



## Income – Schedules K-1 and Rental



### Introduction

This lesson covers the reporting of:

- Certain income from Schedules K-1 (Forms 1065, 1120S, and 1041). Only volunteers who certify at the Advanced level are permitted to prepare a Schedule E with Schedule K-1 income items identified in this lesson or Form 1099-MISC, Box 2, Royalties, with no associated expenses.
- Rental income and expenses are in-scope only for military families renting their personal residence. Taxpayers are not required to report income and expenses if their home is rented less than 15 days.
- Rental income and expenses **only** for the Military course. Volunteers must certify at Military level to prepare Schedule E for rental income.



Rental income and expenses are in-scope only for military families renting their personal residence. Generally, the at-risk and passive activity issues in this lesson are beyond the scope of the VITA/TCE programs. These issues are referenced for those assisting military members living abroad who have limited access to resources and professional preparers.

The intake and interview sheet provides a line to list income from rental property but does not provide a place to list income from Schedules K-1. It is important to ensure that all income is accurately reported on the return. For military families, ask taxpayers if they rented out their home during the tax year or if they received a Schedule K-1 (Form 1041, Form 1065, or Form 1120S) from an estate, trust, partnership, or S corporation.



This lesson does not apply to taxpayers who are in the business of renting properties.

### Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Identify Schedule K-1 income items that are within the scope of the VITA/TCE programs
- Determine how to report Schedule K-1 income items
- Determine which types of rental income must be reported
- Identify how to report rental expenses

#### What do I need?

- Form 13614-C
- Publication 4012
- Publication 17
- Publication 4491-W
- Schedule A
- Schedule E

#### **Optional:**

- Publication 527
- Publication 541
- Publication 551
- Publication 559
- Publication 925
- Publication 946
- Form 8582
- Schedule K-1 (Form 1041 and Instructions)
- Schedule K-1 (Form 1065 and Instructions)
- Schedule K-1 (Form 1120S and Instructions)



## Schedule K-1

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### What is reported on Schedule K-1?

Schedule K-1 is used to report the taxpayer's share of income, other distributions, deductions, and credits from partnerships, S corporations, and some estates and trusts. One copy of Schedule K-1 is sent to the IRS and is later matched with individual returns. Another copy of Schedule K-1 is sent to the taxpayer. Ask taxpayers if they received a Schedule K-1 from such an entity that reflects their share of income, reportable on their Form 1040. It is important to correctly report this income to avoid notices or correspondence from the IRS.

### How and where can income be reported?

Income reported on Schedule K-1 will be included on the taxpayer's return in various places depending upon the type of income. Income reported on Schedule K-1 that is within the scope of the VITA/TCE programs includes:

- Interest income (1040, line 8a)
- Dividend income (1040, line 9a)
- Qualified Dividends income (1040, line 9b)
- Net short-term capital gains and losses (Schedule D, line 5)
- Net long-term capital gains and losses (Schedule D, line 12)
- Tax-exempt interest income (Form 1040, line 8b)
- Royalty income (Schedule E)

In Part I of Schedule E, enter a code 6 for royalties. Refer to the Schedule E Instructions for more information.



Royalty income is in scope for the VITA/TCE programs only when the source document of the royalty income is reported on Schedule K-1 or Form 1099-MISC, Box 2, Royalties, with no associated expenses. For these investors, the depletion allowance would already have been figured for them by the partnership or S corporation. Any other income, deductions, credits, etc., reported on Schedule K-1 is out of scope for the VITA/TCE programs, and the taxpayer should be referred to a professional tax preparer.

### Schedule K-1 (Form 1041)

The fiduciary of a domestic decedent's estate, trust, or bankruptcy estate uses Form 1041 to report income, gains, losses, etc., of the estate or trust.

Taxpayers receive Form 1041, Schedule K-1, to report their share of income from interest, dividends (ordinary and qualified), and capital gains (net short-term and net long-term). The taxpayer's income from these sources should be reported on the appropriate forms and schedules as listed on Form 1041, Schedule K-1, page 2.

