Department of the Treasury
Internal Revenue Service

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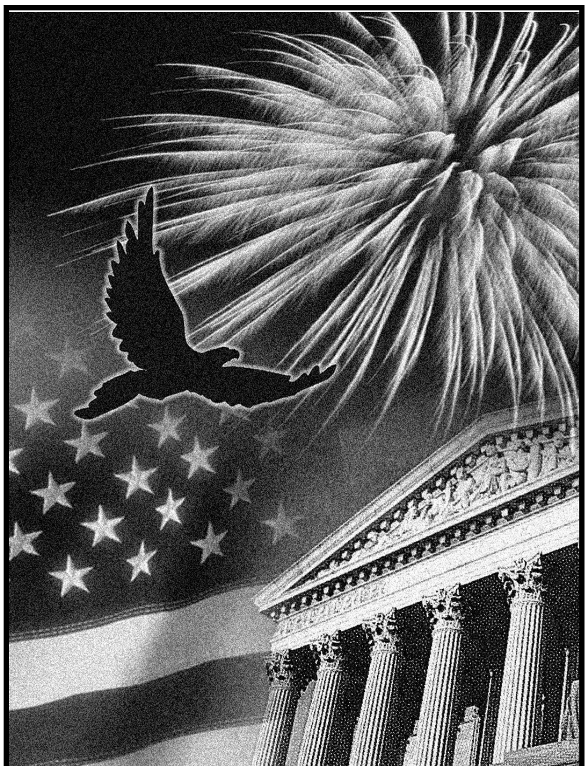
Residential Rental Property

(Including Rental of Vacation Homes)

For use in preparing

2012 Returns



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Future Developments

For the latest information about developments related to Publication 527, such as legislation enacted after it was published, go to *www.irs.gov/pub527*.

Reminders

Tax-free exchange of rental property used for personal purposes. You may qualify for a tax-free exchange (a like-kind or section 1031 exchange) of one piece of rental property you own for a similar piece of rental property, even if you have used the rental property for personal purposes. You must meet the following criteria.

- You own the rental property for at least 24 months before the exchange.
- During the 2 years before the exchange you rent the property to another person at a fair rental price for 14 days or more.
- Your personal use of the rental property during each of the two years before the exchange does not exceed the greater of 14 days or 10% of the number of days the property is rented.

For information on like-kind exchanges, see Publication 544, Sales and Other Dispositions of Assets, chapter 1.

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-5678) if you recognize a child.

Introduction

Do you own a second house that you rent out all the time? Do you own a vacation home that you rent out when you or your family isn't using it?

These are two common types of residential rental activities discussed in this publication. In most cases, all rental income must be reported on your tax return, but there are differences in the expenses you are allowed to deduct and in the way the rental activity is reported on your return.

First, this publication will look at the rental-for-profit activity in which there is no personal use of the property. We will look at types of income and when each is reported, and at types of expenses and which are deductible.

Chapter 2 discusses depreciation as it applies to your rental real estate activity—what property can be depreciated and how to figure it.

Chapter 3 covers the actual reporting of your rental income and deductions, including casualties and thefts, limitations on losses, and claiming the correct amount of depreciation.

Special rental situations are grouped together in chapter 4. These include condominiums, cooperatives, property changed to rental use, renting only part of your property, and a not-for-profit rental activity.

Finally, in chapter 5, we will look at the rules for rental income and expenses when there is also personal use of the dwelling unit, such as a vacation home.

Sale of rental property. For information on how to figure and report any gain or loss from the sale or other disposition of your rental property, see Publication 544.

Sale of main home used as rental property. For information on how to figure and report any gain or loss from the sale or other disposition of your main home that you also used as rental property, see Publication 523, Selling Your Home.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

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Useful Items

You may want to see:

Publication

- ❏ **463** Travel, Entertainment, Gift, and Car Expenses
- ❏ **523** Selling Your Home
- ❏ **534** Depreciating Property Placed in Service Before 1987
- ❏ **535** Business Expenses
- ❏ **544** Sales and Other Dispositions of Assets
- ❏ **547** Casualties, Disasters, and Thefts
- ❏ **551** Basis of Assets
- ❏ **925** Passive Activity and At-Risk Rules
- ❏ **946** How To Depreciate Property

Form (and Instructions)

- ❏ **4562** Depreciation and Amortization
- ❏ **5213** Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit
- ❏ **8582** Passive Activity Loss Limitations
- ❏ **Schedule E (Form 1040)** Supplemental Income and Loss

See chapter 6, *How To Get Tax Help*, for information about getting these publications and forms.

1. Rental Income and Expenses (If No Personal Use of Dwelling)

This chapter discusses the various types of rental income and expenses for a residential rental activity with no personal use of the dwelling. Generally, each year you will report all income and deduct all out-of-pocket expenses in full. The deduction to recover the cost of your rental property—depreciation—is taken over a prescribed number of years, and is discussed in chapter 2, *Depreciation of Rental Property*.

If your rental income is from property you also use personally or rent to someone at less than a fair rental price, first read the information in chapter 5, Personal Use of Dwelling Unit (Including Vacation Home).

Rental Income

In most cases, you must include in your gross income all amounts you receive as rent. Rental income is any payment you receive for the use or occupation of property. In addition to amounts you receive as normal rental payments, there are other amounts that may be rental income.

When To Report

When you report rental income on your tax return generally depends on whether you are a cash basis taxpayer or use an accrual method. Most individual taxpayers use the cash method.

Cash method. You are a cash basis taxpayer if you report income on your return in the year you actually or constructively receive it, regardless of when it was earned. You constructively receive income when it is made available to you, for example, by being credited to your bank account.

Accrual method. If you are an accrual basis taxpayer, you generally report income when you earn it, rather than when you receive it. You generally deduct your expenses when you incur them, rather than when you pay them.

More information. See Publication 538, Accounting Periods and Methods, for more information about when you constructively receive income and accrual methods of accounting.

Types of Income

The following are common types of rental income.

Advance rent. Advance rent is any amount you receive before the period that it covers. Include advance rent in your rental income in the year you receive it regardless of the period covered or the method of accounting you use.

Example. On March 18, 2012, you signed a 10-year lease to rent your property. During 2012, you received $9,600 for the first year's rent and $9,600 as rent for the last year of the lease. You must include $19,200 in your rental income in the first year.

Canceling a lease. If your tenant pays you to cancel a lease, the amount you receive is rent. Include the payment in your income in the year you receive it regardless of your method of accounting.

Expenses paid by tenant. If your tenant pays any of your expenses, those payments are rental income. Because you must include this amount in income, you can also deduct the expenses if they are deductible rental expenses. For more information, see *Rental Expenses*, later.

Example 1. Your tenant pays the water and sewage bill for your rental property and deducts the amount from the normal rent payment. Under the terms of the lease, your tenant does not have to pay this bill. Include the utility bill paid by the tenant and any amount received as a rent payment in your rental income. You can deduct the utility payment made by your tenant as a rental expense.

Example 2. While you are out of town, the furnace in your rental property stops working. Your tenant pays for the necessary repairs and deducts the repair bill from the rent payment. Include the repair bill paid by the tenant and any amount received as a rent payment in your rental income. You can deduct the repair payment made by your tenant as a rental expense.

Property or services. If you receive property or services as rent, instead of money, include the fair market value of the property or services in your rental income.

If the services are provided at an agreed upon or specified price, that price is the fair market value unless there is evidence to the contrary.

Example. Your tenant is a house painter. He offers to paint your rental property instead of paying 2 months rent. You accept his offer.

Include in your rental income the amount the tenant would have paid for 2 months rent. You can deduct that same amount as a rental expense for painting your property.

Security deposits. Do not include a security deposit in your income when you receive it if you plan to return it to your tenant at the end of the lease. But if you keep part or all of the security deposit during any year because your tenant does not live up to the terms of the lease, include the amount you keep in your income in that year.

If an amount called a security deposit is to be used as a final payment of rent, it is advance rent. Include it in your income when you receive it.

Other Sources of Rental Income

Lease with option to buy. If the rental agreement gives your tenant the right to buy your rental property, the payments you receive under the agreement are generally rental income. If your tenant exercises the right to buy the property, the payments you receive for the period after the date of sale are considered part of the selling price.

Part interest. If you own a part interest in rental property, you must report your part of the rental income from the property.

Rental of property also used as your home. If you rent property that you also use as your home and you rent it less than 15 days during the tax year, do not include the rent you receive in your income and do not deduct rental expenses. However, you can deduct on Schedule A (Form 1040), Itemized Deductions, the interest, taxes, and casualty and theft losses that are allowed for nonrental property. See chapter 5, *Personal Use of Dwelling Unit (Including Vacation Home)*.

Rental Expenses

In most cases, the expenses of renting your property, such as maintenance, insurance, taxes, and interest, can be deducted from your rental income.

Personal use of rental property. If you sometimes use your rental property for personal purposes, you must divide your expenses between rental and personal use. Also, your rental expense deductions may be limited. See chapter 5, *Personal Use of Dwelling Unit (Including Vacation Home)*.

Part interest. If you own a part interest in rental property, you can deduct expenses you paid according to your percentage of ownership.

Example. Roger owns a one-half undivided interest in a rental house. Last year he paid $968 for necessary repairs on the property. Roger can deduct $484 (50% × $968) as a rental expense. He is entitled to reimbursement for the remaining half from the co-owner.

When To Deduct

You generally deduct your rental expenses in the year you pay them.

If you use the accrual method, see Publication 538 for more information.

Types of Expenses

Listed below are the most common rental expenses.

- Advertising.
- Auto and travel expenses.
- Cleaning and maintenance.
- Commissions.
- Depreciation.
- Insurance.
- Interest (other).
- Legal and other professional fees.
- Local transportation expenses.
- Management fees.
- Mortgage interest paid to banks, etc.
- Points.
- Rental payments.
- Repairs.
- Taxes.
- Utilities.

Some of these expenses, as well as other less common ones, are discussed below.

Depreciation. Depreciation is a capital expense. It is the mechanism for recovering your cost in an income producing property and must be taken over the expected life of the property.

You can begin to depreciate rental property when it is ready and available for rent. See *Placed in Service* under *When Does Depreciation Begin and End* in chapter 2.

Insurance premiums paid in advance. If you pay an insurance premium for more than one year in advance, for each year of coverage you can deduct the part of the premium payment that will apply to that year. You cannot deduct the total premium in the year you pay it. See Publication 535, chapter 6, for information on deductible premiums.

Interest expense. You can deduct mortgage interest you pay on your rental property. When you refinance a rental property for more than the previous outstanding balance, the portion of the interest allocable to loan proceeds not related to rental use generally cannot be deducted as a rental expense. Chapter 4 of Publication 535 explains mortgage interest in detail.

Expenses paid to obtain a mortgage. Certain expenses you pay to obtain a mortgage on your rental property cannot be deducted as interest. These expenses, which include mortgage commissions, abstract fees, and recording fees, are capital expenses that are part of your basis in the property.

Form 1098, Mortgage Interest Statement. If you paid $600 or more of mortgage interest on your rental property to any one person, you should receive a Form 1098 or similar statement showing the interest you paid for the year. If you and at least one other person (other than your spouse if you file a joint return) were liable for, and paid interest on, the mortgage, and the other person received the Form 1098, report your share of the interest on Schedule E (Form 1040), line 13. Attach a statement to your return showing the name and address of the other person. On the dotted line next to line 13, enter "See attached."

Legal and other professional fees. You can deduct, as a rental expense, legal and other professional expenses such as tax return preparation fees you paid to prepare Schedule E, Part I. For example, on your 2012 Schedule E you can deduct fees paid in 2012 to prepare Part I of your 2011 Schedule E. You can also deduct, as a rental expense, any expense (other than federal taxes and penalties) you paid to resolve a tax underpayment related to your rental activities.

Local benefit taxes. In most cases, you cannot deduct charges for local benefits that increase the value of your property, such as charges for putting in streets, sidewalks, or water and sewer systems. These charges are nondepreciable capital expenditures and must be added to the basis of your property. However, you can deduct local benefit taxes that are for maintaining, repairing, or paying interest charges for the benefits.

Local transportation expenses. You may be able to deduct your ordinary and necessary local transportation expenses if you incur them to collect rental income or to manage, conserve, or maintain your rental property. Transportation expenses incurred to travel between your home and a rental property generally constitute nondeductible commuting costs unless you use your home as your principal place of business. See Publication 587, Business Use of Your Home, for information on determining if your home office qualifies as a principal place of business.

Generally, if you use your personal car, pickup truck, or light van for rental activities, you can deduct the expenses using one of two methods: actual expenses or the standard mileage rate. For 2012, the standard mileage rate for business use is 55.5 cents per mile. For more information, see chapter 4 of Publication 463.

RECORDS To deduct car expenses under either method, you must keep records that follow the rules in chapter 5 of Publication 463. In addition, you must complete Form 4562, Part V, and attach it to your tax return.

Pre-rental expenses. You can deduct your ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time you make it available for rent.

Rental of equipment. You can deduct the rent you pay for equipment that you use for rental purposes. However, in some cases, lease contracts are actually purchase contracts. If so, you cannot deduct these payments. You can recover the cost of purchased equipment through depreciation.

Rental of property. You can deduct the rent you pay for property that you use for rental purposes. If you buy a leasehold for rental purposes, you can deduct an equal part of the cost each year over the term of the lease.

Travel expenses. You can deduct the ordinary and necessary expenses of traveling away from home if the primary purpose of the trip is to collect rental income or to manage, conserve, or maintain your rental property. You must properly allocate your expenses between rental and nonrental activities. You cannot deduct the cost of traveling away from home if the primary purpose of the trip is to improve the property. The cost of improvements is recovered by taking depreciation. For information on travel expenses, see chapter 1 of Publication 463.

RECORDS To deduct travel expenses, you must keep records that follow the rules in chapter 5 of Publication 463.

Uncollected rent. If you are a cash basis taxpayer, do not deduct uncollected rent. Because you have not included it in your income, it is not deductible.

If you use an accrual method, report income when you earn it. If you are unable to collect the rent, you may be able to deduct it as a business bad debt. See chapter 10 of Publication 535 for more information about business bad debts.

