



Fact Sheet

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Rental Property and the Tax Gap

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Not reporting or under reporting rental income contributes to the tax gap. Landlords need to be aware of everything that counts as income so they pay their fair share of taxes. They also need to be aware of all deductible expenses so they don't overpay their taxes.

This fact sheet is the 14th in a series to help reduce the tax gap by helping taxpayers better understand the tax code. The tax gap is the difference between the amount of taxes that should be paid in a given year and the amount actually paid voluntarily and in a timely way.

Rental Income

In the simplest terms, rental income is any payment received for the use or occupation of property. Most landlords operate on a cash basis. That means they count payments as income in the period they are received and deduct expenses in the period they are paid.

Landlords also need to be aware of other forms of rental income that may need to be declared. Rental income may also include:

- Advance rent payments
- Early-termination fees on lease agreements
- Expenses paid by tenant for the landlord (These may also be deductible as rental expenses.)
- Property or services received in lieu of money (This is based on the fair market value of the property or services.)
- Lease payments with option to buy (These payments are usually counted at rental income. If the tenant buys the property, payments received after the sale date are generally counted as part of the selling price.)
- Payments for renting a portion of your home may or may not be taxable income depending on certain thresholds. [See IRS Publication 527, Residential Rental Property.](#)

Security deposits are not counted as income if they are to be refunded at the end of a lease period per an agreement. Landlords sometimes retain portions of security deposits because tenants don't live up to the terms of a lease. Any funds withheld from a deposit are counted as income in the year they are retained. Deposits used as final lease payments are considered advance rents and counted as income in the period they are received.

Rental Expenses

Landlords can deduct the ordinary and necessary expenses for managing, conserving, and maintaining their rental property. Ordinary expenses are those that are common and generally accepted in the business. Necessary expenses are those that are deemed appropriate, such as interest, taxes, advertising, maintenance, utilities, and insurance.

Other deductible expenses may include:

- Expenses incurred from the time a property is made available for rent and is actually rented.
- Some or all of the original investment in the rental property may be recovered through depreciation using [Form 4562](#). Subsequent improvements may also be depreciated.
- The cost of repairs may also be deductible. This may include the cost of labor and materials. However, landlords cannot deduct the value of their own labor.

Improvements that add to the value of a property or prolong its useful life are considered capital expenses and generally must be depreciated. Discussion about whether an expense is an improvement or a repair is included in [Publication 946, How to Depreciate Property](#).

Expenses may be deductible on rental property also used for personal use, but only on a proportional basis. Landlords are permitted to use any reasonable method for calculating what portion of a property should be considered rental. Using square footage is a common method and frequently the most accurate.

Some property is rented out at times and used for personal use other times, such as a beach house. In this case, deductible expenses must be calculated based on the number of days the property is used for each purpose. Deductible rental expenses can not exceed gross rental income for property used for both personal use and as a rental in a given year.

Expenses incurred while property is vacant but available for rent may be deductible. Lost rental income while a property is vacant is not deductible.

Information on other rental expenses and reporting requirements is available in [Publication 527, Residential Rental Property](#).