



Department  
of the  
Treasury

Internal  
Revenue  
Service

**Publication 527**

Cat. No. 15052W

# Residential Rental Property

**(Including  
Rental of  
Vacation Homes)**

For use in preparing  
**2004** Returns



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## Reminder

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

## Introduction

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 and at-risk rules.

**Sale of rental property.** For information on how to figure and report any gain or loss from

the sale or other disposition of your rental property, get Publication 544, Sales and Other Dispositions of Assets.

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

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

You can write to us at the following address:

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You can email us at [taxforms@irs.gov](mailto:taxforms@irs.gov). (The asterisk must be included in the address.) Please put "Publications Comment" on the subject line. Although we cannot respond individually to each email, we do appreciate your feedback and will consider your comments as we revise our tax products.

**Tax questions.** If you have a tax question, visit [www.irs.gov](http://www.irs.gov) or call 1-800-829-1040. We cannot answer tax questions at either of the addresses listed above.

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## Useful Items

You may want to see:

### Publication

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

### Form (and Instructions)

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

See *How To Get Tax Help* at the end of this publication for information about getting these publications and forms.

## Rental Income

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

**When to report.** When you report rental income on your return depends on whether you are a cash basis taxpayer or use an accrual method.

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

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

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

**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 you keep part or all of the security deposit during any year because your tenant does not live up to the terms of the lease, include the amount you keep in your income in that year.

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

**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, the payments are rental income. You must include them in your income. You can deduct the expenses if they are deductible rental expenses. See *Rental Expenses*, later, for more information.

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

payment made by your tenant as a rental expense.

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

**Property or services.** If you receive property or services, 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 unless there is evidence to the contrary.

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

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

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

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

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

## Rental Expenses

This section discusses expenses of renting property that you ordinarily can deduct from your rental income. It includes information on the expenses you can 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 rental income, is discussed later under *Depreciation*.

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

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

**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.

**Depreciation.** You can begin to depreciate rental property when it is ready and available for rent. See *Placed-in-Service Date* under *Depreciation*, later.

**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 Dwelling Unit (Including Vacation Home)*, later.

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

## Repairs and Improvements

You can deduct the cost of repairs to your rental property. You cannot deduct the cost of improvements. You recover the cost 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, plaster-

ing, 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. Table 1 shows examples of many improvements.

If you make an improvement to property, the cost of the improvement must be capitalized. The capitalized cost can generally be depreciated as if the improvement were separate property.

## Other Expenses

In addition to depreciation and the cost of repairs, you can deduct the following expenses from your rental income.

- Advertising.
- Cleaning and maintenance.
- Utilities.
- Insurance.
- Taxes.
- Interest.
- Points.
- Commissions.
- Tax return preparation fees.
- Travel expenses.
- Rental payments.
- Local transportation expenses.

Some of these expenses are discussed next.

**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 paid in advance.** If you pay an insurance premium 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 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 charges 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 5 of Publication 535 explains mortgage interest in detail.

**Expenses paid to obtain a mortgage.** Certain expenses you pay to obtain a mortgage on your rental property cannot be deducted as interest. These expenses, which include mortgage commissions, abstract fees, and recording fees, are capital expenses. However, you can amortize them over the life of the mortgage.

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

**Points.** The term "points" is often used to describe some of the charges paid by a borrower to take out a loan or a mortgage. These charges are also called loan origination fees, maximum loan charges, or premium charges. If any of these charges (points) are solely for the use of money, they are interest.

Points paid when you take out a loan or mortgage result in original issue discount (OID). In general, the points (OID) are deductible as interest unless they must be capitalized. How you figure the amount of points (OID) you can deduct each year depends on whether or not your total OID, including the OID resulting from the points, is insignificant or *de minimis*. If the OID is not *de minimis*, you must use the constant-yield method to figure how much you can deduct.

**De minimis OID.** The OID is *de minimis* if it is less than one-fourth of 1% (.0025) of the stated redemption price at maturity multiplied by

Table 1. Examples of Improvements

*Caution: Work you do (or have done) on your home that does not add much to either the value or the life of the property, but rather keeps the property in good condition, is considered a repair, not an improvement.*

<p><b>Additions</b></p> <ul style="list-style-type: none"> <li>Bedroom</li> <li>Bathroom</li> <li>Deck</li> <li>Garage</li> <li>Porch</li> <li>Patio</li> </ul> <p><b>Lawn &amp; Grounds</b></p> <ul style="list-style-type: none"> <li>Landscaping</li> <li>Driveway</li> <li>Walkway</li> <li>Fence</li> <li>Retaining wall</li> <li>Sprinkler system</li> <li>Swimming pool</li> </ul> <p><b>Miscellaneous</b></p> <ul style="list-style-type: none"> <li>Storm windows, doors</li> <li>New roof</li> <li>Central vacuum</li> <li>Wiring upgrades</li> <li>Satellite dish</li> <li>Security system</li> </ul>	<p><b>Heating &amp; Air Conditioning</b></p> <ul style="list-style-type: none"> <li>Heating system</li> <li>Central air conditioning</li> <li>Furnace</li> <li>Duct work</li> <li>Central humidifier</li> <li>Filtration system</li> </ul> <p><b>Plumbing</b></p> <ul style="list-style-type: none"> <li>Septic system</li> <li>Water heater</li> <li>Soft water system</li> <li>Filtration system</li> </ul> <p><b>Interior Improvements</b></p> <ul style="list-style-type: none"> <li>Built-in appliances</li> <li>Kitchen modernization</li> <li>Flooring</li> <li>Wall-to-wall carpeting</li> </ul> <p><b>Insulation</b></p> <ul style="list-style-type: none"> <li>Attic</li> <li>Walls, floor</li> <li>Pipes, duct work</li> </ul>
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the number of full years from the date of original issue to maturity (the term of the loan).

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

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

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

**Example of de minimis amount.** On January 1, 2004, you took out a loan for \$100,000. The loan matures on January 1, 2014 (a 10-year term), and the stated principal amount of the loan (\$100,000) is payable on that date. An interest payment of \$10,000 is payable to the bank on January 2 of each year, beginning on January 2, 2005. When the loan was made, you paid \$1,500 in points to the bank. The points reduced the issue price of the loan from \$100,000 to \$98,500, resulting in \$1,500 of OID. You determine that the points (OID) you paid are *de minimis* based on the following computation.

Redemption price at maturity (principal amount of the loan) . . . . .	\$100,000
Multiplied by: The term of the loan in complete years . . . . .	× 10
Multiplied by . . . . .	× .0025
<i>De minimis</i> amount	<u>\$ 2,500</u>

The points (OID) you paid (\$1,500) are less than the *de minimis* amount. Therefore, you have *de minimis* OID and you can choose one of the four ways discussed earlier to figure the amount you can deduct each year. Under the straight line method, you can deduct \$150 each year for 10 years.

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

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

1. Determine the issue price of the loan. Generally, this equals the proceeds of the loan. If you paid points on the loan, the issue price generally is the difference between the proceeds and the points.
2. Multiply the result in (1) by the yield to maturity.
3. Subtract any qualified stated interest payments from the result in (2). This is the OID you can deduct in the first year.

