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**Internal
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Service**

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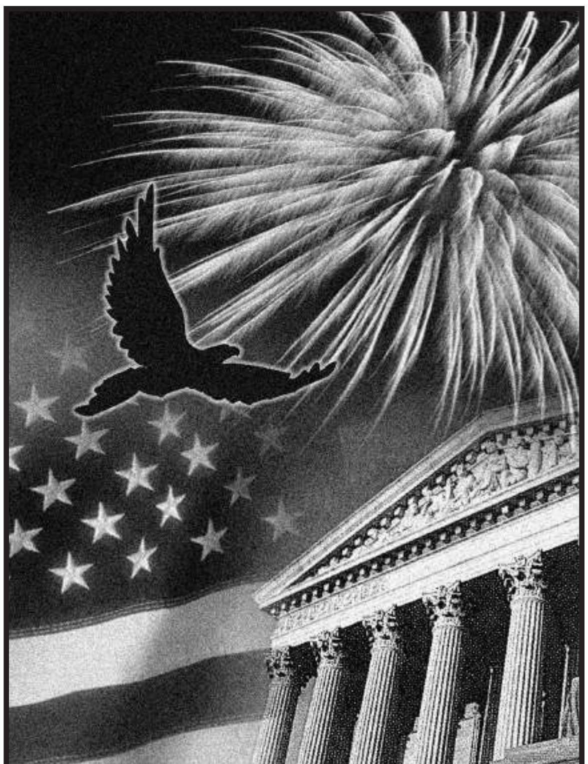
Residential Rental Property

(Including Rental of Vacation Homes)

For use in preparing

2016 Returns



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Nov 29, 2016

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Future Developments

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

Reminders

Net Investment Income Tax (NIIT). You may be subject to the Net Investment Income Tax (NIIT). NIIT is a 3.8% tax on the lesser of net investment income or the excess of modified adjusted gross income (MAGI) over the threshold amount. Net investment income may include rental income and other income from passive activities. Use Form 8960, Net Investment Income Tax, to figure this tax. For more information on NIIT, go to IRS.gov and enter "Net Investment Income Tax" in the search box.

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

Introduction

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

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

Chapter 1 discusses rental-for-profit activity in which there is no personal use of the property. It examines some common types of rental income and when each is reported, as well as some common types of expenses and which are deductible.

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

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

Chapter 4 discusses special rental situations. These include condominiums, cooperatives, property changed to rental use, renting only part of your property, and a not-for-profit rental activity.

Chapter 5 discusses the rules for rental income and expenses when there is also personal use of the dwelling unit, such as a vacation home.

Finally, chapter 6 explains how to get tax help from the IRS.

Sale or exchange of rental property. For information on how to figure and report any gain or loss from the sale, exchange or other disposition of your rental property, see Pub. 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, see Pub. 523, Selling Your Home.

Tax-free exchange of rental property occasionally used for personal purposes. If you meet certain qualifying use standards, you may qualify for a tax-free exchange (a like-kind or section 1031 exchange) of one piece of rental property you own for a similar piece of rental property, even if you have used the rental property for personal purposes.

For information on the qualifying use standards, see Rev. Proc. 2008–16, 2008 I.R.B. 547, at *IRS.gov/irb/2008-10_IRB/ar12.html*. For more information on like-kind exchanges, see chapter 1 of Pub. 544.

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Although we cannot respond individually to each comment received, we do appreciate your feedback and will consider your comments as we revise our tax products.

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Tax questions. If you have a tax question not answered by this publication, check IRS.gov and *How To Get Tax Help* at the end of this publication.

Useful Items

You may want to see:

Publication

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

Form (and Instructions)

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

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

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

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

Rental Income

In most cases, you must include in your gross income all amounts you receive as rent. Rental income is any payment you receive for the use or occupation of property. It is not limited to amounts you receive as normal rental payments.

When To Report

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

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

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

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

Types of Income

The following are common types of rental income.

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

Example. On March 18, 2016, you signed a 10-year lease to rent your property. During 2016, you received $9,600 for the first year's rent and $9,600 as rent for the last year of the lease. You must include $19,200 in your rental income in 2016.

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

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

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

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

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

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

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

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

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

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

Other Sources of Rental Income

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

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

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

Rental Expenses

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

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

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

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

When To Deduct

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

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

Types of Expenses

Listed below are the most common rental expenses.

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

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

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

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

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

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

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

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

Legal and other professional fees. You can deduct, as a rental expense, legal and other professional expenses such as tax return preparation fees you paid to prepare Schedule E, Part I. For example, on your 2016 Schedule E you can deduct fees paid in 2016 to prepare Part I of your 2015 Schedule E. You can also deduct, as a rental expense, any expense (other than federal taxes and penalties) you paid to resolve a tax underpayment related to your rental activities.

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

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

Generally, if you use your personal car, pickup truck, or light van for rental activities, you can deduct the expenses using one of two methods: actual expenses or the standard mileage rate. For 2016, the standard mileage rate for business use is 54 cents per mile. For more information, see chapter 4 of Pub. 463.