Vacant rental property. If you hold property for rental purposes, you may be able to deduct your ordinary and necessary expenses (including depreciation) for managing, conserving, or maintaining the property while the property is vacant. However, you cannot deduct any loss of rental income for the period the property is vacant.

Vacant while listed for sale. If you sell property you held for rental purposes, you can deduct the ordinary and necessary expenses for managing, conserving, or maintaining the property until it is sold. If the property is not held out and available for rent while listed for sale, the expenses are not deductible rental expenses.

Points

The term "points" is often used to describe some of the charges paid, or treated as paid, by a borrower to take out a loan or a mortgage. These charges are also called loan origination fees, maximum loan charges, or premium charges. Any of these charges (points) that are solely for the use of money are interest. Because points are prepaid interest, you generally cannot deduct the full amount in the year paid, but must deduct the interest over the term of the loan.

The method used to figure the amount of points you can deduct each year follows the original issue discount (OID) rules. In this case, points are equivalent to OID, which is the difference between:

- The amount borrowed (redemption price at maturity, or principal) and
- The proceeds (issue price).

The first step is to determine whether your total OID (which you may have on bonds or other investments in addition to the mortgage loan), including the OID resulting from the points, is insignificant or *de minimis*. If the OID is not *de minimis*, you must use the constant-yield method to figure how much you can deduct.

***De minimis* OID.** The OID is *de minimis* if it is less than one-fourth of 1% (.0025) of the stated redemption price at maturity (principal amount of the loan) multiplied by the number of full years from the date of original issue to maturity (term of the loan).

If the OID is *de minimis*, you can choose one of the following ways to figure the amount of points you can deduct each year.

- On a constant-yield basis over the term of the loan.
- On a straight line basis over the term of the loan.
- In proportion to stated interest payments.
- In its entirety at maturity of the loan.

You make this choice by deducting the OID (points) in a manner consistent with the method chosen on your timely filed tax return for the tax year in which the loan is issued.

Example. Carol Madison took out a $100,000 mortgage loan on January 1, 2012, to buy a house she will use as a rental during 2012. The loan is to be repaid over 30 years. During 2012, Carol paid $10,000 of mortgage interest (stated interest) to the lender. When the loan was made, she paid $1,500 in points to the lender. The points reduced the principal amount of the loan from $100,000 to $98,500, resulting in $1,500 of OID. Carol determines that the points (OID) she paid are *de minimis* based on the following computation.

Redemption price at maturity (principal amount of the loan)	$100,000
Multiplied by: The term of the loan in complete years	× 30
Multiplied by	× .0025
***De minimis* amount**	$ 7,500

The points (OID) she paid ($1,500) are less than the *de minimis* amount ($7,500). Therefore, Carol has *de minimis* OID and she can choose one of the four ways discussed earlier to figure the amount she can deduct each year. Under the straight line method, she can deduct $50 each year for 30 years.

Constant-yield method. If the OID is not *de minimis*, you must use the constant-yield method to figure how much you can deduct each year.

You figure your deduction for the first year in the following manner.

1. Determine the issue price of the loan. If you paid points on the loan, the issue price

generally is the difference between the principal and the points.

2. Multiply the result in (1) by the yield to maturity (defined later).
3. Subtract any qualified stated interest payments (defined below) from the result in (2). This is the OID you can deduct in the first year.

Yield to maturity (YTM). This rate is generally shown in the literature you receive from your lender. If you do not have this information, consult your lender or tax advisor. In general, the YTM is the discount rate that, when used in computing the present value of all principal and interest payments, produces an amount equal to the principal amount of the loan.

Qualified stated interest (QSI). In general, this is the stated interest that is unconditionally payable in cash or property (other than another loan of the issuer) at least annually over the term of the loan at a fixed rate.

Example—Year 1. The facts are the same as in the previous example. The yield to maturity on Carol's loan is 10.2467%, compounded annually.

She figured the amount of points (OID) she could deduct in 2012 as follows.

Principal amount of the loan	$100,000
Minus: Points (OID)	− 1,500
Issue price of the loan	$ 98,500
Multiplied by: YTM	× .102467
Total	10,093
Minus: QSI	− 10,000
Points (OID) deductible in 2012	$ 93

To figure your deduction in any subsequent year, you start with the adjusted issue price. To get the adjusted issue price, add to the issue price figured in Year 1 any OID previously deducted. Then follow steps (2) and (3) above.

Example—Year 2. Carol figured the deduction for 2013 as follows.

Issue price	$98,500
Plus: Points (OID) deducted in 2012	+ 93
Adjusted issue price	$98,593
Multiplied by: YTM	× .102467
Total	10,103
Minus: QSI	− 10,000
Points (OID) deductible in 2013	$ 103

Loan or mortgage ends. If your loan or mortgage ends, you may be able to deduct any remaining points (OID) in the tax year in which the loan or mortgage ends. A loan or mortgage may end due to a refinancing, prepayment, foreclosure, or similar event. However, if the refinancing is with the same lender, the remaining points (OID) generally are not deductible in the year in which the refinancing occurs, but may be deductible over the term of the new mortgage or loan.

Points when loan refinance is more than the previous outstanding balance. When you refinance a rental property for more than the previous outstanding balance, the portion of the points allocable to loan proceeds **not** related to rental use generally cannot be deducted as a rental expense. For example, if an individual refinanced a loan with a balance of $100,000, the amount of the new loan was $120,000, and the taxpayer used $20,000 to purchase a car, points allocable to the $20,000 would be treated as nondeductible personal interest.

Repairs and Improvements

Generally, an expense for repairing or maintaining your rental property may be deducted if you are not required to capitalize the expense.

Improvements. You must capitalize any expense you pay to improve your rental property. An expense is for an improvement if it results in a betterment to your property, restores your property, or adapts your property to a new or different use.

Betterments. Expenses that may result in a betterment to your property include expenses for fixing a pre-existing defect or condition, enlarging or expanding your property, or increasing the capacity, strength, or quality of your property.

Restoration. Expenses that may be for restoration include expenses for replacing a substantial structural part of your property, repairing damage to your property after you properly adjusted the basis of your property as a result of a casualty loss, or rebuilding your property to a like-new condition.

Adaptation. Expenses that may be for adaptation include expenses for altering your property to a use that is not consistent with the intended ordinary use of your property when you began renting the property.

RECORDS Separate the costs of repairs and improvements, and keep accurate records. You will need to know the cost of improvements when you sell or depreciate your property.

The expenses you capitalize for improving your property can generally be depreciated as if the improvement were separate property.

Table 1-1. **Examples of Improvements**

Additions	Miscellaneous	Plumbing
Bedroom	Storm windows, doors	Septic system
Bathroom	New roof	Water heater
Deck	Central vacuum	Soft water system
Garage	Wiring upgrades	Filtration system
Porch	Satellite dish	
Patio	Security system	**Interior Improvements**
		Built-in appliances
Lawn & Grounds	**Heating & Air Conditioning**	Kitchen modernization
Landscaping	Heating system	Flooring
Driveway	Central air conditioning	Wall-to-wall carpeting
Walkway	Furnace	
Fence	Duct work	**Insulation**
Retaining wall	Central humidifier	Attic
Sprinkler system	Filtration system	Walls, floor
Swimming pool		Pipes, duct work

2. Depreciation of Rental Property

You recover the cost of income producing property through yearly tax deductions. You do this by depreciating the property; that is, by deducting some of the cost each year on your tax return.

Three factors determine how much depreciation you can deduct each year: (1) your basis in the property, (2) the recovery period for the property, and (3) the depreciation method used. You cannot simply deduct your mortgage or principal payments, or the cost of furniture, fixtures and equipment, as an expense.

You can deduct depreciation only on the part of your property used for rental purposes. Depreciation reduces your basis for figuring gain or loss on a later sale or exchange.

You may have to use Form 4562 to figure and report your depreciation. See *Which Forms To Use* in chapter 3. Also see Publication 946.

Section 179 deduction. The section 179 deduction is a means of recovering part or all of the cost of certain qualifying property in the year you place the property in service. This deduction is not allowed for property used in connection with residential rental property. See chapter 2 of Publication 946.

Alternative minimum tax (AMT). If you use accelerated depreciation, you may be subject to the AMT. Accelerated depreciation allows you to deduct more depreciation earlier in the recovery period than you could deduct using a straight line method (same deduction each year).

The prescribed depreciation methods for rental real estate are not accelerated, so the depreciation deduction is not adjusted for the AMT. However, accelerated methods are generally used for other property connected with rental activities (for example, appliances and wall-to-wall carpeting).

To find out if you are subject to the AMT, see the Instructions for Form 6251.

The Basics

The following section discusses the information you will need to have about the rental property and the decisions to be made before figuring your depreciation deduction.

What Rental Property Can Be Depreciated?

You can depreciate your property if it meets all the following requirements.

- You own the property.
- You use the property in your business or income-producing activity (such as rental property).
- The property has a determinable useful life.
- The property is expected to last more than one year.

Property you own. To claim depreciation, you usually must be the owner of the property. You are considered as owning property even if it is subject to a debt.

Rented property. Generally, if you pay rent for property, you cannot depreciate that property. Usually, only the owner can depreciate it. However, if you make permanent improvements to leased property, you may be able to depreciate the improvements. See *Additions or improvements to property*, later in this chapter, under *Recovery Periods Under GDS*.

Cooperative apartments. If you are a tenant-stockholder in a cooperative housing corporation and rent your cooperative apartment to others, you can deduct depreciation on your stock in the corporation. See chapter 4, *Special Situations*.

Property having a determinable useful life. To be depreciable, your property must have a determinable useful life. This means that it must be something that wears out, decays, gets used up, becomes obsolete, or loses its value from natural causes.

What Rental Property Cannot Be Depreciated?

Certain property cannot be depreciated. This includes land and certain excepted property.

Land. You cannot depreciate the cost of land because land generally does not wear out, become obsolete, or get used up. But if it does, the loss is accounted for upon disposition. The costs of clearing, grading, planting, and landscaping are usually all part of the cost of land and cannot be depreciated.

Although you cannot depreciate land, you can depreciate certain land preparation costs, such as landscaping costs, incurred in preparing land for business use. These costs must be so closely associated with other depreciable property that you can determine a life for them along with the life of the associated property.

Example. You built a new house to use as a rental and paid for grading, clearing, seeding, and planting bushes and trees. Some of the bushes and trees were planted right next to the house, while others were planted around the outer border of the lot. If you replace the house, you would have to destroy the bushes and trees right next to it. These bushes and trees are closely associated with the house, so they have a determinable useful life. Therefore, you can depreciate them. Add your other land preparation costs to the basis of your land because they have no determinable life and you cannot depreciate them.

Excepted property. Even if the property meets all the requirements listed earlier under *What Rental Property Can Be Depreciated*, you cannot depreciate the following property.

- Property placed in service and disposed of (or taken out of business use) in the same year.
- Equipment used to build capital improvements. You must add otherwise allowable depreciation on the equipment during the period of construction to the basis of your improvements.

For more information, see Publication 946, chapter 1.

When Does Depreciation Begin and End?

You begin to depreciate your rental property when you place it in service for the production of income. You stop depreciating it either when you have fully recovered your cost or other basis, or when you retire it from service, whichever happens first.

Placed in Service

You place property in service in a rental activity when it is ready and available for a specific use in that activity. Even if you are not using the property, it is in service when it is ready and available for its specific use.

Example 1. On November 22 of last year, you purchased a dishwasher for your rental property. The appliance was delivered on December 7, but was not installed and ready for use until January 3 of this year. Because the dishwasher was not ready for use last year, it is not considered placed in service until this year.

If the appliance had been installed and ready for use when it was delivered in December of last year, it would have been considered placed in service in December, even if it was not actually used until this year.

Example 2. On April 6, you purchased a house to use as residential rental property. You made extensive repairs to the house and had it ready for rent on July 5. You began to advertise the house for rent in July and actually rented it beginning September 1. The house is considered placed in service in July when it was ready and available for rent. You can begin to depreciate the house in July.

Example 3. You moved from your home in July. During August and September you made several repairs to the house. On October 1, you listed the property for rent with a real estate company, which rented it on December 1. The property is considered placed in service on October 1, the date when it was available for rent.

Conversion to business use. If you place property in service in a personal activity, you cannot claim depreciation. However, if you change the property's use to business or the production of income, you can begin to depreciate it at the time of the change. You place the property in service for business or income-producing use on the date of the change.

Example. You bought a home and used it as your personal home several years before you converted it to rental property. Although its specific use was personal and no depreciation was allowable, you placed the home in service when you began using it as your home. You can begin to claim depreciation in the year you converted it to rental property because at that time its use changed to the production of income.

Idle Property

Continue to claim a deduction for depreciation on property used in your rental activity even if it is temporarily idle (not in use). For example, if you must make repairs after a tenant moves out, you still depreciate the rental property during the time it is not available for rent.

Cost or Other Basis Fully Recovered

You must stop depreciating property when the total of your yearly depreciation deductions equals your cost or other basis of your property. For this purpose, your yearly depreciation deductions include any depreciation that you were allowed to claim, even if you did not claim it. See *Basis of Depreciable Property*, later.

Retired From Service

You stop depreciating property when you retire it from service, even if you have not fully recovered its cost or other basis. You retire property from service when you permanently withdraw it from use in a trade or business or from use in the production of income because of any of the following events.

- You sell or exchange the property.
- You convert the property to personal use.
- You abandon the property.
- The property is destroyed.

Depreciation Methods

Generally, you must use the Modified Accelerated Cost Recovery System (MACRS) to depreciate residential rental property placed in service after 1986.

If you placed rental property in service before 1987, you are using one of the following methods.

- ACRS (Accelerated Cost Recovery System) for property placed in service after 1980 but before 1987.
- Straight line or declining balance method over the useful life of property placed in service before 1981.

See [MACRS Depreciation](#), later, for more information.

Rental property placed in service before 2012. Continue to use the same method of figuring depreciation that you used in the past.