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

The yield to maturity (YTM) is generally shown in the literature you receive from your lender. If you do not have this information, consult your lender or tax advisor. In general, the YTM is the discount rate that, when used in

computing the present value of all principal and interest payments, produces an amount equal to the principal amount of the loan.

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

**Example of constant yield.** The facts are the same as in the previous example. The yield to maturity on your loan is 10.2467%, compounded annually.

You figure the amount of points (OID) you can deduct in 2004 as follows.

Principal amount of the loan . . . . .	\$100,000
Minus: Points . . . . .	<u>1,500</u>
Issue price of the loan . . . . .	\$ 98,500
Multiplied by: YTM . . . . .	× .102467
Total . . . . .	10,093
Minus: QSI . . . . .	<u>10,000</u>
Points (OID) deductible in 2004	<u>\$ 93</u>

You figure the deduction for 2005 as follows.

Issue price . . . . .	\$98,500
Plus: Points (OID) deducted in 2004	<u>93</u>
Adjusted issue price . . . . .	\$98,593
Multiplied by: YTM . . . . .	× .102467
Total . . . . .	10,103
Minus: QSI . . . . .	<u>10,000</u>
Points (OID) deductible in 2005 . . . . .	<u>\$ 103</u>

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

**Travel expenses.** You can deduct the ordinary and necessary expenses 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 your expenses between rental and nonrental activities. For information on travel expenses, see chapter 1 of 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 the expenses using one of two methods: actual expenses or the standard mileage rate. For 2004, the standard mileage rate for all business miles is 37½ cents a mile. For more information, see chapter 4 of Publication 463.



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

**Tax return preparation.** You can deduct, as a rental expense, the part of tax return preparation fees you paid to prepare Schedule E (Form 1040), Part I. For example, on your 2004 Schedule E you can deduct fees paid in 2004 to prepare Part I of your 2003 Schedule E. You can also deduct, as a rental expense, any expense you paid to resolve a tax underpayment related to your rental activities.

## Condominiums and Cooperatives

If you rent out a condominium or a cooperative apartment, special rules apply. Condominiums are treated differently from cooperatives.

### Condominium

If you own a condominium, you own 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, dues, 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. This cannot be more than the amount by which your payments to the corporation exceeded your share of the corporation's mortgage interest and real estate taxes.

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

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## Not Rented for Profit

If you do not rent your property to make a profit, you can deduct your rental expenses only up to the amount of your rental income. You cannot carry forward to the next year any rental expenses that are more than your rental income for the year. 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 not-for-profit rental income on Form 1040, line 21. You can include your mortgage interest (if you use the property as your main home or second home), real estate taxes, and casualty losses on the appropriate lines of Schedule A (Form 1040) if you itemize your deductions.

Claim your other rental expenses, subject to the rules explained in chapter 1 of Publication 535, as miscellaneous itemized deductions on line 22 of Schedule A (Form 1040). You can deduct these expenses only if they, together with certain other miscellaneous itemized deductions, total more than 2% of your adjusted gross income.

**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, you are presumed to be renting your property to make a profit. You may choose to postpone the decision of whether the rental is for profit by filing Form 5213.

See Publication 535 for more information.

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## Property Changed to Rental Use

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

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

For depreciation purposes, treat the property as being placed in service on the conversion date.

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

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

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

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

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## Renting Part of Property

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

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

You can deduct the expenses for the part of the property used for personal purposes, subject to certain limitations, only if you itemize your deductions on Schedule A (Form 1040).

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

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

**How to divide expenses.** If an expense is for both rental use and personal use, such as mortgage interest or heat for the entire house, you must divide the expense between rental use and personal use. You can use any reasonable method for dividing the expense. It may be reasonable to divide the cost of some items (for example, water) based on the number of people using them. However, the two most common methods for dividing an expense 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 that you cannot deduct.

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## Personal Use of Dwelling Unit (Including Vacation Home)

If you have any personal use of a dwelling unit (defined later) (including a vacation home) that you rent, 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 used a dwelling unit for personal purposes, it may be considered a "dwelling unit used as a home." If it is, you cannot deduct rental expenses that are more than your rental income for the unit. See *Dwelling Unit Used as Home* and *How To Figure Rental Income and Deductions*, later. If the dwelling unit is not considered a dwelling unit used as a home, you can deduct rental expenses that are more than your rental income for the unit, subject to certain limits. See *Limits on Rental Losses*, later.

**Exception for minimal rental use.** If you use the dwelling unit as a home and you rent it 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. See *Dwelling Unit Used as Home*, later.

**Dwelling unit.** A dwelling unit includes a house, apartment, condominium, mobile home, boat, vacation home, 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 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.

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## Dwelling Unit Used as Home

The tax treatment of rental income and expenses for a dwelling unit that you also use for personal purposes depends on whether you use it as a home. (See *How To Figure Rental Income and Deductions*, later).

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 use in applying (2) above. Instead, count it as a day of personal use in applying both (1) and (2) above. This rule does not apply when dividing expenses between rental and personal use.

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

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 rented the basement apartment at a fair rental price to college students during the regular school year. You rented to them on a 9-month lease (273 days). You figured 10% of the total days rented to others at a fair rental price is 27 days.

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

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

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

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

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

You figure 10% of the total days rented to others at a fair rental price is 16 days. Your family also used the apartment for 7 other days during the year.

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

## Use as Main Home Before or After Renting

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

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

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

**Example 1.** On February 28, 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 of that year to May 14 of the next year (14 months). On the following June 1, you move back into your old house.

The days you used the house as your main home from January 1 to February 28 and from June 1 to December 31 of the next year are not counted as days of personal use.

**Example 2.** On January 31, you moved out of the condominium where you had lived for 3 years. You offered it for rent at a fair rental price beginning on February 1. You were unable to rent it until April. On September 15, you sold the condominium.

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

## Figuring Days of Personal Use

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

1. You or any other person who has an interest in it, unless you rent it to another owner as his or her main home under a shared equity financing agreement (defined later). However, see *Use as Main Home Before or After Renting under Dwelling Unit Used As Home*, earlier.
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, an-

cestors (parents, grandparents, etc.) and lineal descendants (children, grandchildren, etc.).

3. Anyone under an arrangement that lets you use some other dwelling unit.
4. Anyone at less than a fair rental price.

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

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

**Donation of use of 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 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 property. 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 Rosa. Rosa 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 Rosa uses it because your house is used by Rosa 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 because you rent it for less than a fair rental price.

## Days Used for Repairs and Maintenance

Any day that you spend working substantially full time repairing and maintaining 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 that you rent during the summer. You spend 3 days at the cabin each May, working full time 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 getting the cabin ready for the winter.

These 6 days do not count as days of personal use even if your family uses the cabin while you are repairing it.

## How To Divide Expenses

If you use a dwelling unit for both rental and personal purposes, divide your expenses between the rental use and the personal use based on the number of days used for each purpose. You can deduct expenses for the rental use of the unit under the rules explained in *How To Figure Rental Income and Deductions*, later.

