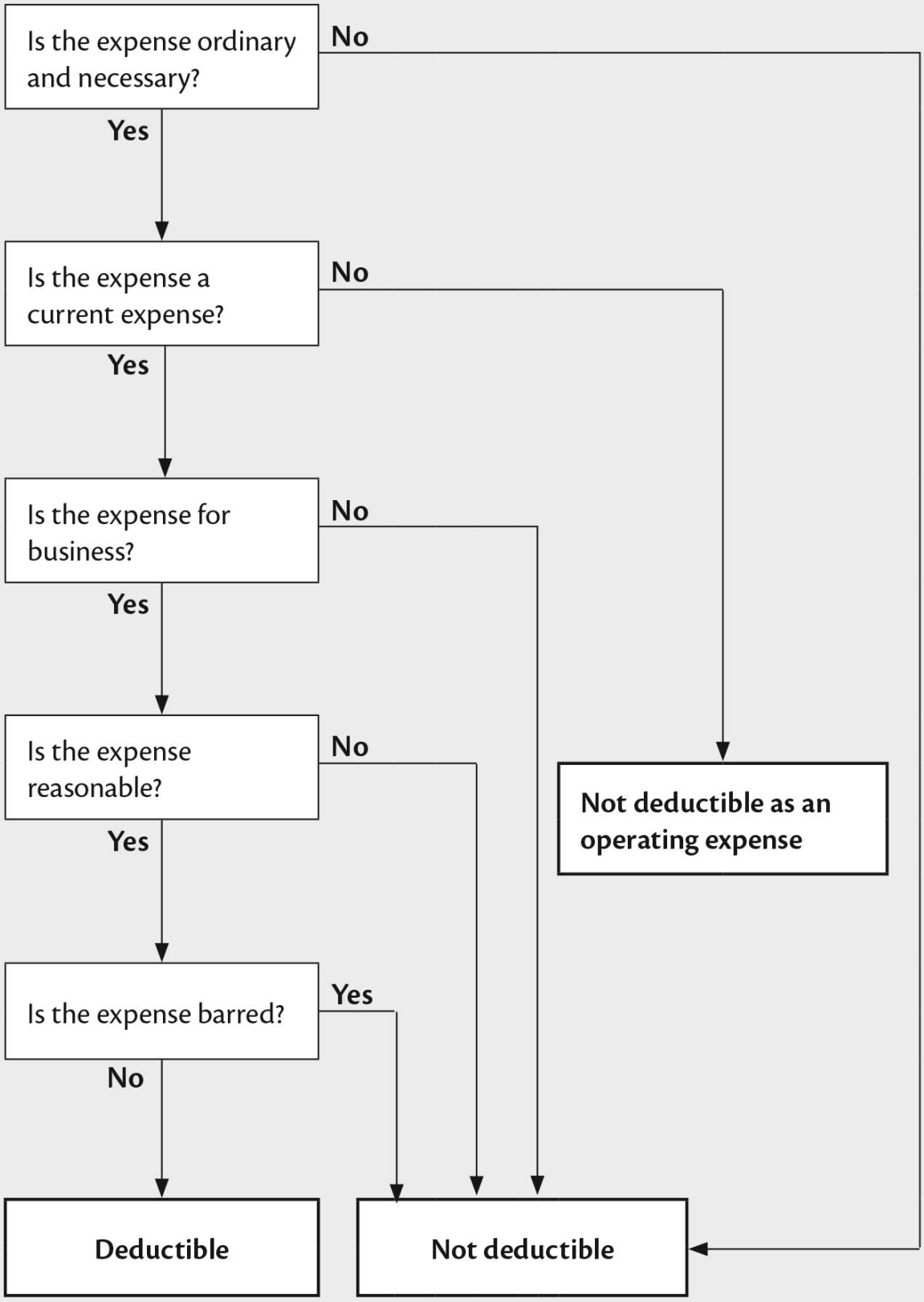
Rayford Strickland owned two parcels of real estate about 500 miles from his Texas home. During a two-year period, he made 80 trips to the property at a claimed cost of $11,000. The properties generated a total of $1,653 in income during this time. The IRS and tax court disallowed Strickland's travel expense deductions. The court found that the 80 trips weren't an ordinary and necessary expense because Strickland was unable to provide any explanation of why it was necessary to make so many trips to these two properties. (*Strickland v. Comm'r*., 43 T.C. Memo 1061.)

Current Expense

Only current expenses are deductible as operating expenses. Current expenses are for items that will benefit your rental activity for less than one year. These expenses are the costs of keeping your rental venture going on a day-to-day basis, including money you spend on items or services that get used up, wear out, or become obsolete in less than one year. A good example of a current expense is the monthly fee a landlord pays to a gardener to perform landscaping work on a rental property.

Each monthly fee benefits the landlord's rental activity for less than one year, so it is a current expense.

Requirements to Deduct Operating Expenses



You deduct operating expenses in the year in which they're incurred—this helps your bottom line. Not everything you buy for your rental activity qualifies as a current expense. Anything you purchase that will benefit your rental activity for more than one year is a capital, not a current, expense. For example, if a landlord purchases a lawn mower to use for his rental properties, the purchase would be a capital expense (not a current expense) because the lawn mower will benefit the rental activity for more than one year. In some cases, capital expenses may only be deducted a little at a time over many years through a process known as "depreciation," which is the case for rental buildings and other real property. However, long-term personal property like a lawn mower can usually be deducted in one year using the *de minimis* safe harbor, bonus depreciation, or Section 179 expensing.