Use of real property changed. Generally, you must use MACRS to depreciate real property that you acquired for personal use before 1987 and changed to business or income-producing use after 1986. This includes your residence that you changed to rental use. See *Property Owned or Used in 1986* in Publication 946, chapter 1, for those situations in which MACRS is not allowed.

Improvements made after 1986. Treat an improvement made after 1986 to property you placed in service before 1987 as separate depreciable property. As a result, you can depreciate that improvement as separate property under MACRS if it is the type of property that otherwise qualifies for MACRS depreciation. For more information about improvements, see [*Additions or improvements to property*](#), later in this chapter under *Recovery Periods Under GDS*.

CAUTION *This publication discusses MACRS depreciation only. If you need information about depreciating property placed in service before 1987, see Publication 534.*

Basis of Depreciable Property

The basis of property used in a rental activity is generally its adjusted basis when you place it in service in that activity. This is its cost or other basis when you acquired it, adjusted for certain items occurring before you place it in service in the rental activity.

If you depreciate your property under MACRS, you may also have to reduce your basis by certain deductions and credits with respect to the property.

Basis and adjusted basis are explained in the following discussions.

CAUTION *If you used the property for personal purposes before changing it to rental use, its basis for depreciation is the lesser of its adjusted basis or its fair market value when you change it to rental use. See [Basis of Property Changed to Rental Use](#) in chapter 4.*

Cost Basis

The basis of property you buy is usually its cost. The cost is the amount you pay for it in cash, in debt obligation, in other property, or in services. Your cost also includes amounts you pay for:

- Sales tax charged on the purchase (but see *Exception* later),
- Freight charges to obtain the property, and
- Installation and testing charges.

Exception. If you deducted state and local general sales taxes as an itemized deduction on Schedule A (Form 1040), do not include those sales taxes as part of your cost basis. Such taxes were deductible before 1987 and after 2003.

Loans with low or no interest. If you buy property on any time-payment plan that charges little or no interest, the basis of your property is your stated purchase price, less the amount considered to be unstated interest. See *Unstated Interest and Original Issue Discount (OID)* in Publication 537, Installment Sales.

Real property. If you buy real property, such as a building and land, certain fees and other expenses you pay are part of your cost basis in the property.

Real estate taxes. If you buy real property and agree to pay real estate taxes on it that were owed by the seller and the seller does not reimburse you, the taxes you pay are treated as part of your basis in the property. You cannot deduct them as taxes paid.

If you reimburse the seller for real estate taxes the seller paid for you, you can usually deduct that amount. Do not include that amount in your basis in the property.

Settlement fees and other costs. The following settlement fees and closing costs for buying the property are part of your basis in the property.

- Abstract fees.
- Charges for installing utility services.
- Legal fees.
- Recording fees.
- Surveys.
- Transfer taxes.
- Title insurance.
- Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

The following are settlement fees and closing costs you cannot include in your basis in the property.

1. Fire insurance premiums.
2. Rent or other charges relating to occupancy of the property before closing.
3. Charges connected with getting or refinancing a loan, such as:
   a. Points (discount points, loan origination fees),
   b. Mortgage insurance premiums,
   c. Loan assumption fees,
   d. Cost of a credit report, and
   e. Fees for an appraisal required by a lender.

Also, do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

Assumption of a mortgage. If you buy property and become liable for an existing mortgage on the property, your basis is the amount you pay for the property plus the amount remaining to be paid on the mortgage.

Example. You buy a building for $60,000 cash and assume a mortgage of $240,000 on it. Your basis is $300,000.

Separating cost of land and buildings. If you buy buildings and your cost includes the cost of the land on which they stand, you must divide the cost between the land and the buildings to figure the basis for depreciation of the buildings. The part of the cost that you allocate to each asset is the ratio of the fair market value of that asset to the fair market value of the whole property at the time you buy it.

If you are not certain of the fair market values of the land and the buildings, you can divide the cost between them based on their assessed values for real estate tax purposes.

Example. You buy a house and land for $200,000. The purchase contract does not specify how much of the purchase price is for the house and how much is for the land.

The latest real estate tax assessment on the property was based on an assessed value of $160,000, of which $136,000 was for the house and $24,000 was for the land.

You can allocate 85% ($136,000 ÷ $160,000) of the purchase price to the house and 15% ($24,000 ÷ $160,000) of the purchase price to the land.

Your basis in the house is $170,000 (85% of $200,000) and your basis in the land is $30,000 (15% of $200,000).

Basis Other Than Cost

You cannot use cost as a basis for property that you received:

- In return for services you performed;
- In an exchange for other property;
- As a gift;
- From your spouse, or from your former spouse as the result of a divorce; or
- As an inheritance.

If you received property in one of these ways, see Publication 551 for information on how to figure your basis.

Adjusted Basis

To figure your property's basis for depreciation, you may have to make certain adjustments (increases and decreases) to the basis of the property for events occurring between the time you acquired the property and the time you placed it in service for business or the production of income. The result of these adjustments to the basis is the adjusted basis.

Increases to basis. You must increase the basis of any property by the cost of all items properly added to a capital account. These include the following.

- The cost of any additions or improvements made before placing your property into service as a rental that have a useful life of more than 1 year.
- Amounts spent after a casualty to restore the damaged property.
- The cost of extending utility service lines to the property.
- Legal fees, such as the cost of defending and perfecting title, or settling zoning issues.

Additions or improvements. Add to the basis of your property the amount an addition or improvement actually cost you, including any amount you borrowed to make the addition or improvement. This includes all direct costs, such as material and labor, but does not include your own labor. It also includes all expenses related to the addition or improvement.

For example, if you had an architect draw up plans for remodeling your property, the architect's fee is a part of the cost of the remodeling. Or, if you had your lot surveyed to put up a fence, the cost of the survey is a part of the cost of the fence.

Keep separate accounts for depreciable additions or improvements made after you place the property in service in your rental activity. For information on depreciating additions or improvements, see [Additions or improvements to property](), later in this chapter, under *Recovery Periods Under GDS*.

CAUTION *The cost of landscaping improvements is usually treated as an addition to the basis of the land, which is not depreciable. However, see [What Rental Property Cannot Be Depreciated](), earlier.*

Assessments for local improvements. Assessments for items which tend to increase the value of property, such as streets and sidewalks, must be added to the basis of the property. For example, if your city installs curbing on the street in front of your house, and assesses you and your neighbors for its cost, you must add the assessment to the basis of your property. Also add the cost of legal fees paid to obtain a decrease in an assessment levied against property to pay for local improvements. You cannot deduct these items as taxes or depreciate them.

However, you can deduct as taxes, charges or assessments for maintenance, repairs, or interest charges related to the improvements. Do not add them to your basis in the property.

Deducting vs. capitalizing costs. Do not add to your basis costs you can deduct as current expenses. However, there are certain costs you can choose either to deduct or to capitalize. If you capitalize these costs, include them in your basis. If you deduct them, do not include them in your basis.

The costs you may choose to deduct or capitalize include carrying charges, such as interest and taxes, that you must pay to own property.

For more information about deducting or capitalizing costs and how to make the election, see *Carrying Charges* in Publication 535, chapter 7.

Decreases to basis. You must decrease the basis of your property by any items that represent a return of your cost. These include the following.

- Insurance or other payment you receive as the result of a casualty or theft loss.
- Casualty loss not covered by insurance for which you took a deduction.
- Amount(s) you receive for granting an easement.
- Residential energy credits you were allowed before 1986, or after 2005, if you added the cost of the energy items to the basis of your home.
- Exclusion from income of subsidies for energy conservation measures.
- Special depreciation allowance claimed on qualified property.
- Depreciation you deducted, or could have deducted, on your tax returns under the method of depreciation you chose. If you did not deduct enough or deducted too much in any year, see *Depreciation* under *Decreases to Basis* in Publication 551.

If your rental property was previously used as your main home, you must also decrease the basis by the following.

- Gain you postponed from the sale of your main home before May 7, 1997, if the replacement home was converted to your rental property.
- District of Columbia first-time homebuyer credit allowed on the purchase of your main home after August 4, 1997 and before January 1, 2012.
- Amount of qualified principal residence indebtedness discharged on or after January 1, 2007.

Claiming the Special Depreciation Allowance

For 2012, your residential rental property may qualify for a special depreciation allowance. This allowance is figured before you figure your regular depreciation deduction. See Publication 946, chapter 3, for details. Also see the Instructions for Form 4562, *Line 14*.

If you qualify for, but choose not to take, a special depreciation allowance, you must attach a statement to your return. The details of this election are in Publication 946, chapter 3, and the Instructions for Form 4562, *Line 14*.

MACRS Depreciation

Most business and investment property placed in service after 1986 is depreciated using MACRS.

This section explains how to determine which MACRS depreciation system applies to your property. It also discusses other information you need to know before you can figure depreciation under MACRS. This information includes the property's:

- Recovery class,
- Applicable recovery period,
- Convention,
- Placed-in-service date,
- Basis for depreciation, and
- Depreciation method.

Depreciation Systems

MACRS consists of two systems that determine how you depreciate your property—the General Depreciation System (GDS) and the Alternative Depreciation System (ADS). You must use GDS unless your are specifically required by law to use ADS or you elect to use ADS.

Excluded Property

You cannot use MACRS for certain personal property (such as furniture or appliances) placed in service in your rental property in 2012 if it had been previously placed in service before 1987 when MACRS became effective.

In most cases, personal property is excluded from MACRS if you (or a person related to you) owned or used it in 1986 or if your tenant is a person (or someone related to the person) who owned or used it in 1986. However, the property is not excluded if your 2012 deduction under MACRS (using a half-year convention) is less than the deduction you would have under ACRS. For more information, see *What Method Can You Use To Depreciate Your Property?* in Publication 946, chapter 1.

Electing ADS

If you choose, you can use the ADS method for most property. Under ADS, you use the straight line method of depreciation.

The election of ADS for one item in a class of property generally applies to all property in that class that is placed in service during the tax year of the election. However, the election applies on a property-by-property basis for residential rental property and nonresidential real property.

If you choose to use ADS for your residential rental property, the election must be made in the first year the property is placed in service. Once you make this election, you can never revoke it.

For property placed in service during 2012, you make the election to use ADS by entering the depreciation on Form 4562, Part III, Section C, line 20c.

Property Classes Under GDS

Each item of property that can be depreciated under MACRS is assigned to a property class, determined by its class life. The property class generally determines the depreciation method, recovery period, and convention.

The property classes under GDS are:

- 3-year property,
- 5-year property,

- 7-year property,
- 10-year property,
- 15-year property,
- 20-year property,
- Nonresidential real property, and
- Residential rental property.

Under MACRS, property that you placed in service during 2012 in your rental activities generally falls into one of the following classes.

- ***5-year property.*** This class includes computers and peripheral equipment, office machinery (typewriters, calculators, copiers, etc.), automobiles, and light trucks.

  This class also includes appliances, carpeting, furniture, etc., used in a residential rental real estate activity.

  Depreciation on automobiles, other property used for transportation, computers and related peripheral equipment, and property of a type generally used for entertainment, recreation, or amusement is limited. See chapter 5 of Publication 946.

- ***7-year property.*** This class includes office furniture and equipment (desks, file cabinets, etc.). This class also includes any property that does not have a class life and that has not been designated by law as being in any other class.
- ***15-year property.*** This class includes roads, fences, and shrubbery (if depreciable).
- ***Residential rental property.*** This class includes any real property that is a rental building or structure (including a mobile home) for which 80% or more of the gross rental income for the tax year is from dwelling units. It does not include a unit in a hotel, motel, inn, or other establishment where more than half of the units are used on a transient basis. If you live in any part of the building or structure, the gross rental income includes the fair rental value of the part you live in.

CAUTION *The other property classes do not generally apply to property used in rental activities. These classes are not discussed in this publication. See Publication 946 for more information.*

Recovery Periods Under GDS

The recovery period of property is the number of years over which you recover its cost or other basis. The recovery periods are generally longer under ADS than GDS.

The recovery period of property depends on its property class. Under GDS, the recovery period of an asset is generally the same as its property class.

Class lives and recovery periods for most assets are listed in *Appendix B* of Publication 946. See Table 2-1 for recovery periods of property commonly used in residential rental activities.

Qualified Indian reservation property. Shorter recovery periods are provided under MACRS for qualified Indian reservation property placed in service on Indian reservations. For more information, see chapter 4 of Publication 946.

Additions or improvements to property. Treat additions or improvements you make to your depreciable rental property as separate property items for depreciation purposes.

The property class and recovery period of the addition or improvement is the one that would apply to the original property if you had placed it in service at the same time as the addition or improvement.

The recovery period for an addition or improvement to property begins on the later of:

- The date the addition or improvement is placed in service, or
- The date the property to which the addition or improvement was made is placed in service.

Example. You own a residential rental house that you have been renting since 1986 and depreciating under ACRS. You built an addition onto the house and placed it in service in 2012. You must use MACRS for the addition. Under GDS, the addition is depreciated as residential rental property over 27.5 years.

Conventions

A convention is a method established under MACRS to set the beginning and end of the recovery period. The convention you use determines the number of months for which you can claim depreciation in the year you place property in service and in the year you dispose of the property.

Mid-month convention. A mid-month convention is used for all residential rental property and nonresidential real property. Under this convention, you treat all property placed in service, or disposed of, during any month as placed in service, or disposed of, at the midpoint of that month.

Mid-quarter convention. A mid-quarter convention must be used if the mid-month convention does not apply and the total depreciable basis of MACRS property placed in service in the last 3 months of a tax year (excluding

Table 2-1. **MACRS Recovery Periods for Property Used in Rental Activities**

Keep for Your Records

	MACRS Recovery Period	
Type of Property	**General Depreciation System**	**Alternative Depreciation System**
Computers and their peripheral equipment	5 years	5 years
Office machinery, such as: Typewriters, Calculators, Copiers	5 years	6 years
Automobiles	5 years	5 years
Light trucks	5 years	5 years
Appliances, such as: Stoves, Refrigerators	5 years	9 years
Carpets	5 years	9 years
Furniture used in rental property	5 years	9 years
Office furniture and equipment, such as: Desks, Files	7 years	10 years
Any property that does not have a class life and that has not been designated by law as being in any other class	7 years	12 years
Roads	15 years	20 years
Shrubbery	15 years	20 years
Fences	15 years	20 years
Residential rental property (buildings or structures) and structural components such as furnaces, waterpipes, venting, etc.	27.5 years	40 years
Additions and improvements, such as a new roof	The same recovery period as that of the property to which the addition or improvement is made, determined as if the property were placed in service at the same time as the addition or improvement.	