When dividing your expenses, follow these rules.

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

**Example.** Your beach cottage was available for rent from June 1 through August 31 (92 days). Your family uses the cottage during the last 2 weeks in May (14 days). 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.

You figure the part of the cottage expenses to treat as rental expenses by using the following steps.

1. The cottage was used for rental a total of 85 days (92 – 7). The days it was available for rent but not rented (7 days) are not days of rental use. The July weekend (2 days) you used it is rental use because you received a fair rental price for the weekend.

2. You used the cottage for personal purposes for 14 days (the last 2 weeks in May).
3. The total use of the cottage was 99 days (14 days personal use + 85 days rental use).
4. Your rental expenses are 85/99 (86%) of the cottage expenses.

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

## How To Figure Rental Income and Deductions

How you figure your rental income and deductions depends on whether you used the dwelling unit as a home (see *Dwelling Unit Used as Home*, earlier) and, if you used it as a home, how many days the property was rented at a fair rental price.

### Property Not Used as a Home

If you do not use a dwelling unit as a home, report all the rental income and deduct all the rental expenses. See *How To Report Rental Income and Expenses*, later.

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

### Property Used as a Home

If you use a dwelling unit as a home during the year, how you figure your rental income and deductions depends on how many days the unit was rented at a fair rental price.

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

**Rented 15 days or more.** If you use a dwelling unit as a home and rent it 15 days or more during the year, you include all your rental income in your income. See *How To Report Rental Income and Expenses*, later. 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, your deduction for certain rental expenses is limited.

**Limit on deductions.** If your rental expenses are more than your rental income, you cannot use the excess expenses to offset income from other sources. The excess 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 sub-

ject 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.

To figure your deductible rental expenses and any carryover to next year, use Table 2.

## Depreciation

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

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

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

You may have to use Form 4562 to figure and report your depreciation. See *How To Report Rental Income and Expenses*, later. Also see Publication 946.

### Claiming the correct amount of depreciation.

You should claim the correct amount of depreciation each tax year. Even if you did not claim depreciation that you were entitled to deduct, you must still reduce your basis in the property by the full amount of depreciation that you could have deducted. See *Decreases to basis*, later, for more information. If you did not deduct the correct amount of depreciation for property in any year, you may be able to make a correction for that year by filing Form 1040X, Amended U.S. Individual Income Tax Return. If you are not allowed to make the correction on an amended return, you can change your accounting method to claim the correct amount of depreciation. See *Changing your accounting method*, later.

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

- You claimed the incorrect amount because of a mathematical error made in any year.
- You claimed the incorrect amount because of a posting error made in any year.
- You have not adopted a method of accounting for the property.

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

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

**Changing your accounting method.** To change your accounting method, you must file Form 3115, Application for Change in Account-

**Table 2. 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 Home*.)
- Did you rent the dwelling unit 15 days or more this year?
- Is the total of your rental expenses and depreciation more than your rental income?

<b>1.</b>	Enter rents received . . . . .	_____
<b>2a.</b>	Enter the rental portion of deductible home mortgage interest (see instructions) . . . . .	_____
<b>b.</b>	Enter the rental portion of real estate taxes . . . . .	_____
<b>c.</b>	Enter the rental portion of deductible casualty and theft losses (see instructions) . . . . .	_____
<b>d.</b>	Enter direct rental expenses (see instructions) . . . . .	_____
<b>e.</b>	<b>Fully deductible rental expenses.</b> Add lines 2a–2d . . . . .	_____
<b>3.</b>	Subtract line 2e from line 1. If zero or less, enter zero . . . . .	_____
<b>4a.</b>	Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities) . . . . .	_____
<b>b.</b>	Enter the rental portion of excess mortgage interest (see instructions) . . . . .	_____
<b>c.</b>	Add lines 4a and 4b . . . . .	_____
<b>d.</b>	<b>Allowable operating expenses.</b> Enter the smaller of line 3 or line 4c . . . . .	_____
<b>5.</b>	Subtract line 4d from line 3. If zero or less, enter zero . . . . .	_____
<b>6a.</b>	Enter the rental portion of excess casualty and theft losses (see instructions) . . . . .	_____
<b>b.</b>	Enter the rental portion of depreciation of the dwelling unit . . . . .	_____
<b>c.</b>	Add lines 6a and 6b . . . . .	_____
<b>d.</b>	<b>Allowable excess casualty and theft losses and depreciation.</b> Enter the smaller of line 5 or line 6c . . . . .	_____
<b>7a.</b>	<b>Operating expenses to be carried over to next year.</b> Subtract line 4d from line 4c . . . . .	_____
<b>b.</b>	<b>Excess casualty and theft losses and depreciation to be carried over to next year.</b> 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, 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 Form 4684, Casualties and Thefts, Section A, treating the losses as personal losses. On Form 4684, line 17, enter 10%

of your adjusted gross income figured without your rental income and expenses from the dwelling unit. Enter the rental portion of the result from Form 4684, line 18, on line 2c of this worksheet.

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

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

**Line 4b.** On line 2a, you entered the rental portion of the mortgage interest you could deduct on Schedule A if you had not rented the dwelling unit. Enter on line 4b of this worksheet the rental portion of 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, use the Form 4684 you prepared for line 2c of this worksheet.

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

ing Method, to get the consent of the IRS. In some instances, that consent is automatic. For more information, see *Changing Your Accounting Method* in Publication 946.

**What Property Can be Depreciated**

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

- You own the property.

- You use the property in your business or income-producing activity (such as rental property).
- The property has a determinable useful life.
- The property is expected to last more than one year.
- The property is not excepted property (such as property placed in service and disposed of in the same year and section 197 intangibles).

**Property having a determinable useful life.**

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

**Land.** You can never depreciate the cost of land because land does not wear out, become obsolete, or get used up. The costs of clearing, grading, planting, and landscaping are usually all part of the cost of land and cannot be depreciated.



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

**Rented property.** Generally, if you pay rent on property, you cannot depreciate that property. Usually, 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.

**Cooperative apartments.** If you are a tenant-stockholder in a cooperative housing corporation and rent your cooperative apartment to others, you can deduct depreciation for your stock in the corporation.

Figure your depreciation deduction as follows.

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

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

See *Cooperative apartments* under *What Property Can Be Depreciated?* in chapter 1 of Publication 946 for more information.

**No deduction greater than basis.** The total of all your yearly depreciation deductions cannot be more than the cost or other basis of the property. For this purpose, your yearly depreciation deductions include any depreciation that you were allowed to claim, even if you did not claim it.

## Depreciation Methods

There are three ways to figure depreciation. The depreciation method you use depends on the type of property and when it was placed in service. For property used in rental activities you use one of the following.

- MACRS (Modified Accelerated Cost Recovery System) for property placed in service after 1986.
- ACRS (Accelerated Cost Recovery System) for property placed in service after 1980 but before 1987.
- Useful lives and either straight line or an accelerated method of depreciation, such as the declining balance method, for property placed in service before 1981.



