PacificCPE

COURSE
34307B

Landlords: Additional Deductions and Rental Loss Rules

Rounding out the full picture of landlord deductions, this course covers additional credits and deductions rental property owners may qualify for, along with the rules governing when rental losses can actually be deducted. Passive activity limitations, the active participation exception, and related planning considerations all come into play here. Tax professionals who advise clients with rental activities will benefit from a clear-eyed review of these rules and the strategies that help clients make the most of allowable losses.

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 the deductibility limits for various expenses incurred by landlords.
- Identify limits for deducting rental losses.
- Recognize the requirements to qualify for the $25,000 offset.
- Recall the benefits of the real estate professional exemption.

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Chapter 1: ADDITIONAL DEDUCTIONS AND CREDITS

Chapter Objective

After completing this chapter, you should be able to:

- Identify the deductibility limits for various expenses incurred by landlords.

This chapter looks at some common deductible operating expenses that you're likely to incur in the course of your rental activity, such as real estate taxes, insurance, and legal fees. You can deduct these costs as operating expenses as long as they are ordinary, necessary, and reasonable in amount —and meet the additional requirements discussed below.

BUSINESS ENERGY INVESTMENT TAX CREDIT

The business energy investment tax credit (ITC) is used primarily for solar panel installations for commercial buildings and residential rentals. But it's also available for other forms of green energy, such as small wind-power installations, fuel cells, and standalone battery storage. The One Big Beautiful Bill Act makes major changes to this credit.

As a result of the Act, solar and wind projects qualify for a tax credit only if they meet strict deadlines.

- If you start a new solar or wind project after July 4, 2026, you must complete the installation and place the system in service by December 31, 2027, to qualify for the ITC.
- If you begin construction of a solar or wind project before July 4, 2026, the system must be placed in service within four years to qualify for the tax credit.

These deadlines don't apply to other clean electricity technologies. For those technologies, the ITC continues through 2033, and then phases out during 2034 through 2035.

The One Big Beautiful Bill Act also imposes new restrictions on the use of components from certain countries, called "foreign entities of concern" (FEOC), which includes China. For projects beginning construction in 2026, at least 40% of the value of all the components of the solar or wind system must come from non-FEOC sources for the project to be eligible for a tax credit. The percentage increases by 5% every year until it reaches 60% for projects beginning construction in 2030.

The base amount of the ITC is 30% of depreciable basis for installations placed in service after 2021. However, the building owner must continue to own the property for five years after the energy installation, or the credit will have to be counted as taxable income.

In addition, building owners can utilize stackable "bonus" ITC adders that can increase the total ITC to 40% or 50% or more.

- **Domestic content bonus.** You can earn a 10% ITC bonus (bringing the ITC to 40%) if a project satisfies domestic content requirements. To qualify, 100% of the steel and iron used must be U.S. sourced, and manufactured components must be at least 40% U.S. sourced.
- **Low-income community bonus.** You can also earn a 10% ITC bonus if you make a solar or wind installation to a building that's located in a low-income community or on Native American land. Low-income communities are those with at least a 20% poverty rate or whose residents earn less than 80% of the statewide median income.
- **Qualified low-income residential building project bonus.** A 20% bonus can be earned for solar or wind installations for residential buildings if the building owner participates in various federal low-income housing programs or 50% of the affected building households have an income less than 200% of the poverty line or less than 80% of the area's median gross income.
- **Energy community bonus.** A 10% ITC bonus also applies if the building is located in a brownfield site, an area with significant employment related to fossil fuels, or a coal-related census tract.

The year a solar or other energy installation is placed in service, you may depreciate it. Ordinarily, you reduce the basis of depreciable property by the full amount of any credit. However, the ITC reduces the energy property's basis by only half the credit amount, increasing your depreciation deductions. IRC Section 48 energy property gets a five-year depreciation period under MACRS, which is generous because solar panels usually last 25 to 30 years.

Example

Sally owns a rental duplex in Buffalo, New York. She spent $15,000 to install solar panels in January of 2026. The project qualifies for the 10% domestic content bonus and 10% low-income community bonus. Sally's total ITC is 50%, and she gets a $7,500 ITC. The depreciable basis in her solar installation is reduced by only 50% of her ITC, so her basis is $11,250.

DUES AND SUBSCRIPTIONS

Dues you pay to professional, business, and civic organizations are deductible expenses, as long as the organization's main purpose isn't to provide entertainment facilities to members. You can deduct dues paid to:

- Apartment owner associations

- Real estate boards
- Local chambers of commerce and business leagues, and
- Civic or public service organizations, such as a Rotary or Lions Club.

