



CPAs & Business Advisors

17501 East 17th Street, Suite 100 • Tustin, California 92780-7924
(714) 505-9000 • Fax (714) 505-9200 • www.hmwc CPA.com • cpas@hmwc CPA.com

Member:
American Institute of Certified Public Accountants
Alliance of Merger & Acquisition Advisors
AHA Affiliated Healthcare Advisors

Global Representation:
INTEGRA  INTERNATIONAL

How are reportable income and deductions determined?

Determining rental income and deductions for federal tax purposes isn't always as straightforward as it might seem. Without an expert's eye keeping watch, sources of taxable rental income can be overlooked and deductions can be overstated. If such mistakes are uncovered in an IRS audit, they could prove costly.

Rental income

"Rental income" refers to more than just monthly rent payments. The IRS defines it as any payment received for the use or occupation of property, which can include:

Prepaid rent. This is any amount received *before* the period it's supposed to cover. Prepaid rent is included in rental income in the year received, regardless of the period covered or the method of accounting used.

Security deposits. Those held as final payment of rent are considered to be advance rent and included as rental income when received. If you keep part or all of the security deposit during any year because a tenant hasn't fulfilled the lease terms, that amount is included in your income for that year.

Lease cancellation penalties. The amount received upon cancellation constitutes rent. Therefore, it's included in your rental income in the year received.

Expenses paid by the tenant. If your tenant pays, for example, a garbage removal bill — when the lease doesn't oblige the tenant to do so — and deducts the amount from the normal rent payment, that amount is considered rental income. (You can, however, take an offsetting deduction for the garbage removal expense.)

Property or services received in lieu of rent. These are included in rental income at their fair market value.

Allowable deductions

Certain rental expenses are deducted from rental income, including mortgage interest, property tax, operating expenses, advertising, maintenance, utilities, depreciation and repairs.

But you can't deduct the cost of improvements that will add value to your property, prolong its useful life or adapt it for new uses. The cost of those improvements is recovered through depreciation.



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You can deduct expenses paid by a tenant, as well as the fair market value of any property or services received in lieu of rent, if they're deductible rental expenses (and not required to be depreciated).

Peace of mind

The twists and turns in the U.S. tax code can create uncertainty when dealing with rental income and deductions. But a tax professional who's well versed in real estate matters can bring clarity to your tax return. To ensure your own peace of mind, work with a pro.