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

If you placed property in service before 2004, continue to use the same method of figuring depreciation that you used in the past.

**Section 179 deduction.** You cannot claim the section 179 deduction for property held to produce rental income. See chapter 2 of Publication 946.

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

## Special Depreciation Allowance

You can take a special depreciation allowance (in addition to your regular MACRS depreciation deduction) for qualified property you placed in service in 2004. The allowance is 50% of the property's depreciable basis. You figure the special depreciation allowance before you figure your regular MACRS deduction.

**Electing to claim a lower or no special allowance.** You can elect, for any class of property, to deduct the 30% (instead of 50%) special allowance for all property in such class placed in service during the tax year. Or, you can elect not to deduct any special allowance for all property in such class placed in service during the tax year.

To make an election, attach a statement to your return indicating what election you are making and the class of property for which you are making the election. See *How Can You Elect Not To Claim an Allowance?* in Publication 946 for more information.

**Qualified property.** To qualify for the special depreciation allowance, your property must meet the following requirements.

1. It is new property that is depreciated under MACRS with a recovery period of 20 years or less.
2. It meets the following tests.
  - a. Acquisition date test.
  - b. Placed in service date test.
  - c. Original use test.

**Acquisition date test.** Generally, you must have acquired the property after September 10,

2001 (after May 5, 2003, to be eligible for the 50% special depreciation allowance).

**Placed in service date test.** Generally, the property must be placed in service for use in your trade or business or for the production of income after September 10, 2001 (after May 5, 2003, to be eligible for the 50% special depreciation allowance), and before January 1, 2005.

**Original use test.** The original use of the property must have begun with you after September 10, 2001 (after May 5, 2003, to be eligible for the 50% special depreciation allowance). "Original use" means the first use to which the property is put, whether or not by you.

**Example.** Dave bought and placed in service a new refrigerator (\$700) for one of his residential rental properties in 2004. Dave notes that the refrigerator has a 5-year recovery period (see Table 3). Dave's refrigerator is qualifying property and he claims the 50% special depreciation allowance.

Dave determines the total depreciable basis of the property to be \$700. Next, he multiplies this amount by 50% to figure his special depreciation allowance of \$350 ( $\$700 \times 50\%$ ). This leaves an adjusted basis of \$350 ( $\$700 - \$350$ ), which he will use to figure his MACRS deduction.

For more information, see *Claiming the Special Depreciation Allowance (or Liberty Zone Depreciation Allowance)* in Publication 946.

## MACRS

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

MACRS consists of two systems that determine how you depreciate your property—the General Depreciation System (GDS) and 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 2004.

**Excluded property.** You cannot use MACRS for certain personal property placed in service in your rental property in 2004 if it had been previously placed in service before MACRS became effective. Generally, personal property is excluded from MACRS if you (or a person related to you) owned or used it in 1986 or if your tenant is a person (or someone related to the person) who owned or used it in 1986. However, the property is not excluded if your 2004 deduction under MACRS (using a half-year convention) is less than the deduction you would have under ACRS. See *Can You Use MACRS To Depreciate Your Property?* in Publication 946 for more information.

**Table 3. MACRS Recovery Periods for Property Used in Rental Activities**

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



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

**Qualified Indian reservation property.** Shorter recovery periods are provided under MACRS for qualified Indian reservation property placed in service on Indian reservations before 2006. For more information, see chapter 4 of Publication 946.

**Additions or improvements to property.** Treat depreciable 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 property class and recovery period of the addition or improvement is the one that would apply to the original 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 since 1986 and that you are depreciating under ACRS. You put an addition onto the house and placed it in service in 2004. You must use MACRS for the addition. Under GDS, the addition is depreciated as residential rental property over 27.5 years.

**Recovery Periods Under GDS**

Each item of property that can be depreciated is assigned to a property class. The recovery period of the property depends on the class the property is in. Under GDS, the recovery period of an asset is generally the same as its property class. The property classes under GDS are:

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

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, property that you placed in service during 2004 in your rental activities generally falls into one of the following classes. Also see Table 3.

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

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

Depreciation on automobiles, certain computers, and cellular telephones is limited. See chapter 5 of Publication 946.

2. **7-year property.** This class includes office furniture and equipment (desks, files, etc.). This class also includes any property that does not have a class life and that has not been designated by law as being in any other class.
3. **15-year property.** This class includes roads and shrubby (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. It does not include a unit in a hotel, motel, inn, or other establishment where more than half of the units are used on a transient basis. If you live in any part of the building or structure, the gross rental income includes the fair rental value of the part you live in. The recovery period for residential rental property is 27.5 years.

**Placed-in-Service Date**

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

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

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

**Example 3.** You moved from your home in July. During August and September you made several repairs to the house. On October 1, you

listed the property for rent with a real estate company, which rented it on December 1. The property is considered placed in service on October 1, the date when it was available for rent.

## Depreciable Basis

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

If you depreciate your property under MACRS, you may also have to reduce your basis by certain deductions and credits with respect to the property, including any special depreciation allowance (discussed earlier).

Basis and adjusted basis are explained in the following discussions.



*If you used the property for personal purposes before changing it to rental use, its depreciable basis is the lesser of its adjusted basis or its fair market value when you change it to rental use. See Basis of Property Changed to Rental Use, later.*

## Cost Basis

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

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

**Exception.** For tax years beginning after 2003, you can elect to deduct state and local general sales taxes instead of state and local income taxes as an itemized deduction on Schedule A (Form 1040). If you make that choice, you cannot include those sales taxes as part of your cost basis.

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

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

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

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

**Settlement fees and other costs.** Settlement fees and closing costs that are for buying

the property are part of your basis in the property. These include:

- Abstract fees,
- Charges for installing utility services,
- Legal fees,
- Recording fees,
- 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.

Some settlement fees and closing costs you cannot include in your basis in the property are:

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

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

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

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

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

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

**Example.** You buy a house and land for \$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 was based on an assessed value of \$80,000, of which \$68,000 is for the house and \$12,000 is for the land.

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

## 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 for information on how to figure your basis.

## 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 properly added to a capital account. This includes:

- The cost of any additions or improvements having a useful life of more than one year,
- Amounts spent after a casualty to restore the damaged property,
- The cost of extending utility service lines to the property, and
- Legal fees, such as the cost of defending and perfecting title.

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

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

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



*The cost of landscaping improvements is usually treated as an addition to the basis of the land, which is not depreciable. See What property can be depreciated, earlier.*

**Assessments for local improvements.**

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

Assessments for maintenance or repair or meeting interest charges are deductible as taxes. Do not add them to your basis in the property.

**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 8 in Publication 535.

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

- The amount of any insurance or other payment 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, and
- 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 of Property Changed to Rental Use**

When you change property you held for personal use to rental use (for example, you rent your former home), you figure the basis for de-

preciation 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 additions or improvements since you acquired it, minus deductions for any casualty or theft losses claimed on earlier years' income tax returns and other decreases to basis.