You get no deduction for dues you pay to belong to other types of social, business, or recreational clubs— for example, country clubs or athletic clubs. For this reason, it's best not to use the word "dues" on your tax return because the IRS might question the expense. Use other words to describe the deduction—for example, if you're deducting membership dues for an apartment owners' organization, list the expense as "apartment owners' association membership fees."

You may also deduct the cost of publications you read for your rental activity—magazines or journals on real estate, taxation, law, or finance. Subscription websites dealing with real estate are also deductible.

EDUCATION EXPENSES

You may deduct your expenses for landlord-related education—for example, a seminar or course on buying or operating rental property. You may also deduct the cost of attending a real estate–related convention or meeting as an education expense. To qualify for an education deduction, you must be able to show the education:

- Maintains or improves skills required to be a successful landlord, or
- Is required by law or regulation to maintain your professional status.

Example 1

Jeremy owns three rental houses. He attends a one-day seminar on how to make more money from rental property offered by The Learning Annex, a company that produces educational seminars on various subjects. The cost is deductible as an education expense.

Example 2

Hamzah is a landlord and licensed real estate broker. Every year, he is required by his state real estate licensing board to take 30 hours of continuing education to maintain his status as a licensed broker. He may deduct the cost as an education expense.

Deductible education expenses include tuition, fees, books, and other learning materials. They also include transportation and travel (see below). You may also deduct expenses you pay to educate or train your employees.

Lifetime Learning Credit

Instead of taking a tax deduction for your rental-business–related education expenses, you may qualify for the lifetime learning credit. A tax credit is a dollar-for-dollar reduction in your tax liability, so it's even better than a tax deduction.

The lifetime learning credit can be used to help pay for any undergraduate or graduate-level education, including nondegree education to acquire or improve job skills (for example, a continuing education course). If you qualify, your credit equals 20% of the first $10,000 of postsecondary tuition and fees you pay during the year, for a maximum credit of $2,000 per tax return. But the credit is phased out and then eliminated at certain income levels: It begins to go down if your modified adjusted gross income (MAGI) is more than $80,000 ($160,000 for a joint return), and you can't claim the credit at all if your MAGI is more than $90,000 ($180,000 for a joint return). These limits started in 2021. They aren't adjusted for inflation, so the phaseout range will remain the same for all future years.

You can take this credit not only for yourself, but for a dependent child (or children) for whom you claim a tax exemption, or your spouse as well (if you file jointly). And it can be taken any number of times. However, you can't take the credit if you've already deducted the education cost as a business expense.

> **EXAMPLE:** Bill, a self-employed real estate broker with a $75,000 AGI, spends $2,000 on continuing real estate education courses. He may take a $400 lifetime learning credit (20% × $2,000 = $400).

Before You Are in Business

You can't currently deduct education expenses you incur before your rental activity begins. For example, if you have never owned rental property and attend a course on how to be a successful landlord, you may not deduct the expense as an education expense. However, if you do end up buying rental property, you may deduct the expense as a startup expense. You can deduct up to $5,000 in start-up expenses the first year your rental activity is in operation. You must deduct any amount over the applicable limit in equal installments over the first 180 months you're in business. (See Chapter 2 of course 34305C.)

Likewise, if you're not already involved in the real estate field, you may not deduct the cost of attending courses to become a licensed real estate broker. (IRS Reg. § 1.162-5(a).)

Traveling for Education

Transportation expenses you pay to travel to and from a deductible educational activity are deductible. This includes transportation between your home and the educational activity. Going to

or from home to an educational activity doesn't constitute nondeductible commuting. If you drive, you may deduct your actual expenses or use the standard mileage rate. (See Chapter 1 of course 34306C for more on deducting car expenses.)

No law says that you must take your education courses as close to home as possible. You can travel outside your geographic area for education, even if the same or a similar educational activity is available near your home or place of business. Companies and groups that sponsor educational events are well aware of this rule and take advantage of it by offering courses and seminars at resorts and other enjoyable vacation spots such as Hawaii and California. Deductible travel expenses can include airfare or other transportation, lodging, and meals. (See Chapter 2 of course 34306C for more on deducting travel expenses.)

GIFTS

You may deduct the cost of gifts you make in the course of your rental business—for example, to thank or maintain goodwill with a vendor, tenant, or employee, including holiday gifts to tenants. But the gift expense deduction is limited to $25 per person per year. Any amount more than the $25 limit isn't deductible. If this amount seems low, that's because it was established in 1954 and has never been increased. In addition, special record-keeping requirements apply to gifts. (See Chapter 2 of course 34308C.)

Example

Landlord Lisa gives a $100 Christmas gift to the gardener who takes care of her rental properties. She may deduct $25 of the cost.