Table 2-2. **Optional MACRS GDS Percentage Tables**

a. MACRS 5-Year Property (200% DB)

	Half-year convention	Mid-quarter convention			
Year		**First quarter**	**Second quarter**	**Third quarter**	**Fourth quarter**
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00	26.00	30.00	34.00	38.00
3	19.20	15.60	18.00	20.40	22.80
4	11.52	11.01	11.37	12.24	13.68
5	11.52	11.01	11.37	11.30	10.94
6	5.76	1.38	4.26	7.06	9.58

b. MACRS 7-Year Property (200% DB)

	Half-year convention	Mid-quarter convention			
Year		**First quarter**	**Second quarter**	**Third quarter**	**Fourth quarter**
1	14.29%	25.00%	17.85%	10.71%	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06
5	8.93	8.75	8.87	9.30	10.04
6	8.92	8.74	8.87	8.85	8.73
7	8.93	8.75	8.87	8.86	8.73

c. MACRS 15-Year Property (150% DB)

	Half-year convention	Mid-quarter convention			
Year		**First quarter**	**Second quarter**	**Third quarter**	**Fourth quarter**
1	5.00%	8.75%	6.25%	3.75%	1.25%
2	9.50	9.13	9.38	9.63	9.88
3	8.55	8.21	8.44	8.66	8.89
4	7.70	7.39	7.59	7.80	8.00
5	6.93	6.65	6.83	7.02	7.20
6	6.23	5.99	6.15	6.31	6.48
7	5.90	5.90	5.91	5.90	5.90
8	5.90	5.91	5.90	5.90	5.90

d. Residential Rental Property-GDS (27.5-year S/L with mid-month convention)

	Use the row for the month of the taxable year placed in service.					
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
Jan.	3.485%	3.636%	3.636%	3.636%	3.636%	3.636%
Feb.	3.182	3.636	3.636	3.636	3.636	3.636
March	2.879	3.636	3.636	3.636	3.636	3.636
Apr.	2.576	3.636	3.636	3.636	3.636	3.636
May	2.273	3.636	3.636	3.636	3.636	3.636
June	1.970	3.636	3.636	3.636	3.636	3.636
July	1.667	3.636	3.636	3.636	3.636	3.636
Aug.	1.364	3.636	3.636	3.636	3.636	3.636
Sept.	1.061	3.636	3.636	3.636	3.636	3.636
Oct.	0.758	3.636	3.636	3.636	3.636	3.636
Nov.	0.455	3.636	3.636	3.636	3.636	3.636
Dec.	0.152	3.636	3.636	3.636	3.636	3.636

nonresidential real property, residential rental property, and property placed in service and disposed of in the same year) is more than 40% of the total basis of all such property you place in service during the year.

Under this convention, you treat all property placed in service, or disposed of, during any quarter of a tax year as placed in service, or disposed of, at the midpoint of the quarter.

Example. During the tax year, Tom Martin purchased the following items to use in his rental property. He elects not to claim the special depreciation allowance discussed earlier.

- A dishwasher for $400 that he placed in service in January.
- Used furniture for $100 that he placed in service in September.
- A refrigerator for $800 that he placed in service in October.

Tom uses the calendar year as his tax year. The total basis of all property placed in service that year is $1,300. The $800 basis of the refrigerator placed in service during the last 3 months of his tax year exceeds $520 (40% × $1,300). Tom must use the mid-quarter convention instead of the half-year convention for all three items.

Half-year convention. The half-year convention is used if neither the mid-quarter convention nor the mid-month convention applies. Under this convention, you treat all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, at the midpoint of that tax year.

If this convention applies, you deduct a half year of depreciation for the first year and the last year that you depreciate the property. You deduct a full year of depreciation for any other year during the recovery period.

Figuring Your Depreciation Deduction

You can figure your MACRS depreciation deduction in one of two ways. The deduction is substantially the same both ways. You can either:

- Actually compute the deduction using the depreciation method and convention that apply over the recovery period of the property, or
- Use the percentage from the MACRS percentage tables.

In this publication we will use the percentage tables. For instructions on how to compute the deduction, see chapter 4 of Publication 946.

Residential rental property. You must use the straight line method and a mid-month convention for residential rental property. In the first year that you claim depreciation for residential rental property, you can claim depreciation only for the number of months the property is in use, and you must use the mid-month convention (explained under *Conventions*, earlier).

5-, 7-, or 15-year property. For property in the 5- or 7-year class, use the 200% declining balance method and a half-year convention. However, in limited cases you must use the mid-quarter convention, if it applies. For property in the 15-year class, use the 150% declining balance method and a half-year convention.

You can also choose to use the 150% declining balance method for property in the 5- or 7-year class. The choice to use the 150% method for one item in a class of property applies to all property in that class that is placed in service during the tax year of the election. You make this election on Form 4562. In Part III, column (f), enter "150 DB." Once you make this election, you cannot change to another method.

If you use either the 200% or 150% declining balance method, you figure your deduction using the straight line method in the first tax year that the straight line method gives you an equal or larger deduction.

You can also choose to use the straight line method with a half-year or mid-quarter convention for 5-, 7-, or 15-year property. The choice to use the straight line method for one item in a class of property applies to all property in that class that is placed in service during the tax year of the election. You elect the straight line method on Form 4562. In Part III, column (f), enter “S/L.” Once you make this election, you cannot change to another method.

MACRS Percentage Tables

You can use the percentages in Table 2-2, earlier, to compute annual depreciation under MACRS. The tables show the percentages for the first few years or until the change to the straight line method is made. See *Appendix A* of Publication 946 for complete tables. The percentages in Tables 2-2a, 2-2b, and 2-2c make the change from declining balance to straight line in the year that straight line will give a larger deduction.

If you elect to use the straight line method for 5-, 7-, or 15-year property, or the 150% declining balance method for 5- or 7-year property, use the tables in *Appendix A* of Publication 946.

How to use the percentage tables. You must apply the table rates to your property's unadjusted basis (defined below) each year of the recovery period.

Once you begin using a percentage table to figure depreciation, you must continue to use it for the entire recovery period unless there is an adjustment to the basis of your property for a reason other than:

1. Depreciation allowed or allowable, or
2. An addition or improvement that is depreciated as a separate item of property.

If there is an adjustment for any reason other than (1) or (2), for example, because of a deductible casualty loss, you can no longer use the table. For the year of the adjustment and for the remaining recovery period, figure depreciation using the property's adjusted basis at the end of the year and the appropriate depreciation method, as explained earlier under Figuring Your Depreciation Deduction. See *Figuring the Deduction Without Using the Tables* in Publication 946, chapter 4.

Unadjusted basis. This is the same basis you would use to figure gain on a sale (see Basis of Depreciable Property, earlier), but without reducing your original basis by any MACRS depreciation taken in earlier years.

However, you do reduce your original basis by other amounts claimed on the property, including:

- Any amortization,
- Any section 179 deduction, and
- Any special depreciation allowance.

For more information, see Publication 946, chapter 4.

Tables 2-2a, 2-2b, and 2-2c. The percentages in these tables take into account the half-year and mid-quarter conventions. Use Table 2-2a for 5-year property, Table 2-2b for 7-year property, and Table 2-2c for 15-year property. Use the percentage in the second column (half-year convention) unless you are required to use the *mid-quarter convention* (explained earlier). If you must use the mid-quarter convention, use the column that corresponds to the calendar year quarter in which you placed the property in service.

Example 1. You purchased a stove and refrigerator and placed them in service in June. Your basis in the stove is $600 and your basis in the refrigerator is $1,000. Both are 5-year property. Using the half-year convention column in Table 2-2a, the depreciation percentage for Year 1 is 20%. For that year your depreciation deduction is $120 ($600 × .20) for the stove and $200 ($1,000 × .20) for the refrigerator.

For Year 2, the depreciation percentage is 32%. That year's depreciation deduction will be $192 ($600 × .32) for the stove and $320 ($1,000 × .32) for the refrigerator.

Example 2. Assume the same facts as in *Example 1*, except you buy the refrigerator in October instead of June. Since the refrigerator was placed in service in the last 3 months of the tax year, and its basis ($1,000) is more than 40% of the total basis of all property placed in service during the year ($1,600 × .40 = $640), you are required to use the mid-quarter convention to figure depreciation on both the stove and refrigerator.

Because you placed the refrigerator in service in October, you use the fourth quarter column of Table 2-2a and find the depreciation percentage for Year 1 is 5%. Your depreciation deduction for the refrigerator is $50 ($1,000 x .05).

Because you placed the stove in service in June, you use the second quarter column of Table 2-2a and find the depreciation percentage for Year 1 is 25%. For that year, your depreciation deduction for the stove is $150 ($600 x .25).

Table 2-2d. Use this table when you are using the GDS 27.5 year option for residential rental property. Find the row for the month that you placed the property in service. Use the percentages listed for that month to figure your depreciation deduction. The mid-month convention is taken into account in the percentages shown in the table. Continue to use the same row (month) under the column for the appropriate year.

Example. You purchased a single family rental house for $185,000 and placed it in service on February 8. The sales contract showed that the building cost $160,000 and the land cost $25,000. Your basis for depreciation is its original cost, $160,000. This is the first year of service for your residential rental property and you decide to use GDS which has a recovery period of 27.5 years. Using Table 2-2d, you find that the percentage for property placed in service in February of Year 1 is 3.182%. That year's depreciation deduction is $5,091 ($160,000 x .03182).

Figuring MACRS Depreciation Under ADS

Table 2-1, earlier, shows the ADS recovery periods for property used in rental activities.

See *Appendix B* in Publication 946 for other property. If your property is not listed in *Appendix B*, it is considered to have no class life. Under ADS, personal property with no class life is depreciated using a recovery period of 12 years.

Use the mid-month convention for residential rental property and nonresidential real property. For all other property, use the half-year or mid-quarter convention, as appropriate.

See Publication 946 for ADS depreciation tables.

Claiming the Correct Amount of Depreciation

You should claim the correct amount of depreciation each tax year. If you did not claim all the depreciation you were entitled to deduct, you must still reduce your basis in the property by the full amount of depreciation that you could have deducted. For more information, see *Depreciation* under *Decreases to Basis* in Publication 551.

If you deducted an incorrect amount of depreciation for property in any year, you may be able to make a correction by filing Form 1040X, Amended U.S. Individual Income Tax Return. If you are not allowed to make the correction on an amended return, you can change your accounting method to claim the correct amount of depreciation.

Filing an amended return. You can file an amended return to correct the amount of depreciation claimed for any property in any of the following situations.

- You claimed the incorrect amount because of a mathematical error made in any year.
- You claimed the incorrect amount because of a posting error made in any year.
- You have not adopted a method of accounting for property placed in service by you in tax years ending after December 29, 2003.
- You claimed the incorrect amount on property placed in service by you in tax years ending before December 30, 2003.

Generally, you adopt a method of accounting for depreciation by using a permissible method of determining depreciation when you file your first tax return for the property used in your rental activity. This also occurs when you use the same impermissible method of determining depreciation (for example, using the wrong MACRS recovery period) in two or more consecutively filed tax returns.

If an amended return is allowed, you must file it by the later of the following dates.

- 3 years from the date you filed your original return for the year in which you did not deduct the correct amount. A return filed before an unextended due date is considered filed on that due date.
- 2 years from the time you paid your tax for that year.

Changing your accounting method. To change your accounting method, you generally must file Form 3115, Application for Change in Accounting Method, to get the consent of the IRS. In some instances, that consent is automatic. For more information, see *Changing Your Accounting Method* in Publication 946, chapter 1.

3. Reporting Rental Income, Expenses, and Losses

Figuring the net income or loss for a residential rental activity may involve more than just listing the income and deductions on Schedule E (Form 1040). There are activities which do not qualify to use Schedule E, such as when the activity is not engaged in to make a profit or when you provide substantial services in conjunction with the property.

There are also the limitations which may need to be applied if you have a net loss on Schedule E. There are two: (1) the limitation based on the amount of investment you have at risk in your rental activity, and (2) the special limits imposed on passive activities.

You may also have a gain or loss related to your rental property from a casualty or theft. This is considered separately from the income and expense information you report on Schedule E.

Which Forms To Use

The basic form for reporting residential rental income and expenses is Schedule E (Form 1040). However, do not use that schedule to report a not-for-profit activity. See Not Rented for Profit, in chapter 4. There are also other rental situations in which forms other than Schedule E would be used.

Schedule E (Form 1040)

If you rent buildings, rooms, or apartments, and provide basic services such as heat and light, trash collection, etc., you normally report your rental income and expenses on Schedule E, Part I.

List your total income, expenses, and depreciation for each rental property. Be sure to enter the number of fair rental and personal use days on line 2.

If you have more than three rental or royalty properties, complete and attach as many Schedules E as are needed to list the properties. Complete lines 1 and 2 for each property. However, fill in lines 23a through 26 on only one Schedule E.

On Schedule E, page 1, line 18, enter the depreciation you are claiming for each property. To find out if you need to attach Form 4562, see Form 4562, later.

If you have a loss from your rental real estate activity, you also may need to complete one or both of the following forms.

- Form 6198, At-Risk Limitations. See At-Risk Rules, later. Also see Publication 925.
- Form 8582, Passive Activity Loss Limitations. See Passive Activity Limits, later.

Page 2 of Schedule E is used to report income or loss from partnerships, S corporations, estates, trusts, and real estate mortgage investment conduits. If you need to use page 2 of Schedule E, use page 2 of the same Schedule E you used to enter your rental activity on page 1. Also, include the amount from line 26 (Part I) in the "Total income or (loss)" on line 41 (Part V).