## Schedule K-1 (Forms 1065 and 1120S)

Partnerships use Form 1065, Schedule K-1, to report the taxpayers' share of the partnership's income, deductions, credits, etc. In general, a partnership is not subject to income tax and is a flow-through entity. This means the income flows through to the partners, who pay tax on their allocated share of the partnership income.

S corporations use Form 1120S, Schedule K-1, to report the taxpayers' share of the corporation's income (reduced by any tax the corporation paid on the income), as well as any deductions, credits, etc. The S corporation is also a flow-through entity with the reported income flowing to each shareholder. Shareholders pay tax on their allocated share of the income.

Taxpayers receive a Schedule K-1 (Form 1065 or Form 1120S) reporting their share of income from interest, dividends (ordinary and qualified), and capital gains (net short-term and net long-term) from partnerships and corporations. Schedule K-1, page 2, lists the appropriate forms and schedules where taxpayers' income from these sources should be reported.



Schedules K-1 are not filed with the tax return. Advise taxpayers to keep Schedules K-1 with their records.



## What is rental income?

Generally, payment received for renting a room or a home to a tenant is rental income reportable on Form 1040, Schedule E. U.S. citizens and resident aliens must report rental income, regardless of whether the rental property is located in the U.S. or in a foreign country. Gross rental income may include other payments in addition to the normal and ordinary rents received, such as:

- Advanced rent
- Security deposits, if it represents rental income
- Payments for breaking a lease
- Expenses paid by the tenant
- Fair market value of property or services received instead of rental payments



The security deposit is not included in income when the taxpayer plans on returning the deposit at the end of the lease. However, if the security deposit is intended to serve as the last month's rent, then it should be included in income when received.

The taxpayer's method of accounting affects when the rental income is reported. The cash method reports income when received and expenses when paid; most individuals use this method. The accrual method reports income when earned and expenses when incurred, and is out of scope for the VITA/TCE programs. Refer taxpayers using the accrual method of accounting to a professional tax preparer.

In completing Schedule E, the following should be answered:

- Question A – Check the box “Yes” or “No” to the question: Did the taxpayer make any payments in the current year that would require the filing of Form 1099? If Yes, the return is out of scope.
- Question B – If Yes, did or will the taxpayer file all required Forms 1099? Check the box “Yes” or “No.”
- In Part I, line 2 – The number of fair rental value days and number of personal use days is reported on Schedule E.



Landlords who are not in the business of renting property are not required to file Form 1099 even if they pay a service provided more than \$600 a year.



**Tax Software Hint:** Use Schedule E to report rental income only when the taxpayer is not in the business of renting property. For software entries, see the Volunteer Resource Guide, Income tab, Schedule E – Rental and Royalty Income and Loss (Limited).



It is important that property be rented at fair rental value. If a property is rented at less than fair rental value, the income and expenses are reported in a different manner than discussed in this lesson. Refer taxpayers who rent their property at less than fair rental value to a professional tax preparer.

## What qualifies as a rental expense?

Taxpayers who reside in homes they own generally itemize and deduct mortgage interest and property taxes on Schedule A. However, when a taxpayer rents out a home, those become rental expenses along with the cost of certain other operating expenses. Taxpayers who do not use the rental home as their residence should:

- Include the rent as income and
- Deduct all of the rental expenses, even if they exceed income

### Mortgage interest and property taxes

Mortgage interest on a loan used to buy or improve the property and property taxes are deductible as rental expenses. If the residence (or a portion of the residence) was used as rental property for any part of the year, the taxpayer must allocate the property tax and mortgage interest deductions between Schedule A and Schedule E.

In general, taxpayers use Schedule A, Itemized Deductions, to report the portion of the mortgage interest and property taxes that apply to their use of the home. That portion can be based on a percentage of time (4 months as a residence and 8 months used as rental) or based on an area (1,500 sq. ft. as a residence and 500 sq. ft. as the rental portion). For the part of the year and/or the portion of the home that is rented out, taxpayers report rental income and expenses (including a portion of the mortgage interest, property taxes, and other expenses that relate to the rental time/portion of the home) on Schedule E, Supplemental Income and Loss.

