Publication 527
Cat. No. 15052W

Department of the Treasury
Internal Revenue Service

Residential Rental Property
(Including Rental of Vacation Homes)

For use in preparing
1995 Returns

Contents

Important Change for 1995

Caution. As this publication was being prepared for print, Congress was considering tax law changes that could affect your 1995 tax return and 1996 estimated taxes. These changes include:

- Capital gains and losses, and
- Sale of your home.

See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information on these changes will also be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

Important Reminder

Passive Activity Rules for Rental Activities. There are passive loss limits and at-risk rules that may affect the amount of rental loss you can claim on your return. However, rental activities in which you materially participate are not passive activities if you meet certain requirements. Losses from these activities are not limited by the passive activity rules. See *Limits on Rental Losses* in Chapter 1.

Introduction

Chapter 1 of this publication discusses rental income and expenses, including depreciation, and explains how to report them on your return. It also covers casualty losses on rental property and the passive activity limits and at-risk rules. Chapter 2 explains how to figure the gain or loss on the sale of rental property, and how to report it on your return.

This publication is designed for those who only rent out no more than a few residential dwelling units.

Ordering publications and forms. To order free publications and forms, call 1-800-TAX-FORM (**1-800-829-3676**). If you have access to TDD equipment, you can call 1–800–829–4059. See your tax package for the hours of operation. You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address.

If you have access to a personal computer and a modem, you can also get many forms and publications electronically. See *How To Get Forms and Publications* in your income tax package for details.

Asking tax questions. You can call the IRS with your tax questions Monday through Friday during regular business hours. Check your telephone book or your tax package for the local number or you can call **1–800–829–1040** (1–800–829–4059 for TDD users).

1.

Rental Activities

Topics

This chapter discusses:

- Rental income and expenses,
- The rental of vacation homes,
- The deduction for depreciation,
- How to figure a casualty loss on rental property,
- The limits on rental losses, and
- How to report rental income and expenses.

Useful Items

You may want to see:

Publication

- ☐ **334** Tax Guide for Small Business
- ☐ **463** Travel, Entertainment, and Gift Expenses
- ☐ **529** Miscellaneous Deductions
- ☐ **533** Self-Employment Tax
- ☐ **534** Depreciating Property Placed in Service Before 1987
- ☐ **535** Business Expenses
- ☐ **538** Accounting Periods and Methods
- ☐ **547** Nonbusiness Disasters, Casualties, and Thefts
- ☐ **550** Investment Income and Expenses
- ☐ **551** Basis of Assets
- ☐ **917** Business Use of a Car
- ☐ **925** Passive Activity and At-Risk Rules
- ☐ **946** How To Depreciate Property

Form (and Instructions)

- ☐ **4562** Depreciation and Amortization
- ☐ **4684** Casualties and Thefts
- ☐ **4797** Sales of Business Property
- ☐ **5213** Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit
- ☐ **6251** Alternative Minimum Tax—Individuals
- ☐ **8582** Passive Activity Loss Limitations
- ☐ **Schedule A** Itemized Deductions
- ☐ **Schedule C** Profit or Loss From Business
- ☐ **Schedule E** Supplemental Income and Loss

Rental Income

Rental income is any payment you receive for the use or occupation of property.

You generally must include in your gross income all amounts you receive as rent. In addition to amounts you receive as normal rent payments, there are other amounts that may be 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. You sign a 10–year lease to rent your property. In the first year, you receive $5,000 for the first year's rent and $5,000 as rent for the last year of the lease. You must include $10,000 in your income in the first year.

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 during any year you keep part or all of the security deposit 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.

Payment for 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 and these payments are in lieu of rent, then these payments are rental income. You must include them in your income. You can deduct the expenses if they are deductible rental expenses.

Example 1. The water and sewage bill for your rental property is mailed to the property. Under the terms of the lease, your tenant does not have to pay this bill. Your tenant pays the bill and deducts it from the normal rent payment.

Include in your rental income both the net amount of the rent payment and the amount the tenant paid for the utility bill. You can include the amount of the bill as a rental expense.

Example 2. While you are out of town, the furnace in your rental property stops working. Your tenant calls a plumber and pays for the necessary repairs. Your tenant deducts the plumbing bill from the rent payment.

Include in your rental income both the net amount of the rent payment and the amount the tenant paid for the plumbing repairs. You can include the cost of the repairs as a rental expense.

Property or services. If you receive property or services, instead of money, as rent, 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 in the absence of evidence to the contrary.

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

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

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

Rental of property also used as a home. If you rent property that you also use as your home and you rent it for less than 15 days during the tax year, do not include the rent you receive in your gross income. You cannot deduct rental expenses. However, you can deduct allowable interest, taxes, and casualty and theft losses as itemized deductions on Schedule A of Form 1040. See *Personal Use of Vacation Homes and Other Dwelling Units,* later.

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

Rental Expenses

This part discusses repairs and certain other expenses of renting property that you ordinarily can deduct from your gross rental income. It includes information on the expenses you may deduct if you rent a condominium or cooperative apartment, if you rent part of your property, or if you change your property to rental use. Depreciation, which you can also deduct from your gross rental income, is discussed later.

When to deduct. You generally deduct your rental expenses in the year you pay or incur them.

Vacant rental property. If you hold property for rental purposes, you may be able to deduct your ordinary and necessary expenses 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.

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.

Expenses for rental property sold. 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.

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 *Personal Use of Vacation Homes and Other Dwelling Units,* later.

Repairs and Improvements

You can deduct the cost of repairs that you make to your rental property. You cannot deduct the cost of improvements. You recover the costs of improvements by taking depreciation (explained later).

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.

Repairs. A repair keeps your property in good operating condition. It does not materially add to the value of your property or substantially prolong its life. Repainting your property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs.

If you make repairs as part of an extensive remodeling or restoration of your property, the whole job is an improvement.

Improvements. An improvement adds to the value of property, prolongs its useful life, or adapts it to new uses. Putting a recreation room in an unfinished basement, paneling a den, adding a bathroom or bedroom, putting decorative grillwork on a balcony, putting up a fence, putting in new plumbing or wiring, putting in new cabinets, putting on a new roof, and paving a driveway are examples of improvements.

If you make improvements to property before you begin renting it, add the cost of the improvement to the basis of the property. Basis is explained later under *Modified Accelerated Cost Recovery System (MACRS).*

Other Expenses

Other expenses you can deduct from your gross rental income include advertising, janitor and maid service, utilities, fire and liability insurance, taxes, interest, commissions for the collection of rent, ordinary and necessary travel and transportation, and other expenses discussed below.

Salaries and wages. You can deduct reasonable salaries and wages you pay to your employees. You can also deduct bonuses you pay to your employees if, when added to their regular salaries or wages, the total is not more than reasonable pay.

You can deduct reasonable wages you pay to your dependent child if your child is your bona fide employee. However, you cannot deduct the cost of meals and lodging for the child.

Rental payments for 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.

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.

Insurance premiums. You can deduct insurance premiums you pay for rental purposes. If you pay the premiums for more than one year in advance, each year you can deduct the part of the premium payment that will apply to that year. You continue to deduct your premium in this manner for as long as the insurance is in effect. You cannot deduct the total premium in the year you pay it.

Local benefit taxes. Generally, you cannot deduct charges for local benefits that increase the value of your property, such as for putting in streets, sidewalks, or water and sewer systems. These charges are nondepreciable capital expenditures. You must add them to the basis of your property. You can deduct local benefit taxes if they are for maintaining, repairing, or paying interest charges for the benefits.

Interest expense. You can deduct mortgage interest you pay on your rental property. Chapter 8 of Publication 535, *Business Expenses*, explains mortgage interest in detail.

Points. The term ''points'' is often used to describe some of the charges paid by a borrower when the borrower takes out a loan or a mortgage. These charges are also called loan origination fees, maximum loan charges, or premium charges. If any of these charges is solely for the use of money, it is interest.

These points are interest paid in advance and you cannot deduct it all in one tax year. Instead, you deduct part of the interest each tax year during the period of the loan, unless the interest must be capitalized.

To figure how much to deduct each year, divide the part of the loan period falling within your tax year by the total loan period. Then multiply this answer by the amount of prepaid interest. For example, if you take out a 10–year loan on October 1, 1995, 3 months of the loan period fall in your 1995 tax year. You can deduct 3/120 of the payment you made for the points on your 1995 tax return. You can deduct 12/120 of the prepaid interest on your 1996 tax return.

Expenses paid to obtain a mortgage. Certain expenses you pay to obtain a mortgage cannot be deducted as interest. These expenses, which include mortgage commissions, abstract fees, and recording fees, are capital expenses. If the property mortgaged is business or income-producing property, you can amortize the costs over the life of the mortgage.

Charges for services. You can deduct charges you pay for services provided for your rental property, such as water, sewer, and trash collection.

Travel expenses. You can deduct the ordinary and necessary costs of traveling away from home if the primary purpose of the trip was to collect rental income or to manage, conserve, or maintain your rental property. You must properly allocate between rental and nonrental activities. For information on travel expenses, see Publication 463.

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

Local transportation expenses. You can 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.

Generally, if you use your personal car, pickup truck, or light van for rental activities, you can deduct local transportation expenses using one of two methods: actual expenses or the standard mileage rate. The standard mileage rate for 1995 is ***30 cents a mile*** for all business miles.

To deduct car expenses under either method, you must follow certain rules. These rules are discussed in Publication 917.

In addition, you must complete Part V of Form 4562, and attach it to your tax return.

Tax return preparation. You can deduct, as a rental expense, the part of tax return preparation fees you paid to prepare Part I of Schedule E (income or loss from rentals or royalties). You can also deduct, as a rental expense, any expense you paid to resolve a tax underpayment related to your rental activities. On your 1995 Schedule E (Form 1040), you can deduct fees paid in 1995 to prepare Part I of your 1994 Schedule E (Form 1040).

Part interest in property. If you own a part interest in rental property, you can deduct your part of the expenses that you paid.

Renting Part of Your 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 a part of some expenses, such as mortgage interest and property taxes, as a rental expense. You can deduct the other part, subject to certain limitations, only if you itemize your deductions. You can also deduct as a rental expense a part of other expenses that normally are nondeductible personal expenses, such as expenses for electricity, a second telephone line, or painting the outside of your house.

You do not have to divide the expenses that belong only to the rental part of your property. 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. You can deduct depreciation, discussed later, on the part of the property used for rental purposes as well as on the furniture and equipment you use for these 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. The two most common methods are one based on the number of rooms in your home and one based on 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 and you cannot deduct it.

Allocating costs. Dividing certain expenses by the number of people involved may be the proper method to use. For example, if you provide meals to tenants, the most accurate method of dividing food costs between rental and personal expenses may be one based on the total number of people eating the food. Or, if you rent an apartment and your tenants have unrestricted use of your second telephone line, dividing the monthly charge for that line by the number of people using it may be the best method to use.

Limits on Deductions for Rental Expenses

If you rent out part of your property and you also use that or another part of the same property for personal purposes during the year, your deductions for rental expenses for the property may be limited. See *Personal Use of Vacation Homes and Other Dwelling Units* later for more information.

Condominiums and Cooperatives

If you rent out a condominium or a cooperative apartment, some special rules apply to you even though you receive the same tax treatment as other owners of rental property. Condominiums are treated differently from cooperatives.

Condominium

If you own a condominium, you own outright a dwelling unit in a multi-unit building. You also own a share of the common elements of the structure, 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.

If you rent your condominium to others, you can deduct depreciation, repairs, upkeep, and other expenses, such as interest and taxes, and assessments for the care of the common parts of the structure. You cannot deduct special assessments you pay to a condominium management corporation for improvements. But you may be able to recover your share of the cost of any improvement by taking depreciation.

Cooperative

If you have a cooperative apartment that you rent to others, you can usually deduct, as a rental expense, all the maintenance fees you pay to the cooperative housing corporation. However, you cannot deduct a payment earmarked for a capital asset or improvement, or otherwise charged to the corporation's capital account. 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. You must add the payment to the basis of your stock in the corporation.

Treat as a capital cost the amount you were assessed for capital items, but not more than your payments to the corporation that 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 way.

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.

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. The depreciation deduction allowed for cooperative apartments is discussed later.

If you use your cooperative apartment for both personal and rental purposes, see *How to Divide Expenses*, earlier.

Property Changed to Rental Use

If you change your home, apartment, or other property, or a part of it, to rental use at any time other than at the beginning of your tax year, you must divide yearly expenses, such as depreciation, 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 any property or part of property held for personal use. However, you can deduct the allowable part of the interest and tax expenses for personal use as an itemized deduction on Schedule A (Form 1040).

Example. You moved from your home in May 1995 and started renting it out on June 1, 1995. You can deduct as rental expenses seven-twelfths of your yearly expenses, such as taxes and insurance.

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

Information on depreciation. See *Personal home changed to rental use*, later under *Modified Accelerated Cost Recovery System (MACRS)* for information about how to figure your deduction for depreciation.

Other limits. If you change property to rental use and later use part or all of it for personal purposes, there are other rules that apply to how much of your rental expenses you can deduct. These rules are explained later under *Personal Use of Vacation Homes and Other Dwelling Units*.

Not Rented For Profit

If your rental of a property is an activity that you do not carry on to make a profit, you can deduct your rental expenses only up to the amount of your rental income. You cannot carry forward your rental expenses that are more than your rental income. For more information about the rules for an activity not engaged in for profit, see Chapter 1 of Publication 535.

Where to report. Report your rental income on line 21, Form 1040. Deduct your mortgage interest, real estate taxes, and casualty losses on the appropriate lines of Schedule A (Form 1040).

You claim your other expenses, subject to the rules explained in Chapter 1 of Publication 535, as miscellaneous itemized deductions on line 22 of Schedule A. You can deduct these expenses only if they, together with certain other miscellaneous itemized deductions, total more than 2% of your adjusted gross income. For more information about miscellaneous deductions, see Publication 529.