**Example.** Several years ago you built your home for \$140,000 on a lot that cost you \$14,000. Before changing the property to rental use last year, you added \$28,000 of permanent improvements to the house and claimed a \$3,500 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.

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

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

The basis for depreciation on the house is the fair market value at the date of the change (\$147,000), because it is less than your adjusted basis (\$164,500).

**MACRS Depreciation Under GDS**

You can figure your MACRS depreciation deduction under GDS in one of two ways. The deduction is substantially the same both ways. (The difference, if any, is slight.) 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, shown later.

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, use the 200% declining balance method and a half-year convention. However, in limited cases you must use the mid-quarter convention, if it applies. These conventions are explained later. For property in the 15-year class, use the 150% declining balance method and a half-year convention.

You can also choose to use the 150% declining balance method for property in the 5- or 7-year class. The choice to use the 150%

method for one item in a class of property applies to all property in that class that is placed in service during the tax year of the election. You make this election on Form 4562. In Part III, column (f), enter "150 DB."

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

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

**Residential rental property.** You must use the straight line method and a mid-month convention 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 recovery period for the property.

In the first tax year, multiply the adjusted basis of the property by the declining balance rate and apply the appropriate convention to figure your depreciation. In later years (before the year you switch to the straight line method), use the following steps to figure your depreciation.

1. Reduce your adjusted basis by the depreciation allowable for the earlier years.
2. Multiply the new adjusted basis in (1) by the same rate used in earlier years.

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. The rate for 15-year property is based on the 150% 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 apply a different depreciation rate to the adjusted basis of your property for each tax year in the recovery period.

In the first year, multiply the adjusted 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.)

**Straight line rate.** 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. When figuring the number of years remaining, you must take into account the convention used in the first year. 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.** You place in service property with a basis of \$1,000 and a 5-year recovery period. You elect not to claim the special depreciation allowance, discussed earlier. The straight line rate is 20% (1 divided by 5) for the first tax year. After you apply the half-year convention, the first year rate is 10% (20% divided by 2). Depreciation for the first year is \$100.

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 (\$100) from the basis of the property (\$1,000), and
2. Multiply the remaining basis (\$900) by 22.22%. The depreciation for the second year is \$200.

**Residential rental property.** In the first year that 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 under *Conventions*, next).

## Conventions

Under MACRS, conventions establish when the recovery period begins and ends. The convention you use determines the number of months for which you can claim depreciation in the year you place property in service and in the year you dispose of the property.

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

**Mid-quarter convention.** A mid-quarter convention must be used if the mid-month convention does not apply and the total depreciable basis of MACRS property placed in service in the last 3 months of a tax year (excluding nonresidential real property, residential rental property, and property placed in service and disposed of in the same year) is more than 40% of the total basis of all such property you place in service during the year.

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

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

- A dishwasher for \$400 that he placed in service in January.
- Used furniture for \$100 that he placed in service in September.
- A refrigerator for \$500 that he placed in service in October.

Tom uses the calendar year as his tax year. The total basis of all property placed in service that year is \$1,000. The \$500 basis of the refrigerator placed in service during the last 3 months of his tax year exceeds \$400 (40% × \$1,000). Tom must use the mid-quarter convention instead of the half-year convention for all three items.

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

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

## Optional Tables

You can use the tables in Table 4 to compute annual depreciation under MACRS. The tables show the percentages for the first 6 years. See *Appendix A* of Publication 946 for complete tables. The percentages in Tables 4-A, 4-B, and 4-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.



*Figure any special depreciation allowance on qualified property before using Table 4-A, 4-B, and 4-C, or the 5-, 7-, or 15-year property 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 MACRS depreciation previously claimed.

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

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

If there is an adjustment for any reason other than (1) or (2) (for example, because of a deductible casualty loss) you can no longer use the

table. For the year of the adjustment and for the remaining recovery period, figure depreciation using the property's adjusted basis at the end of the year and the appropriate depreciation method, as explained earlier under *MACRS Depreciation Under GDS*.

**Tables 4-A, 4-B, and 4-C.** The percentages in these tables take into account the half-year and mid-quarter conventions. Use Table 4-A for 5-year property, Table 4-B for 7-year property, and Table 4-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 in June. Your basis in the stove is \$600 and your basis in the refrigerator is \$1,000. After figuring the 50% special depreciation allowance, your basis in the stove is \$300 and your basis in the refrigerator is \$500. Both are 5-year property. Using the half-year convention column in Table 4-A, you find the depreciation percentage for year 1 is 20%. For that year your depreciation deduction is \$60 (\$300 × .20) for the stove and \$100 (\$500 × .20) for the refrigerator.

For year 2, you find your depreciation percentage is 32%. That year's depreciation deduction will be \$96 (\$300 × .32) for the stove and \$160 (\$500 × .32) for the refrigerator.

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

Because you placed the refrigerator in service in October, you use the fourth quarter column of Table 4-A and find that the depreciation percentage for year 1 is 5%. Your depreciation deduction for the refrigerator (after figuring the special depreciation allowance) is \$25 (\$500 × .05).

Because you placed the stove in service in June, you use the second quarter column of Table 4-A and find that the depreciation percentage for year 1 is 25%. For that year, your depreciation deduction for the stove (after figuring the special depreciation allowance) is \$75 (\$300 × .25).

**Table 4-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 to figure your depreciation deduction. The mid-month convention is taken into account in the percentages shown in the table.

**Example.** You purchased a single family rental house and placed it in service in February. Your basis in the house is \$160,000. Using *Table 4-D*, you find that the percentage for property placed in service in February of year 1 is 3.182%. That year's depreciation deduction is \$5,091 (\$160,000 × .03182).

Table 4. **Optional MACRS Tables**

Table 4-A. **MACRS 5-Year Property**

Year	Half-year convention	Mid-quarter convention			
		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 4-B. **MACRS 7-Year Property**

Year	Half-year convention	Mid-quarter convention			
		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 4-C. **MACRS 15-Year Property**

Year	Half-year convention	Mid-quarter convention			
		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 4-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

## 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 3 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 con-

sidered to have no class life. Under ADS, personal property with no class life is depreciated using a recovery period of 12 years.

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

**Election.** For property placed in service during 2004 you choose to use ADS by entering the depreciation on Form 4562, Part III, line 20.

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

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

## Casualties and Thefts

As a result of a casualty or theft, you may have a loss related to your property. You may be able to deduct the loss on your income tax return. For information on casualty and theft losses (business and nonbusiness), see Publication 547.

**Casualty.** Damage to, destruction of, 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.

**Gain from casualty or theft.** When you have a casualty to, or theft of, your property and 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 paying 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 first 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 payment you received. For more information, see Publication 547.

**How to report.** If you had a casualty or theft that involved property used in your rental activity, you figure the net gain or loss in Section B of Form 4684, *Casualties and Thefts*. Also, you may have to report the net gain or loss from Form 4684 on Form 4797, *Sales of Business Property*. (Follow the instructions for Form 4684.)

## 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. However, you may be able to deduct rental losses without regard to whether you have income from other passive activities if you "materially" or "actively" participated in your rental activity. See *Passive Activity Limits*, later.