If any part of the property tax is designated for local benefits that increase the value of the property, such as streets and sidewalks, that portion of the tax is added to the basis of the property rather than as an ordinary rental expense or an itemized deduction.

Mortgage interest is reported to the taxpayer on Form 1098, Mortgage Interest Statement. This statement may also include property taxes. If it does not, the taxpayer will have a document from the local taxing authority.



Generally, mortgage interest expense is fully deductible. However, refer taxpayers with rental-related interest expenses other than mortgage interest to a professional tax preparer.

### example

Paul Kingman lived in his home through September, when he was notified he was being transferred overseas. He rented his home beginning in October. The total amount of Kingman's mortgage interest for the tax year was \$2,400 and his property taxes were \$600. Report nine months (January–September) of mortgage interest and property taxes as itemized deductions on Schedule A, that is, \$1,800 and \$450, and the other three months (October–December) as expenses on Schedule E, that is, \$600 and \$150.

### What are other deductible rental expenses?

In addition to mortgage interest and property taxes, deductible rental property expenses include these items listed on Schedule E:

- Advertising
- Auto and travel expenses to check on the property
- Cleaning and maintenance
- Commissions paid for collecting rental income
- Insurance premiums
- Mortgage points
- Legal and professional fees
- Property management fees
- Repairs
- Utilities
- Other rental-related expenses, such as rental of equipment, long distance phone calls, and condominium/cooperative maintenance fees
- Small assets, each less than \$2,500, can be expensed immediately as “de minimis”



When a tenant does not pay the rent, a cash-basis landlord cannot take a deduction for the unpaid rent. Taxpayers cannot take a deduction for a payment they did not include in income.



### EXERCISES

**Question 1:** John Princeton was transferred overseas and began renting out his residence on September 1 of the tax year. How much of his mortgage interest and property taxes should be reported on his Schedule E?

- A. All of it
- B. Eight-twelfths ( $2/3$  or 67%)
- C. Four-twelfths ( $1/3$  or 33%)
- D. None of it

### What about property insurance?

The property insurance that taxpayers pay on their residence is deductible as a rental expense for the time it is considered rental property. If the residence is rented for part of the year, only the amount that covers

the rental time is deductible. If a portion of the residence is rented, the deductible portion must be allocated and deducted on Schedule E.

Insurance premiums paid more than one year in advance cannot be deducted in one year. All taxpayers must prorate advanced premium payments over the period covered by the policy. The only portion deductible in the current year is that amount that covers the current year. The remainder is spread out over the life of the insurance coverage.

### Can auto and travel expenses be deducted as rental expenses?

Taxpayers can deduct ordinary and necessary travel and transportation expenses attributable to the production of rental income. If the travel was in or outside of the U.S., taxpayers should substantiate the pleasure vs. business portions of the trip and allocate the expenses accordingly.

Taxpayers who use their personal automobile for rental-related trips may use either the standard mileage rate or the actual expense method for business mileage. However, if the taxpayers wish to use the actual expense method, refer them to a professional tax preparer.

The standard mileage method multiplies the miles driven for business by a standard cost. The standard rate includes all expenses of operating the vehicle. Only parking and tolls can be added to the standard mileage deduction. See Publication 17, Car Expenses and Other Employee Business Expenses, for the current year standard mileage rate. Taxpayers may use the standard mileage rate only if they meet one of these requirements:

- The vehicle was owned and used the standard method the first year the vehicle was put into service or
- The vehicle was leased and used the standard method for the life of the lease

The actual expense method figures the deduction based on a variety of factors, including gasoline, oil, repairs, insurance, and rentals and may even involve depreciation or the value of a vehicle provided by the taxpayer's employer.



This lesson discusses only the standard mileage rate. If taxpayers wish to use the actual method, refer them to a professional tax preparer.

### Are repairs and improvements deductible?

Taxpayers often misunderstand when an expense qualifies as a repair or an improvement. A repair keeps the property in good operating condition; the cost is a current year deduction. An improvement adds to the life or material value of the property, prolongs its useful life, or adapts it to new uses. This cost must be depreciated over the recovery period for the improvement. The total cost of an improvement includes material, labor, and installation.



