PacificCPE

COURSE
34305B

Landlords: Start-Up Costs, Home Office, and Transportation Deductions

Landlords who actively manage their properties often incur expenses that don't fit neatly into obvious deduction categories — and those are exactly the deductions that tend to get missed. This course addresses three areas where that happens most: start-up expenses when a rental activity is getting off the ground, the home office deduction for landlords managing from home, and car and local transportation costs. Tax professionals will gain clear, workable guidance for helping clients document and claim these commonly overlooked deductions.

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

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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

- Identify what start-up expenses are deductible.
- Recognize the requirements for the home office deduction.
- Identify how to calculate the simplified home office deduction.
- Recall what car and transportation expenses are deductible.

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Chapter 1: START-UP EXPENSES

Chapter Objective

After completing this chapter, you should be able to:

- Identify what start-up expenses are deductible.

Landlords often need to spend money to get their rental business started. Costs you incur before you are actually in business are called "start-up expenses." Special tax rules govern the deduction of these costs. As long as your rental activity qualifies as a business, these expenses are fully deductible. If you are a landlord who is already actively engaged in the residential rental business, this chapter would not necessarily apply. But if you aren't yet in business or are considering expanding your residential rental business into new geographic areas, this material explains what type of expenditures are start-up expenses and how you can deduct these costs.

WHAT ARE START-UP EXPENSES?

"Start-up expenses" are the costs you incur to get your rental business up and running. Any expense that would be deductible as an operating expense by an ongoing business is a start-up expense when it's incurred before a business begins. Common start-up expenses for landlords include:

- Minor or incidental repairs to get a rental property ready to rent
- Outside office expenses paid for before a rental business begins, such as office rent, telephone service, utilities, office supplies, and office equipment rental
- Home office expenses
- The cost of investigating what it will take to create a successful residential rental business, including research on potential real estate markets
- Insurance premiums (but not title insurance)
- Maintenance costs for a rental property paid for before the property is offered for rent—for example, landscaping and utilities (but not the cost of connecting utilities)
- Costs for recruiting and training employees before the business opens—for example, hiring and training an apartment manager
- Costs to create and set up a website
- Fees paid to a market research firm to analyze the demographics, traffic patterns, and general economic conditions of a neighborhood
- Business licenses, permits, and other fees, and

- Fees paid to lawyers, accountants, consultants, and others for professional services; however, legal and other fees paid to purchase a rental property aren't start-up expenses.

Unlike operating expenses, start-up expenses can't automatically be deducted in a single year because the money you spend to start a rental (or any other) business is a capital expense—a cost that will benefit you for more than one year. Normally, you can't deduct these types of capital expenses until you sell or otherwise dispose of the business. However, a special tax rule allows you to deduct up to $5,000 in start-up expenses the first year you are in business, and then deduct the remainder, if any, in equal amounts over the next 15 years.

Example

Ed, a Los Angeles resident, is thinking about purchasing a rental house in Las Vegas. He has never been a landlord before, but he thinks it might be a good investment. He starts looking for a house to buy. But he discovers that it isn't so easy to find a suitable property. He makes six trips to Las Vegas over the next year. He incurs substantial travel expenses but finds no property he likes. Then, on the seventh trip, he discovers his dream rental house. He quickly buys it and takes title on September 1. The house is vacant but requires some repairs. Ed hires a handyman to do the work and arranges for a gardener to take care of the lawn and landscaping on a weekly basis. On November 1, he lists the property for rent by taking out an ad in the local newspaper. He finds a tenant who moves in on December 1.

Before November 1 (the date he offered the house for rent) Ed paid the following expenses during the year:

Travel, lodging, and food for six unsuccessful trips to Las Vegas	$3,800
Travel, lodging, and food for one successful Las Vegas trip	500
Gardener	100
Utilities	100
Repairs	7,000
Total	$11,500

All of these expenses are start-up expenses except for the $500 travel costs to find the property Ed ended up buying. Those costs must be added to the property's tax basis and depreciated, leaving $11,000 in deductible start-up expenses. Ed may deduct $5,000 of the $11,000 on his tax return for the current year. He can deduct the remaining $6,000 in equal installments over the first 180 months (15 years) he's in business, starting with the month his rental business began (November). He deducts $33.33 for every full month he's in business until he has completely deducted the $6,000 (assuming his rental business lasts that long).

Obviously, you want to spend no more than the first-year limit on start-up expenses so you don't have to wait 15 years to get all of your money back. Some ways you can avoid spending more than the limit are described in more detail below. But first, you need to understand when a rental business begins for tax purposes.

DETERMINING YOUR BUSINESS START DATE

A crucial moment in your tax life as a landlord is when your rental business begins. Once your business is up and running, the start-up expense rule won't apply. Until then, you need to count every penny you spend to make sure you don't go over the limit for currently deductible start-up expenses.

Rental Business Begins When You Offer Property for Rent

The general rule is that a new business begins for tax purposes when it starts to function as a going concern and performs the activities for which it was organized. (*Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir. 1965).) For a rental business, this is when you first offer property for rent. You don't have to actually rent out your property—that is, have it occupied by tenants—you only have to put it on the rental market. (*Francis v. Comm'r.*, T.C. Memo 1977-170.)

Obviously, you must actually own a rental property before you can rent it out. So, your rental business doesn't begin until you take ownership of the property, make the building available for immediate occupancy, and offer it for rent. In other words, a rental business doesn't begin when you make an offer to buy, put a deposit on, or sign a sales contract for a property you plan to rent.