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 1986.

**Exception.** If your rental losses are less than \$25,000, and you actively participated in the rental activity, 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 under *Personal Use of Dwelling Unit (Including Vacation Home)*, earlier.

## 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. Losses from holding real property (other than mineral property) placed in service before 1987 are 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 for more information.

## Passive Activity Limits

In general, all rental activities (except those meeting the exception for real estate professionals, below) are passive activities. For this purpose, a rental activity is an activity from which you receive income mainly for the use of tangible property, rather than for services.

**Limits on passive activity deductions and credits.** Deductions for losses from passive activities are limited. You generally cannot offset income, other than passive income, with losses from passive activities. Nor can you offset taxes on income, other than passive income, with credits resulting from passive activities. Any excess loss or credit is carried forward to the next tax year.

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

You may have to complete Form 8582 to figure the amount of any passive activity loss for the current tax year for all activities and the amount of the passive activity loss allowed on your tax return. See *Form 8582 not required under Losses From Rental Real Estate Activities*, later, to determine whether you have to complete Form 8582.

## Exception for Real Estate Professionals

Rental activities in which you materially participated during the year are not passive activities if for that year you were a real estate professional. Losses from these activities are not limited by the passive activity rules.

For this purpose, each interest you have in a rental real estate activity is a separate activity, unless you choose to treat all interests in rental real estate activities as one activity.

If you were a real estate professional for 2004, complete line 43 of Schedule E (Form 1040).

**Real estate professional.** You qualified as a real estate professional for the tax year if you met both of the following requirements.

1. More than half of the personal services you performed in all trades or businesses during the tax year were performed in real property trades or businesses in which you materially participated.
2. You performed more than 750 hours of services during the tax year in real property trades or businesses in which you materially participated.

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

If you file a joint return, do not count your spouse's personal services to determine whether you met the preceding requirements. However, you can count your spouse's participation in an activity in determining if you materially participated.

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

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

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

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

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

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

See the instructions for Schedule E (Form 1040) for information about making this choice.

## Losses From Rental Real Estate Activities

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

If you are married, filing a separate return, and lived apart from your spouse for the entire tax year, your special allowance cannot be more than \$12,500. If you lived with your spouse at any time during the year and are filing a separate return, you cannot use the special allowance to reduce your nonpassive income or tax on nonpassive income.

The maximum amount of the special allowance is reduced if your modified adjusted gross income is more than \$100,000 (\$50,000 if married filing separately).

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

**Active participation.** You actively participated in a rental real estate activity if you (and your spouse) owned at least 10% of the rental property and you made management decisions in a significant and *bona fide* sense. Management decisions include approving new tenants, deciding on rental terms, approving expenditures, and similar decisions.

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

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

The rental loss 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.

**Maximum special allowance.** If your modified adjusted gross income is \$100,000 or less (\$50,000 or less if married filing separately), you can deduct your loss up to \$25,000 (\$12,500 if married filing separately). If your modified adjusted gross income is more than \$100,000 (more than \$50,000 if married filing separately), this special allowance is limited to 50% of the difference between \$150,000 (\$75,000 if married filing separately) and your modified adjusted gross income.

Generally, there is no relief from the passive activity loss limits if your modified adjusted gross

income is \$150,000 or more (\$75,000 or more if married filing separately).

**Modified adjusted gross income.** This is your adjusted gross income from Form 1040, line 37, figured without taking into account:

1. Taxable social security or equivalent tier 1 railroad retirement benefits,
2. Deductible contributions to an IRA or certain other qualified retirement plans,
3. The exclusion allowed for qualified U.S. savings bond interest used to pay higher educational expenses,
4. The exclusion allowed for employer-provided adoption benefits,
5. Any passive activity income or loss included on Form 8582,
6. Any passive income or loss or any loss allowable by reason of the exception for real estate professionals discussed earlier,
7. Any overall loss from a publicly traded partnership (see *Publicly Traded Partnerships (PTPs)* in the instructions for Form 8582,
8. The deduction for one-half of self-employment tax,
9. The deduction allowed for interest on student loans, or
10. The deduction for qualified tuition and related expenses.

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

1. Your only passive activities were rental real estate activities in which you actively participated.
2. Your overall net loss from these activities is \$25,000 or less (\$12,500 or less if married filing separately).
3. You do not have any prior year unallowed losses from any passive activities.
4. If married filing separately, you lived apart from your spouse all year.
5. You have no current or prior year unallowed credits from passive activities.
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.

If you meet all of the conditions listed above, your rental real estate activities are not limited by the passive activity rules and you do not have to complete Form 8582. Enter each rental real estate loss from line 22 of Schedule E (Form 1040) on line 23 of Schedule E.

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 to your tax return.

## How To Report Rental Income and Expenses

If you rent buildings, rooms, or apartments, and provide only heat and light, trash collection, etc., you normally report your rental income and expenses on Schedule E (Form 1040), Part I. However, do not use that schedule to report a not-for-profit activity. 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, *Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)*. You also may have to pay self-employment tax on your rental income. See Publication 533, *Self-Employment Tax*.

### Schedule E (Form 1040)

Use Schedule E (Form 1040), Part I, 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 Schedule E, page 1, line 20, enter the depreciation you are claiming. You must complete and attach Form 4562 for rental activities only if you are claiming:

- Depreciation on property placed in service during 2004,
- Depreciation on listed property (such as a car), regardless of when it was placed in service, or
- Any car expenses reported on a form other than Schedule C or C-EZ (Form 1040) or Form 2106 or Form 2106-EZ.

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

### Illustrated Example

In January, Eileen Johnson bought a condominium apartment to live in. Instead of selling the house she had been living in, she decided to change it to rental property. Eileen selected a tenant and started renting the house on Febru-

ary 1. Eileen charges \$750 a month for rent and collects it herself. Eileen received a \$750 security deposit from her tenant. Because she plans to return it to her tenant at the end of the lease, she does not include it in her income. Her house expenses for the year are as follows:

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

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

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

Improvements	Cost
House . . . . .	\$25,000
Remodeled kitchen . . . . .	4,200
Recreation room . . . . .	5,800
New roof . . . . .	1,600
Patio and deck . . . . .	2,400
<b>Adjusted basis . . . . .</b>	<b><u>\$39,000</u></b>

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

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

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

She uses Table 4-D to find her depreciation percentage. Because she placed the property in service in February, she finds the percentage to be 3.182%.

On April 1, Eileen bought a new dishwasher for the rental property at a cost of \$425. The dishwasher is personal property used in a rental real estate activity, which has a 5-year recovery period. The dishwasher qualifies for the 50% special depreciation allowance which she figures first. Next, she uses the percentage under "Half-year convention" in Table 4-A to figure her MACRS depreciation deduction for the dishwasher.