Form 4562. You must complete and attach Form 4562 for rental activities only if you are claiming:

- Depreciation, including the special depreciation allowance, on property placed in service during 2012;
- Depreciation on listed property (such as a car), regardless of when it was placed in service; or
- Any other car expenses, including the standard mileage rate or lease expenses.

Otherwise, figure your depreciation on your own worksheet. You do not have to attach these computations to your return, but you should keep them in your records for future reference.

See Publication 946 for information on preparing Form 4562.

Schedule C (Form 1040), Profit or Loss From Business

Generally, Schedule C is used when you provide substantial services in conjunction with the property or the rental is part of a trade or business as a real estate dealer.

Providing substantial services. If you provide substantial services that are primarily for your tenant's convenience, such as regular cleaning, changing linen, or maid service, you report your rental income and expenses on Schedule C (Form 1040), Profit or Loss From Business, or Schedule C-EZ (Form 1040), Net Profit From Business. Use Form 1065, U.S. Return of Partnership Income, if your rental activity is a partnership (including a partnership with your spouse unless it is a qualified joint venture). Substantial services do not include the furnishing of heat and light, cleaning of public areas, trash collection, etc. For information, see Publication 334, Tax Guide for Small Business. Also, you may have to pay self-employment tax on your rental income using Schedule SE (Form 1040), Self-Employment Tax. For a discussion of "substantial services," see *Real Estate Rents* in Publication 334, chapter 5.

Qualified Joint Venture

If you and your spouse each materially participate (see Material participation under *Passive Activity Limits*, later) as the only members of a jointly owned and operated real estate business, and you file a joint return for the tax year, you can make a joint election to be treated as a qualified joint venture instead of a partnership. This election, in most cases, will not increase the total tax owed on the joint return, but it does give each of you credit for social security earnings on which retirement benefits are based and for Medicare coverage if your rental income is subject to self-employment tax.

If you make this election, you must report rental real estate income on Schedule E (or Schedule C if you provide substantial services). You will not be required to file Form 1065 for any year the election is in effect. Rental real estate income generally is not included in net earnings from self-employment subject to self-employment tax and generally is subject to the passive activity limits.

If you and your spouse filed a Form 1065 for the year prior to the election, the partnership terminates at the end of the tax year immediately preceding the year the election takes effect.

For more information on qualified joint ventures, go to IRS.gov. Enter "qualified joint venture" in the search box and select "Election for Husband and Wife Unincorporated Businesses."

Limits on Rental Losses

If you have a loss from your rental real estate activity, two sets of rules may limit the amount of loss you can deduct. You must consider these rules in the order shown below. Both are discussed in this section.

1. At-risk rules. These rules are applied first if there is investment in your rental real estate activity for which you are not at risk. This applies only if the real property was placed in service after 1986.
2. Passive activity limits. Generally, rental real estate activities are considered passive activities and losses are not deductible unless you have income from other passive activities to offset them. However, there are exceptions.

At-Risk Rules

You may be subject to the at-risk rules if you have:

- A loss from an activity carried on as a trade or business or for the production of income, and
- Amounts invested in the activity for which you are not fully at risk.

Losses from holding real property (other than mineral property) placed in service before 1987 are not subject to the at-risk rules.

In most cases, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount you have at risk in the activity at the end of the tax year. You are considered at risk in an activity to the extent of cash and the adjusted basis of other property you contributed to the activity and certain amounts borrowed for use in the activity. Any loss that is disallowed because of the at-risk limits is treated as a deduction from the same activity in the next tax year. See Publication 925 for a discussion of the at-risk rules.

Form 6198. If you are subject to the at-risk rules, file Form 6198, At-Risk Limitations, with your tax return.

Passive Activity Limits

In most cases, all rental real estate activities (except those of certain real estate professionals, discussed later) are passive activities. For this purpose, a rental activity is an activity from which you receive income mainly for the use of tangible property, rather than for services. For a discussion of activities that are not considered rental activities, see *Rental Activities* in Publication 925.

Deductions or losses from passive activities are limited. You generally cannot offset income, other than passive income, with losses from passive activities. Nor can you offset taxes on income, other than passive income, with credits resulting from passive activities. Any excess loss or credit is carried forward to the next tax year. Exceptions to the rules for figuring passive activity limits for personal use of a dwelling unit and for rental real estate with active participation are discussed later.

For a detailed discussion of these rules, see Publication 925.

Real estate professionals. If you are a real estate professional, complete line 43 of Schedule E.

You qualify as a real estate professional for the tax year if you meet both of the following requirements.

- More than half of the personal services you perform in all trades or businesses during the tax year are performed in real property trades or businesses in which you materially participate.
- You perform more than 750 hours of services during the tax year in real property trades or businesses in which you materially participate.

If you qualify as a real estate professional, rental real estate activities in which you materially participated are not passive activities. For purposes of determining whether you materially participated in your rental real estate activities, each interest in rental real estate is a separate activity unless you elect to treat all your interests in rental real estate as one activity.

Do not count personal services you perform as an employee in real property trades or businesses unless you are a 5% owner of your employer. You are a 5% owner if you own (or are considered to own) more than 5% of your employer's outstanding stock, or capital or profits interest.

Do not count your spouse's personal services to determine whether you met the requirements listed above. However, you can count your spouse's participation in an activity in determining if you materially participated.

Real property trades or businesses. A real property trade or business is a trade or business that does any of the following with real property.

- Develops or redevelops it.
- Constructs or reconstructs it.
- Acquires it.
- Converts it.
- Rents or leases it.
- Operates or manages it.
- Brokers it.

Choice to treat all interests as one activity. If you were a real estate professional and had more than one rental real estate interest during the year, you can choose to treat all the interests as one activity. You can make this choice for any year that you qualify as a real estate professional. If you forgo making the choice for one year, you can still make it for a later year.

If you make the choice, it is binding for the tax year you make it and for any later year that you are a real estate professional. This is true even if you are not a real estate professional in any intervening year. (For that year, the exception for real estate professionals will not apply in determining whether your activity is subject to the passive activity rules.)

See the Instructions for Schedule E for information about making this choice.

Material participation. Generally, you materially participated in an activity for the tax year if you were involved in its operations on a regular, continuous, and substantial basis during the year. For details, see Publication 925 or the Instructions for Schedule C.

Participating spouse. If you are married, determine whether you materially participated in an activity by also counting any participation in the activity by your spouse during the year. Do this even if your spouse owns no interest in the activity or files a separate return for the year.

Form 8582. You may have to complete Form 8582 to figure the amount of any passive activity loss for the current tax year for all activities and the amount of the passive activity loss allowed on your tax return. See *Form 8582 not required*, later in this chapter, to determine if you must complete Form 8582.

If you are required to complete Form 8582 and are also subject to the at-risk rules, include the amount from Form 6198, line 21 (deductible loss) in column (b) of Form 8582, Worksheet 1 or 3, as required.

Exception for Personal Use of Dwelling Unit

If you used the rental property as a home during the year, any income, deductions, gain, or loss allocable to such use shall not be taken into account for purposes of the passive activity loss limitation. Instead, follow the rules explained in chapter 5, *Personal Use of Dwelling Unit (Including Vacation Home).*

Exception for Rental Real Estate With Active Participation

If you or your spouse actively participated in a passive rental real estate activity, you can deduct up to $25,000 of loss from the activity from your nonpassive income. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities. Similarly, you can offset credits from the activity against the tax on up to $25,000 of nonpassive income after taking into account any losses allowed under this exception.

Example. Jane is single and has $40,000 in wages, $2,000 of passive income from a limited partnership, and $3,500 of passive loss from a rental real estate activity in which she actively participated. $2,000 of Jane's $3,500 loss offsets her passive income. The remaining $1,500 loss can be deducted from her $40,000 wages.

CAUTION *The special allowance is not available if you were married, lived with your spouse at any time during the year, and are filing a separate return.*

Active participation. You actively participated in a rental real estate activity if you (and your spouse) owned at least 10% of the rental property and you made management decisions or arranged for others to provide services (such as repairs) in a significant and *bona fide* sense. Management decisions that may count as active participation include approving new tenants, deciding on rental terms, approving expenditures, and other similar decisions.

Example. Mike is single and had the following income and losses during the tax year:

Salary	$42,300
Dividends	300
Interest	1,400
Rental loss	(4,000)

The rental loss was from the rental of a house Mike owned. Mike had advertised and rented the house to the current tenant himself. He also collected the rents, which usually came by mail. All repairs were either made or contracted out by Mike.

Although the rental loss is from a passive activity, because Mike actively participated in the rental property management he can use the entire $4,000 loss to offset his other income.

Maximum special allowance. The maximum special allowance is:

- $25,000 for single individuals and married individuals filing a joint return for the tax year,
- $12,500 for married individuals who file separate returns for the tax year and lived apart from their spouses at all times during the tax year, and
- $25,000 for a qualifying estate reduced by the special allowance for which the surviving spouse qualified.

If your modified adjusted gross income (MAGI) is $100,000 or less ($50,000 or less if married filing separately), you can deduct your loss up to the amount specified above. If your MAGI is more than $100,000 (more than $50,000 if married filing separately), your special allowance is limited to 50% of the difference between $150,000 ($75,000 if married filing separately) and your MAGI.

Generally, if your MAGI is $150,000 or more ($75,000 or more if you are married filing separately), there is no special allowance.

Modified adjusted gross income (MAGI). This is your adjusted gross income from Form 1040, U.S. Individual Income Tax Return, line 38, or Form 1040NR, U.S. Nonresident Alien Income Tax Return, line 37, figured without taking into account:

1. The taxable amount of social security or equivalent tier 1 railroad retirement benefits,
2. The deductible contributions to traditional individual retirement accounts (IRAs) and section 501(c)(18) pension plans,
3. The exclusion from income of interest from Series EE and I U.S. savings bonds used to pay higher educational expenses,
4. The exclusion of amounts received under an employer's adoption assistance program,
5. Any passive activity income or loss included on Form 8582,
6. Any rental real estate loss allowed to real estate professionals,
7. Any overall loss from a publicly traded partnership (see *Publicly Traded Partnerships (PTPs)* in the Instructions for Form 8582),
8. The deduction allowed for a portion of self-employment tax,
9. The deduction allowed for interest paid on student loans,
10. The deduction for qualified tuition and related fees, and
11. The domestic production activities deduction (see the Instructions for Form 8903).

Form 8582 not required. Do not complete Form 8582 if you meet all of the following conditions.

- Your only passive activities were rental real estate activities in which you actively participated.
- Your overall net loss from these activities is $25,000 or less ($12,500 or less if married filing separately).
- If married filing separately, you lived apart from your spouse all year.
- You have no prior year unallowed losses from these activities.
- You have no current or prior year unallowed credits from passive activities.
- Your MAGI is $100,000 or less ($50,000 or less if married filing separately and you lived apart from your spouse all year).
- You do not hold any interest in a rental real estate activity as a limited partner or as a beneficiary of an estate or a trust.

If you meet all of the conditions listed above, your rental real estate activities are not limited by the passive activity rules and you do not have to complete Form 8582. On lines 23a through 23e of your Schedule E, enter the applicable amounts.

Casualties and Thefts

As a result of a casualty or theft, you may have a loss related to your rental property. You may be able to deduct the loss on your income tax return.

Casualty. This is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. Such events include a storm, fire, or earthquake.

Theft. This is defined as the unlawful taking and removing of your money or property with the intent to deprive you of it.

Gain from casualty or theft. It is also possible to have a gain from a casualty or theft if you receive money, including insurance, that is more than your adjusted basis in the property. Generally, you must report this gain. However, under certain circumstances, you may defer paying tax by choosing to postpone reporting the gain. To do this, you generally must buy replacement property within 2 years after the close of the first tax year in which any part of your gain is realized. Generally, the replacement period is 5 years for property located in disaster areas. The cost of the replacement property must be equal to or more than the net insurance or other payment you received.

More information. For information on business and nonbusiness casualty and theft losses, see Publication 547.

How to report. If you had a casualty or theft that involved property used in your rental activity, figure the net gain or loss in Section B of Form 4684, Casualties and Thefts. Follow the Instructions for Form 4684 for where to carry your net gain or loss.

Example

In February 2007, Marie Pfister bought a rental house for $135,000 (house $120,000 and land $15,000) and immediately began renting it out. In 2012, she rented it all 12 months for a monthly rental fee of $1,125. In addition to her rental income of $13,500 (12 x $1,125), Marie had the following expenses.

Mortgage interest	$8,000
Fire insurance (1-year policy)	250
Miscellaneous repairs	400
Real estate taxes imposed and paid	500
Maintenance	200

Marie depreciates the residential rental property under MACRS GDS. This means using the straight line method over a recovery period of 27.5 years.

She uses Table 2-2d to find her depreciation percentage. Because she placed the property in service in February 2007, she continues to use that row of Table 2-2d. For year 6, the rate is 3.636%.

Marie figures her net rental income or loss for the house as follows:

Total rental income received ($1,125 × 12)		$13,500
Minus: Expenses		
Mortgage interest	$8,000	
Fire insurance	250	
Miscellaneous repairs	400	
Real estate taxes	500	
Maintenance	200	
Total expenses		9,350
Balance		$4,150
Minus: Depreciation ($120,000 x 3.636%)		4,363
Net rental (loss) for house		($213)

Marie had a net loss for the year. Because she actively participated in her passive rental real estate activity and her loss was less than $25,000, she can deduct the loss on her return. Marie also meets all of the requirements for not having to file Form 8582. She uses Schedule E, Part I, to report her rental income and expenses. She enters her income, expenses, and depreciation for the house in the column for Property A and enters her loss on line 22. Form 4562 is not required.

4. Special Situations

This chapter discusses some rental real estate activities that are subject to additional rules.

Condominiums

A condominium is most often a dwelling unit in a multi-unit building, but can also take other forms, such as a townhouse or garden apartment.

If you own a condominium, you also own a share of the common elements, such as land, lobbies, elevators, and service areas. You and the other condominium owners may pay dues or assessments to a special corporation that is organized to take care of the common elements.