**Tax Software Hint:** Tax Software Hint: For software entries, go to the Volunteer Resource Guide, Income tab, Entering Rental Income in TaxSlayer®.

| Repairs (Deduction)    | Improvements (Depreciation)       |
|------------------------|-----------------------------------|
| Painting               | Adding a room                     |
| Fixing gutters         | Installing a new fence            |
| Repairing driveways    | Putting in plumbing or wiring     |
| Replacing window glass | Replacing a hot water tank        |
| Repairing the roof     | Putting on a new roof             |
| Repairing appliances   | Replacing/adding major appliances |



Additional information on rental income can be found in Publication 527, Residential Rental Property and Publication 946, How to Depreciate Property.



## EXERCISES (continued)

**Question 2:** All of the following are examples of deductible rental expenses *except* \_\_\_\_\_.

- A. Carpet cleaning fees
- B. Charges for phone calls made to the property manager
- C. Gas and electric bills paid for the rental property
- D. Repairs made to the homeowner's personal residence

**Question 3:** Which of the following rental expenses must be recovered by taking depreciation?

- A. Home insurance premiums
- B. Painting
- C. Installing a backyard fence at a cost of \$3,500
- D. Repairing a broken furnace

### How do I handle depreciation of rental property?

The cost of property with a useful life of one year or more, and used in a trade or business or held for the production of income (such as rent), is recovered by deducting an expense called depreciation.

"Depreciable property" includes buildings, machinery, furniture, equipment, vehicles, and any cost for additions or improvements to rental property. The value of land, however, is not depreciable; therefore, the cost of clearing, grading, planting, or other land improvements are also not depreciable.

Depreciation allows the taxpayers to deduct some of the cost of the property each year on their tax return. The annual amount of depreciation on property reduces the taxpayers' basis in that property. Taxpayers should claim the correct amount of depreciation every year. Even if they did not deduct the depreciation during any tax year, they must still reduce their basis in the property by the amount of depreciation that they should have deducted.

### What factors determine the amount of depreciation to deduct?

The factors that determine the depreciation amount are:

- Depreciation method used
- Basis of the property
- Recovery period for the property

#### **Depreciation Method**

The most common methods for determining depreciation are:

- Straight line or declining balance: Property placed in service before 1981
- ACRS (Accelerated Cost Recovery System): Property placed in service after 1980, but before 1987
- MACRS (Modified Accelerated Cost Recovery System): Property placed in service after 1986

### ***What is considered the basis and adjusted basis for depreciation purposes?***

Generally, the basis for depreciation is the purchase price of the property, including the cost of improvements, but not including the value of the land. When property is converted from personal use to rental use, the basis is the lesser of the adjusted basis or fair market value (FMV) at the time of conversion. The total of the yearly deductions for depreciation can never total more than the basis of the property.

### **Form 4562 Depreciation and Amortization**

Taxpayers must complete and attach Form 4562 for rental activities only if claiming:

- Depreciation, including the special depreciation allowance, on property placed in service during 2016 (out of scope)
- Depreciation on listed property (such as a car), regardless of when it was placed in service (out of scope)
- Any other car expenses, including the standard mileage rate or lease expenses (out of scope)

Otherwise, taxpayers should figure the depreciation on their own worksheet. Do not attach these computations to the return, but taxpayers should keep them in their records for future reference.



**Tax Software Hint:** For depreciation software entries, go to the Volunteer Resource Guide, Income tab, Entering Rental Income in TaxSlayer®.

### **How do I handle rental property that the taxpayer also uses?**

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When the rental property is a portion of the taxpayer's residence, the rental income and expenses must be allocated separately from the taxpayer's personal expenses.

### **How do I differentiate between rental expenses and personal use expenses?**

Expenses that apply to only the rental part of a property are direct business expenses and should be reported in full on Schedule E. The cost of installing a second phone line strictly for a tenant's use, for example, is deductible as a rental expense. However, the taxpayer cannot deduct any part of the cost of the *first* phone in a partially-rented property, even if tenants use it.