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

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

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

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

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

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

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

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

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

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

Points

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

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

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

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

***De minimis* OID.** The OID is *de minimis* if it is less than one-fourth of 1% (0.0025) of the stated redemption price at maturity (principal amount of the loan) multiplied by the number of full years from the date of original issue to maturity (term of the loan).

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

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

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

Example. Carol took out a $100,000 mortgage loan on January 1, 2016, to buy a house she will use as a rental during 2016. The loan is to be repaid over 30 years. During 2016, Carol paid $10,000 of mortgage interest (stated interest) to the lender. When the loan was made, she paid $1,500 in points to the lender. The points reduced the principal amount of the loan from $100,000 to $98,500, resulting in $1,500 of OID. Carol determines that the points (OID) she paid are *de minimis* based on the following computation.

Redemption price at maturity (principal amount of the loan)	$100,000
Multiplied by: The term of the loan in complete years	× 30
Multiplied by	× 0.0025
***De minimis* amount**	$ 7,500

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

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

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

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

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

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

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

She figured the amount of points (OID) she could deduct in 2016 as follows.

Principal amount of the loan	$100,000
Minus: Points (OID)	− 1,500
Issue price of the loan	$ 98,500
Multiplied by: YTM	× 0.102467
Total	10,093
Minus: QSI	− 10,000
Points (OID) deductible in 2016	$ 93

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

Example—Year 2. Carol figured the deduction for 2017 as follows.

Issue price	$98,500
Plus: Points (OID) deducted in 2016	+ 93
Adjusted issue price	$98,593
Multiplied by: YTM	× 0.102467
Total	10,103
Minus: QSI	− 10,000
Points (OID) deductible in 2017	$ 103

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

Points when loan refinance is more than the previous outstanding balance. When you refinance a rental property for more than the previous outstanding balance, the portion of the points allocable to loan proceeds **not** related to rental use generally cannot be deducted as a rental expense.

Example. Charles refinanced a loan with a balance of $100,000. The amount of the new loan was $120,000. Charles used the additional $20,000 to purchase a car. The points allocable to the $20,000 would be treated as nondeductible personal interest.

Repairs and Improvements

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

Improvements. You must capitalize any expense you pay to improve your rental property. An expense is for an improvement if it results in a betterment to your property, restores your property, or adapts your property to a new or different use. Table 1-1 shows examples of many improvements.

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

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

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

RECORDS

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

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

2. Depreciation of Rental Property

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

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

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

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

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

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

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

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

The Basics

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

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

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

What Rental Property Can Be Depreciated?

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

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

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

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

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

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

What Rental Property Cannot Be Depreciated?

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

Land. You cannot depreciate the cost of land because land generally does not wear out, become obsolete, or get used up. But if it does, the loss is accounted for upon disposition. The costs of clearing, grading, planting, and landscaping are usually all part of the cost of land and cannot be depreciated. You may, however, be able to depreciate certain land preparation costs if the costs are so closely associated with other depreciable property that you can determine a life for them along with the life of the associated property.

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

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

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

For more information, see chapter 1 of Pub. 946.

When Does Depreciation Begin and End?

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

Placed in Service

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

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

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

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

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

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

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

Idle Property

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

Cost or Other Basis Fully Recovered

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

Retired From Service

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

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

Depreciation Methods

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

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

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

See *MACRS Depreciation*, later, for more information.

Rental property placed in service before 2016. Continue to use the same method of figuring depreciation that you used in the past.

Use of real property changed. Generally, you must use MACRS to depreciate real property that you acquired for personal use before 1987 and changed to business or income-producing use after 1986. This includes your residence that you changed to rental use. See

Property Owned or Used in 1986 in Pub. 946, chapter 1, for those situations in which MACRS is not allowed.

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

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

Basis of Depreciable Property

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

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

Basis and adjusted basis are explained in the following discussions.

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

Cost Basis

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Basis Other Than Cost

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

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

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

Adjusted Basis

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

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

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

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

For example, if you had an architect draw up plans for remodeling your property, the architect's fee is a part of the cost of the remodeling.

Or, if you had your lot surveyed to put up a fence, the cost of the survey is a part of the cost of the fence.

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

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

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

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

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

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

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

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

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

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

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

Special Depreciation Allowance

For 2016, some properties used in connection with residential real property activities may qualify for a special depreciation allowance. This allowance is figured before you figure your regular depreciation deduction. See Pub. 946, chapter 3, for details. Also see the instructions for Form 4562, line 14.

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

MACRS Depreciation

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

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

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

Depreciation Systems

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

Excluded Property

You cannot use MACRS for certain personal property (such as furniture or appliances) placed in service in your rental property in 2016 if it had been previously placed in service before 1987, when MACRS became effective.

In most cases, personal property is excluded from MACRS if you (or a person related to you) owned or used it in 1986 or if your tenant is a person (or someone related to the person) who owned or used it in 1986. However, the property is not excluded if your 2016 deduction under MACRS (using a half-year convention) is less than the deduction you would have under ACRS. For more information, see *What Method Can You Use To Depreciate Your Property?* in Pub. 946, chapter 1.

