

## Legislators work to create new options for security deposits

Cash security deposits, on top of high rents in most cities, make it difficult for many people to find affordable places to live.

State and city lawmakers are working to eliminate the requirement that renters pay the deposits, which can be as much as one to two months' rent, up front. The bills would require that landlords accept installment payments over time or insurance that would protect against damages to the rental.

Legislators say many people who could afford monthly rent can't secure a rental because they don't have enough savings to pay the security deposit in cash.

A law in Cincinnati now mandates that landlords accept payment plans or insurance in lieu of a cash security deposit upfront, and a new law in New York State limits security deposits to no more than one month's rent.



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A law that would provide new options for paying security deposits has been proposed in Virginia, and lawmakers in Alabama, Connecticut and New Hampshire are planning to introduce similar ones.

Many landlords oppose the bills, arguing that cash security deposits are the best way to protect themselves and their buildings.

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# Legal Matters®

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## New tax break for rental real estate owners

The IRS recently clarified the terms under which rental real estate owners can qualify for a new tax break under section 199A of the Internal Revenue Code.

The section provides a tax deduction of up to 20 percent of an entity's qualified business income, or QBI, for many owners of pass-through entities, including sole proprietorships, partnerships and S corporations. (QBI is defined as the net amount of qualified items of income, gain, deduction and loss from any qualified "trade or business," but the law does not include a clear rule defining what constitutes a "trade or business.")

For rental real estate owners, it had been unclear whether they were eligible for the deduction. The IRS initially released Notice 2019-07 proposing a "safe harbor" that determines when rental real estate would be defined as a "trade or business" to qualify for the deduction.

The new Revenue Procedure finalizes the safe harbor, with a few changes. It defines the safe harbor, but states that a taxpayer who finds the requirements too complicated to satisfy could use other information to establish they qualify for the deduction under general tax principles.

The safe harbor applies for tax years ending after Dec. 31, 2017.

### The details

The safe harbor is available to taxpayers and relevant pass-through entities seeking to claim the deduction under section 199A with respect to a "rental real estate enterprise." It states that a "rental real estate enterprise" is an interest in real property held to generate rental or lease income.



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Under the safe harbor, the following conditions must be met for a rental real estate enterprise to satisfy the trade or business requirements under section 199A:

- separate books and records must be maintained to reflect income and expenses for each rental real estate enterprise;
- for rental real estate enterprises that have been in existence for less than four years, 250 or more hours of rental services must be performed per year. For rental real estate enterprises that have been in existence for four years or more, 250 or more hours of "rental services" must have been performed in at least three of the past five years. "Rental services"

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# Tips for writing off investment property on your taxes



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You can maximize the return on your real estate investments by knowing the rules for writing them off on your taxes.

### Taxes on rental income

Rental income is taxable as income on your ordinary income tax return, but is not subject to FICA tax.

Income on your rental property includes anything paid to you as rent or royalty, minus any

deductible expenses, which include mortgage interest and basic repairs to bring the property to a minimally functional condition. (You cannot deduct additions, renovations or new buildings.)

### Capital gains tax

Capital gains tax applies to any net profits you make when you sell your property.

If you sell after owning a property for less than one year, the IRS will assess a short-term capital gains tax equal to the same rate as your marginal income tax rate.

For tax purposes, it is better to wait to sell until you have owned the property for at least 12 months. In such a sale, you pay long-term capital gains tax, with a rate that ranges between 0 percent and 15 percent, depending on your tax bracket.

Capital gains tax is paid on the difference between the selling price of the property and your adjusted tax basis. Adjusted tax basis is equal to the original amount paid for the property plus any investments made to improve the property, as long as those amounts haven't been previously deducted. When calculating the tax basis, be sure to subtract any deductions related to the property.

If your adjusted tax basis is higher than the amount of the sale, you have a capital loss. The amount of capital

gains tax you owe is then reduced by subtracting capital losses from the capital gains tax amount.

Each year, you can use at most \$3,000 as a tax write-off against income other than capital gains. When you have more capital losses than capital gains beyond \$3,000, you can use the capital losses to offset capital gains in future years. This is called carrying the losses forward.