Special rules apply if you rent your condominium to others. You can deduct as rental expenses all the expenses discussed in chapters 1 and 2. In addition, you can deduct any dues or assessments paid for maintenance of the common elements.

You cannot deduct special assessments you pay to a condominium management corporation for improvements. However, you may be able to recover your share of the cost of any improvement by taking depreciation.

Cooperatives

If you live in a cooperative, you do not own your apartment. Instead, a corporation owns the apartments and you are a tenant-stockholder in the cooperative housing corporation. If you rent your apartment to others, you usually can deduct, as a rental expense, all the maintenance fees you pay to the cooperative housing corporation.

In addition to the maintenance fees paid to the cooperative housing corporation, you can deduct your direct payments for repairs, upkeep, and other rental expenses, including interest paid on a loan used to buy your stock in the corporation.

Depreciation

You will be depreciating your stock in the corporation rather than the apartment itself. Figure your depreciation deduction as follows.

1. Figure the depreciation for all the depreciable real property owned by the corporation. (Depreciation methods are discussed in chapter 2 of this publication and Publication 946.) If you bought your cooperative stock after its first offering, figure the depreciable basis of this property as follows.
   a. Multiply your cost per share by the total number of outstanding shares.
   b. Add to the amount figured in (a) any mortgage debt on the property on the date you bought the stock.
   c. Subtract from the amount figured in (b) any mortgage debt that is not for the depreciable real property, such as the part for the land.
2. Subtract from the amount figured in (1) any depreciation for space owned by the corporation that can be rented but cannot be lived in by tenant-stockholders.
3. Divide the number of your shares of stock by the total number of shares outstanding, including any shares held by the corporation.
4. Multiply the result of (2) by the percentage you figured in (3). This is your depreciation on the stock.

Your depreciation deduction for the year cannot be more than the part of your adjusted basis (defined in chapter 2) in the stock of the corporation that is allocable to your rental property.

Payments added to capital account. Payments earmarked for a capital asset or improvement, or otherwise charged to the corporation's capital account are added to the basis of your stock in the corporation. For example, you cannot deduct a payment used to pave a community parking lot, install a new roof, or pay the principal of the corporation's mortgage.

Treat as a capital cost the amount you were assessed for capital items. This cannot be more than the amount by which your payments to the corporation exceeded your share of the corporation's mortgage interest and real estate taxes.

Your share of interest and taxes is the amount the corporation elected to allocate to you, if it reasonably reflects those expenses for your apartment. Otherwise, figure your share in the following manner.

1. Divide the number of your shares of stock by the total number of shares outstanding, including any shares held by the corporation.
2. Multiply the corporation's deductible interest by the number you figured in (1). This is your share of the interest.
3. Multiply the corporation's deductible taxes by the number you figured in (1). This is your share of the taxes.

Property Changed to Rental Use

If you change your home or other property (or a part of it) to rental use at any time other than the beginning of your tax year, you must divide yearly expenses, such as taxes and insurance, between rental use and personal use.

You can deduct as rental expenses only the part of the expense that is for the part of the year the property was used or held for rental purposes.

You cannot deduct depreciation or insurance for the part of the year the property was held for personal use. However, you can include the home mortgage interest, qualified mortgage insurance premiums, and real estate tax expenses for the part of the year the property was held for personal use as an itemized deduction on Schedule A (Form 1040).

Example. Your tax year is the calendar year. You moved from your home in May and started renting it out on June 1. You can deduct as rental expenses seven-twelfths of your yearly expenses, such as taxes and insurance.

Starting with June, you can deduct as rental expenses the amounts you pay for items generally billed monthly, such as utilities.

When figuring depreciation, treat the property as placed in service on June 1.

Basis of Property Changed to Rental Use

When you change property you held for personal use to rental use (for example, you rent your former home), the basis for depreciation will be the lesser of fair market value or adjusted basis on the date of conversion.

Fair market value. This is the price at which the property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all the relevant facts. Sales of similar property, on or about the same date, may be helpful in figuring the fair market value of the property.

Figuring the basis. The basis for depreciation is the lesser of:

- The fair market value of the property on the date you changed it to rental use, or
- Your adjusted basis on the date of the change—that is, your original cost or other basis of the property, plus the cost of permanent additions or improvements since you acquired it, minus deductions for any casualty or theft losses claimed on earlier years' income tax returns and other decreases to basis. For other increases and decreases to basis, see *Adjusted Basis* in chapter 2.

Example. Several years ago you built your home for $140,000 on a lot that cost you $14,000. Before changing the property to rental use this year, you added $28,000 of permanent improvements to the house and claimed a $3,500 casualty loss deduction for damage to the house. Part of the improvements qualified for a $500 residential energy credit, which you claimed on your 2010 tax return. Because land is not depreciable, you can only include the cost of the house when figuring the basis for depreciation.

The adjusted basis of the house at the time of the change in its use was $164,000 ($140,000 + $28,000 – $3,500 – $500).

On the date of the change in use, your property had a fair market value of $168,000, of which $21,000 was for the land and $147,000 was for the house.

The basis for depreciation on the house is the fair market value on the date of the change ($147,000), because it is less than your adjusted basis ($164,000).

Cooperatives

If you change your cooperative apartment to rental use, figure your allowable depreciation as explained earlier. (Depreciation methods are discussed in chapter 2 of this publication and Publication 946.) The basis of all the depreciable real property owned by the cooperative housing corporation is the smaller of the following amounts.

- The fair market value of the property on the date you change your apartment to rental use. This is considered to be the same as the corporation's adjusted basis minus straight line depreciation, unless this value is unrealistic.
- The corporation's adjusted basis in the property on that date. Do not subtract depreciation when figuring the corporation's adjusted basis.

If you bought the stock after its first offering, the corporation's adjusted basis in the property is the amount figured in (1) under *Depreciation* (under *Cooperatives*, near the beginning of this chapter). The fair market value of the property is considered to be the same as the corporation's adjusted basis figured in this way minus straight line depreciation, unless the value is unrealistic.

Figuring the Depreciation Deduction

To figure the deduction, use the depreciation system in effect when you convert your residence to rental use. Generally, that will be MACRS for any conversion after 1986. Treat the property as placed in service on the conversion date.

Example. Your converted residence (see previous example) was available for rent on August 1. Using Table 2-2d (see chapter 2), the percentage for Year 1 beginning in August is 1.364% and the depreciation deduction for Year 1 is $2,005 ($147,000 × .01364).

Renting Part of Property

If you rent part of your property, you must divide certain expenses between the part of the property used for rental purposes and the part of the property used for personal purposes, as though you actually had two separate pieces of property.

You can deduct the expenses related to the part of the property used for rental purposes, such as home mortgage interest, qualified mortgage insurance premiums, and real estate taxes, as rental expenses on Schedule E (Form 1040). You can also deduct as rental expenses a portion of other expenses that normally are nondeductible personal expenses, such as expenses for electricity, or painting the outside of the house.

There is no change in the types of expenses deductible for the personal-use part of your property. Generally, these expenses may be deducted only if you itemize your deductions on Schedule A (Form 1040).

You cannot deduct any part of the cost of the first phone line even if your tenants have unlimited use of it.

You do not have to divide the expenses that belong only to the rental part of your property. For example, if you paint a room that you rent, or if you pay premiums for liability insurance in connection with renting a room in your home, your entire cost is a rental expense. If you install a second phone line strictly for your tenant's use, all of the cost of the second line is deductible as a rental expense. You can deduct depreciation on the part of the house used for rental purposes as well as on the furniture and equipment you use for rental purposes.

How to divide expenses. If an expense is for both rental use and personal use, such as mortgage interest or heat for the entire house, you must divide the expense between rental use and personal use. You can use any reasonable method for dividing the expense. It may be reasonable to divide the cost of some items (for example, water) based on the number of people using them. The two most common methods for dividing an expense are (1) the number of rooms in your home, and (2) the square footage of your home.

Example. You rent a room in your house. The room is 12 × 15 feet, or 180 square feet. Your entire house has 1,800 square feet of floor space. You can deduct as a rental expense 10% of any expense that must be divided between rental use and personal use. If your heating bill for the year for the entire house was $600, $60 ($600 × .10) is a rental expense. The balance, $540, is a personal expense that you cannot deduct.

Duplex. A common situation is the duplex where you live in one unit and rent out the other. Certain expenses apply to the entire property, such as mortgage interest and real estate taxes, and must be split to determine rental and personal expenses.

Example. You own a duplex and live in one half, renting the other half. Both units are approximately the same size. Last year, you paid a total of $10,000 mortgage interest and $2,000 real estate taxes for the entire property. You can deduct $5,000 mortgage interest and $1,000 real estate taxes on Schedule E (Form 1040), and if you itemize your deductions, you can deduct the other $5,000 mortgage interest and $1,000 real estate taxes on Schedule A (Form 1040).

Not Rented for Profit

If you do not rent your property to make a profit, you can deduct your rental expenses only up to the amount of your rental income. You cannot deduct a loss or carry forward to the next year any rental expenses that are more than your rental income for the year.

Where to report. Report your not-for-profit rental income on Form 1040 or 1040NR, line 21. For example, if you are filing Form 1040, you can include your mortgage interest and any qualified mortgage insurance premiums (if you use the property as your main home or second home), real estate taxes, and casualty losses on the appropriate lines of Schedule A (Form 1040) if you itemize your deductions.

If you itemize your deductions, claim your other rental expenses, subject to the rules explained in chapter 1 of Publication 535, as miscellaneous itemized deductions on Schedule A (Form 1040), line 23, or Schedule A (Form 1040NR), line 9. You can deduct these expenses only if they, together with certain other miscellaneous itemized deductions, total more than 2% of your adjusted gross income.

Presumption of profit. If your rental income is more than your rental expenses for at least 3 years out of a period of 5 consecutive years, you are presumed to be renting your property to make a profit.

Postponing decision. If you are starting your rental activity and do not have 3 years showing a profit, you can elect to have the presumption made after you have the 5 years of experience required by the test. You may choose to postpone the decision of whether the rental is for profit by filing Form 5213. You must file Form 5213 within 3 years after the due date of your return (determined without extensions) for the year in which you first carried on the activity or, if earlier, within 60 days after receiving written notice from the Internal Revenue Service proposing to disallow deductions attributable to the activity.

More information. For more information about the rules for an activity not engaged in for profit, see *Not-for-Profit Activities* in chapter 1 of Publication 535.

Example—Property Changed to Rental Use

In January, Eileen Johnson bought a condominium apartment to live in. Instead of selling the house she had been living in, she decided to change it to rental property. Eileen selected a tenant and started renting the house on February 1. Eileen charges $750 a month for rent and collects it herself. Eileen also received a $750 security deposit from her tenant. Because she plans to return it to her tenant at the end of the lease, she does not include it in her income. Her rental expenses for the year are as follows.

Mortgage interest	$1,800
Fire insurance (1-year policy)	100
Miscellaneous repairs (after renting)	297
Real estate taxes imposed and paid	1,200

Eileen must divide the real estate taxes, mortgage interest, and fire insurance between the personal use of the property and the rental use of the property. She can deduct eleven-twelfths of these expenses as rental expenses. She can include the balance of the allowable taxes and mortgage interest on Schedule A (Form 1040) if she itemizes. She cannot deduct the balance of the fire insurance because it is a personal expense.

Eileen bought this house in 1984 for $35,000. Her property tax was based on assessed values of $10,000 for the land and $25,000 for the house. Before changing it to rental property, Eileen added several improvements to the house. She figures her adjusted basis as follows:

Improvements	**Cost**
House	$25,000
Remodeled kitchen	4,200
Recreation room	5,800
New roof	1,600
Patio and deck	2,400
Adjusted basis	$39,000

On February 1, when Eileen changed her house to rental property, the property had a fair market value of $152,000. Of this amount, $35,000 was for the land and $117,000 was for the house.

Because Eileen's adjusted basis is less than the fair market value on the date of the change, Eileen uses $39,000 as her basis for depreciation.

As specified for residential rental property, Eileen must use the straight line method of depreciation over the GDS or ADS recovery period. She chooses the GDS recovery period of 27.5 years.

She uses Table 2-2d to find her depreciation percentage. Since she placed the property in service in February, the percentage is 3.182%.

On April 1, Eileen bought a new dishwasher for the rental property at a cost of $425. The dishwasher is personal property used in a rental real estate activity, which has a 5-year recovery period. She uses Table 2-2a to find the percentage for Year 1 under "Half-year convention" (20%) to figure her depreciation deduction.

On May 1, Eileen paid $4,000 to have a furnace installed in the house. The furnace is residential rental property. Because she placed the property in service in May, the percentage from Table 2-2d is 2.273%.

Eileen figures her net rental income or loss for the house as follows:

Total rental income received ($750 × 11)		$8,250
Minus: Expenses		
Mortgage interest ($1,800 × 11/12)	$1,650	
Fire insurance ($100 × 11/12)	92	
Miscellaneous repairs	297	
Real estate taxes ($1,200 × 11/12)	1,100	
Total expenses		3,139
Balance		$5,111
Minus: Depreciation		
House ($39,000 × .03182)	$1,241	
Dishwasher ($425 × .20)	85	
Furnace ($4,000 × .02273)	91	
Total depreciation		1,417
Net rental income for house		$3,694

Eileen uses Schedule E, Part I, to report her rental income and expenses. She enters her income, expenses, and depreciation for the house in the column for Property A. Since all property was placed in service this year, Eileen must use Form 4562 to figure the depreciation. See the Instructions for Form 4562 for more information on preparing the form.

5. Personal Use of Dwelling Unit (Including Vacation Home)

If you have any personal use of a dwelling unit (including a vacation home) that you rent, you must divide your expenses between rental use and personal use. In general, your rental expenses will be no more than your total expenses multiplied by a fraction; the denominator of which is the total number of days the dwelling unit is used and the numerator of which is the total number of days actually rented at a fair rental price. Only your rental expenses may deducted on Schedule E (Form 1040). Some of your personal expenses may be deductible if you itemize your deductions on Schedule A (Form 1040).