The date you offer your property for rent is an important one that you should plan for and make careful note of. You should also be prepared to prove you offered your property for rent on the date you claim.

Expanding an Existing Rental Business

If you've never owned a rental property, it's easy to tell when your rental business begins—the date you offer your first property for rent. But what if you already own rental property and decide to purchase additional rental property? The cost of expanding an existing business is a business operating expense, not a start-up expense. As long as business expansion costs are ordinary and necessary, they are currently deductible.

Example

Alex owns an apartment building that he has rented out for over two years. This rental (which qualifies as a business) has been so successful that he decides to purchase another apartment building. He spends $4,000 in travel expenses looking for properties to buy. Because Alex is already in business, these costs are currently deductible as business operating expenses—they aren't start-up expenses.

However, your expenses will be currently deductible only if the expansion involves an activity that is "within the compass" of your existing rental business. In other words, it must be part of "the normal

expansion" of your business. (*Malmstedt v. Comm'r.*, 578 F.2d 520 (4th Cir. 1978).) The costs of expanding into a new business are start-up expenses, not operating expenses.

The IRS and tax court have taken a very narrow view of what constitutes a rental business. They have held that a landlord's rental business only exists in the geographic area where the property is located. So, a landlord who buys (or seeks to buy) property in a different area is starting a new rental business, which means the expenses for expanding in the new location are start-up expenses.

Example

Patrick O'Donnell was a Chicago resident who owned two apartments in Las Vegas. He took a two-day trip to Miami to investigate buying a rental property there. However, he decided not to go through with the deal. Both the IRS and tax court denied him a deduction for his travel expenses. The court found that, even though O'Donnell was in the rental business in Las Vegas, his business didn't extend to Miami, so he couldn't deduct the trip as an operating expense. (*O'Donnell v. Comm'r.,* 62 T.C. 781.)

In another case, the tax court held that a husband and wife who owned several rental properties in North Carolina started a new rental business (as opposed to expanded their existing rental business) when they purchased a rental house in Richmond, Virginia–even though they lived in Richmond. (*Odom v. Comm'r.*, T.C. Memo 1982-531.)

Forming New Business Entities

Another situation where a landlord could be viewed as starting a new rental business, not expanding an existing one, is where a new business entity, such as an LLC or partnership, is formed to own the new property. A landlord might form a new business entity, like an LLC, in an attempt to limit their legal liability. (See Chapter 1 of course 34301C.)

> **EXAMPLE:** Hayley and her husband own an LLC that, in turn, owns an apartment building. They decide to purchase a new apartment building. They form a second LLC, unrelated to the first, to own this property, hoping separate ownership entities will insulate each property from debts or lawsuits arising from the other property. The second LLC could be viewed by the IRS as an entirely new rental business. Any costs the second LLC incurs before the new apartment building is offered for rent would be start-up expenses.

HOW TO DEDUCT START-UP EXPENSES

The amount of start-up expenses you're allowed to deduct the first year you're in business is limited. For the past several years, the limit has been $5,000. You'll have to deduct any expenses in excess of

the first-year limit in equal amounts over the first 180 months (15 years) you're in business. This process is called "amortization." The 180 months is the minimum amortization period; you can choose a longer period if you wish (almost no one does).

But you won't be entitled to the full $5,000 first-year deduction if you have more than $50,000 in start- up expenses. Your first-year deduction is reduced by the amount by which such start-up expenditures exceed the $50,000 limit. For example, if you have $53,000 in start-up expenses, you may only deduct $2,000 the first year, instead of $5,000. If you have $60,000 or more in start-up expenses, you get no current deduction. The whole amount must be deducted over 180 months.

Caution!

Investors can't deduct start-up expenses. Only people engaged in a business can deduct start-up expenses. Investors in real estate aren't considered to be "in business" for tax purposes.(*Sorrell v. Comm'r*., 882 F.2d 484(11th Cir. 1989).)(See Chapter 1 of course 34302C for a detailed discussion of investors versus landlords for tax purposes.)

You used to have to attach a separate written statement to your tax return electing to claim start-up expenses as a current deduction. This step is no longer required. Instead, you are automatically deemed to have made the election for the year in which your business began. All you must do is list your start-up costs as "Other expenses" on your Schedule E (or another appropriate return). You don't have to specifically identify the deducted amounts as start-up expenditures for the election to be effective. However, if you have more than $5,000 in start-up expenses, you must amortize (deduct) the excess over 180 months. To do so, you must complete and attach IRS Form 4562 to your return for the first tax year you are in business.

If you don't want to currently deduct your start-up expenses, you can forgo the deemed election by clearly capitalizing your start-up expenses instead. You must do this on your federal income tax return for the tax year in which your business began. Your return must be filed on time (including any extensions) and this election is irrevocable. If you do this, your start-up costs become part of the tax basis of your business.

Expenses You Can Deduct

You can deduct as start-up expenses any costs that would be currently deductible as operating expenses after your rental business begins. So, the expenses must be ordinary, necessary, directly related to the business, and reasonable in amount. (See Chapter 2 of course 34302C for a discussion of operating expenses.) For example, you can't deduct the cost of pleasure travel unrelated to your rental business. These expenses wouldn't be deductible as operating expenses by an ongoing rental business, so you can't deduct them as start-up expenses either. (See "What Are Start-Up Expenses?" above, for common examples of deductible start-up expenses for landlords.)