### Like-kind exchanges

If you sell an investment property and make a profit, then invest in another property within 60 days, you don't have to pay capital gains tax. This is called a like-kind exchange under Section 1031 of the Internal Revenue Code.

### Depreciation and amortization

The IRS takes into account the fact that your investment property will depreciate in value over time and that you will use the property to bring in more income over time. You are able to take a deduction for the property's reduction in value over the year.

In most cases, you may amortize your deduction for your investment property over 27.5 years.

### Rules for passive activity

A passive investor, who doesn't work on managing real estate investments day to day, is subject to passive activity rules, which permit deduction of passive losses only to cancel out the gains from passive activities. You cannot use losses from passive activities to offset other capital gains from other property.

Generally, most individual landlords can deduct up to \$25,000 per year in losses on rental properties, if needed, subject to an income limitation.

### Property taxes

You must pay property taxes each year. You can deduct the property taxes against your rental income, as long as it isn't a special tax assessment.

An attorney familiar with real estate tax rules can help you make sure you are following all of the rules.

# New tax break for rental real estate owners

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specifically include (i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information contained in prospective tenant applications; (iv) collection of rent; (v) daily operation, maintenance, and repair of the property, including the purchase of materials and supplies; (vi) management of the real estate; and (vii) supervision of employees and independent contractors;

- the taxpayer must maintain contemporaneous records regarding the services performed. That includes a description of the services, the dates on which such services were performed, the identity of the person who performed the services and the total hours spent performing the services. The contemporaneous records requirement applies to tax years beginning on or after Jan. 1, 2020;

- the taxpayer or relevant pass-through entity must attach a statement to its tax return filed for the tax year(s) for which the taxpayer relies upon the safe harbor, specifically representing that the requirements of the IRS Revenue Procedure have been met.

### Rental services hours

Many entities that commented on the proposal urged the IRS to reduce the number of rental services hours required under the safe harbor, but the IRS left it at 250 hours. The challenge of this requirement is reduced because the rule allows services of both employees and independent contractors to satisfy the requirement.

However, that requires some owners of rental real estate to adjust their practices to ensure detailed invoicing with service providers, especially because employees and independent contractors do not always report the number of hours they spend servicing a property.

### Mixed-use properties

Under the proposed definition of the safe har-

bor, it was unclear if mixed-use properties were eligible for the deduction under section 199A. The final version states that an interest in mixed-use property may be treated in one of two ways: 1) as a single rental real estate enterprise, or 2) bifurcated into separate residential and commercial interests.

The Revenue Procedure defines "mixed-use property" as a single building that combines residential and commercial units.

While it is favorable for mixed-use properties to be eligible for the tax break, it does require owners to review their properties and decide the best way to categorize them. That is especially true because separate record-keeping would also be required.

A real estate attorney can help you evaluate the best way to categorize your rental properties.

### Property under triple net lease not eligible

Property under a triple net lease is not eligible for the safe harbor, but an owner can still establish that the property meets the "trade or business" requirements to get the tax break.

Under the Revenue Procedure, a triple net lease is defined as a lease agreement that requires the tenant or lessee to pay taxes, fees and insurance, and to be responsible for property maintenance in addition to rent and utilities.



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# 2019 a big year for refinancing, mortgage recovery

The year 2019 was the best year for mortgages since the crisis in 2006, the Wall Street Journal reported. The lending boom amounted to \$2.4 trillion in home loans, an increase in 46 percent since 2018, according to industry research group Inside Mortgage Finance. The trend is expected to continue this year.

According to the Mortgage Bankers Association, refinancings made up nearly 40 percent of mortgage



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originations in 2019.

Lending, fueled by cuts in interest rates, led to a boost in housing prices and home sales, all of which meant a boost for the economy overall. At the end of 2019, the average rate on a 30-year fixed-rate mortgage fell to 3.74 percent, compared to 4.55 percent at the same time last year.

Despite the overall improvement in the market, buyers face several barriers. A low supply of housing, and the fact that home prices are rising more quickly than incomes, continue to make it difficult for many Americans to buy. This is especially true for people seeking to buy their first homes, because lower rates can lead to higher prices, given that some buyers might be able to pay more in bidding wars.