You must also determine if the dwelling unit is considered a home. The amount of rental expenses that you can deduct may be limited if the dwelling unit is considered a home. Whether a dwelling unit is considered a home depends on how many days during the year are considered to be days of personal use. There is a special rule if you used the dwelling unit as a home and you rented it for less than 15 days during the year.

Dwelling unit. A dwelling unit includes a house, apartment, condominium, mobile home, boat, vacation home, or similar property. It also includes all structures or other property belonging to the dwelling unit. A dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities.

A dwelling unit does not include property (or part of the property) used solely as a hotel, motel, inn, or similar establishment. Property is used solely as a hotel, motel, inn, or similar establishment if it is regularly available for occupancy by paying customers and is not used by an owner as a home during the year.

Example. You rent a room in your home that is always available for short-term occupancy by paying customers. You do not use the room yourself and you allow only paying customers to use the room. This room is used solely as a hotel, motel, inn, or similar establishment and is not a dwelling unit.

Dividing Expenses

If you use a dwelling unit for both rental and personal purposes, divide your expenses between the rental use and the personal use based on the number of days used for each purpose.

When dividing your expenses, follow these rules.

- Any day that the unit is rented at a fair rental price is a day of rental use even if you used the unit for personal purposes that day. (This rule does not apply when determining whether you used the unit as a home.)
- Any day that the unit is available for rent but not actually rented is not a day of rental use.

Fair rental price. A fair rental price for your property generally is the amount of rent that a person who is not related to you would be willing to pay. The rent you charge is not a fair rental price if it is substantially less than the rents charged for other properties that are similar to your property in your area.

Ask yourself the following questions when comparing another property with yours.

- Is it used for the same purpose?
- Is it approximately the same size?
- Is it in approximately the same condition?
- Does it have similar furnishings?
- Is it in a similar location?

If any of the answers are no, the properties probably are not similar.

Example. Your beach cottage was available for rent from June 1 through August 31 (92 days). Except for the first week in August (7 days), when you were unable to find a renter, you rented the cottage at a fair rental price during that time. The person who rented the cottage for July allowed you to use it over the weekend (2 days) without any reduction in or refund of rent. Your family also used the cottage during the last 2 weeks of May (14 days). The cottage was not used at all before May 17 or after August 31.

You figure the part of the cottage expenses to treat as rental expenses as follows.

- The cottage was used for rental a total of 85 days (92 – 7). The days it was available for rent but not rented (7 days) are not days of rental use. The July weekend (2 days) you used it is rental use because you received a fair rental price for the weekend.
- You used the cottage for personal purposes for 14 days (the last 2 weeks in May).
- The total use of the cottage was 99 days (14 days personal use + 85 days rental use).
- Your rental expenses are 85/99 (86%) of the cottage expenses.

Note. When determining whether you used the cottage as a home, the July weekend (2 days) you used it is considered personal use even though you received a fair rental price for the weekend. Therefore, you had 16 days of personal use and 83 days of rental use for this purpose. Because you used the cottage for personal purposes more than 14 days and more than 10% of the days of rental use (8 days), you used it as a home. If you have a net loss, you may not be able to deduct all of the rental expenses. See *Dwelling Unit Used as a Home*, next.

Dwelling Unit Used as a Home

If you use a dwelling unit for both rental and personal purposes, the tax treatment of the rental expenses you figured earlier under *Dividing Expenses* and rental income depends on whether you are considered to be using the dwelling unit as a home.

You use a dwelling unit as a home during the tax year if you use it for personal purposes more than the greater of:

1. 14 days, or
2. 10% of the total days it is rented to others at a fair rental price.

See *What Is a day of personal use*, later.

If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price (discussed earlier), do not count that day as a day of rental use in applying (2) above. Instead, count it as a day of personal use in applying both (1) and (2) above.

What is a day of personal use? A day of personal use of a dwelling unit is any day that the unit is used by any of the following persons.

1. You or any other person who owns an interest in it, unless you rent it to another owner as his or her main home under a shared equity financing agreement (defined later). However, see *Days used as a main home before or after renting*, later.
2. A member of your family or a member of the family of any other person who owns an interest in it, unless the family member uses the dwelling unit as his or her main home and pays a fair rental price. Family includes only your spouse, brothers and sisters, half-brothers and half-sisters, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
3. Anyone under an arrangement that lets you use some other dwelling unit.
4. Anyone at less than a fair rental price.

Main home. If the other person or member of the family in (1) or (2) above has more than one home, his or her main home is ordinarily the one he or she lived in most of the time.

Shared equity financing agreement. This is an agreement under which two or more persons acquire undivided interests for more than 50 years in an entire dwelling unit, including the land, and one or more of the co-owners is entitled to occupy the unit as his or her main home upon payment of rent to the other co-owner or owners.

Donation of use of the property. You use a dwelling unit for personal purposes if:

- You donate the use of the unit to a charitable organization,
- The organization sells the use of the unit at a fund-raising event, and
- The “purchaser” uses the unit.

Examples. The following examples show how to determine if you have days of personal use.

Example 1. You and your neighbor are co-owners of a condominium at the beach. Last year, you rented the unit to vacationers whenever possible. The unit was not used as a main home by anyone. Your neighbor used the unit for 2 weeks last year; you did not use it at all.

Because your neighbor has an interest in the unit, both of you are considered to have used the unit for personal purposes during those 2 weeks.

Example 2. You and your neighbors are co-owners of a house under a shared equity financing agreement. Your neighbors live in the house and pay you a fair rental price.

Even though your neighbors have an interest in the house, the days your neighbors live there are not counted as days of personal use by you. This is because your neighbors rent the house as their main home under a shared equity financing agreement.

Example 3. You own a rental property that you rent to your son. Your son does not own any interest in this property. He uses it as his main home and pays you a fair rental price.

Your son's use of the property is not personal use by you because your son is using it as his main home, he owns no interest in the property, and he is paying you a fair rental price.

Example 4. You rent your beach house to Rosa. Rosa rents her cabin in the mountains to you. You each pay a fair rental price.

You are using your beach house for personal purposes on the days that Rosa uses it because your house is used by Rosa under an arrangement that allows you to use her cabin.

Example 5. You rent an apartment to your mother at less than a fair rental price. You are using the apartment for personal purposes on the days that your mother rents it because you rent it for less than a fair rental price.

Days used for repairs and maintenance. Any day that you spend working substantially full time repairing and maintaining (not improving) your property is not counted as a day of personal use. Do not count such a day as a day of personal use even if family members use the property for recreational purposes on the same day.

Example. Corey owns a cabin in the mountains that he rents for most of the year. He spends a week at the cabin with family members. Corey works on maintenance of the cabin 3 or 4 hours each day during the week and spends the rest of the time fishing, hiking, and relaxing. Corey's family members, however, work substantially full time on the cabin each day during the week. The main purpose of being at the cabin that week is to do maintenance work. Therefore, the use of the cabin during the week by Corey and his family will not be considered personal use by Corey.

Days used as a main home before or after renting. For purposes of determining whether a dwelling unit was used as a home, you may not have to count days you used the property as your main home before or after renting it or offering it for rent as days of personal use. Do not count them as days of personal use if:

- You rented or tried to rent the property for 12 or more consecutive months.
- You rented or tried to rent the property for a period of less than 12 consecutive months and the period ended because you sold or exchanged the property.

However, this special rule does not apply when dividing expenses between rental and personal use. See *Property Changed to Rental Use* in chapter 4.

Example 1. On February 28, 2011, you moved out of the house you had lived in for 6 years because you accepted a job in another town. You rented your house at a fair rental price from March 15, 2011, to May 14, 2012 (14 months). On June 1, 2012, you moved back into your old house.

The days you used the house as your main home from January 1 to February 28, 2011, and from June 1 to December 31, 2012, are not counted as days of personal use. Therefore, you would use the rules in chapter 1 when figuring your rental income and expenses.

Example 2. On January 31, you moved out of the condominium where you had lived for 3 years. You offered it for rent at a fair rental price beginning on February 1. You were unable to rent it until April.

The days you used the condominium as your main home from January 1 to January 31 are not counted as days of personal use when determining whether you used it as a home.

Examples. The following examples show how to determine whether you used your rental property as a home.

Example 1. You converted the basement of your home into an apartment with a bedroom, a bathroom, and a small kitchen. You rented the basement apartment at a fair rental price to college students during the regular school year. You rented to them on a 9-month lease (273 days). You figured 10% of the total days rented to others at a fair rental price is 27 days.

During June (30 days), your brothers stayed with you and lived in the basement apartment rent free.

Your basement apartment was used as a home because you used it for personal purposes for 30 days. Rent-free use by your brothers is considered personal use. Your personal use (30 days) is more than the greater of 14 days or 10% of the total days it was rented (27 days).

Example 2. You rented the guest bedroom in your home at a fair rental price during the local college's homecoming, commencement, and football weekends (a total of 27 days). Your sister-in-law stayed in the room, rent free, for the last 3 weeks (21 days) in July. You figured 10% of the total days rented to others at a fair rental price is 3 days.

The room was used as a home because you used it for personal purposes for 21 days. That is more than the greater of 14 days or 10% of the 27 days it was rented (3 days).

Example 3. You own a condominium apartment in a resort area. You rented it at a fair rental price for a total of 170 days during the year. For 12 of these days, the tenant was not able to use the apartment and allowed you to use it even though you did not refund any of the rent. Your family actually used the apartment for 10 of those days. Therefore, the apartment is treated as having been rented for 160 (170 – 10) days. You figured 10% of the total days rented to others at a fair rental price is 16 days. Your family also used the apartment for 7 other days during the year.

You used the apartment as a home because you used it for personal purposes for 17 days. That is more than the greater of 14 days or 10% of the 160 days it was rented (16 days).

Minimal rental use. If you use the dwelling unit as a home and you rent it less than 15 days during the year, that period is not treated as rental activity. See *Used as a home but rented less than 15 days*, later, for more information.

Limit on deductions. Renting a dwelling unit that is considered a home is not a passive activity. Instead, if your rental expenses are more than your rental income, some or all of the excess expenses cannot be used to offset income from other sources. The excess expenses that cannot be used to offset income from other sources are carried forward to the next year and treated as rental expenses for the same property. Any expenses carried forward to the next year will be subject to any limits that apply for that year. This limitation will apply to expenses carried forward to another year even if you do not use the property as your home for that subsequent year.

To figure your deductible rental expenses for this year and any carryover to next year, use Worksheet 5-1.

Reporting Income and Deductions

Property not used for personal purposes. If you do not use a dwelling unit for personal purposes, see chapter 3 for how to report your rental income and expenses.

Property used personal purposes. If you do use a dwelling unit for personal purposes, then how you report your rental income and expenses depends on whether you used the dwelling unit as a home.

Not used as a home. If you use a dwelling unit for personal purposes, but not as a home, report all the rental income in your income. Since you used the dwelling unit for personal purposes, you must divide your expenses between the rental use and the personal use as described earlier in this chapter under *Dividing Expenses*. The expenses for personal use are not deductible as rental expenses.

Your deductible rental expenses can be more than your gross rental income; however, see *Limits on Rental Losses* in chapter 3.

Used as a home but rented less than 15 days. If you use a dwelling unit as a home and you rent it less than 15 days during the year, its primary function is not considered to be rental and it should not be reported on Schedule E (Form 1040). You are not required to report the rental income and rental expenses from this activity. The expenses, including qualified mortgage interest, property taxes, and any qualified casualty loss will be reported as normally allowed on Schedule A (Form 1040). See the Instructions for Schedule A (Form 1040) for more information on deducting these expenses.

Used as a home and rented 15 days or more. If you use a dwelling unit as a home and rent it 15 days or more during the year, include all your rental income in your income. Since you used the dwelling unit for personal purposes, you must divide your expenses between the rental use and the personal use as described earlier in this chapter under *Dividing Expenses*. The expenses for personal use are not deductible as rental expenses.

If you had a net profit from renting the dwelling unit for the year (that is, if your rental income is more than the total of your rental expenses, including depreciation), deduct all of your rental expenses. You do not need to use Worksheet 5-1.

However, if you had a net loss from renting the dwelling unit for the year, your deduction for certain rental expenses is limited. To figure your deductible rental expenses and any carryover to next year, use Worksheet 5-1.

Worksheet 5-1. **Worksheet for Figuring Rental Deductions for a Dwelling Unit Used as a Home**

Keep for Your Records

Use this worksheet only if you answer “yes” to all of the following questions.

- Did you use the dwelling unit as a home this year? (See *Dwelling Unit Used as a Home*.)
- Did you rent the dwelling unit at a fair rental price 15 days or more this year?
- Is the total of your rental expenses and depreciation more than your rental income?

PART I. Rental Use Percentage

A.	Total days available for rent at fair rental price	**A.** ______	
B.	Total days available for rent (line A) but not rented	**B.** ______	
C.	**Total days of rental use.** Subtract line B from line A	**C.** ______	
D.	**Total days of personal use** (including days rented at less than fair rental price)	**D.** ______	
E.	**Total days of rental and personal use.** Add lines C and D	**E.** ______	
F.	**Percentage of expenses allowed for rental.** Divide line C by line E		**F.** ___ . ______

PART II. Allowable Rental Expenses

1.	Enter rents received		**1.** ______
2a.	Enter the rental portion of deductible home mortgage interest and qualified mortgage insurance premiums (see instructions)	**2a.** ______	
b.	Enter the rental portion of real estate taxes	**b.** ______	
c.	Enter the rental portion of deductible casualty and theft losses (see instructions)	**c.** ______	
d.	Enter direct rental expenses (see instructions)	**d.** ______	
e.	**Fully deductible rental expenses.** Add lines 2a–2d. Enter here and on the appropriate lines on Schedule E (see instructions)		**2e.** ______
3.	Subtract line 2e from line 1. If zero or less, enter -0-		**3.** ______
4a.	Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities)	**4a.** ______	
b.	Enter the rental portion of excess mortgage interest and qualified mortgage insurance premiums (see instructions)	**b.** ______	
c.	Carryover of operating expenses from 2011 worksheet	**c.** ______	
d.	Add lines 4a–4c	**d.** ______	
e.	**Allowable expenses.** Enter the **smaller** of line 3 or line 4d (see instructions)		**4e.** ______
5.	Subtract line 4e from line 3. If zero or less, enter -0-		**5.** ______
6a.	Enter the rental portion of excess casualty and theft losses (see instructions)	**6a.** ______	
b.	Enter the rental portion of depreciation of the dwelling unit	**b.** ______	
c.	Carryover of excess casualty losses and depreciation from 2011 worksheet	**c.** ______	
d.	Add lines 6a–6c	**d.** ______	
e.	**Allowable excess casualty and theft losses and depreciation.** Enter the **smaller** of line 5 or line 6d (see instructions)		**6e.** ______

PART III. Carryover of Unallowed Expenses to Next Year

7a.	**Operating expenses to be carried over to next year.** Subtract line 4e from line 4d		**7a.** ______
b.	**Excess casualty and theft losses and depreciation to be carried over to next year.** Subtract line 6e from line 6d		**b.** ______

Caution. Use the percentage determined in Part I, line F, to figure the rental portions to enter on lines 2a–2c, 4a–4b, and 6a–6b of Part II.