Postponing decision. If your rental income is more than your rental expenses for at least 3 years out of a period of 5 consecutive years, your rental use of the dwelling unit is presumed to be for a profit. You may choose to postpone the decision of whether the rental is for profit by filing **Form 5213**, *Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit*.

See Publication 535 for more information.

Personal Use of Vacation Homes and Other Dwelling Units

If you have any personal use of a vacation home or other dwelling unit that you rent out, you must divide your expenses between rental use and personal use. See *Figuring Days of Personal Use* and *How to Divide Expenses*, later.

If you use the dwelling unit as a home and you rent it for fewer than 15 days during the year, do not include any of the rent in your income and do not deduct any of the rental expenses. If you rent out the dwelling unit for 15 or more days, you must include the rent in your income and, if you have a net loss, you may not be able to deduct all of the rental expenses. See *How to Figure Your Income and Deductions*, later.

Dwelling unit. The rules in this section apply to vacation homes and other dwelling units. A dwelling unit includes a house, apartment, condominium, mobile home, boat, or similar property. A dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities. A dwelling unit does not include 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 out 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. The room is used solely as a hotel, motel, inn, or similar establishment and is not a dwelling unit.

Dwelling Unit Used as 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 *Figuring Days of Personal Use* later.

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

Example. You own a cottage at the shore. You rent it out at a fair rental price from June 1 through August 31, a total of 92 days. The tenant who rented the cottage for the month of July was unable to use it from July 4 through July 8. The tenant allowed you to use the cottage for those 5 days. The tenant did not ask for a refund of or a reduction in the rent. Your family used the cottage for 3 of those days.

To determine the number of days the cottage was rented at a fair rental price, do not count those 3 days you used it for personal purposes. The cottage was rented at a fair rental price for 89 days (92 – 3).

Fair rental price. A fair rental price for your property generally is an amount 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.

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.

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 rent the apartment at a fair rental price to college students during the regular school year. You rent to them on a 9-month (273 days) lease.

During the summer, your brothers stay with you for a month (30 days) and live in the apartment rent free.

Your basement apartment is used as a home because you use it for personal use for 30 days. That is more than the greater of 14 days or 10% of the total days it is rented.

Example 2. You rent out 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 stays in the room, rent free, for the last 3 weeks (21 days) in July.

The room is used as a home because you use it for personal use for 21 days. That is more than the greater of 14 days or 10% of the total days it is rented.

Figuring Days of Personal Use

A day of personal use of a dwelling unit is any day that it is used by:

1) You or any other person who has an interest in it, unless you rent it out to another owner as his or her main home under a shared equity financing agreement (defined later),
2) A member of your family or a member of the family of any other person who has 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 brothers and sisters, half-brothers and half-sisters, spouses, ancestors (parents, grandparents, etc.) and lineal descendants (children, grandchildren, etc.),
3) Anyone under an arrangement that lets you use some other dwelling unit, or
4) Anyone at less than a fair rental price.

Main home. If the other owner or member of the family in (1) or (2) above has more than one home, his or her main home is the one 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 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 days of personal use.

Example 1. You and your neighbor are co-owners of a condominium at the beach. You rent the unit out to vacationers whenever possible. The unit is not used as a main home by anyone. Your neighbor uses the unit for 2 weeks every year.

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 has no interest in this dwelling unit. He uses it as his main home. He pays you a fair rental price for the property.

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

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

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

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.

Days Not Counted as Personal Use

Some days you spend at the dwelling unit are not counted as days of personal use.

Repairs and maintenance. Any day that you spend working substantially full time repairing and maintaining 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. You own a cabin in the mountains which you rent out during the summer. You spend 3 days at the cabin each May working full time each day to repair anything that was damaged over the winter and get the cabin ready for the summer. You also spend 3 days each September working full time to repair any damage done by renters and get the cabin ready for the winter.

These 6 days do not count as days of personal use.

Use as a home before or after renting. When determining if you used your property as a home, the following special rule applies. Do not count as days of personal use the days on which you used the property as your main home either before or after renting it or offering it for rent in the following circumstances:

1) You rented or tried to rent the property for 12 or more consecutive months, or
2) 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.

This special rule does not apply when dividing expenses between rental and personal use.

Example 1. On February 28, 1995, you moved out of the house you had lived in for 6 years because you accepted a job in another town. You rent your house at a fair rental price from March 15, 1995, to May 14, 1996. On June 1, 1996, you move back into your old house.

To determine whether you used the house as a home, its use as your main home from January 1 to February 28, 1995, and from June 1 to December 31, 1996, is not counted as personal use.

Example 2. On January 31, 1995, 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, 1995. You are unable to rent it until April. On September 15, 1995, you sell the condominium.

Your use of the condominium from January 1 to January 31, 1995, is not counted as personal use when determining whether you used it as a home.

How to Divide Expenses

If you use a dwelling unit for both rental and personal purposes, you must divide your expenses between the rental use and the personal use. For purposes of dividing your expenses:

Any day that the unit is rented at a fair rental price is a day of rental use even if you have personally used the unit for that day, and

A unit is not considered used for rental during the time that it is held out for rent but not actually rented.

Example. You offer your beach cottage for rent from June 1 through August 31 (92 days). Your family uses the cottage during the last 2 weeks in May (14 days). During 1995, you were unable to find a renter for the first week in August (7 days). The person who rented the cottage for July allowed you to use it over a weekend (2 days) without any reduction in or refund of rent. The cottage was not used at all before May 17 or after August 31.

The cottage was used for rental a total of 85 days (92 − 7). The days it was held out for rent but not rented (7 days) are not days of rental use. For purposes of dividing expenses, the July weekend on which you used it (2 days) 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). You use 85/99 (86%) of these expenses as rental expenses.

How to Figure Your Income and Deductions

How you figure your rental income and deductions depends on how much personal use you made of the property and how many days the property was rented.

General Rule

If you do not use a dwelling unit as a home, you divide your expenses between personal use and rental use based on the number of days it was used for each purpose.

Your deductible rental expenses can be more than your gross rental income. However, see *Limits on Rental Losses*, later.

Where to report. Report the rental income and all of the rental expenses on **Schedule E** (Form 1040), *Supplemental Income and Loss*.

You can deduct allowable interest, taxes, and casualty losses for the personal use of the property on Schedule A (Form 1040) if you itemize deductions.

Income and Deductions for Property Used as a Home

If you use a dwelling unit as a home during the year (as explained earlier), how you figure your rental income and deductions depends on how many days the unit was rented.

Rented fewer than 15 days. If you use a dwelling unit as a home and you rent it for fewer than 15 days during the year, you do not include in income any of the rental income. Also, you cannot deduct any expenses as rental expenses.

However, you can deduct your allowable interest, taxes, and casualty and theft losses on Schedule A (Form 1040) if you itemize deductions.

Rented 15 days or more. If you use a dwelling unit as a home and rent it for 15 days or more during the year, you include all your rental income in your gross income. You must divide your expenses between the personal use and the rental use based on the number of days used for each purpose. If you had a net profit from the rental property 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. However, if you had a net loss, you may not be able to deduct all of your rental expenses. See *Limit on Certain Expenses,* next.

Limit on Certain Expenses

If you use your rental property as a home (as explained earlier), rented it for 15 days or more during the year, and your rental expenses are more than your rental income, there is a limit on the amount you can deduct for certain rental expenses.

This limit ensures that the rental expenses are used to offset only rental income. If the total of these expenses exceeds the rental income, you cannot use the excess to offset income from other sources. The excess can be carried forward to next year and treated as rental expenses for the next year.

Use *Table 1–1, Worksheet for Figuring the Limit on Rental Deductions for a Dwelling Unit Used as a Home*.

Where to report. Report your rental income and all your deductible expenses for the rental use on Schedule E (Form 1040). This includes the rental use portion of interest, taxes, and casualty losses. You deduct allowable interest, taxes, and casualty losses for the personal use of the property on the appropriate

Table 1-1. **Worksheet for Figuring the Limit on Rental Deductions for a Dwelling Unit Used as a Home**

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 15 days or more this year?
- Are the total of your rental expenses and depreciation more than your rental income?

1. Enter rents received		______
2. a. Enter the rental portion of deductible home mortgage interest (see instructions)	______	
b. Enter the rental portion of real estate taxes	______	
c. Enter the rental portion of deductible casualty and theft losses (see instructions)	______	
d. Enter indirect rental expenses (see instructions)	______	
e. **Fully deductible rental expenses.** Add lines 2a–2d		______
3. Subtract line 2e from line 1. If zero or less, enter zero		______
4. a. Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities)	______	
b. Enter the rental portion of excess mortgage interest (see instructions)	______	
c. Add lines 4a and 4b	______	
d. **Allowable operating expenses.** Enter the smaller of line 3 or line 4c		______
5. Subtract line 4d from line 3. If zero or less, enter zero		______
6. a. Enter the rental portion of excess casualty and theft losses (see instructions)	______	
b. Enter the rental portion of depreciation of the dwelling unit	______	
c. Add lines 6a and 6b	______	
d. **Allowable excess casualty and theft losses and depreciation.** Enter the smaller of line 5 or line 6c		______
7. a. **Operating expenses to be carried over to next year.** Subtract line 4d from line 4c		______
b. **Excess casualty and theft losses and depreciation to be carried over to next year.** Subtract line 6d from line 6c		______

Enter the amounts on **lines 2e, 4d, and 6d** on the appropriate lines of Schedule E (Form 1040), Part I.

Worksheet Instructions

Follow these instructions for the worksheet above. If you were unable to deduct all your expenses last year, including operating expenses, casualty and theft losses, and depreciation, because of the rental income limit, add these unused amounts to your expenses for this year.

Line 2a. Figure the mortgage interest on the dwelling unit that you could deduct on Schedule A (Form 1040) 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. Enter the rental portion of this interest on line 2a of the worksheet.

Line 2c. Figure the casualty and theft losses related to the dwelling unit that you could deduct on Schedule A (Form 1040) if you had not rented the dwelling unit. To do this, complete Section A of Form 4684, treating the losses as personal losses. On line 17 of Form 4684, 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 line 18 of Form 4684 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 not directly related to operating or maintaining the dwelling unit. 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 4b. On line 2a, you entered the mortgage interest you could deduct on Schedule A if you had not rented out the dwelling unit. Enter on line 4b of this worksheet the mortgage interest you could not deduct on Schedule A because it is **more than** the limit on home mortgage interest. **Do not** include interest on a loan that did not benefit the dwelling unit (as explained in the line 2a instructions).

Line 6a. To find the rental portion of excess casualty and theft losses you can deduct, follow these steps. Use the Form 4684 you prepared for line 2c of this worksheet.

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

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

lines of Schedule A (Form 1040) if you itemize deductions.

Carryover of expenses. If the total of your rental expenses is more than your gross rental income, the expenses that you are not allowed to deduct can be carried forward to the next year and treated as rental expenses for the same property. Any expenses carried forward to next year will be subject to any limits that apply next year. You can deduct the expenses carried over to a year only up to the amount of your rental income for that year, even if you do not use the property as your home for that year.

Depreciation

When you use your property to produce income, such as rents, the law generally allows you to recover (get back) some or all of what you paid for the property through tax deductions. You do this by ''depreciating'' the property; that is, by deducting some of your cost on your tax return each year.

Several factors determine how much depreciation you can deduct. The main factors are: (1) your basis in the property, and (2) the recovery period for the property. You cannot simply deduct your mortgage or principal payments 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,** *Depreciation and Amortization,* to figure and report your depreciation. See *How to Report Rental Income and Expenses,* later. Also see Publication 946, *How To Depreciate Property.*

Claiming the correct amount of depreciation. You should claim the correct amount of depreciation each tax year. If, in an earlier year, you did not claim depreciation that you were entitled to deduct, you must still reduce your basis in the property by the amount of depreciation that you should have deducted. You cannot deduct the unclaimed depreciation in the current year or in any later tax year. However, you may be able to claim the correct amount of depreciation on an amended return for the earlier year. You must file an amended return within 3 years from the date you filed your original return, or within 2 years from the time you paid your tax, whichever is later. A return filed early is considered filed on the due date.

What can be depreciated. You can depreciate your property if it:

1) Is used in business or held for the production of income (such as rental property),
2) Has a determinable useful life longer than one year, and
3) Is something that wears out, gets used up, decays, becomes obsolete, or loses value from natural causes.

To be depreciable, the property must meet ***all three*** of the above conditions.

You can depreciate both ***real property*** other than land and ***personal property***.

Real property is land and, generally, anything that is built on, growing on, or attached to land.

Buildings, fences, sidewalks, and trees are real property.

Personal property is property, such as machinery and equipment, that is not real property.

Furniture, appliances, and lawn mowers are personal property.

Rented property. If you pay rent on property, you cannot depreciate that property. Only the owner can depreciate it. If you make permanent improvements to the property, you may be able to depreciate the improvements. See *Additions or improvements to property,* later.

Land. You can never depreciate land. This generally includes the cost of clearing, grading, planting, and landscaping because these expenses are all part of the cost of land.

Cooperative apartments. If you are a tenant-stockholder in a cooperative housing corporation and you rent your cooperative apartment to others, you can deduct your share of the corporation's depreciation.

You are a ***tenant-stockholder*** if you have the right to live in one or more dwelling units in the cooperative. You need not actually live in any unit. You can rent them to others.

You can deduct your share of the depreciation only if the cooperative housing corporation meets the following conditions:

- The corporation must have only one class of stock outstanding,
- Each of the stockholders, because he or she owns stock in the corporation, must be able to live in, or rent for dwelling purposes, a house or apartment owned or leased by the corporation,
- No stockholder may receive any distribution out of capital, except on a partial or complete liquidation of the corporation, and
- At least 80% of the corporation's gross income for the tax year must be from the tenant-stockholders. For this purpose, gross income means all income received during the tax year, including any received before the corporation changed to cooperative ownership.

If you bought the stock as part of its first offering, you figure the amount of depreciation you can deduct in the following way.

1) Figure the depreciation for all the depreciable real property owned by the corporation. Depreciation methods are discussed later.
2) Subtract from (1) any depreciation for space owned by the corporation that can be rented but that may not be lived in by tenant-stockholders. The result is the yearly depreciation as reduced.
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 yearly depreciation as reduced (from (2)) by the number you figured in (3). This is your share of the corporation's depreciation.