Expenses that benefit the entire property (indirect expenses) must be divided between rental use and personal use; the rental portion is reported on Schedule E. If deductions are itemized, the personal portion of home mortgage interest and property tax may be reported on Schedule A. The taxpayer can choose any reasonable method to allocate the expenses. The most common methods are based on the number of rooms in the dwelling or on the total area of the dwelling.

On Schedule E, report expenses that apply exclusively to the rental room and the allowed percentage of expenses that benefit the entire house. For example, if the rented portion is 10% of the property, the taxpayer could deduct:

- 100% of the cost to wallpaper the tenant's room
- 10% of property taxes, utilities, mortgage interest, and depreciation

#### **example**

Gloria rents one room in her 1,200 square foot house to a tenant. The rental room measures 10 feet by 12 feet (120 square feet, or 10% of the total house). She may deduct:

- 100% of any expenses that relate only to the rental portion of the house, such as repairs or upgrades to the rented room
- 10% of any qualified expense that benefits the entire house



When taxpayers can itemize personal deductions on Schedule A, they can report the deductible expenses that benefit the entire house minus the percentage that applies to the tenant's room. In Gloria's case, if she is treating the rental portion as 10% of the residence, she can deduct the following on Schedule A:

- 90% of the mortgage interest
- 90% of the property taxes



Expenses related to days of personal use do not qualify as rental expenses. The taxpayer must allocate the expenses based on the number of days of personal use to total use of the property.

#### example

Charles used his rental property for personal use 7 days and rented it for 63 days. In most cases, 10% of Charles' expenses are not rental expenses and cannot be deducted on Schedule E (7 = 10% of 70 total days: 7 personal days + 63 rented days).



#### EXERCISES (continued)

**Question 4:** For taxpayers who rent part of a property in which they live, which expenses are reported only on Schedule E and not on Schedule A?

- A. Home insurance and mortgage interest
- B. Property taxes and repairs
- C. Utilities and home insurance
- D. Depreciation and property taxes

### How should taxpayers report rental expenses that exceed their rental income when they live in the home for part of the year?

Questions in Part I, line 2 of Schedule E ask for information on the number of rental days at fair rental value and the number of days for personal use. If taxpayers rented out a dwelling unit that they also used for **personal purposes** during the year, they may not be able to deduct all the expenses for the rental part.

**Dwelling unit** (the unit) means a house, apartment, condominium, or similar property. A day of **personal use** is any day, or part of a day, that the unit was used by:

- The taxpayer for personal purposes,
- Any other person for personal purposes, if that person owns part of the unit (unless rented to that person under a "shared equity" financing agreement),
- Anyone in the taxpayer's family (or in the family of someone else who owns part of the unit), unless the unit is rented at a fair rental price to that person as his or her main home,
- Anyone who pays less than a fair rental price for the unit, or
- Anyone under an agreement that lets the taxpayer use some other unit

#### **Are there any exceptions?**

Taxpayers who used a dwelling unit as their main home may not have to count all that time as "days of personal use." Do not count as personal use any day the taxpayer:

- Spends working substantially full time repairing and maintaining the unit, even if a family member used it for recreational purposes on that day, or

- Used the unit as the taxpayer's main home before or after renting it or offering it for rent, if the taxpayer rented or tried to rent it for at least 12 consecutive months (or for a period of less than 12 consecutive months at the end of which the taxpayer sold or exchanged the home)

#### example

On February 28, 2011, Trent moved out of the house he had lived in for six years because he was deployed overseas. He rented his house at a fair rental price from March 15 last year to May 14 this year. On June 1 this year, he returned from his deployment and moved back into his house. Because he rented his property for 12 or more consecutive months, his use of the house is not counted as personal use. Since these days are not counted as days of personal use, the limitations on deductions do not apply.

## Are there any limitations?

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There are limitations based on whether the taxpayer used the dwelling unit as a home and it meets the personal use test. The personal use test is met if the taxpayer used the unit for personal purposes in the current tax year **more than the greater of:**

- 14 days or
- 10% of the total days it was rented to others at a fair rental price

Fair rental days and personal use days are reported in Part I, line 2, of Schedule E.