The $25 limit applies only to gifts to individuals. It doesn't apply if you give a gift to an entire company. Such companywide gifts are deductible in any amount, as long as they are reasonable. However, the $25 limit does apply if the gift is intended for a particular person or group of people within the company.

If you give a gift to a family member of a tenant, the gift is considered to be an indirect gift to the tenant and is subject to the $25 limit. So, you're limited to a single $25 gift deduction for each tenant and their entire family.

INSURANCE FOR YOUR RENTAL ACTIVITY

You can deduct the premiums you pay for almost any insurance related to your rental activity, including fire, theft, and flood insurance for rental property, as well as landlord liability insurance. If you have employees, you may deduct the cost of their health and workers' compensation insurance. Unemployment insurance contributions you make for your employees are deducted either as insurance costs or as taxes, depending on how they are characterized by your state's laws.

The one type of insurance that may not be deducted as an operating expense is title insurance you obtain when you purchase rental property. Its cost is added to the basis of the property and depreciated over 27.5 years. The same rule applies to insurance premiums you pay on property under construction. (See Chapter 1 of course 34304C.)

Homeowners' Insurance for Your Home Office

If you have a home office and qualify for the home office deduction, you may deduct the home office percentage of your homeowners' or renters' insurance premiums. For example, if your home office takes up 10% of your home, you may deduct 10% of the premiums. You can deduct 100% of any coverage that you add to your homeowners' policy specifically for your home office and/or rental property. For example, if you add an endorsement to your policy to cover business property, you can deduct 100% of the cost. (See Chapter 3 of course 34305C.)

Car Insurance

If you use the actual expense method to deduct your car expenses, you can deduct the cost of insurance that covers liability, damages, and other losses for vehicles used in your rental activity as an operating expense. If you use a vehicle only for your rental activity, you can deduct 100% of your insurance costs. If you operate a vehicle both for your rental activity and for personal use, you can deduct only the part of the insurance premiums that applies to the rental use of your vehicle. For example, if you use a car 10% for your rental activity and 90% for personal reasons, you can deduct 10% of your insurance costs.

If you use the standard mileage rate to deduct your car expenses, you can't take a separate deduction for insurance. The standard rate is intended to cover all your automobile costs, including insurance. (See Chapter 1 of course 34306C for more on vehicle deductions.)

Prepaying Your Insurance Premiums

Many landlords make a single payment for an entire year of insurance coverage. This type of prepayment is fully deductible in the year it was made, provided it complies with the 12-month rule. Under this rule, cash basis taxpayers (which includes most small landlords) may deduct a prepaid expense such as insurance in the current year, if the term of the insurance coverage extends no longer than the earlier of 12 months, or the end of the tax year after the tax year in which the payment was made.

There is one small catch: If you previously followed the old rule under which expenses prepaid beyond the calendar year weren't currently deductible, you must get IRS approval to use the 12-month rule. Approval is granted automatically by the IRS upon filing of IRS Form 3115, *Application for Change in Accounting Method*. You should attach one copy of the form to the return for the year of the change and send another copy to the IRS national office (not the service center where you file your return). The address is on the instructions for the form.

It is a good idea to get a tax pro to help you with this form because it might require some adjustment of the deductions you've taken for prepaid expenses in previous years under the old rule.

LEGAL AND PROFESSIONAL SERVICES

You can deduct fees that you pay to attorneys, accountants, property management companies, real estate investment advisers, and other professionals as operating expenses if the fees are for work related to your rental activity.

Example

Landlord Ian hires attorney Jake to evict a tenant who has failed to pay rent. The legal fees Ian pays Jake are a deductible operating expense.

Legal and professional fees that you pay for personal purposes generally aren't deductible. For example, you can't deduct the legal fees you incur if you get divorced or you sue someone for a traffic accident injury. Nor are the fees that you pay to write your will deductible, even if the will covers rental property that you own.

Buying Long-Term Property

If you pay legal or other fees in the course of buying real estate or other long-term property, you must add the amount of the fee to the tax basis (cost) of the property. You deduct this cost over several years, through depreciation. This rule also applies to attorneys' fees incurred in legal disputes over who holds title to real estate, or in boundary disputes or condemnation proceedings.

Management Fees

The fees you pay a real estate management company to manage your property are deductible operating expenses. But be careful if you hire your child, spouse, or other relatives to serve as your manager. If you pay a relative more than the going market rate and you are audited, the IRS can deny your deduction for the excess amount. (IRS Reg. § 1.162-1(a).)

Starting a Business

Legal and accounting fees that you pay to start a rental business are deductible only as business start-up expenses. You may deduct them over the first 180 months you are in business. You may not deduct such fees if your rental activity is an investment for tax purposes, not a business. (See Chapter 2 of course 34305C for more on deducting start-up costs.)

Accounting Fees