If you bought your cooperative stock after its first offering, you figure the basis of the depreciable real property to use in (1) above as follows.

1) Multiply your cost per share by the total number of shares outstanding.
2) Add the mortgage indebtedness on the property on the date you bought the stock.
3) Subtract the part that is not for the depreciable real property, such as the part for the land.

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

See *Cooperative apartments* in Publication 946 for more information.

Cannot be more than basis. The total of all your yearly depreciation deductions cannot be more than your cost or other basis of the property. For this purpose, the total depreciation must include any depreciation that you were allowed to claim, even if you did not claim it.

Depreciation systems. There are three ways to figure depreciation. The depreciation system you use depends on the type of asset and when the asset was placed in service. For ***tangible property*** you use:

- MACRS if placed in service after 1986,
- ACRS if placed in service after 1980 but before 1987, or
- Straight line or an accelerated method of depreciation, such as the declining balance method, if placed in service before 1981.

Tangible property is any property that you can see and touch. This includes automobiles, buildings, and equipment.

This publication discusses MACRS only.

If you placed property in service before 1995, continue to use the same method of figuring depreciation that you used in the past. If you need information about depreciating property placed in service before 1987, see Publication 534.

Section 179 election. You cannot claim the section 179 deduction for property merely held for the production of income, including certain rental property. See Publication 946.

Alternative minimum tax. If you use accelerated depreciation, you may have to file **Form 6251,** *Alternative Minimum Tax—Individuals.* Accelerated depreciation includes MACRS and ACRS and any other method that allows you to deduct more depreciation than you could deduct using a straight line method.

Modified Accelerated Cost Recovery System (MACRS)

The modified accelerated cost recovery system (MACRS) applies to all tangible property placed in service during 1995.

MACRS consists of two systems that determine how you depreciate your property. The main system is called the ***General Depreciation System (GDS)***. The second system is called the ***Alternative Depreciation System (ADS)***. GDS is used to figure your depreciation deduction for property used in most rental activities, unless you elect ADS.

To figure your MACRS deduction, you need to know the following information about your property:

1) Its recovery period,
2) Its placed-in-service date, and
3) Its depreciable basis.

Personal home changed to rental use. You must use MACRS to figure the depreciation on property used as your home and changed to rental property in 1995.

Excluded property. You cannot use MACRS for certain personal property placed in service before 1987 (before August 1, 1986, if election

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

Type of property	MACRS Recovery Period to use: General Depreciation System	MACRS Recovery Period to use: 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
Office furniture and equipment, such as: desks, files	7 years	10 years
Appliances, such as: stoves, refrigerators	7 years	12 years
Carpets	7 years	12 years
Furniture used in rental property	7 years	12 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, water pipes, venting, etc.	27.5 years	40 years
Improvements and additions, such as a new roof	The recovery period 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 improvement or addition.	

made) that is transferred after 1986 (after July 31, 1986, if election made). Generally, if you acquired the property from a related party, or if you or a related party used the property before 1987, you cannot use MACRS. Property that does not come under MACRS must be depreciated under ACRS or one of the other methods of depreciation, such as straight line or declining balance. In addition, you may elect to exclude certain property from the application of MACRS.

See Publication 534 for more information.

Recovery Periods Under GDS

Each item of property that can be depreciated is assigned to a property class. The recovery period of a piece of property depends on the class the property is in. The property classes 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.

The class to which property is assigned is determined by its class life. Class lives and recovery periods for most assets are listed in *Appendix B* in Publication 946.

Under GDS, tangible property that you placed in service during 1995 in your rental activities generally falls into one of the following classes. Also see *Table 1–2*.

1) ***5–year property.*** This class includes computers and peripheral equipment, office machinery (typewriters, calculators, copiers, etc.), automobiles, and light trucks.

   Depreciation on automobiles, certain computers, and cellular telephones is limited. See Chapter 4 of Publication 946.

2) ***7–year property.*** This class includes office furniture and equipment (desks, files, etc.), and appliances, carpets, furniture, etc., used in residential rental property. 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.

3) ***15–year property.*** This class includes roads and shrubbery (if depreciable).

4) ***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. A dwelling unit is a house or an apartment used to provide living accommodations in a building or structure, but 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. Residential rental property is depreciated over ***27.5 years.***

Note. There are other recovery classes that do not generally apply to rental property. These classes are not discussed in this publication. See Publication 946 for more information.

Qualified Indian reservation property. For the applicable recovery period for qualified Indian reservation property, see Publication 946.

Additions or improvements to property. Treat additions or improvements you make to any property as separate property items for depreciation purposes. The recovery period for an addition or improvement to property begins on the later of:

1) The date the addition or improvement is placed in service, or

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

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

Example. You own a residential rental house that you have been renting out since 1980 and that you are depreciating under ACRS. If you put an addition onto the house, and you place the improvement in service after 1986, you use MACRS for the addition. Under MACRS, the addition would be depreciated as residential rental property.

When to begin depreciation. You can begin to depreciate property when you place it in service in your trade or business or for the production of income. Property is considered placed in service in a rental activity when it is ready and available for a specific use in that activity.

Example 1. On November 22, 1994, you purchased a dishwasher for your rental property. The appliance was delivered on December 7, 1994, but was not installed and ready for use until January 3, 1995. Because the dishwasher was not ready for use until 1995, it is considered placed in service in 1995.

If the appliance had been ready for use when it was delivered in 1994, it would have been considered placed in service in 1994, even if it was not actually used until 1995.

Example 2. On April 6, 1995, 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, 1995. You began to advertise the house for rent in July and actually rented it out beginning September 1, 1995. 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 1995. During August and September you made several repairs to the house. On October 1, 1995, you listed the property for rent with a real estate company, which rented it on December 1, 1995. You can begin to depreciate the property on October 1, 1995, the date when it was available for rent.

Basis

In order to depreciate property, you must know its basis. The basis of property you buy is usually its cost. The cost is the amount you pay for it in cash or in other property or services. Your cost also includes amounts you pay for:

- Sales tax charged on the purchase,
- Freight charges to obtain the property, and
- Installation and testing charges.

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* 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, 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 of the property.

Settlement fees and other costs. Settlement fees, such as legal and recording fees, are closing costs that you include in the basis of property. You also include:

- Abstract fees,
- Charges for installing utility services,
- Surveys,
- Transfer taxes,
- Title insurance, and
- 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.

You must reasonably allocate these fees or costs between land and improvements, such as buildings, to figure the basis for depreciation of the improvements. Allocate the fees according to the fair market values of the land and improvements at the time of purchase. Settlement fees 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 that still must be paid on the mortgage.

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

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 before you can figure the depreciation allowable on the buildings.

When you divide your cost between land and buildings, the part of the cost that is used as the basis of 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 the assessed values for real estate tax purposes.

Example. You buy a house and land for $100,000. 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 is $80,000, of which $68,000 is for the house and $12,000 is for the land.

You can allocate 85% ($68,000 ÷ $80,000) of the purchase price to the house and 15% ($12,000 ÷ $80,000) of the purchase price to the land.

Your basis in the house is $85,000 (85% of $100,000) and your basis in the land is $15,000 (15% of $100,000).

Adjusted Basis

Before you can figure allowable depreciation, you may have to make certain adjustments (increases and decreases) to the basis of the property. 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 that must be depreciated, rather than deducted as an expense. This includes the cost of any improvements having a useful life of more than one year and amounts spent after a casualty to restore the damaged property.

Some of the items that you must add to the basis of property are:

- The cost of extending utility service lines to the property, and
- Legal fees, such as the cost of defending and perfecting title.

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

For information on depreciating improvements, see *Additions or improvements to property*, earlier, under *Recovery Periods Under GDS*.

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. 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. For example, if your city installs curbing on the street in front of your house, and assesses you and your neighbors for the cost of curbing, you must add the assessment to the basis of your property.

Assessments for maintenance or repair or meeting interest charges are deductible, not depreciable.

Deducting vs. capitalizing costs. You cannot add to your basis costs that are deductible 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 be able to choose to deduct or to capitalize include carrying charges, such as interest and taxes, that you must pay to own property.

For more information about deducting or capitalizing costs, see Chapter 11 in Publication 535.

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

- The amount of any insurance or other reimbursement you receive as the result of a casualty or theft loss,
- Any deductible casualty loss not covered by insurance,
- Any amount you receive for granting an easement,
- Any residential energy credit you were allowed before 1986, if you added the cost of the energy items to the basis of your home,
- The amount of depreciation you could have deducted on your tax returns

under the method of depreciation you selected. If you took less depreciation than you could have under the method you selected, you must decrease the basis by the amount you could have taken under that method.

If you deducted more depreciation than you should have, you must decrease your basis by the amount you should have deducted, plus the part of the excess you deducted that actually lowered your tax liability for any year.

Basis Other Than Cost

There are many times when you cannot use cost as a basis. 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, *Basis of Assets*, for information on how to figure your basis.

Basis of Property Changed to Rental Use

When you change property you held for personal use to rental use, such as renting out your former home, you figure the basis for depreciation using the lesser of fair market value or adjusted basis.

Fair market value. This is the price at which the property would change hands between a buyer and a 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 improvements or additions since you acquired it, minus deductions for any casualty or theft losses claimed on earlier years' income tax returns and other decreases to basis.

Example. Several years ago you built your home for $40,000 on a lot that cost you $4,000. Before changing the property to rental use last year, you added $8,000 of permanent improvements to the house and claimed a $1,000 deduction for a casualty loss to the house. Because land is not depreciable, you can only include the cost of the house when figuring the basis for depreciation.

Your adjusted basis at the time of the change in use is $47,000 ($40,000 + $8,000 − $1,000).

On the date of the change in use, your property has a fair market value of $48,000, of which $6,000 is for the land and $42,000 is for the house.

The basis for depreciation on the house is the fair market value at the date of the change ($42,000), because it is less than your adjusted basis ($47,000).

Figuring MACRS Depreciation Under GDS

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

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

If you actually compute the deduction, the depreciation method you use depends on the class of the property.

5–, 7–, or 15–year property. For property in the 5– or 7–year class, you use the double (200%) declining balance method over 5 or 7 years and a half-year convention. Or use the mid-quarter convention, if it applies. These conventions are explained later. For property in the 15–year class, you use the 150% declining balance method over 15 years and a half-year convention.

You can also choose to use the 150% declining balance method for property in the 5–, 7–, or 15–year class over its ADS recovery period. See *Figuring MACRS Depreciation Under ADS*, later, for the ADS recovery periods. You make this election on Form 4562. In column (f), Part II, enter ''150 DB''.

Change from either declining balance method to the straight line method in the first tax year that the straight line method gives you a larger deduction.

You must use the straight line method and a mid-month convention (explained later) for residential rental property.

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 column (f), Part II, enter ''S/L''. Once you make this election, you cannot change to another method.

Residential rental property. You must use the straight line method and a mid-month convention (explained later) for residential rental property.

Declining Balance Method

To figure your MACRS deduction, first determine your declining balance rate from the table below. However, if you elect to use the 150% declining balance method for 5– or 7–year property, figure the declining balance rate by dividing 1.5 (150%) by the ADS recovery period for the property.

Multiply the adjusted basis of the property by the declining balance rate and apply the convention that applies to figure your depreciation for the first year. In later years, use the following steps to figure your depreciation.

1) Adjust your basis by subtracting the amount of depreciation allowable for the earlier years.
2) Multiply your adjusted basis in (1) by the same rate used in the first year.

Follow these steps each year that you use the declining balance method. See *Conventions*, later, for information on depreciation in the year you dispose of property.

Declining balance rates. The following table shows the declining balance rate that applies for each class of property and the first year for which the straight line method will give an equal or greater deduction. (The rates for 5– and 7–year property are based on the 200% declining balance method.)

Class	Declining Balance Rate	Year
5	40%	4th
7	28.57%	5th
15	10%	7th

Straight Line Method

To figure your MACRS deduction under the straight line method, you must figure a new depreciation rate for each tax year in the recovery period. For any tax year, figure the straight line rate by dividing the number 1 by the years remaining in the recovery period at the beginning of the tax year. Multiply the unrecovered basis of the property by the straight line rate. You must figure the depreciation for the first year using the convention that applies. (See *Conventions*, later.) If the remaining recovery period at the beginning of the tax year is less than one year, the straight line rate for that tax year is 100%.

Example. Using the straight line method for property with a 5–year recovery period, the straight line rate is 20% (1 divided by 5) for the first tax year. After applying the half-year convention, the first year rate is 10% (20% divided by 2).

At the beginning of the second year, the remaining recovery period is 4½ years because of the half-year convention. The straight line rate for the second year is 22.22% (1 divided by 4.5).

To figure your depreciation deduction for the second year:

1) Subtract the depreciation taken in the first year from the basis of the property, and
2) Multiply the remaining basis in (1) by 22.22%.

Residential rental property. In the first year you claim depreciation for residential rental property, you can only claim depreciation for the number of months the property is in use, and you must use the mid-month convention (explained later). Also, for the first year of depreciation under ADS, you must use the mid-month convention to figure your depreciation deduction.

Conventions

In the year that you place property in service or in the year that you dispose of property, you are allowed to claim depreciation for only part of the year. The part of the year (or convention) depends on the class of the property.

A half-year convention is used to figure the deduction for property used in rental activities other than residential rental property. However, under a special rule, a mid-quarter convention may have to be used. For residential rental property, use a mid-month convention in all situations.

Half-year convention. The half-year convention treats all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, in the middle of that tax year.

A half year of depreciation is allowable for the first year property is placed in service, regardless of when the property is placed in service during the tax year. For each of the remaining years of the recovery period, you will take a full year of depreciation. If you hold the property for the entire recovery period, a half year of depreciation is allowable for the year following the end of the recovery period. If you dispose of the property before the end of the recovery period, a half year of depreciation is allowable for the year of disposition.