If the taxpayer did not use the dwelling unit as a home, the taxpayer can deduct all the expenses for the rental part, subject to the At-Risk Rules and the Passive Activity Loss Rules. For more details on these rules, refer to Publication 527, Residential Rental Property.

If the taxpayer used the dwelling as a home and rented the unit for **fewer than 15 days** in the current tax year, do not report the rental income and do not deduct any rental expenses. If the taxpayer itemizes deductions on Schedule A, the taxpayer can deduct allowable interest, taxes, and casualty losses. (Remember that the topic of casualty losses is out of scope for the VITA/TCE programs.)

If the taxpayer used the dwelling as a home and rented out the unit **at least 15 days** in the current tax year, the taxpayer may not be able to deduct all of the rental expenses. The taxpayer can deduct all of the following expenses for the rental part on Schedule E:

- Mortgage interest
- Real estate taxes
- Casualty losses (out of scope)
- Other rental expenses not related to the taxpayer's use of the unit as a home, such as advertising expenses and rental agents' fees

If there is rental income left after deducting these expenses, the taxpayer can deduct other expenses, including depreciation, up to the amount of remaining income. The taxpayer can carry over to the following tax year the unused expense amounts.



**Tax Software Hint:** If the property was used as a rental for the entire year, the income and expenses can be reported on Schedule E. If the property was used partially as a rental and partially as a residence, some expenses may need to be allocated. For software entries, go to the Volunteer Resource Guide, Income tab, Entering Rental Income in TaxSlayer®.

## How do I handle rental losses?

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Deducting all rental expenses and depreciation from the rent received may result in a net loss. Rental losses are not always fully deductible. There are two restrictions on how much a loss can offset other sources of income:

- At-risk rule
- Passive activity rules

### What is the at-risk rule?

The at-risk rule places a limitation on the amount the taxpayer can deduct as losses from activities often described as tax shelters. Generally, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount the taxpayer has at risk in the activity at the end of the tax year.

### What are the passive activity rules?

The passive activity rules state that passive activity losses can be deducted only from passive activity income. Passive income does not include salary, dividends, or investments but is generally attributed to such things as rental income. Therefore, losses that exceed rental income (the passive activity) are not deductible; however, some losses may be deductible if an exception is met.

#### ***Passive income and active participation***

The limits on deducting rental losses are affected by the degree to which renting out the property is a passive activity or involves active participation:

- Passive rental activity means receiving income mainly from the use of property rather than for services.
- Active participation means making significant management decisions, such as approving rental terms, repairs, expenditures, and new tenants. Taxpayers who use a leasing agent or property manager could be considered active participants if they retain final management rights.

#### ***Exception***

Rental activities are generally considered passive activities. For this reason, rental losses are not fully deductible. However, an exception to the passive activity rule provides that taxpayers who actively participate in the rental activity can use up to \$25,000 of their rental losses to offset any other nonpassive income (\$12,500 for married taxpayers filing separately and living apart for the entire year). Examples of nonpassive income are salaries, wages, commissions, tips, self-employment income, interest, dividends, annuities, and some royalties. (This deduction is subject to phaseout if the taxpayer's adjusted gross income (AGI) exceeds certain limits.)

### What is active participation?

It is considered active participation when taxpayers own at least 10% of the rental property and make management decisions in a significant and bona fide sense. Management decisions include approving new tenants, deciding on rental terms, approving expenditure, and similar decisions.



For more information, see Publication 925, Passive Activity and At-Risk Rules.

### ***Phase-Out of Offset***

The amount allowed to offset nonpassive income is:

- Reduced once the taxpayer's Adjusted Gross Income (AGI) exceeds \$100,000 (\$50,000 for Married Filing Separately)
- Completely phased out when AGI exceeds \$150,000 (\$75,000 for Married Filing Separately)



### **EXERCISES** (continued)

**Question 5:** Which restriction limits the deductibility of rental loss to the amount of rental income?

- A. Phase-out of offset
- B. Passive activity rules
- C. Active participation rule

### **How are passive rental losses reported?**

Taxpayers use Form 8582 to figure the amount of any passive activity loss allowed for the current tax year. Form 8582 summarizes losses and income from all passive activities.