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

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



Total rental income received (\$750 × 11) . . . . .	\$8,250
Minus: Expenses	
Mortgage interest (\$1,800 × <sup>11</sup> / <sub>12</sub> ) . . . . .	\$1,650
Fire insurance (\$100 × <sup>11</sup> / <sub>12</sub> ) . . . .	92
Miscellaneous repairs . . . . .	297
Real estate taxes (\$1,200 × <sup>11</sup> / <sub>12</sub> ) . . . . .	<u>1,100</u>
Total expenses . . . . .	<u>3,139</u>
Balance . . . . .	\$5,111
Minus: Depreciation	
House (\$39,000 × 3.182%) . . . . .	\$1,241
Dishwasher—special allowance (\$425 × 50%) . . . . .	213
Dishwasher (\$425 – \$213 special allowance) × 20% . . . . .	42
Furnace (\$4,000 × 2.273%) . . . . .	<u>91</u>
Total depreciation . . . . .	<u>1,587</u>
<b>Net rental income for house</b>	<b><u>\$3,524</u></b>

Eileen uses Schedule E (Form 1040), Part I, to report her rental income and expenses. She enters her income, expenses, and depreciation for the house in the column for Property A. She uses Form 4562 to figure and report her depreci-

ation. Eileen's Schedule E (Form 1040) is shown next. Her Form 4562 is not shown. See Publication 946 for information on how to prepare Form 4562.

**SCHEDULE E  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service (99)

**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

**2004**

Attachment  
Sequence No. **13**

Name(s) shown on return

Eileen Johnson

Your social security number

123 : 00 : 4567

**Part I Income or Loss From Rental Real Estate and Royalties** Note. If you are in the business of renting personal property, use Schedule C or C-EZ (see page E-3). Report farm rental income or loss from Form 4835 on page 2, line 40.

1	List the type and location of each rental real estate property:	2	For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of:	Yes	No
A	Brick House 123 Main Street, Hometown, MN 56200		<ul style="list-style-type: none"> <li>• 14 days or</li> <li>• 10% of the total days rented at fair rental value?</li> </ul> (See page E-3.)		✓
B					
C					

Income:	Properties			Totals	
	A	B	C	(Add columns A, B, and C.)	
3 Rents received . . . . .	3 8,250			3	8,250
4 Royalties received . . . . .	4			4	
<b>Expenses:</b>					
5 Advertising . . . . .	5				
6 Auto and travel (see page E-4).	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-4) . . . . .	12 1,650			12	1,650
13 Other interest . . . . .	13				
14 Repairs . . . . .	14 297				
15 Supplies . . . . .	15				
16 Taxes . . . . .	16 1,100				
17 Utilities . . . . .	17				
18 Other (list) ▶	18				
19 Add lines 5 through 18 . . . . .	19 3,139			19	3,139
20 Depreciation expense or depletion (see page E-4) . . . . .	20 1,587			20	1,587
21 Total expenses. Add lines 19 and 20	21 4,726				
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-4 to find out if you must file Form 6198 . . . . .	22 3,524				
23 Deductible rental real estate loss. <b>Caution.</b> Your rental real estate loss on line 22 may be limited. See page E-4 to find out if you must file Form 8582. Real estate professionals must complete line 43 on page 2 . . . . .	23 ( ) ( ) ( )				
24 <b>Income.</b> Add positive amounts shown on line 22. <b>Do not</b> include any losses . . . . .	24			24	3,524
25 <b>Losses.</b> Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here	25 ( ) ( ) ( )			25	( )
26 <b>Total rental real estate and royalty income or (loss).</b> Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 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 41 on page 2 . . . . .	26			26	3,524

# How To Get Tax Help

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

**Contacting your Taxpayer Advocate.** If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate independently represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate toll free at 1-877-777-4778.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call 1-800-829-4059 if you are a TTY/TDD user.
- Visit [www.irs.gov/advocate](http://www.irs.gov/advocate).

For more information, see Publication 1546, The Taxpayer Advocate Service of the IRS—How To Get Help With Unresolved Tax Problems.

**Free tax services.** To find out what services are available, get Publication 910, IRS Guide to Free Tax Services. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.



**Internet.** You can access the IRS website 24 hours a day, 7 days a week, at [www.irs.gov](http://www.irs.gov) to:

- *E-file* your return. Find out about commercial tax preparation and *e-file* services available free to eligible taxpayers.
- Check the status of your 2004 refund. Click on *Where's My Refund*. Be sure to wait at least 6 weeks from the date

you filed your return (3 weeks if you filed electronically). Have your 2004 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.

- Download forms, instructions, and publications.
- Order IRS products online.
- Research your tax questions online.
- Search publications online by topic or keyword.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Figure your withholding allowances using our Form W-4 calculator.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.



**Fax.** You can get over 100 of the most requested forms and instructions 24 hours a day, 7 days a week, by fax. Just call 703-368-9694 from the telephone connected to your fax machine. When you call, you will hear instructions on how to use the service. The items you request will be faxed to you.

For help with transmission problems, call 703-487-4608.

Long-distance charges may apply.



**Phone.** Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call 1-800-829-3676 to order current-year forms, instructions, and publications and prior-year forms and instructions. You should receive your order within 10 days.
- *Asking tax questions.* Call the IRS with your tax questions at 1-800-829-1040.
- *Solving problems.* You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find

the number, go to [www.irs.gov/localcontacts](http://www.irs.gov/localcontacts) or look in the phone book under *United States Government, Internal Revenue Service*.

- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call 1-800-829-4477 and press 2 to listen to pre-recorded messages covering various tax topics.
- *Refund information.* If you would like to check the status of your 2004 refund, call 1-800-829-4477 and press 1 for automated refund information or call 1-800-829-1954. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2004 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.

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



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

- *Products.* You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.

- *Services.* You can walk in to your local Taxpayer Assistance Center every business day to ask tax questions or get help with a tax problem. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. You can set up an appointment by calling your local Center and, at the prompt, leaving a message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. To find the number, go to [www.irs.gov/localcontacts](http://www.irs.gov/localcontacts) or look in the phone book under *United States Government, Internal Revenue Service*.



**Mail.** You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 business days after your request is received. Use the address that applies to your part of the country.

- **Western part of U.S.:**  
Western Area Distribution Center  
Rancho Cordova, CA  
95743-0001
- **Central part of U.S.:**  
Central Area Distribution Center  
P.O. Box 8903  
Bloomington, IL 61702-8903
- **Eastern part of U.S. and foreign addresses:**  
Eastern Area Distribution Center  
P.O. Box 85074  
Richmond, VA 23261-5074



**CD-ROM for tax products.** You can order Publication 1796, IRS Federal Tax Products CD-ROM, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms and instructions.
- Frequently requested tax forms that may be filled in electronically, printed out for submission, or saved for recordkeeping.
- Internal Revenue Bulletins.

Buy the CD-ROM from National Technical Information Service (NTIS) at [www.irs.gov/cdorders](http://www.irs.gov/cdorders) for \$22 (no handling fee) or call 1-877-233-6767 toll free to buy the CD-ROM for \$22 (plus a \$5 handling fee). The first release is available in early January and the final release is available in late February.