Mid-quarter convention. Under a mid-quarter convention, all property placed in service, or disposed of, during any quarter of a tax year is treated as placed in service, or disposed of, in the middle of the quarter.

A mid-quarter convention must be used in certain circumstances for property used in rental activities, other than residential rental property. This convention applies if the total basis of such property that is placed in service in the last 3 months of a tax year is more than 40% of the total basis of all such property you place in service during the year.

Do not include in the total basis any property placed in service and disposed of during the same tax year.

Example. During 1995, John Joyce purchased the following items to use in his rental property:

- Dishwasher for $400, which he placed in service in January;
- Used furniture for $100, which he placed in service in September; and
- A refrigerator for $500, which he placed in service in October.

John uses the calendar year as his tax year. The total basis of all property placed in service in 1995 is $1,000. The $500 basis of the refrigerator placed in service during the last 3 months of his tax year exceeds $400 (40% × $1,000). John must use the mid-quarter convention for all three items. The dishwasher, refrigerator, and used furniture are 7–year property under GDS.

Mid-month convention. Under a mid-month convention, residential rental property placed in service, or disposed of, during any month is treated as placed in service, or disposed of, in the middle of that month.

Optional Tables

You can use *Table 1–3* to compute annual depreciation under MACRS. The percentages in Tables A, B, and C make the change from declining balance to straight line in the year that straight line will yield a larger deduction. See *Declining Balance Method*, earlier.

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 tables. The following section explains how to use the optional tables.

Figure the depreciation deduction by multiplying your unadjusted basis in the property by the percentage shown in the appropriate table. Your ***unadjusted basis*** is your depreciable basis without reduction for depreciation previously claimed. The tables show the percentages for the first 6 years.

Tables A, B, and C. These tables take the half-year and mid-quarter conventions into consideration in figuring percentages. Use Table A for 5–year property, Table B for 7–year property, and Table C for 15–year property. Use the percentage in the second column (half-year convention) unless you must 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 on February 1, 1995. Your basis in the stove is $300 and your basis in the refrigerator is $500. Both are 7–year property. Using the half-year convention column in Table B, you find the depreciation percentage for year 1 is 14.29%. Your 1995 depreciation deduction on the stove is $43 ($300 × .1429). Your 1995 depreciation deduction on the refrigerator is $71 ($500 × .1429).

Using the half-year convention for year 2, you find your depreciation percentage is 24.49%. Your 1996 depreciation deduction will be $73 ($300 × .2449) for the stove and $122 ($500 × .2449) for the refrigerator.

Example 2. Assume the same facts in Example 1, except you buy the refrigerator in October 1995 instead of February. You must use the mid-quarter convention to figure depreciation on the stove and refrigerator. The basis of the refrigerator ($500), placed in service in the last 3 months of the tax year, is more than 40% of the total basis of all property ($800) placed in service during the year.

Because you placed the stove in service in February, you use the first quarter column of Table B and find that the depreciation percentage for year 1 is 25%. Your 1995 depreciation deduction on the stove is $75 ($300 × .25).

Because you placed the refrigerator in service in October, you use the fourth quarter column of Table B and find that the depreciation percentage for year 1 is 3.57%. Your depreciation deduction on the refrigerator is $18 ($500 × .0357).

Table D. Use this table for residential rental property. Find the row for the month that you placed the property in service. Use the percentages listed for that month for your depreciation deduction. The mid-month convention is considered in the percentages used in the tables.

Example. You purchased a single family rental house and placed it in service on February 1, 1995. Your basis in the house is $80,000. Using Table D, you find that the percentage for property placed in service in February of year 1 is 3.182%. Your 1995 depreciation deduction is $2,546 ($80,000 × .03182).

Figuring MACRS Depreciation Under ADS

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

Table 1–2 shows the recovery periods for property used in rental activities that you depreciate under ADS.

See *Appendix B* in Publication 946 for other property. If your property is not listed, it is considered to have no class life.

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

Election. You choose to use ADS by entering the depreciation on line 16, Part II of Form 4562.

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.

Once you choose to use ADS, you cannot change your election.

Casualty and Theft Losses on Rental Property

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 federal income tax return. For information on casualty or theft losses to your personal property (property not used in a business or rental activity),

Table 1-3. **Optional MACRS Tables**

Table 1-3-A. **MACRS 5-Year Property**

	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

Table 1-3-B. **MACRS 7-Year Property**

	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

Table 1-3-C. **MACRS 15-Year Property**

	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

Table 1-3-D. **Residential Rental Property (27.5-year)**

	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

see Publication 547, *Nonbusiness Disasters, Casualties, and Thefts*.

Casualty. The damage, destruction, or loss of property is a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

Theft. The unlawful taking and removing of your money or property with the intent to deprive you of it is a theft.

Proof of loss. You must be able to show that you actually have had a casualty or theft loss and the amount of the loss.

For a ***casualty loss***, you should be able to show:

- The type of casualty (car accident, fire, storm, etc.) and when it occurred,
- That your loss was the direct result of the casualty, and
- That you were the owner of the property, or, if you leased the property from someone else, that you were contractually liable to the owner for the damage.

For a ***theft loss***, you should be able to show:

- When you discovered that your property was missing,
- That your property was actually stolen, and
- That you were the owner of the property.

Gain from casualty or theft. When you receive money, including insurance, that is more than your adjusted basis in the property, you generally must report the gain. However, under certain circumstances, you may defer the payment of tax by choosing to postpone reporting the gain. To do this, you must generally buy replacement property within 2 years after the close of the tax year in which any part of your gain is realized. The cost of the replacement property must be equal to or more than the net insurance or other reimbursement you received. For more information about casualty gains and losses to business and income producing property, see Chapter 25 in Publication 334, *Tax Guide for Small Business*.

How to Figure Your Deduction

Generally, you can deduct a loss to rental property caused by a fire, storm, accident, or other casualty. You must figure the loss for each property damaged or destroyed. For example, if a casualty damages a rental building and trees, both of which are a part of the same property, you figure separate losses for the building and the trees.

Property Completely Destroyed

If your property is completely destroyed, your deductible loss is the adjusted basis of the property minus any salvage value and any insurance or other reimbursement you received or expect to receive.

Example. You owned a building that you rented out. The building had an adjusted basis of $80,000, not including the land, at the time it was completely destroyed by fire. Its fair market value just before the fire was $70,000. Because your building was completely destroyed, your deductible loss is your adjusted basis for the building, $80,000, minus any salvage value, insurance, or other reimbursement.

Property Partly Destroyed

If your property is partly destroyed, your deductible loss is the decrease in value of the property because of the casualty, or the adjusted basis of the property damaged, whichever is less. From this amount (the smaller of adjusted basis or decrease in value), you must subtract the insurance or other reimbursement you received or expect to receive.

Example. In March 1992, you bought property for rental purposes. You paid $15,000 for the land and $60,000 for the building. You also paid $3,400 for shrubs. For the years 1992 through 1994, you took total depreciation of $6,091 for the building. Its adjusted basis was $53,909 ($60,000 – $6,091). You took total depreciation of $400 for the shrubs. Their adjusted basis was $3,000 ($3,400 – $400).

In January 1995 the building was completely destroyed by fire. The shrubs were damaged.

Appraisers determined that the shrubs were worth $4,500 before the fire, but only $3,000 after the fire. The shrubs were not covered by insurance. The building was insured for its fair market value of $90,000. Shortly after the fire, the insurance company paid you $90,000 in full settlement of its liability.

You figure your gain or loss from the fire as follows:

	Building	Shrubs
Value before fire	$90,000	$4,500
Value after fire	–0–	3,000
Decrease in value	$90,000	$1,500
Adjusted basis	$53,909	$3,000
Insurance	$90,000	$ –0–
Minus: Adjusted basis of building	53,909	
Minus: Decrease in value of shrubs		1,500
Gain from fire insurance on building	$36,091	
Loss from damage to shrubs		$1,500

You can deduct the $1,500 casualty loss from the damage to the shrubs. You have a $36,091 gain on the building. You can postpone reporting your $36,091 gain on the building if you reinvest the $90,000 insurance proceeds in a replacement building before 1998.

Property Used Partly for Rental Purposes

When you use property partly for rental purposes and partly for personal purposes, you must figure the casualty or theft loss deduction separately for the rental portion and the personal use portion. The personal loss must be reduced by $100, and the total of all such losses during the year must be reduced by 10% of your adjusted gross income. For more information about nonbusiness (personal) casualty and theft losses, see Publication 547.

Example. You live in half of your house and rent out the other half. The original cost of the house was $140,000, not including the land. You did not make any improvements or additions to the house.

A flood in 1995 caused damage to the entire house. The fair market value of the house was $138,000 before the flood and $132,000 after the flood. Your house was insured and you received $4,000 for the damage to it. You claimed $7,000 depreciation on the rental part of the house before the flood. You had no other casualty losses in 1995, and your adjusted gross income was $30,000.

You figure your deductible business casualty loss of $1,000 and your deductible personal casualty loss of zero as follows:

	Rental use property	Personal use property
Decrease in value of house:		
Value before flood (total $138,000)	$69,000	$69,000
Value after flood (total $132,000)	66,000	66,000
Decrease in value	$ 3,000	$ 3,000
Adjusted basis of house:		
Rental part ($70,000 cost minus $7,000 depreciation)	$63,000	
Personal part (same as cost)		$70,000
Loss on house (smaller of adjusted basis or decrease in value)	$ 3,000	$ 3,000
Minus: Insurance received	2,000	2,000
Loss on house	$ 1,000	$ 1,000
Minus: $100 and 10% limits on property held for personal use		3,100
Deductible rental casualty loss	$ 1,000	
Deductible personal casualty loss		$ –0–

When to Deduct a Loss

Although a casualty is apparent when it happens, you may not discover a theft until later. The year in which you discover a theft affects the year in which you can deduct a theft loss.

Casualty Losses

Generally, you can deduct casualty losses only in the tax year in which they happen. This is true even if you do not repair or replace the damaged property until a later year. If you are liable for casualty damage to leased property, you cannot deduct your loss until the year in which your liability under the lease is ascertainable with reasonable accuracy. This is true even if the loss occurred or the liability was paid in a different year.

If you have a loss from a disaster that occurred in an area that the President of the United States later declares eligible for federal disaster assistance, see *Disaster Area Losses* in Publication 547.

Theft Losses

Generally, you can deduct theft losses only in the year that you discover the property was stolen. You must prove that there was a theft of your property and establish the year in which you discover the property was stolen. You do not have to prove the date it was stolen.

Insurance Claims

If you filed a claim for reimbursement, and there is reason to believe that you will recover all or part of the loss, you must reduce the loss by the expected recovery. This is true even if you do not receive payment until a later tax year. You have reason to believe that you will recover all or part of the loss if you filed suit for damages.

If your property is covered by insurance, you should file a timely insurance claim for reimbursement of a loss. Otherwise, you cannot deduct any part of this loss as a casualty or theft loss. However, that portion of the loss that is not covered by insurance, for example, a deductible, is not subject to this rule.

If you have a loss to property used only for business purposes, you may deduct the portion of the loss that is more than the insurance policy's coverage unless the deduction is otherwise prohibited or limited.

If you have a loss to property used for personal purposes, you must follow the rules explained in Publication 547.

How to Report

If you had a casualty or theft that involved your rental property, you figure the net gain or loss in Section B of **Form 4684**, *Casualties and Thefts.* Report any net gain or loss from lines 31 and 38a of Form 4684, on line 15, Part II of **Form 4797**, *Sales of Business Property*, or on line 14, Form 1040, if you do not use Form 4797 to report other gains and losses. If you do not use Form 4797, write ''Form 4684'' on line 14 of Form 1040. Report any long-term gain from line 39 of Form 4684, on line 3, Part I of Form 4797.

Limits on Rental Losses

Rental real estate activities are generally considered passive activities and the amount of loss you can deduct is limited. Generally, you cannot deduct losses from rental real estate activities unless you have income from other passive activities. See *Passive Activity Limits*, below.

Losses from passive activities are first subject to the at-risk rules. At-risk rules limit the amount of deductible losses from holding most real property placed in service after December 31, 1986.

Exception. If your rental losses are less than $25,000 ($12,500 if married filing separately), the passive activity limits probably do not apply to you. See *Losses From Rental Real Estate Activities,* later.

Property used as a home. If you used the rental property as a home during the year, the passive activity rules do not apply to that home. Instead, you must follow the rules explained earlier under *Personal Use of Vacation Homes and Other Dwelling Units.*

At-Risk Rules

The at-risk rules place a limit on the amount you can deduct as losses from activities often described as tax shelters. Holding real property (other than mineral property) placed in service before 1987 is not subject to the at-risk rules.

Generally, 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. See Publication 925, *Passive Activity and At-Risk Rules*, for more information.

Passive Activity Limits

All rental activities (except those meeting the exception for taxpayers in real property business, below) are passive activities. Losses from such activities are limited.

Passive activity rules. 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.

In general, any rental activity not meeting the exception below is a passive activity. 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.

Use **Form 8582**, *Passive Activity Loss Limitations*, 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 *Rental Loss,* under *How to Report Rental Income and Expenses*, later, to determine whether you have to complete Form 8582.

Exception for taxpayers in real property business. Rental activities in which you materially participate are not passive activities if you meet the requirements below. Losses from these activities are not limited by the passive activity rules.

Requirements. The time you spend performing services in real property trades or businesses in which you materially participate must be:

1) More than half of the time spent performing all personal services during the year, and
2) More than 750 hours.

A real property trade or business is one that develops, redevelops, constructs, reconstructs, acquires, converts, rents, operates, manages, leases, or sells real property.

Services you performed as an employee are not treated as performed in a real property trade or business, unless you own more than 5% of the stock (or more than 5% of the capital or profits interest) in the employer.

Once you meet the requirements, you can determine whether you materially participate in your rental activities on a property-by-property basis or you can treat all interests in rental real estate as one activity.

Married persons. In the case of a joint return, you meet the requirements only if either you or your spouse separately satisfies the requirements. However, you can count the time your spouse spends to determine whether you materially participate.