Electing ADS

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

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

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

For property placed in service during 2016, you make the election to use ADS by entering the depreciation on Form 4562, Part III, Section C, line 20c.

Property Classes Under GDS

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

The property classes under GDS are:

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

Under MACRS, property that you placed in service during 2016 in your rental activities generally falls into one of the following classes.

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

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

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

- ***7-year property.*** This class includes office furniture and equipment (desks, file cabinets, and similar items). This class also includes any property that does not have a class life and that has not been

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

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

Recovery Periods Under GDS

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

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

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

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

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

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

The recovery period for an addition or improvement to property begins on the later of:
- The date the addition or improvement is placed in service, or
- The date the property to which the addition or improvement was made is placed in service.

Example. You own a residential rental house that you have been renting since 1986 and depreciating under ACRS. You built an addition onto the house and placed it in service in 2016. You must use MACRS for the addition. Under GDS, the addition is depreciated as residential rental property over 27.5 years.

Conventions

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

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

Mid-quarter convention. A mid-quarter convention must be used if the mid-month convention does not apply and the total depreciable basis of MACRS property placed in service in the last 3 months of a tax year (excluding 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 purchased the following items to use in his rental property. He elects not to claim the special depreciation allowance discussed earlier.
- A dishwasher for $400 that he placed in service in January.
- Used furniture for $100 that he placed in service in September.
- A refrigerator for $800 that he placed in service in October.

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

Half-year convention. The half-year convention is used if neither the mid-quarter convention nor the mid-month convention applies. Under this convention, you treat all property

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

Keep for Your Records

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

placed in service, or disposed of, during a tax year as placed in service, or disposed of, at the midpoint of that tax year.

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

Figuring Your Depreciation Deduction

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

- The depreciation method and convention that apply over the recovery period of the property, or
- The percentage from the MACRS percentage tables.

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

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

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

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

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

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

MACRS Percentage Tables

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

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

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

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

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

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

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

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

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

For more information, see chapter 4 of Pub. 946.

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

Example 1. You purchased a stove and refrigerator and placed them in service in June. Your basis in the stove is $600 and your basis in the refrigerator is $1,000. Both are 5-year property. Using the half-year convention column in Table 2-2a, the depreciation percentage for Year 1 is 20%. For that year your depreciation deduction is $120 ($600 × 0.20) for the stove and $200 ($1,000 × 0.20) for the refrigerator.

For Year 2, the depreciation percentage is 32%. That year's depreciation deduction will be $192 ($600 × 0.32) for the stove and $320 ($1,000 × 0.32) for the refrigerator.

Example 2. Assume the same facts as in *Example 1*, except you buy the refrigerator in October instead of June. Since the refrigerator was placed in service in the last 3 months of the tax year, and its basis ($1,000) is more than 40% of the total basis of all property placed in service during the year ($1,600 × 0.40 = $640), you are required to use the mid-quarter convention to figure depreciation on both the stove and refrigerator.

Because you placed the refrigerator in service in October, you use the fourth quarter column of Table 2-2a and find the depreciation percentage for Year 1 is 5%. Your depreciation deduction for the refrigerator is $50 ($1,000 x 0.05).

Because you placed the stove in service in June, you use the second quarter column of Table 2-2a and find the depreciation percentage for Year 1 is 25%. For that year, your depreciation deduction for the stove is $150 ($600 x 0.25).

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

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

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

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

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
7	8.93	8.75	8.87	8.86	8.73

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

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
7	5.90	5.90	5.91	5.90	5.90
8	5.90	5.91	5.90	5.90	5.90

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

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

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

Example. You purchased a single family rental house for $185,000 and placed it in service on February 8. The sales contract showed that the building cost $160,000 and the land cost $25,000. Your basis for depreciation is its original cost, $160,000. This is the first year of service for your residential rental property and you decide to use GDS which has a recovery period of 27.5 years. Using Table 2-2d, you find that the percentage for property placed in service in February of Year 1 is 3.182%. That year's depreciation deduction is $5,091 ($160,000 x 0.03182).

Figuring MACRS Depreciation Under ADS

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

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

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

See Pub. 946 for ADS depreciation tables.

Claiming the Correct Amount of Depreciation

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

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

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

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

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

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

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

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

3. Reporting Rental Income, Expenses, and Losses

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

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

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

Which Forms To Use

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

Schedule E (Form 1040)

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

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

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

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

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

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

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

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

- Depreciation, including the special depreciation allowance, on property placed in service during 2016;
- Depreciation on listed property (such as a car), regardless of when it was placed in service; or
- Any other car expenses, including the standard mileage rate or lease expenses.

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

See Pub. 946 for information on preparing Form 4562.

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

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

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

Qualified Joint Venture

If you and your spouse each materially participate (see *Material participation* under *Passive Activity Limits*, later) as the only members of a jointly owned and operated real estate business, and you file a joint return for the tax year, you can make a joint election to be treated as a