**CD-ROM for small businesses.** Publication 3207, The Small Business Resource Guide, CD-ROM 2004, is a must for every small business owner or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instruc-

tions, and publications needed to successfully manage a business. In addition, the CD provides other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy and quick and incorporates file for-

mats and browsers that can be run on virtually any desktop or laptop computer.

It is available in early April. You can get a free copy by calling 1-800-829-3676 or by visiting [www.irs.gov/smallbiz](http://www.irs.gov/smallbiz).



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## Tax Publications for Individual Taxpayers

See *How To Get Tax Help* for a variety of ways to get publications, including by computer, phone, and mail.

### General Guides

- 1 Your Rights as a Taxpayer
- 17 Your Federal Income Tax (For Individuals)
- 334 Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)
- 509 Tax Calendars for 2005
- 553 Highlights of 2004 Tax Changes
- 910 IRS Guide to Free Tax Services

### Specialized Publications

- 3 Armed Forces' Tax Guide
- 54 Tax Guide for U.S. Citizens and Residents Aliens Abroad
- 225 Farmer's Tax Guide
- 378 Fuel Tax Credits and Refunds
- 463 Travel, Entertainment, Gift, and Car Expenses
- 501 Exemptions, Standard Deduction, and Filing Information
- 502 Medical and Dental Expenses (Including the Health Coverage Tax Credit)
- 503 Child and Dependent Care Expenses
- 504 Divorced or Separated Individuals
- 505 Tax Withholding and Estimated Tax
- 514 Foreign Tax Credit for Individuals
- 516 U.S. Government Civilian Employees Stationed Abroad
- 517 Social Security and Other Information for Members of the Clergy and Religious Workers
- 519 U.S. Tax Guide for Aliens
- 521 Moving Expenses
- 523 Selling Your Home
- 524 Credit for the Elderly or the Disabled
- 525 Taxable and Nontaxable Income
- 526 Charitable Contributions
- 527 Residential Rental Property
- 529 Miscellaneous Deductions
- 530 Tax Information for First-Time Homeowners

- 531 Reporting Tip Income
- 533 Self-Employment Tax
- 536 Net Operating Losses (NOLs) for Individuals, Estates, and Trusts
- 537 Installment Sales
- 541 Partnerships
- 544 Sales and Other Dispositions of Assets
- 547 Casualties, Disasters, and Thefts
- 550 Investment Income and Expenses
- 551 Basis of Assets
- 552 Recordkeeping for Individuals
- 554 Older Americans' Tax Guide
- 555 Community Property
- 556 Examination of Returns, Appeal Rights, and Claims for Refund
- 559 Survivors, Executors, and Administrators
- 561 Determining the Value of Donated Property
- 564 Mutual Fund Distributions
- 570 Tax Guide for Individuals With Income From U.S. Possessions
- 571 Tax-Sheltered Annuity Plans (403(b) Plans)
- 575 Pension and Annuity Income
- 584 Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)
- 587 Business Use of Your Home (Including Use by Daycare Providers)
- 590 Individual Retirement Arrangements (IRAs)
- 593 Tax Highlights for U.S. Citizens and Residents Going Abroad
- 594 What You Should Know About the IRS Collection Process
- 595 Tax Highlights for Commercial Fishermen
- 596 Earned Income Credit (EIC)
- 721 Tax Guide to U.S. Civil Service Retirement Benefits
- 901 U.S. Tax Treaties

- 907 Tax Highlights for Persons with Disabilities
- 908 Bankruptcy Tax Guide
- 911 Direct Sellers
- 915 Social Security and Equivalent Railroad Retirement Benefits
- 919 How Do I Adjust My Tax Withholding?
- 925 Passive Activity and At-Risk Rules
- 926 Household Employer's Tax Guide
- 929 Tax Rules for Children and Dependents
- 936 Home Mortgage Interest Deduction
- 946 How To Depreciate Property
- 947 Practice Before the IRS and Power of Attorney
- 950 Introduction to Estate and Gift Taxes
- 967 The IRS Will Figure Your Tax
- 968 Tax Benefits for Adoption
- 969 Health Savings Accounts and Other Tax-Favored Health Plans
- 970 Tax Benefits for Education
- 971 Innocent Spouse Relief
- 972 Child Tax Credit
- 1542 Per Diem Rates
- 1544 Reporting Cash Payments of Over \$10,000 (Received in a Trade or Business)
- 1546 The Taxpayer Advocate Service—How to Get Help With Unresolved Problems

### Spanish Language Publications

- 1SP Derechos del Contribuyente
- 579SP Cómo Preparar la Declaración de Impuesto Federal
- 594SP Comprendiendo el Proceso de Cobro
- 596SP Crédito por Ingreso del Trabajo
- 850 English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
- 1544SP Informe de Pagos en Efectivo en Exceso de \$10,000 (Recibidos en una Ocupación o Negocio)

## Commonly Used Tax Forms

See *How To Get Tax Help* for a variety of ways to get forms, including by computer, fax, phone, and mail. For fax orders only, use the catalog number when ordering.

Form Number and Title	Catalog Number	Form Number and Title	Catalog Number
1040 U.S. Individual Income Tax Return	11320	2106 Employee Business Expenses	11700
Sch A&B Itemized Deductions & Interest and Ordinary Dividends	11330	2106-EZ Reimbursed Employee Business Expenses	20604
Sch C Profit or Loss From Business	11334	2210 Underpayment of Estimated Tax by Individuals, Estates, and Trusts	11744
Sch C-EZ Net Profit From Business	14374	2441 Child and Dependent Care Expenses	11862
Sch D Capital Gains and Losses	11338	2848 Power of Attorney and Declaration of Representative	11980
Sch D-1 Continuation Sheet for Schedule D	10424	3903 Moving Expenses	12490
Sch E Supplemental Income and Loss	11344	4562 Depreciation and Amortization	12906
Sch EIC Earned Income Credit	13339	4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return	13141
Sch F Profit or Loss From Farming	11346	4952 Investment Interest Expense Deduction	13177
Sch H Household Employment Taxes	12187	5329 Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts	13329
Sch J Farm Income Averaging	25513	6251 Alternative Minimum Tax—Individuals	13600
Sch R Credit for the Elderly or the Disabled	11359	8283 Noncash Charitable Contributions	62299
Sch SE Self-Employment Tax	11358	8582 Passive Activity Loss Limitations	63704
1040A U.S. Individual Income Tax Return	11327	8606 Nondeductible IRAs	63966
Sch 1 Interest and Ordinary Dividends for Form 1040A Filers	12075	8812 Additional Child Tax Credit	10644
Sch 2 Child and Dependent Care Expenses for Form 1040A Filers	10749	8822 Change of Address	12081
Sch 3 Credit for the Elderly or the Disabled for Form 1040A Filers	12064	8829 Expenses for Business Use of Your Home	13232
1040EZ Income Tax Return for Single and Joint Filers With No Dependents	11329	8863 Education Credits	25379
1040-ES Estimated Tax for Individuals	11340	9465 Installment Agreement Request	14842
1040X Amended U.S. Individual Income Tax Return	11360		