Losses From Rental Real Estate Activities

You can deduct up to $25,000 ($12,500 if married filing separately and living apart from your spouse the entire year; $0 if married filing separately and not living apart from your spouse the entire year) of losses from rental real estate activities in which you ***actively participated*** during the tax year. This allows you to deduct up to $25,000 of otherwise unallowable losses from rental real estate activities against other income (nonpassive income). The $25,000 ($12,500) figure is reduced if your adjusted gross income is more than $100,000 ($50,000 if married filing separately and living apart from your spouse the entire year).

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

If you lived with your spouse at any time during the year and are filing a separate return, you cannot use this special offset to reduce your nonpassive income or tax on nonpassive income.

A casualty or theft loss is not a passive activity deduction if losses that are similar in cause and severity do not happen regularly in your rental activity. Do not include such a loss with your other rental expenses when figuring your $25,000 ($12,500) limit.

Active participation. You actively participate in a rental real estate activity if you own at least 10% of the rental property and you make management decisions in a significant and bona fide sense. Management decisions include approving new tenants, deciding on rental terms, approving expenditures, and similar decisions. For these purposes, you are considered to own any portion of the property owned by your spouse.

Example. Mike, a bachelor, 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 resulted 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 done or contracted out by Mike.

Even though the rental loss is a loss 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.

Phase-out. The special $25,000 offset permitted for qualifying rental real estate activities is reduced by 50% of the amount by which your modified adjusted gross income is more than $100,000 ($50,000 if you are married filing separately). See *Modified adjusted gross income*, next.

Generally, there is no relief from the passive activity loss limitations if your adjusted gross income is $150,000 or more ($75,000 or more if you are married filing a separate return and lived apart from your spouse the entire year).

Additional information on the passive loss limits, including information on the treatment of unused disallowed passive losses and the treatment of gains and losses realized on the disposition of a passive activity, is provided in Publication 925.

Modified adjusted gross income is your adjusted gross income from line 31, Form 1040, figured without taking into account:

1) Any passive activity loss or loss allowable by reason of the exception for taxpayers in real property business,
2) Taxable social security or tier 1 railroad retirement benefits,
3) Deductible contributions to an IRA or simplified employee pension plan,
4) The deduction for one-half of self-employment tax, and
5) Excludable U.S. savings bond interest used to pay higher education expenses.

How to Report Rental Income and Expenses

Report rental income on your return for the year you actually or constructively receive it (if you are a cash basis taxpayer). You are considered to constructively receive income when it is made available to you, for example, by being credited to your bank account.

For more information about when you constructively receive income, see Publication 538, *Accounting Periods and Methods.*

Expenses carried over. If you could not deduct all of your 1994 rental expenses because you used your property as a home, treat the part you could not deduct in 1994 as a 1995 rental expense.

Deduct the expenses carried over to 1995 only up to the amount of your 1995 gross rental income, even if you did not use the property as your home in 1995.

Where to report. Where you report rental income and expenses, including depreciation, depends on whether you provide certain services to your tenant.

If you rent out buildings, rooms, or apartments, and provide only heat and light, trash collection, etc., you normally report your rental income and expenses in Part I of Schedule E

(Form 1040), *Supplemental Income and Loss*. However, see *Not Rented For Profit*, earlier.

If you provide significant 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, *Net Profit From Business*. Significant services do not include the furnishing of heat and light, cleaning of public areas, trash collection, etc. For information, see Publication 334. You also may have to pay self-employment tax on your rental income. See Publication 533, *Self-Employment Tax*.

Form 1098. If you paid $600 or more of mortgage interest on your rental property, you should receive a Form 1098, *Mortgage Interest Statement,* or a 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 line 13 of Schedule E. Attach a statement to your return showing the name and address of the other person. In the left margin of Schedule E, next to line 13, write ''See attached.''

Schedule E

Use Part I of Schedule E (Form 1040) to report your rental income and expenses. List your total income, expenses, and depreciation for each rental property. Be sure to answer the question 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 the ''Totals'' column on only one Schedule E. The figures in the ''Totals'' column on that Schedule E should be the combined totals of all Schedules E.

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 the combined totals in Part I.

On page 1, line 20 of Schedule E, enter the depreciation you are claiming. You must complete and attach Form 4562 for rental activities only if you are claiming:

- Depreciation on rental property placed in service during 1995, or
- Depreciation on any rental property that is listed property (such as a car) regardless of when it was placed in service, or
- Any automobile expenses (actual or the standard mileage rate).

Otherwise, figure your depreciation on your own worksheet. You do not have to attach these computations to your return.

Example 1. Eileen Johnson owns a townhouse that she rents out. She receives $1,100 a month rental income. Her rental expenses for 1995 are as follows:

Fire insurance (1–year policy)	$ 200
Mortgage interest	5,000
Fee paid to real estate company for collecting monthly rent	572
General repairs	175
Real estate taxes imposed and paid in 1995	800

Eileen bought the property and placed it in service on January 1, 1995. Her basis for depreciation of the townhouse is $65,000. She is using the MACRS method with a 27.5–year recovery period. On April 1, 1995, Eileen bought a new dishwasher for the rental property at a cost of $425. She uses the MACRS method with a 7–year recovery period.

Eileen uses the percentage for ''January'' in *Table 1–3–D* to figure her deduction for the townhouse. She uses the percentage under ''Half-year convention'' in *Table 1–3–B* to figure her deduction for the dishwasher. She must report the depreciation on Form 4562.

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

Total rental income received ($1,100 × 12)		$13,200
Minus: Expenses		
Fire insurance (1-year policy)	$ 200	
Mortgage interest	5,000	
Real estate fee	572	
General repairs	175	
Real estate taxes	800	
Total expenses		6,747
Balance		$ 6,453
Minus: Depreciation		
On townhouse ($65,000 × 3.485%)	$2,265	
On dishwasher ($425 × 14.29%)	61	
Total depreciation		2,326
Net rental income for townhouse		$ 4,127

Example 2. In January 1995, Mary Smith 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. Mary selected a tenant and started renting the house on February 1. Mary charges $550 a month for rent and collects it herself. Mary received a $550 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 in 1995. Her expenses for the house are as follows:

Fire insurance (1–year policy)	$ 100
Mortgage interest	1,800
Miscellaneous repairs (after renting)	297
Real estate taxes imposed and paid in 1995	800

Mary 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 deduct the balance of the allowable taxes and mortgage interest on Schedule A (Form 1040) if she itemizes her deductions. She cannot deduct the balance of the fire insurance because it is a personal expense.

Mary bought this house in 1979 for $35,000. Her property tax was based on assessed values of $10,000 for the land and $25,000 for the house. Between 1979 and 1994, Mary added several improvements to the house. She figures her adjusted basis as follows:

Improvement	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, 1995, when Mary changed her house to rental property, the property had a fair market value of $92,000. Of this amount, $20,000 was for the land and $72,000 was for the house.

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

Because the house is residential rental property, she must use the straight line method of depreciation over either the GDS recovery period or the ADS recovery period. She chooses the GDS recovery period of 27.5 years.

She uses *Table 1–3–D* to find her depreciation percentage. Because she placed the property in service in February, she finds the percentage to be 3.182%.

On May 1, 1995, Mary paid $2,000 to have a furnace installed in the house. The furnace is residential rental property. Because she placed the property in service in May, she finds the percentage to be 2.273%.

Mary figures her net rental income or loss for the house in the following way:

Total rental income received ($550 × 11)		$6,050
Minus: Expenses		
Fire insurance ($100 × 11/12)	$ 92	
Mortgage interest ($1,800 × 11/12)	1,650	
Miscellaneous repairs	297	
Real estate taxes ($800 × 11/12)	733	
Total expenses		2,772
Balance		$3,278
Minus: Depreciation		
On house ($39,000 × 3.182%)	1,241	
On furnace ($2,000 × 2.273%)	45	
Total depreciation		1,286
Net rental gain for house		$1,992

Mary uses Part I of Schedule E to report her rental income and expenses. She enters her income, expenses, and depreciation for the house in the column for Property A. She uses Form 4562 to figure and report her depreciation. Mary's Schedule E and Form 4562 are shown later.

Rental Loss

If you have a loss on line 22, Schedule E, you may have to file **Form 8582**. See *Passive Activity Limits*, earlier. However, do not complete Form 8582 if you meet all of the following conditions:

1) Rental real estate activities with active participation were your only passive activities.
2) You do not have any prior year unallowed losses from any passive activities.
3) If married filing separately, you lived apart from your spouse all year; and
4) Your overall net loss from these activities is $25,000 or less ($12,500 or less if married filing separately); and
5) You have no current or prior year unallowed credits from passive activities; and
6) Your modified adjusted gross income is $100,000 or less ($50,000 or less if married filing separately).
7) 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.

For definitions of ''active participation'' and ''modified adjusted gross income,'' see *Losses From Rental Real Estate Activities*, earlier.

If you meet all of the conditions listed above, your rental real estate losses are not limited by the passive activity rules. Enter the loss from line 22 on line 23.

If you do not meet all of the conditions listed above, see the instructions for Form 8582 to find out if you must complete and attach that form.

SCHEDULE E (Form 1040)

Department of the Treasury Internal Revenue Service

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule E (Form 1040).

OMB No. 1545-0074

1995

Attachment Sequence No. 13

Name(s) shown on return: Mary Smith

Your social security number: 123 00 4567

Part I **Income or Loss From Rental Real Estate and Royalties** *Note: Report income and expenses from your business of renting personal property on Schedule C or C-EZ (see page E-1). Report farm rental income or loss from Form 4835 on page 2, line 39.*

1 Show the kind and location of each rental real estate property:

A Brick House, 123 Main Street, Hometown, MN 56200

B

C

2 For each rental real estate property listed on line 1, did you or your family use it for personal purposes for more than the greater of 14 days or 10% of the total days rented at fair rental value during the tax year? (See page E-1.)

	Yes	No
A		✓
B		
C		

Income:		Properties A	Properties B	Properties C		Totals (Add columns A, B, and C.)
3 Rents received	3	6,050			3	6,050
4 Royalties received	4				4	
Expenses:						
5 Advertising	5					
6 Auto and travel (see page E-2)	6					
7 Cleaning and maintenance	7					
8 Commissions	8					
9 Insurance	9	92				
10 Legal and other professional fees	10					
11 Management fees	11					
12 Mortgage interest paid to banks, etc. (see page E-2)	12	1,650			12	1,650
13 Other interest	13					
14 Repairs	14	297				
15 Supplies	15					
16 Taxes	16	733				
17 Utilities	17					
18 Other (list) ▶	18					
19 Add lines 5 through 18	19	2,772			19	2,772
20 Depreciation expense or depletion (see page E-2)	20	1,286			20	1,286
21 Total expenses. Add lines 19 and 20	21	4,058				
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-2 to find out if you must file Form 6198	22	1,992				
23 Deductible rental real estate loss. **Caution:** *Your rental real estate loss on line 22 may be limited. See page E-3 to find out if you must file Form 8582. Real estate professionals must complete line 42 on page 2*	23	( )	( )	( )		
24 **Income.** Add positive amounts shown on line 22. **Do not** include any losses					24	1,992
25 **Losses.** Add royalty losses from line 22 and rental real estate losses from line 23. Enter the total losses here					25	( )
26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 39 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 40 on page 2					26	1,992

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11344L **Schedule E (Form 1040) 1995**

Form **4562** Department of the Treasury Internal Revenue Service (T)

Depreciation and Amortization
(Including Information on Listed Property)

▶ See separate instructions. ▶ Attach this form to your return.

OMB No. 1545-0172
1995
Attachment Sequence No. 67

Name(s) shown on return	Business or activity to which this form relates	Identifying number
Mary Smith	Rental of house	123-00-4567

Part I **Election To Expense Certain Tangible Property (Section 179) (Note:** *If you have any "Listed Property," complete Part V before you complete Part I.*)

1	Maximum dollar limitation. If an enterprise zone business, see page 1 of the instructions	1	$17,500
2	Total cost of section 179 property placed in service during the tax year. See page 2 of the instructions	2	
3	Threshold cost of section 179 property before reduction in limitation	3	$200,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 2 of the instructions	5	

	(a) Description of property	(b) Cost	(c) Elected cost
6			
7	Listed property. Enter amount from line 27	7	

8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	
9	Tentative deduction. Enter the smaller of line 5 or line 8	9	
10	Carryover of disallowed deduction from 1994. See page 2 of the instructions	10	
11	Taxable income limitation. Enter the smaller of taxable income (not less than zero) or line 5 (see instructions)	11	
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	
13	Carryover of disallowed deduction to 1996. Add lines 9 and 10, less line 12 ▶	13	

Note: *Do not use Part II or Part III below for listed property (automobiles, certain other vehicles, cellular telephones, certain computers, or property used for entertainment, recreation, or amusement). Instead, use Part V for listed property.*

Part II **MACRS Depreciation For Assets Placed in Service ONLY During Your 1995 Tax Year (Do Not Include Listed Property.)**

Section A—General Asset Account Election

14 If you are making the election under section 168(i)(4) to group any assets placed in service during the tax year into one or more general asset accounts, check this box. See page 2 of the instructions ▶ ☐

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
Section B—General Depreciation System (GDS) (See page 2 of the instructions.)						
15a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g Residential rental property	2-95	39,000	27.5 yrs.	MM	S/L	1,241
	5-95	2,000	27.5 yrs.	MM	S/L	45
h Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	
Section C—Alternative Depreciation System (ADS) (See page 4 of the instructions.)						
16a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part III **Other Depreciation (Do Not Include Listed Property.)** (See page 4 of the instructions.)

17	GDS and ADS deductions for assets placed in service in tax years beginning before 1995	17	
18	Property subject to section 168(f)(1) election	18	
19	ACRS and other depreciation	19	

Part IV **Summary** (See page 4 of the instructions.)

20	Listed property. Enter amount from line 26	20	
21	**Total.** Add deductions on line 12, lines 15 and 16 in column (g), and lines 17 through 20. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	21	1,286
22	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	22	

For Paperwork Reduction Act Notice, see page 1 of the separate instructions. Cat. No. 12906N Form **4562** (1995)

2.