Generally, taxpayers are not required to file Form 8582 if they have:

- Only one passive loss generated from a rental activity and
- An AGI of less than \$100,000

Completing Form 8582 is out of scope if volunteers are required by software to enter additional data in Form 8582.

## Summary

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Taxpayers receive Schedule K-1 (Form 1065, Form 1041, or Form 1120S) reporting their share of income from flow through entities. Interest, dividends (ordinary and qualified), capital gains (net short-term and net long-term) are in scope. Schedule K-1, page 2, lists the appropriate forms and schedules where the taxpayers' income from these sources should be reported. Additionally, royalties on Schedule K-1, Forms 1065 and 1120S are within scope. Volunteers must certify to the Advanced level or above to prepare a Schedule E with entries from Schedule K-1.

Rental income and deductible rental expenses are reported on Part I of Schedule E, Supplemental Income and Loss. Volunteers must certify at the Military level to prepare a Schedule E for rental income. Rental income and expenses are in-scope **only** for military families renting their personal residence.

U.S. citizens and resident aliens must report rental income for the months their home is rented, regardless of whether the rental property is located in the U.S. or in a foreign country.

When renting out part of the property, certain expenses must be divided between rental use and personal use; some are reported on Schedule A and some on Schedule E.

Taxpayers who do not use a dwelling unit as a home (for personal purposes) should include all the rent in their income and deduct all the rental expenses. There are special rules and limitations if the taxpayer used the dwelling unit as a home and it meets the personal use test.

Rental income and expenses are not reported if the taxpayer used the dwelling as a home and rented the unit for fewer than 15 days in the current tax year. If the taxpayer itemizes deductions on Schedule A, the taxpayer can deduct allowable interest, taxes, and casualty losses. (Remember that the topic of casualty losses is out of scope for the VITA/TCE programs.)

Because rental activities are generally considered passive activities, rental losses are not fully deductible. However, taxpayers who actively participated in the renting of the property may deduct up to \$25,000 of their rental losses, up to \$12,500 for married taxpayers filing separately and living apart. This deduction is subject to phase-out if the taxpayer's AGI exceeds certain limits.

The passive activity rules state that passive activity losses can be deducted only from passive activity income. Taxpayers with rental losses may be required to file Form 8582, Passive Activity Loss Limitations.

### **What situations are out of scope for the VITA/TCE programs?**

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Income reported on Schedules K-1 (other than what is listed in the introduction to this lesson)
- Deductions, credits, and other items reported on Schedules K-1
- Royalty income reported on Form 1099-MISC with associated expenses
- Rental income and expenses for non-military taxpayers
- Taxpayers who rent their property at less than fair rental value
- Rental-related interest expenses other than mortgage interest
- The actual expense method (auto and travel expense deductions)
- Casualty loss
- Completing Form 8582
- Completing Form 4562
- Taxpayers who filed or need to file Form(s) 1099



## TAX LAW APPLICATION USING THE WORKBOOK

To gain a better understanding of the tax law, complete the comprehensive problem or practice exercise(s) for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L&LT.



## EXERCISE ANSWERS

**Answer 1:** C. You would deduct four-twelfths (33%) of his mortgage interest and taxes on Schedule E, and report the other 67% on Schedule A.

**Answer 2:** D. Repairs made to the homeowner's personal residence are not deductible as rental expenses. However, the other expenses are deductible, along with repairs made to rental property, legal and professional fees, and property management fees.

**Answer 3:** C. The fencing adds value to the property and would have to be capitalized and depreciated. It cannot be expensed because it exceeds the amount allowed as an immediate de minimis write-off.

**Answer 4:** C. The rental portions of utilities, home insurance, repairs, and depreciation are rental deductions on Schedule E, but the personal portions are not a deductible expense reported on Schedule A. Taxpayers who rent out part of a property allocate mortgage interest and property taxes separately on both schedules.

**Answer 5:** B. Passive activity losses can be deducted only from passive activity income. Taxpayers who are not active participants may not deduct rental losses that exceed rental income.