Repairs to real property are current expenses that may be deducted in a single year. For example, replacing a few shingles on the roof of a rental house is a repair that can be currently deducted. However, improvements to real property that extend the property's useful life or make it more valuable must be depreciated. So, the cost of purchasing and installing a whole new roof for a rental home would be a capital expense that would have to be depreciated over several years. It is sometimes difficult to tell the difference between a deductible repair and depreciable improvement. This important issue is covered in detail in Chapter 1 of course 34304C.

Business-Related

An expenditure must be *directly related to your rental activity* to be deductible as an operating expense. So, you can't deduct personal expenses. For example, the cost of a personal computer is a deductible operating expense only if you use the computer for your rental activities; it isn't deductible if you use it to pay personal bills or play computer games.

Allocating Business and Personal Use

If you buy something for both personal and landlord use, you can deduct only the business portion of the expense. You must figure out how much of the time you used the item for landlord purposes and how much for personal purposes. You then allocate the total cost between the two purposes, and deduct only the landlord portion of the cost.

Example

Sam rents a small outside office for $400 per month. He uses it 5 hours a week for his rental activities and 15 hours for personal use. So, he uses it 25% of the time for landlord purposes and 75% for personal reasons. He may deduct only 25% of the cost of the office, or $100 per month, as an operating expense.

The same allocation rule applies when you rent out part of a house that you live in.

Example

Sheila owns a three-bedroom house that she uses as her residence. She rents out one of the bedrooms, which represents 15% of the total house. Sheila may deduct 15% of the cost of utilities and maintenance for the whole house as a landlord operating expense. She could deduct 100% of the cost of any expense incurred just for the rented bedroom—for example, the cost of repainting the bedroom.

Stricter Rules for Certain Expenses

Many expenses have both a personal and a business component, which can make it difficult to tell if an expense is business related. For example, what if a landlord drives to the hardware store and buys one item for his rental property and another for his personal residence? Should he be allowed to deduct all, part, or none of the cost of driving to the hardware store?

The IRS has created rules and regulations for some operating expenses that commonly involve a crossover of personal and business use. Some of these rules lay out guidelines to help you figure out when an expense is and isn't deductible. Others impose recordkeeping and other requirements to prevent abuses by dishonest taxpayers. Much of the complexity in determining whether an expense is deductible as a business operating expense involves understanding and applying these special rules and regulations.

The expenses that present the most common problems (and are, therefore, subject to the most comprehensive IRS rules and regulations) include:

- Home office expenses (see Chapter 3 of course 34305C)
- Meals (see Chapter 2 of course 34307C)
- Travel (see Chapter 2 of course 34306C)
- Car and truck expenses (see Chapter 1 of course 34306C)
- Business gifts (see Chapter 2 of course 34307C)
- Bad debts (see Chapter 2 of course 34307C)
- Employee benefits (see Chapter 3 of course 34306C)
- Interest payments (see Chapter 1 of course 34305C)
- Casualty losses (see Chapter 1 of course 34307C)
- Taxes (see Chapter 2 of course 34307C), and
- Education expenses (see Chapter 2 of course 34307C).

Landlord's Personal Labor Not Deductible

A landlord may never deduct the value of their own time and personal labor working on rental activities. For example, a landlord who spends 50 hours repainting an apartment building gets no deduction for the value of his time. He may only deduct the cost of the paint, brushes, and other materials he uses. This rule prevents the kind of abuse the IRS fears would happen if personal labor were deductible.

Landlords may deduct labor costs only when they hire other people to do the work and pay them for it. The labor can be performed by an employee or independent contractor (nonemployee), or even a member of the landlord's family. (See Chapter 3 of course 34306C.)

However, this doesn't mean landlords should never do any work on their rental properties themselves. Although your personal labor isn't deductible, you'll still save money by doing the work yourself because only a part of the money you deduct for labor costs ends up as a tax savings. (See Chapter 3 of course 34306C.)

Reasonable in Amount

Subject to some important exceptions, no limit applies to how much you can deduct, as long as the amount is reasonable and you *don't* deduct more than you spend. As a rule of thumb, an expense is reasonable unless there are more economical and practical ways to achieve the same result. If the IRS finds that your deductions are unreasonably large, it will disallow them or at least disallow the portion it finds unreasonable.

Certain areas are hot buttons for the IRS—especially travel and meal expenses. The IRS won't allow any lavish expenses here, and you will have to follow strict rules requiring you to fully document these deductions (see Chapter 1 of course 34302C of course 34306C, Chapter 1 of course 34302C of course 34307C). The reasonableness issue also comes up when a business pays excessive salaries to employees to obtain a large tax deduction. For example, a landlord might hire his 14-year-old son to do yard work for his rental units and pay him $50 an hour—clearly an excessive wage for this type of work.

For a few types of operating expenses, the IRS limits how much you can deduct. These include:

- The home office deduction, which is limited to the profit from your business (although you can carry over and deduct any excess amount in future years; see Chapter 3 of course 34305C)
- Business meals, which are 50% deductible (see Chapter 2 of course 34307C)
- Travel expenses, which are limited depending on the length of your trip and the time you spend on business while away (see Chapter 2 of course 34306C), and
- Business gifts, which are subject to a $25 maximum deduction per individual per year (see Chapter 2 of course 34307C).