Selling Your Rental Property

Topics

This chapter discusses:

- Sale of your rental property,
- Rules to follow if the property you sell is your main home,
- Basis for gain or loss,
- How to figure gain or loss,
- Whether you must recapture any depreciation, and
- How to figure any section 1231 gain or loss (gain or loss on the sale or exchange of certain types of property).

Useful Items

You may want to see:

Publication

- ☐ **523** Selling Your Home
- ☐ **534** Depreciating Property Placed in Service Before 1987
- ☐ **537** Installment Sales
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **551** Basis of Assets

Form (and Instructions)

- ☐ **4797** Sales of Business Property
- ☐ **6252** Installment Sale Income
- ☐ **8824** Like-Kind Exchanges

Basis and Adjusted Basis

Whether you bought your property, hired a contractor to build it for you, built it yourself, or received it as compensation for services, as a gift or inheritance, in payment of a debt, or in trade for other property, it is important that you know its basis. You must know its adjusted basis to figure gain or loss when you sell or otherwise dispose of your property.

You should keep records of transactions relating to the basis of your property for as long as you need them to prove the basis of the original or replacement property. For this reason, you should keep records of all capital improvements and additions (such as fences, porches, new rooms, etc.) that you make to your property.

Basis

The original basis of property depends on how and when you acquired the property.

Purchase. The original basis of property you bought is the price you paid for it. This generally includes your down payment and any indebtedness, such as a first or second mortgage, or notes you gave to the seller.

You add to the cost of your property certain items that are charged to you at settlement or closing. They are a part of your original basis. These items include:

1) Attorney's fees,
2) Abstract fees,
3) Charges for installing utility service,
4) Recording fees,
5) Surveys,
6) Transfer taxes,
7) Title insurance, and
8) Any amounts the seller owes that you agreed to pay, such as:
   a) Back taxes or interest,
   b) Recording or mortgage fees,
   c) Charges for improvements or repairs, and
   d) Sales commissions.

If the seller actually paid for any item for which you are liable, such as your share of the real property taxes for that year, you must reduce your basis by that amount if you are not charged for it at settlement.

If you are a tenant-stockholder in a cooperative housing development, your basis generally is the cost of your stock in the corporation. It includes your share of a mortgage on the building that you must pay as a condition of keeping your stock interest.

Your basis of a condominium is generally your cost plus improvements.

Construction. If you contracted to have a building constructed on land that you own, your original basis is the basis of the land plus the amount it cost you to complete the building. This includes the cost of labor and materials, architect's fees, building permit charges, contractor's fees, utility meter and connection charges, and legal fees that are directly connected with building. If you construct all or part of the building yourself, its original basis is the total amount it cost you to complete it. The value of your own labor or any other labor you did not pay for is not part of the cost of the building.

Compensation. If you received your property as compensation for services, your basis is the fair market value of the property when you received it. You also must include this amount in your gross income as wages. If the services are rendered at an agreed upon or specified price, that price is presumed to be the fair market value in the absence of evidence otherwise.

Gifts made before 1977. If someone gave you property before 1977, your original basis is the donor's adjusted basis at the date of the gift. However, if the donor's adjusted basis was more than the fair market value of the property when it was given to you, you must use that fair market value as your basis to figure any possible loss when you sell or exchange your property.

If the fair market value was more than the donor's adjusted basis at the time of the gift, increase your basis by any federal gift tax paid on the gift. Do not increase your basis to more than the fair market value of the property when it was given to you.

If you received the property as a gift before 1921, your original basis is the fair market value of the property at the time of the gift.

Gifts made after 1976. If you received a gift after 1976, your basis in the gift (the donor's adjusted basis) is increased by the part of the gift tax paid that is due to the net increase in the value of the gift. This part is figured by multiplying the gift tax paid on the gift by a fraction. The numerator (top part) of the fraction is the net increase in value of the gift and the denominator (bottom part) is the amount of the gift. The net increase in value of the gift is the fair market value of the gift less the donor's adjusted basis.

Inheritance. If you inherited your property, the original basis of the property generally is its fair market value at the date of the decedent's death or the later alternate valuation date if chosen by the estate for federal estate tax valuation purposes. If a federal estate tax return was filed, the value listed there for the property generally is your basis. If no federal estate tax return was filed, use the appraised value for state inheritance or transmission tax purposes. If no return was filed, use the best available objective evidence of fair market value, such as an appraisal. See Publication 551, *Basis of Assets*, for more information.

Taxable trade. If you traded one property for another, the basis of the new property is its fair market value at the time of the trade unless you received the property in a nontaxable or partly nontaxable trade.

Nontaxable trade. A nontaxable trade is one in which property is exchanged solely for like property (such as a rental house for a rental house).

If you received your property in a nontaxable trade, its original basis is the adjusted basis of the property you gave up, increased by any cash you paid or additional costs you had.

Partly nontaxable trade. A partly nontaxable trade is one in which you receive, in addition to like property, unlike property, money, or both.

If you received your property in a partly nontaxable trade, increase the adjusted basis of the property you gave up by any cash you paid, additional costs you had, and any gain recognized. Reduce this amount by any cash or unlike property you received and any loss recognized on the trade. For more information, see Publication 551.

Deferred gain. If you:

Sold a home,

Deferred gain from the sale of that home because you bought a new home, and

Changed the new home to rental property,

you must reduce the basis of the new home by the amount of gain you deferred from the sale of the old home.

Example. In 1974 you bought your first house for $40,000. In 1985 you sold this house for $60,000 and bought a second house for $100,000. Because the cost of your new house was more than the selling price of your old house, you deferred your gain of $20,000. In 1995 you changed your second house to rental property.

The basis of your rental property is $80,000 ($100,000 price you paid minus $20,000 gain you deferred).

Adjusted Basis

Your adjusted basis is your original basis increased or reduced by certain amounts. Increase your basis by the cost of improvements and additions and by any other capital expenditures you make during the time you own the property. Reduce your basis by deductible casualty losses, payments for any easements or rights-of-way you grant, depreciation you take or could take, and by any other items that represent a return of your investment in the property.

See the discussion of adjusted basis earlier, under *Depreciation.*

Figuring Your Gain or Loss

A ***gain*** is the amount you realize from a sale or exchange minus the adjusted basis of the property. A ***loss*** is the adjusted basis of the property minus the amount you realize from a sale or exchange.

If you have a taxable gain or a deductible loss from a sale or exchange, it may be either a capital gain or loss or an ordinary gain or loss. In some cases, part of your gain or loss may be a capital gain or loss and part may be an ordinary gain or loss. See *Recapture of Depreciation,* later.

Installment sale. If you sold your rental property in a sale where you will receive one or more payments after the close of the tax year, see Publication 537, *Installment Sales.*

Property Used Partly for Rental

If you sell or exchange property that you used in part for rental and in part for personal purposes, you must figure the gain or loss on the sale or exchange as though you had sold two separate pieces of property. You must divide the selling price, selling expenses, and the basis of the property between the rental part and the personal part. You must subtract depreciation you took or could have taken from the basis of the rental part.

Gain or loss on the rental part of the property may be a capital gain or loss or an ordinary gain or loss, as discussed later. Any gain on the personal part of the property is a capital gain. You cannot deduct a loss on the personal part.

Example. You sold a condominium in 1995 for $57,000. You bought the property in 1980 for $30,000. You used two-thirds of it as your home and rented out the other third. You claimed straight line depreciation totaling $3,750 for the rented part during the time you owned the property. You made no improvements to the property. Your expenses of selling the condominium were $3,600. You figure your gain or loss as follows:

	Rental (1/3)	Personal (2/3)
1) Selling price	$19,000	$38,000
2) Less selling expenses	1,200	2,400
3) Amount realized (adjusted sales price)	$17,800	$35,600
4) Basis	$10,000	$20,000
5) Less depreciation	3,750	
6) Adjusted basis	$ 6,250	$20,000
7) Gain (line 3 minus line 6)	$11,550	$15,600

Loss Limit on Sale of Property Changed to Rental Use

You cannot deduct a loss on the sale of property you acquired for use as your home and you used as your home until the time of sale.

You can deduct a loss on the sale of property you acquired for use as your home that you converted to rental property and used as rental property at the time of sale. However, if the adjusted basis of the property at the time of conversion was more than its fair market value, the amount of loss you can deduct is limited.

Determine the amount of loss you can deduct as follows:

1) Choose the smaller of the property's adjusted basis or fair market value at the time of conversion.
2) Add to (1) the cost of any improvements and other increases to basis since the time of conversion.
3) Subtract from (2) depreciation and any other decreases to basis since the time of conversion.
4) Subtract the amount you realized on the sale from the result in (3).

The result in (4) is the amount of loss you can deduct.

Example. Five years ago, you converted your main home to rental property. At the time of conversion, the adjusted basis of your home was $75,000 and the fair market value was $70,000. This year, you sold the property for $55,000. You made no improvements to the property but you have depreciation expense of $12,620 over the five prior years. The amount you can deduct as a loss is limited to $2,380, figured as follows:

1. Enter the smaller of: a. Adjusted basis at time of conversion, or b. Fair market value at time of conversion	$ 70,000
2. Enter the cost of any improvements and any other additions to basis after the conversion	0
3. Add the amounts on lines 1 and 2	70,000
4. Enter depreciation and any other decreases to basis	$ 12,620
5. Subtract line 4 from line 3	57,380
6. Enter the amount you realized from the sale	55,000
7. Subtract the amount on line 6 from the amount on line 5. **This is the amount of loss you can deduct.**	$ 2,380

Trades

If you trade rental property for business or other rental property, you may not have a current taxable gain or deductible loss. You postpone the gain or loss until you sell or dispose of the property that you received in the trade. The following conditions must be met for the trade to be not currently taxable.

1) The property you receive must be ***business or investment property***. You may not use it for personal purposes, such as your home or family car.
2) The property must be ***''like-kind'' property***. The trade of real estate for real estate and the trade of personal property for similar personal property are trades of like-kind property. The trade of an apartment house for a store building, or a panel truck for a pickup truck, are like-kind trades. The trade of a rental house for a piece of machinery is not a like-kind trade.
3) The property you receive must be ***tangible property***. These rules and benefits generally do not apply to trades of stocks, bonds, notes, or certain other intangible property.
4) The property you receive must ***not be property held for sale***. The property you trade and the property you receive must not be property you sell to customers, such as merchandise. It must be property held for use in your business or property held for investment.
5) The property you receive must meet ***identification requirements***. The property to be received in the trade must be identified on or before the day that is 45 days after the date of transfer of the property you trade.
6) The trade must meet the ***completed transaction requirement***. The property to be received in the trade must be received before the earlier of:

a) The 181st day after the date of transfer of the property you trade, or

b) The due date, including extensions, for your tax return for the tax year in which the property you trade is transferred.

Example. You and another landlord agreed to trade rental properties. You agreed on which of your apartments you would transfer and you agreed that the other landlord could transfer either of his two apartments to you.

On October 1, 1995, you transferred your apartment to the other landlord. You file your tax returns on a calendar year basis.

In order for this to be a nontaxable trade, the following two conditions must be met.

1) The other landlord must have identified which apartment would be transferred to you. The identification must have been made before November 16, 1995 (see rule (5) above), and

2) The apartment must be transferred to you before March 30, 1996 (see rule (6) above).

Cash or other property received. If you receive cash or other property in addition to the like-kind property, but otherwise all the above conditions are met, you have a partially nontaxable trade. You are taxed on the gain you realize, but only to the extent of the cash or other property you receive. You cannot deduct a loss.

If you pay cash in addition to the property you give up, gain or loss is still postponed if all the above conditions are otherwise met.

Trades between related persons. In addition to the six conditions mentioned above, additional rules apply to trades of like-kind property between related persons. You generally can postpone gain or loss when you trade property for other property owned by a person related to you. However, if either you or the other person disposes of the property within 2 years after the last transfer that was part of the exchange, then any gain or loss on the exchange is recognized on the date of disposition of the property.

These rules generally do not apply to dispositions due to the death of either related person. Nor do they apply to involuntary conversions, or exchanges or dispositions whose main purpose is other than avoiding federal income tax. For more information, get Publication 544.

Related persons. Under these rules, related persons include members of your family (spouse, brother, sister, parent, child, etc.) and a corporation of which you own more than 50%. For more information, see *Sales and Exchanges Between Related Parties* in Publication 544.

Form 8824. If you trade your rental property in a like-kind exchange, attach Form 8824, *Like-Kind Exchanges* to your return for the year of the trade.

For more information about nontaxable trades, see *Nontaxable Exchanges* in Publication 544.

Recapture of Depreciation

Gain on certain dispositions of depreciable property used in your rental activity may be treated as capital gain. This is explained later under *Section 1231 Gain or Loss.*

However, all or part of the gain on the property may be treated as ordinary income under the rules discussed here. This is called recapture of depreciation. The remaining gain, if any, is included with any other "section 1231" gains and losses to determine your ordinary or capital gain or loss under those rules. See *Section 1231 Gain or Loss*, later.

The rules for recapturing depreciation as ordinary income do not apply if you realize a loss on the disposition of the property.

Personal vs. real property. You use different rules for personal property and real property to figure if part of the gain on disposition is ordinary income.

The classification of property under the headings *Personal Property* and *Real Property*, next, applies only to this discussion. It does not depend on how the property is classified under local law.

Personal Property

Depreciable personal property, for this discussion, includes any property that is or that has been subject to an allowance for depreciation and that is:

1) Personal property, both tangible and intangible,

2) An elevator or an escalator (placed in service before 1987), or

3) Other property described in Chapter 4 of Publication 544 that is not commonly used in a residential rental activity.

This property is called "section 1245" property. Once property qualifies as depreciable personal property, it remains so even though its function may change. A leasehold of any of the property already described is also depreciable personal property.

Figuring ordinary income. Your ordinary income from section 1245 property is equal to the depreciation on the property. For this purpose, depreciation includes the following:

Normal depreciation based on useful life, recovery period, or class life,

Amortization of certain intangibles,

Amortization of certain expenditures for certified historic structures, (This applies to tax years before 1987.)