Line 2a. Figure the mortgage interest on the dwelling unit that you could deduct on Schedule A (as if you were itemizing your deductions) if you had not rented the unit. Do not include interest on a loan that did not benefit the dwelling unit. For example, do not include interest on a home equity loan used to pay off credit cards or other personal loans, buy a car, or pay college tuition. Include interest on a loan used to buy, build, or improve the dwelling unit, or to refinance such a loan. Include the rental portion of this interest in the total you enter on line 2a of the worksheet.

Figure the qualified mortgage insurance premiums on the dwelling unit that you could deduct on line 13 of Schedule A, if you had not rented the unit. See the Schedule A instructions. However, figure your adjusted gross income (Form 1040, line 38) without your rental income and expenses from the dwelling unit. See *Line 4b* to deduct the part of the qualified mortgage insurance premiums not allowed because of the adjusted gross income limit. Include the rental portion of the amount from Schedule A, line 13, in the total you enter on line 2a of the worksheet.

Note. Do not file this Schedule A or use it to figure the amount to deduct on line 13 of that schedule. Instead, figure the personal portion on a separate Schedule A. If you have deducted mortgage interest or qualified mortgage insurance premiums on the dwelling unit on other forms, such as Schedule C or F, remember to reduce your Schedule A deduction by that amount.

Line 2c. Figure the casualty and theft losses related to the dwelling unit that you could deduct on Schedule A if you had not rented the dwelling unit. To do this, complete Section A of Form 4684, Casualties and Thefts, treating the losses as personal losses. If any of the loss is due to a federally declared disaster, see the Instructions for Form 4684. On Form 4684, line 17, enter 10% of your adjusted gross income figured without your rental income and expenses from the dwelling unit. Enter the rental portion of the result from Form 4684, line 18, on line 2c of this worksheet.

Note. Do not file this Form 4684 or use it to figure your personal losses on Schedule A. Instead, figure the personal portion on a separate Form 4684.

Line 2d. Enter the total of your rental expenses that are directly related only to the rental activity. These include interest on loans used for rental activities other than to buy, build, or improve the dwelling unit. Also include rental agency fees, advertising, office supplies, and depreciation on office equipment used in your rental activity.

Line 2e. You can deduct the amounts on lines 2a, 2b, 2c, and 2d as rental expenses on Schedule E even if your rental expenses are more than your rental income. Enter the amounts on lines 2a, 2b, 2c, and 2d on the appropriate lines of Schedule E.

Line 4b. On line 2a, you entered the rental portion of the mortgage interest or qualified mortgage insurance premiums you could deduct on Schedule A if you had not rented the dwelling unit. If you had additional mortgage interest and qualified mortgage insurance premiums that would not be deductible on Schedule A because of limits imposed on them, enter on line 4b of this worksheet the rental portion of those excess amounts. Do not include interest on a loan that did not benefit the dwelling unit (as explained in the line 2a instructions).

Line 4e. You can deduct the amounts on lines 4a, 4b, and 4c as rental expenses on Schedule E only to the extent they are not more than the amount on line 4e.*

Line 6a. To find the rental portion of excess casualty and theft losses, use the Form 4684 you prepared for line 2c of this worksheet.

A. Enter the amount from Form 4684, line 10	________
B. Enter the rental portion of line A	________
C. Enter the amount from line 2c of this worksheet	________
D. Subtract line C from line B. Enter the result here and on line 6a of this worksheet	________

Line 6e. You can deduct the amounts on lines 6a, 6b, and 6c as rental expenses on Schedule E only to the extent they are not more than the amount on line 6e.*

***Allocating the limited deduction.** If you cannot deduct all of the amount on line 4d or 6d this year, you can allocate the allowable deduction in any way you wish among the expenses included on line 4d or 6d. Enter the amount you allocate to each expense on the appropriate line of Schedule E, Part I.

6. How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Free help with your tax return. Free help in preparing your return is available nationwide from IRS-certified volunteers. The Volunteer Income Tax Assistance (VITA) program is designed to help low-moderate income, elderly, disabled, and limited English proficient taxpayers. The Tax Counseling for the Elderly (TCE) program is designed to assist taxpayers age 60 and older with their tax returns. Most VITA and TCE sites offer free electronic filing and all volunteers will let you know about credits and deductions you may be entitled to claim. Some VITA and TCE sites provide taxpayers the opportunity to prepare their return with the assistance of an IRS-certified volunteer. To find the nearest VITA or TCE site, visit IRS.gov or call 1-800-906-9887 or 1-800-829-1040.

As part of the TCE program, AARP offers the Tax-Aide counseling program. To find the nearest AARP Tax-Aide site, visit AARP's website at www.aarp.org/money/taxaide or call 1-888-227-7669.

For more information on these programs, go to IRS.gov and enter “VITA” in the search box.

Internet. You can access the IRS website at IRS.gov 24 hours a day, 7 days a week to:

- *E-file* your return. Find out about commercial tax preparation and *e-file* services available free to eligible taxpayers.
- Check the status of your 2012 refund. Go to IRS.gov and click on *Where's My Refund*. Information about your return will generally be available within 24 hours after the IRS receives your e-filed return, or 4 weeks after you mail your paper return. If you filed Form 8379 with your return, wait 14 weeks (11 weeks if you filed electronically). Have your 2012 tax return handy so you can provide your social security number, your filing status, and the exact whole dollar amount of your refund.
- *Where's My Refund?* has a new look this year! The tool will include a tracker that displays progress through three stages: (1) return received, (2) refund approved, and (3) refund sent. *Where's My Refund?* will provide an actual personalized refund date as soon as the IRS processes your tax return and approves your refund. So in a change from previous filing seasons, you won't get an estimated refund date right away. *Where's My Refund?* includes information for the most recent return filed in

the current year and does not include information about amended returns.
- You can obtain a free transcript online at IRS.gov by clicking on *Order a Return or Account Transcript* under "Tools." For a transcript by phone, call 1-800-908-9946 and follow the prompts in the recorded message. You will be prompted to provide your SSN or Individual Taxpayer Identification Number (ITIN), date of birth, street address and ZIP code.
- Download forms, including talking tax forms, instructions, and publications.
- Order IRS products.
- Research your tax questions.
- Search publications by topic or keyword.
- Use the Internal Revenue Code, regulations, or other official guidance.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Figure your withholding allowances using the IRS Withholding Calculator at *www.irs.gov/individuals*.
- Determine if Form 6251 (Alternative Minimum Tax— Individuals), must be filed by using our Alternative Minimum Tax (AMT) Assistant available at IRS.gov by typing *Alternative Minimum Tax Assistant* in the search box.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.

Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call 1-800-TAX-FORM (1-800-829-3676) to order current-year forms, instructions, and publications, and prior-year forms and instructions (limited to 5 years). You should receive your order within 10 days.
- *Asking tax questions.* Call the IRS with your tax questions at 1-800-829-1040.
- *Solving problems.* You can get face-to-face help solving tax problems most business days in IRS Taxpayer Assistance Centers (TAC). An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to *www.irs.gov/localcontacts* or look in the phone book under *United States Government, Internal Revenue Service*.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications. The TTY/TDD telephone number is for individuals who are deaf, hard of hearing, or have a speech disability. These individuals can also access the IRS through relay services such as the Federal Relay Service at *www.gsa.gov/fedrelay*.
- *TeleTax topics.* Call 1-800-829-4477 to listen to pre-recorded messages covering various tax topics.
- *Checking the status of your 2012 refund.* To check the status of your 2012 refund, call 1-800-829-1954 or 1-800-829-4477 (automated *Where's My Refund?* information 24 hours a day, 7 days a week). Information about your return will generally be available within 24 hours after the IRS receives your e-filed return, or 4 weeks after you mail your paper return. If you filed Form 8379 with your return, wait 14 weeks (11 weeks if you filed electronically). Have your 2012 tax return handy so you can provide your social security number, your filing status, and the exact whole dollar amount of your refund. *Where's My Refund?* will provide an actual personalized refund date as soon as the IRS processes your tax return and approves your refund. *Where's My Refund?* includes information for the most recent return filed in the current year and does not include information about amended returns.

Evaluating the quality of our telephone services. To ensure IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to listen in on or record random telephone calls. Another is to ask some callers to complete a short survey at the end of the call.

Walk-in. Some products and services are available on a walk-in basis.

- *Products.* You can walk in to some post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, and city and county government offices have a collection of products available to photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- *Services.* You can walk in to your local TAC most business days for personal, face-to-face tax help. An employee can explain IRS letters, request adjustments to your tax account, or help you set up a payment plan. If you need to resolve a tax problem, have questions about how the tax law applies to your individual tax return, or you are more comfortable talking with someone in person, visit your local TAC where you can talk with an IRS representative face-to-face. No appointment is necessary—just walk in. Before visiting, check *www.irs.gov/localcontacts* for hours of operation and services provided. If you have an ongoing, complex tax account problem or a special need, such as a disability, an appointment can be requested by calling your local TAC. You can leave a message and a representative will call you back within 2 business days. All other issues will be handled without an appointment. To call your local TAC, go to *www.irs.gov/localcontacts* or look in the phone book under *United States Government, Internal Revenue Service*.

Mail. You can send your order for forms, instructions, and publications to the address below. You should receive a response within 10 days after your request is received.

Internal Revenue Service
1201 N. Mitsubishi Motorway
Bloomington, IL 61705-6613

Taxpayer Advocate Service. The Taxpayer Advocate Service (TAS) is your voice at the IRS. Its job is to ensure that every taxpayer is treated fairly, and that you know and understand your rights. TAS offers free help to guide you through the often-confusing process of resolving tax problems that you haven't been able to solve on your own. Remember, the worst thing you can do is nothing at all.

TAS can help if you can't resolve your problem with the IRS and:
- Your problem is causing financial difficulties for you, your family, or your business.
- You face (or your business is facing) an immediate threat of adverse action.
- You have tried repeatedly to contact the IRS but no one has responded, or the IRS has not responded to you by the date promised.

If you qualify for help, they will do everything they can to get your problem resolved. You will be assigned to one advocate who will be with you at every turn. TAS has offices in every state, the District of Columbia, and Puerto Rico. Although TAS is independent within the IRS, their advocates know how to work with the IRS to get your problems resolved. And its services are always free.

As a taxpayer, you have rights that the IRS must abide by in its dealings with you. The TAS tax toolkit at *www.TaxpayerAdvocate.irs.gov* can help you understand these rights.

If you think TAS might be able to help you, call your local advocate, whose number is in your phone book and on our website at *www.irs.gov/advocate*. You can also call the toll-free number at 1-877-777-4778. Deaf and hard of hearing individuals who have access to TTY/TDD equipment can call 1-800-829-4059. These individuals can also access the IRS through relay services such as the Federal Relay Service at *www.gsa.gov/fedrelay*.

TAS also handles large-scale or systemic problems that affect many taxpayers. If you know of one of these broad issues, please report it through the Systemic Advocacy Management System at *www.irs.gov/advocate*.

Low Income Taxpayer Clinics (LITCs). Low Income Taxpayer Clinics (LITCs) are independent from the IRS. Some clinics serve individuals whose income is below a certain level and who need to resolve a tax problem. These clinics provide professional representation before the IRS or in court on audits, appeals, tax collection disputes, and other issues for free or for a small fee. Some clinics can provide information about taxpayer rights and responsibilities in many different languages for individuals who speak English as a second language. For more information and to find a clinic near you, see the LITC page on *www.irs.gov/advocate* or

IRS Publication 4134, *Low Income Taxpayer Clinic List*. This publication is also available by calling 1-800-TAX-FORM (1-800-829-3676) or at your local IRS office.

Free tax services. Publication 910, IRS Guide to Free Tax Services, is your guide to IRS services and resources. Learn about free tax information from the IRS, including publications, services, and education and assistance programs. The publication also has an index of over 100 TeleTax topics (recorded tax information) you can listen to on the telephone. The majority of the information and services listed in this publication are available to you free of charge. If there is a fee associated with a resource or service, it is listed in the publication.

Accessible versions of IRS published products are available on request in a variety of alternative formats for people with disabilities.

DVD for tax products. You can order Publication 1796, IRS Tax Products DVD, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms, instructions, and publications.
- Tax Map: an electronic research tool and finding aid.
- Tax law frequently asked questions.
- Tax Topics from the IRS telephone response system.
- Internal Revenue Code—Title 26 of the U.S. Code.
- Links to other Internet-based tax research materials.
- Fill-in, print, and save features for most tax forms.
- Internal Revenue Bulletins.
- Toll-free and email technical support.
- Two releases during the year.
  – The first release will ship the beginning of January 2013.
  – The final release will ship the beginning of March 2013.

Purchase the DVD from National Technical Information Service (NTIS) at *www.irs.gov/cdorders* for $30 (no handling fee) or call 1-877-233-6767 toll free to buy the DVD for $30 (plus a $6 handling fee).

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To help us develop a more useful index, please let us know if you have ideas for index entries. See "Comments and Suggestions" in the "Introduction" for the ways you can reach us.