Additional first year depreciation, (This applies to tax years before 1981.) and

Any reduction in basis by 50% of the investment credit. (This applies to tax years after 1982.)

Example. On January 1, 1985, you paid $600 for a new refrigerator for a house that you rent out. On July 1, 1995, you sold the refrigerator for $300. You claimed depreciation on the refrigerator as a 5–year ACRS property and at the end of 1989 the refrigerator was fully depreciated. Your adjusted basis on the date of sale was zero. You figure the gain in Part III of Form 4797. Your gain on the sale is $300. Enter the gain on line 26 of Form 4797. Enter the $600 depreciation taken on line 27a. Because the gain is less than the total depreciation you claimed, you must include the $300 gain in your income as ordinary income. Enter the $300 on line 27b and complete the rest of the Form 4797.

Real Property

Depreciable real property, for this discussion, includes all real property that is subject to an allowance for depreciation and is not or has not been section 1245 property at any time. It also includes leased property to which the lessee has made improvements that are subject to an allowance for depreciation, such as a building, and the cost of getting a lease. This property is called "section 1250" property.

Sales or exchanges which do not result in ordinary income. All of the gain from the sale of some section 1250 properties is capital gain. You do not report any of it as ordinary income. These properties are:

- Property you held for more than one year, if:

  You used the straight line method to figure depreciation on the property, or

  You used a method of depreciation that resulted in no more depreciation than would have resulted had you used the straight line method,

- Qualified low-income rental property that you held for 16⅔ years or longer,

- 15–, 18–, or 19–year real property (such as residential rental property) which you depreciated under the alternate ACRS method, and

- Residential rental property or nonresidential rental real property which you depreciated under the MACRS method.

Ordinary income part. To figure what part of your gain is ordinary income, you must use the following steps:

1) In a sale, exchange, or involuntary conversion of the property, subtract the adjusted basis of the property from the amount realized. In any other disposition of the property, subtract the adjusted basis from the fair market value,

2) Figure the ***additional depreciation***, explained later, for periods after 1975, and

3) Multiply the smaller of (1) or (2) by the ***percentage that applies***, explained later.

You use lines 28a through 28g, Part III of Form 4797, to figure your ordinary income.

Additional depreciation. If you held section 1250 property for more than one year, you figure the additional depreciation by subtracting depreciation figured under the straight line method from the actual depreciation for the same period. You will have additional depreciation if you used the declining balance method, the sum of the years' digits method, regular ACRS, or any other method of rapid depreciation.

If you held depreciable real property for 1 year or less, all of the depreciation is additional depreciation.

You use the same recovery period or useful life and salvage value to figure depreciation under the straight line method as that used under the depreciation method you actually employed.

Percentage that applies. Use the following percentage that applies to your residential rental property:

1) For qualified low-income rental housing, use 100% minus 1% for each full month the property was held for more than 100 months.

2) For other residential rental property, use 100% of depreciation after 1975.

When property in (1) has been held for at least $16\frac{2}{3}$ years, the percentage is zero. At that time you will no longer have income because of additional depreciation.

If you dispose of real property because of a ***foreclosure*** or similar proceeding that began after 1975, you figure the percentage that applies as if you had stopped holding the property on the date the proceeding began.

To figure the percentage when it is less than 100%, the ***holding period*** for property generally begins on the day after you get it.

If you construct or reconstruct property, the holding period begins on the first day of the month in which it is placed in service for any purpose.

If you get depreciable real property by gift or in a tax-free exchange, the basis of which is determined by reference to the basis in the hands of the transferor, the holding period includes the holding period of the transferor.

Property with two or more elements. You must figure gain to be reported as ordinary income separately for each element of a residential rental property. All of the gain from an element is capital gain if the element is property described earlier under *Sales or exchanges which do not result in ordinary income*.

The three types of separate elements are:

1) A separate improvement,

2) The basic section 1250 property plus improvements not qualifying as separate improvements, and

3) The units placed in service at different times before all of the section 1250 property was finished. For example, a 100-unit apartment house that you built would have three separate elements if you placed 30 units in service (available for renting) on January 4, 1980, 50 on July 18, 1980, and the remaining 20 on January 19, 1981.

For more information, see Publication 544.

How to Report Gain on Form 4797

Use Part III of Form 4797 to report gain from the sale, exchange, or other disposition of section 1245 depreciable personal property and section 1250 depreciable residential rental property. Follow the form instructions to figure your gain. The ordinary gain portion gets carried over to Part II of the form while the remainder is carried over to Part I of the form.

Permanent records. You must keep permanent records in order to figure the gain you must report as ordinary income. These records should include:

- The date and the manner in which you acquired the property,
- The cost or other basis of the property on that date,
- How you figured that basis,
- The depreciation you took or could have taken, and
- All other adjustments that increase or reduce your basis.

If the basis of your property was determined from the adjusted basis of other property for which either you or another person claimed depreciation or amortization, you must also keep the above records for the other property. Such property includes, for example, property you received in a nontaxable trade or as a gift.

Section 1231 Gain or Loss

If you dispose of depreciable rental property, you first figure the ordinary gain, as discussed earlier. You include any remaining gain with your other "section 1231" gains and losses in Part I of Form 4797.

Any of the following may give you gain or loss from section 1231 property.

- Sales and exchanges of real property or depreciable personal property you used in a trade or business and held for more than 1 year.
- Sales and exchanges of property you held for the production of rents or royalties and held for more than 1 year.
- Sales and exchanges of leaseholds used in a trade or business and held for more than 1 year.
- Condemnations (taking private property for public use), if the property was held for more than 1 year. This includes business property and capital assets such as investment property.
- Casualties and thefts of property held for more than 1 year, but only if your net gains from casualties and thefts equal or exceed your net losses from casualties or thefts. This includes casualties and thefts of business property, property held for the production of rents or royalties, and investment property. You must consider insurance proceeds or other reimbursements in figuring your net gain or loss.

Net Section 1231 Gain or Loss

Net section 1231 gain for the year is the excess of section 1231 gains over section 1231 losses. Net section 1231 loss for the year is the excess of section 1231 losses over section 1231 gains.

If you have a net section 1231 gain for 1995, you must treat it as ordinary income up to the total of your net section 1231 losses for 1990, 1991, 1992, 1993, and 1994 that were not treated as ordinary income.

The part, if any, of your net section 1231 gain for 1995 that is not treated as ordinary income is treated as long-term capital gain.

If you have a net section 1231 loss for 1995, or if your section 1231 gains and losses for 1995 are equal, you treat all of your section 1231 gains and losses as ordinary gains and losses.

Capital gains tax rate. The maximum tax rate on net capital gains for individuals is 28%.

Comprehensive Examples

The following examples show how to figure net section 1231 gains and losses and how to recapture depreciation. They also show Form 4797 and Schedule D.

Example 1

On September 1, 1975, Jack White bought new property to use as rental property. The property cost $50,000, of which $40,000 was for the house and $10,000 was for the land. On January 4, 1995, he sold the property for $75,000, of which $60,000 was for the house and $15,000 was for the land. During the years Jack owned the property, he claimed $25,159 depreciation using a declining balance rate of 5%. Jack figures his additional depreciation as follows:

	Depreciation claimed	Straight line depreciation	Additional depreciation
1975	$ 667	$ 333	$ 334
Additional depreciation before 1976			$334
1976	$1,967	$1,000	$ 967
1977	1,868	1,000	868
1978	1,775	1,000	775
1979	1,686	1,000	686

1980	1,602	1,000	602
1981	1,522	1,000	522
1982	1,446	1,000	446
1983	1,373	1,000	373
1984	1,305	1,000	305
1985	1,240	1,000	240
1986	1,177	1,000	177
1987	1,119	1,000	119
1988	1,063	1,000	63
1989	1,010	1,000	10
1990	959	1,000	(41)
1991	911	1,000	(89)
1992	866	1,000	(134)
1993	822	1,000	(178)
1994	781	1,000	(219)
Additional depreciation after 1975			$5,492

The percentage that applies for additional depreciation after 1975 is 100%.

Jack must report $5,492 as ordinary income as follows:

1) Gross sales price		$60,000	
2) Cost	$40,000		
3) Minus: Depreciation	25,159		
4) Adjusted basis (line 2 minus line 3)		14,841	
5) Gain (line 1 minus line 4)			$45,159
6) Additional depreciation after 1975		5,492	
7) Percentage that applies		100%	
Gain reported as ordinary income			$ 5,492

Jack has a section 1231 gain for 1995 of $44,667 ($5,000 gain on the land plus $45,159 gain on the house, reduced by $5,492 gain reported as ordinary income). This is Jack's only section 1231 gain or loss during 1995.

In 1990, Jack had a net section 1231 loss of $3,125 from the sale of rental property. He did not have any net section 1231 gains or losses in 1991, 1992, 1993 or 1994. He must treat $3,125 of his net section 1231 gain for 1995 ($44,667) as ordinary income. He treats the balance ($41,542) as long-term capital gain.

Jack enters $8,617 ($5,492 plus $3,125) on line 20b(2), Part II of Form 4797, and as ordinary income on line 14, Form 1040.

He enters the balance of the gain ($41,542) on line 10, Part I of Form 4797, and as a long-term capital gain on Schedule D.

Jack's Form 4797 is shown at the end of this publication.

Example 2

On July 1, 1983, Peter Rivers bought a new apartment to use as rental property. He paid $60,000 for the property, of which $58,000 was for the apartment and $2,000 was for the land. On January 2, 1995, Peter sold the property for $80,000, of which $76,000 was for the apartment and $4,000 was for the land. He paid $4,800 in selling expenses ($4,560 for the apartment and $240 for the land). During the years Peter owned the property, he claimed $47,560 in depreciation using the ACRS method of depreciation.

The apartment is 15–year real property. Peter figures his additional depreciation as follows:

	Depreciation claimed	Straight line depreciation	Additional depreciation
1983	$3,480	$1,933	$1,547
1984	6,380	3,867	2,513
1985	5,800	3,867	1,933
1986	5,220	3,867	1,353
1987	4,640	3,867	773
1988	4,060	3,867	193
1989	3,480	3,867	(387)
1990	2,900	3,867	(967)
1991	2,900	3,867	(967)
1992	2,900	3,867	(967)
1993	2,900	3,867	(967)
1994	2,900	3,867	(967)
Additional depreciation			$3,090

The percentage Peter uses for additional depreciation is 100%. He figures the gain he must report as ordinary income as follows:

1) Gross sales price		$76,000	
2) Cost	$58,000		
Plus: Expense of sale	4,560		
	$62,560		
3) Minus: Depreciation	47,560		
4) Adjusted basis (line 2 minus line 3)		15,000	
5) Gain (line 1 minus line 4)			$61,000
6) Additional depreciation		3,090	
7) Percentage that applies		100%	
Gain reported as ordinary income			$ 3,090

Peter's section 1231 gain for 1995 is $59,670 ($1,760 gain on the land plus $61,000 gain on the apartment, reduced by $3,090 reported as ordinary income). This is Peter's only section 1231 gain or loss during 1995. He did not have any net section 1231 gains or losses in previous years.

Peter enters $59,670 on line 8, Part I of Form 4797, and as long-term capital gain on Schedule D, line 12. He also enters $3,090 on line 20b(2), Part II of Form 4797, and as ordinary gain on Form 1040, line 14. Peter's Schedule D and Form 4797 are shown at the end of this publication.

Caution. As this publication was being prepared for print, Congress was considering tax law changes that would affect capital gains and losses. See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information on these changes will also be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

Sale or Exchange of Your Main Home

If you sell your main home and you used it previously for rental purposes, or you sell rental property previously used as your main home, special rules apply.

Rental property last used as main home. If you used all or part of the property for rental purposes and later converted it to your main home before selling it, the depreciation recapture rules discussed earlier in this chapter do not apply. Instead, you have one of two options:

1) If you replace the property under the rules described in Publication 523, *Selling Your Home*, you carry over the depreciation adjustments and the additional depreciation to the new home, or
2) If you do not replace the property under the rules in Publication 523, you treat all the gain as capital gain.

Note. If you later convert your new home to rental property and then dispose of it, you may have to recapture depreciation on the old home as ordinary income.

Age 55 or older. If you were age 55 or older when you sold or otherwise disposed of rental property, and you owned and used that property as your main home at least 3 years out of the last 5 years, none of your gain is ordinary income. It does not matter whether, during your use of the property as your main home, you used all or part of it for rental purposes during vacations or seasonal absences. This rule applies even if you do not choose to exclude the gain from your gross income under the rules explained in Publication 523. Instead, if you qualify, all the gain will be treated as capital gain.

Property used partly as rental property and partly as main home. If, at the time you sold or otherwise disposed of a property you used partly as rental property and partly as your main home, you have two transactions. The rules in this chapter apply to the rental portion unless otherwise noted. The rules in Publication 523 apply to the main home portion. Also see *Property Used Partly for Rental* earlier in this chapter.

Home changed to rental property. If you converted your main home to rental property, you cannot postpone tax on any gain when you sell it. You must treat the property as rental property and follow the rules in this publication.

Home rented out temporarily. You have not changed your home to rental property if you ***temporarily*** rent out your old home before selling it, or rent out your new home before moving in, as a matter of convenience or for another nonbusiness purpose. You can postpone tax on any gain from the sale if you meet the rules explained under *Postponement of Gain* in Publication 523.

Example. You own a home in New Jersey. In January, your employer informs you that you are being transferred to Texas in April. You try to sell your home before you leave, but have no offers. In May, you buy a new home in Texas.

You rent out the house in New Jersey, while still trying to sell it. You sell the house in October.

Although you temporarily rented out your old home, it is still considered to be your main home and you may be able to postpone tax on the gain from its sale.

Home placed with real estate agent and not rented. If you place your home with a real estate agent for rent or sale and it is not rented, it will not be considered rental property. Follow the rules in Publication 523.

Form **4797**

Department of the Treasury Internal Revenue Service (T)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184

1995

Attachment Sequence No. **27**

Name(s) shown on return: Jack White

Identifying number: 765-00-4321

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1995 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 11, or 22 . . . . 1 75,000

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Property Held More Than 1 Year

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) LOSS ((f) minus the sum of (d) and (e))	(h) GAIN ((d) plus (e) minus (f))
2 Land	9-1-75	1-4-95	15,000		10,000		5,000

Line	Description	(g) LOSS	(h) GAIN
3	Gain, if any, from Form 4684, line 39		
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37		
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824		
6	Gain, if any, from line 34, from other than casualty or theft		39,667
7	Add lines 2 through 6 in columns (g) and (h)	( )	44,667

8 Combine columns (g) and (h) of line 7. Enter gain or (loss) here, and on the appropriate line as follows: 8 44,667

Partnerships—Enter the gain or (loss) on Form 1065, Schedule K, line 6. Skip lines 9, 10, 12, and 13 below.

S corporations—Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 9, 10, 12, and 13 below, unless line 8 is a gain and the S corporation is subject to the capital gains tax.

All others—If line 8 is zero or a loss, enter the amount on line 12 below and skip lines 9 and 10. If line 8 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain as a long-term capital gain on Schedule D and skip lines 9, 10, and 13 below.

9 Nonrecaptured net section 1231 losses from prior years (see instructions) 9 3,125

10 Subtract line 9 from line 8. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions): 10 41,542

S corporations—Enter this amount on Schedule D (Form 1120S), line 13, and skip lines 12 and 13 below.

All others—If line 10 is zero, enter the amount from line 8 on line 13 below. If line 10 is more than zero, enter the amount from line 9 on line 13 below, and enter the amount from line 10 as a long-term capital gain on Schedule D.

Part II Ordinary Gains and Losses

11 Ordinary gains and losses not included on lines 12 through 18 (include property held 1 year or less):

Line	Description	(g) LOSS	(h) GAIN
12	Loss, if any, from line 8		
13	Gain, if any, from line 8, or amount from line 9 if applicable		3,125
14	Gain, if any, from line 33		5,492
15	Net gain or (loss) from Form 4684, lines 31 and 38a		
16	Ordinary gain from installment sales from Form 6252, line 25 or 36		
17	Ordinary gain or (loss) from like-kind exchanges from Form 8824		
18	Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)		
19	Add lines 11 through 18 in columns (g) and (h)	( )	8,617

20 Combine columns (g) and (h) of line 19. Enter gain or (loss) here, and on the appropriate line as follows: . . . 20 8,617

a For all except individual returns: Enter the gain or (loss) from line 20 on the return being filed.

b For individual returns:

(1) If the loss on line 12 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here and on line 22 of Schedule A (Form 1040). Identify as from "Form 4797, line 20b(1)." See instructions . . . . 20b(1)

(2) Redetermine the gain or (loss) on line 20, excluding the loss, if any, on line 20b(1). Enter here and on Form 1040, line 14 . . 20b(2) 8,617

For Paperwork Reduction Act Notice, see page 1 of separate instructions. Cat. No. 13086I Form **4797** (1995)

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255**

21 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A House – Rental Property	9-1-75	1-4-95
B		
C		
D		

Relate lines 21A through 21D to these columns	►	Property A	Property B	Property C	Property D
22 Gross sales price (Note: *See line 1 before completing.*)	22	60,000			
23 Cost or other basis plus expense of sale	23	40,000			
24 Depreciation (or depletion) allowed or allowable	24	25,159			
25 Adjusted basis. Subtract line 24 from line 23	25	14,841			
26 Total gain. Subtract line 25 from line 22	26	45,159			
27 If section 1245 property:					
a Depreciation allowed or allowable from line 24	27a				
b Enter the smaller of line 26 or 27a	27b				
28 If section 1250 property: If straight line depreciation was used, enter -0- on line 28g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	28a	5,492			
b Applicable percentage multiplied by the smaller of line 26 or line 28a (see instructions)	28b	5,492			
c Subtract line 28a from line 26. If residential rental property or line 26 is not more than line 28a, skip lines 28d and 28e	28c	39,667			
d Additional depreciation after 1969 and before 1976	28d				
e Enter the smaller of line 28c or 28d	28e				
f Section 291 amount (corporations only)	28f				
g Add lines 28b, 28e, and 28f	28g	5,492			
29 If section 1252 property: Skip this section if you did not dispose of farmland or if this form is being completed for a partnership.					
a Soil, water, and land clearing expenses	29a				
b Line 29a multiplied by applicable percentage (see instructions)	29b				
c Enter the smaller of line 26 or 29b	29c				
30 If section 1254 property:					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	30a				
b Enter the smaller of line 26 or 30a	30b				
31 If section 1255 property:					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	31a				
b Enter the smaller of line 26 or 31a (see instructions)	31b				

Summary of Part III Gains. Complete property columns A through D, through line 31b before going to line 32.

32 Total gains for all properties. Add property columns A through D, line 26	32	45,159
33 Add property columns A through D, lines 27b, 28g, 29c, 30b, and 31b. Enter here and on line 14	33	5,492
34 Subtract line 33 from line 32. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	34	39,667

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less**
See instructions.

		(a) Section 179	(b) Section 280F(b)(2)
35 Section 179 expense deduction or depreciation allowable in prior years	35		
36 Recomputed depreciation. See instructions	36		
37 Recapture amount. Subtract line 36 from line 35. See the instructions for where to report	37		

SCHEDULE D (Form 1040)

Department of the Treasury Internal Revenue Service (T)

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See instructions for Schedule D (Form 1040).

▶ Use lines 20 and 22 for more space to list transactions for lines 1 and 9.

OMB No. 1545-0074

1995

Attachment Sequence No. 12

Name(s) shown on Form 1040: Peter Rivers

Your social security number: 111 00 1111

Pending tax law may change this form. See page D-1 of instructions.

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-3)	(e) Cost or other basis (see page D-3)	(f) LOSS If (e) is more than (d), subtract (d) from (e)	(g) GAIN If (d) is more than (e), subtract (e) from (d)
1							
2	Enter your short-term totals, if any, from line 21 2						
3	**Total short-term sales price amounts.** Add column (d) of lines 1 and 2 . . . 3						

			(f)	(g)
4	Short-term gain from Forms 2119 and 6252, and short-term gain or loss from Forms 4684, 6781, and 8824 . . .	4		
5	Net short-term gain or loss from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . .	5		
6	Short-term capital loss carryover. Enter the amount, if any, from line 9 of your 1994 Capital Loss Carryover Worksheet . . .	6		
7	Add lines 1 through 6 in columns (f) and (g) . . .	7	( )	
8	**Net short-term capital gain or (loss).** Combine columns (f) and (g) of line 7 . . . ▶	8		

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

	(a)	(b)	(c)	(d)	(e)	(f)	(g)
9							
10	Enter your long-term totals, if any, from line 23 . . . 10						
11	**Total long-term sales price amounts.** Add column (d) of lines 9 and 10 . . . 11						

			(f)	(g)
12	Gain from Form 4797; long-term gain from Forms 2119, 2439, and 6252; and long-term gain or loss from Forms 4684, 6781, and 8824 . . .	12		59,670
13	Net long-term gain or loss from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . .	13		
14	Capital gain distributions . . .	14		
15	Long-term capital loss carryover. Enter the amount, if any, from line 14 of your 1994 Capital Loss Carryover Worksheet . . .	15		
16	Add lines 9 through 15 in columns (f) and (g) . . .	16	( )	59,670
17	**Net long-term capital gain or (loss).** Combine columns (f) and (g) of line 16 . . . ▶	17		59,670

Part III Summary of Parts I and II

18	Combine lines 8 and 17. If a loss, go to line 19. If a gain, enter the gain on Form 1040, line 13. **Note:** *If both lines 17 and 18 are gains, see the Capital Gain Tax Worksheet on page 24* . .	18	59,670
19	If line 18 is a loss, enter here and as a (loss) on Form 1040, line 13, the smaller of these losses:		
a	The loss on line 18; or		
b	($3,000) or, if married filing separately, ($1,500) . . .	19	( )
	Note: *See the Capital Loss Carryover Worksheet on page D-3 if the loss on line 18 exceeds the loss on line 19 or if Form 1040, line 35, is a loss.*		

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H Schedule D (Form 1040) 1995

Form **4797**

Department of the Treasury
Internal Revenue Service (T)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184

1995

Attachment Sequence No. **27**

Name(s) shown on return: Peter Rivers

Identifying number: 111-00-1111

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1995 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 11, or 22 . . . 1 | 80,000

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Property Held More Than 1 Year

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) LOSS ((f) minus the sum of (d) and (e))	(h) GAIN ((d) plus (e) minus (f))
2 Land	7-1-83	1-2-95	4,000		2,240		1,760

3 Gain, if any, from Form 4684, line 39 . . .	3		
4 Section 1231 gain from installment sales from Form 6252, line 26 or 37 . . .	4		
5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824 . . .	5		
6 Gain, if any, from line 34, from other than casualty or theft . . .	6		57,910
7 Add lines 2 through 6 in columns (g) and (h) . . .	7	( )	59,670

8 Combine columns (g) and (h) of line 7. Enter gain or (loss) here, and on the appropriate line as follows: . . . . 8 | 59,670

Partnerships—Enter the gain or (loss) on Form 1065, Schedule K, line 6. Skip lines 9, 10, 12, and 13 below.

S corporations—Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 9, 10, 12, and 13 below, unless line 8 is a gain and the S corporation is subject to the capital gains tax.

All others—If line 8 is zero or a loss, enter the amount on line 12 below and skip lines 9 and 10. If line 8 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain as a long-term capital gain on Schedule D and skip lines 9, 10, and 13 below.

9 Nonrecaptured net section 1231 losses from prior years (see instructions) . . . 9

10 Subtract line 9 from line 8. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions): 10

S corporations—Enter this amount on Schedule D (Form 1120S), line 13, and skip lines 12 and 13 below.

All others—If line 10 is zero, enter the amount from line 8 on line 13 below. If line 10 is more than zero, enter the amount from line 9 on line 13 below, and enter the amount from line 10 as a long-term capital gain on Schedule D.

Part II Ordinary Gains and Losses

11 Ordinary gains and losses not included on lines 12 through 18 (include property held 1 year or less):

12 Loss, if any, from line 8 . . .	12		
13 Gain, if any, from line 8, or amount from line 9 if applicable . . .	13		
14 Gain, if any, from line 33 . . .	14		3,090
15 Net gain or (loss) from Form 4684, lines 31 and 38a . . .	15		
16 Ordinary gain from installment sales from Form 6252, line 25 or 36 . . .	16		
17 Ordinary gain or (loss) from like-kind exchanges from Form 8824 . . .	17		
18 Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions) . . .	18		
19 Add lines 11 through 18 in columns (g) and (h) . . .	19	( )	3,090

20 Combine columns (g) and (h) of line 19. Enter gain or (loss) here, and on the appropriate line as follows: . . . 20 | 3,090

a For all except individual returns: Enter the gain or (loss) from line 20 on the return being filed.

b For individual returns:

(1) If the loss on line 12 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here and on line 22 of Schedule A (Form 1040). Identify as from "Form 4797, line 20b(1)." See instructions . . . 20b(1)

(2) Redetermine the gain or (loss) on line 20, excluding the loss, if any, on line 20b(1). Enter here and on Form 1040, line 14 . . . 20b(2) | 3,090

For Paperwork Reduction Act Notice, see page 1 of separate instructions. Cat. No. 13086I Form **4797** (1995)

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255**

21	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A	Apartment - Rental Property	7-1-83	1-2-95
B			
C			
D			

	Relate lines 21A through 21D to these columns ▶		Property A	Property B	Property C	Property D
22	Gross sales price (Note: *See line 1 before completing.*)	22	76,000			
23	Cost or other basis plus expense of sale	23	62,560			
24	Depreciation (or depletion) allowed or allowable	24	47,560			
25	Adjusted basis. Subtract line 24 from line 23	25	15,000			
26	Total gain. Subtract line 25 from line 22	26	61,000			
27	If section 1245 property:					
a	Depreciation allowed or allowable from line 24	27a				
b	Enter the smaller of line 26 or 27a	27b				
28	If section 1250 property: If straight line depreciation was used, enter -0- on line 28g, except for a corporation subject to section 291.					
a	Additional depreciation after 1975 (see instructions)	28a	3,090			
b	Applicable percentage multiplied by the smaller of line 26 or line 28a (see instructions)	28b	3,090			
c	Subtract line 28a from line 26. If residential rental property or line 26 is not more than line 28a, skip lines 28d and 28e	28c	57,910			
d	Additional depreciation after 1969 and before 1976	28d				
e	Enter the smaller of line 28c or 28d	28e				
f	Section 291 amount (corporations only)	28f				
g	Add lines 28b, 28e, and 28f	28g	3,090			
29	If section 1252 property: Skip this section if you did not dispose of farmland or if this form is being completed for a partnership.					
a	Soil, water, and land clearing expenses	29a				
b	Line 29a multiplied by applicable percentage (see instructions)	29b				
c	Enter the smaller of line 26 or 29b	29c				
30	If section 1254 property:					
a	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	30a				
b	Enter the smaller of line 26 or 30a	30b				
31	If section 1255 property:					
a	Applicable percentage of payments excluded from income under section 126 (see instructions)	31a				
b	Enter the smaller of line 26 or 31a (see instructions)	31b				

Summary of Part III Gains. Complete property columns A through D, through line 31b before going to line 32.

32	Total gains for all properties. Add property columns A through D, line 26	32	61,000
33	Add property columns A through D, lines 27b, 28g, 29c, 30b, and 31b. Enter here and on line 14	33	3,090
34	Subtract line 33 from line 32. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	34	57,910

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** See instructions.

			(a) Section 179	(b) Section 280F(b)(2)
35	Section 179 expense deduction or depreciation allowable in prior years	35		
36	Recomputed depreciation. See instructions	36		
37	Recapture amount. Subtract line 36 from line 35. See the instructions for where to report	37		

Printed on recycled paper