



REAL ESTATE • CLIENT GUIDE

Rental Property Basics

Depreciation, passive loss rules, short-term rentals, and 1031 exchanges.



Real estate carries some of the most favorable tax treatment in the code.

Depreciation alone can shelter a meaningful share of rental income from tax each year, on paper, without costing you a dollar in cash.

◆ Reporting rental income and expenses

Rental activity is generally reported on Schedule E, where rental income is offset by operating expenses: mortgage interest, property taxes, insurance, repairs, management fees, and depreciation. Repairs that keep a property in its existing condition are typically deducted immediately; improvements that add value or extend the property's life are usually capitalized and depreciated instead, and the line between the two is where a lot of rental returns get it wrong.

◆ Depreciation, in plain terms

Residential rental property is depreciated over 27.5 years using the straight-line method, covering the building itself. Land is never depreciable, so the purchase price has to be allocated between land and building before depreciation begins. This deduction reduces taxable income every year you hold the property without any cash leaving your pocket, which is exactly why real estate investors talk about it so much. It also reduces your basis in the property, which matters later when you sell.

◆ Passive losses and the rules that limit them

Rental losses are generally treated as passive and can only offset passive income, with a narrower exception allowing certain active participants to deduct a limited amount of rental loss against other income, phasing out at higher income levels. Real estate professionals who meet specific time and material-participation tests can treat rental losses as non-passive instead, a status worth evaluating carefully, since it changes what a loss year is actually worth to you.

◆ Short-term rentals are a different animal

A property rented short-term with an average stay of seven days or less, especially where you provide hotel-like services, can fall outside the passive rental rules entirely and sometimes outside Schedule E altogether, which changes both the loss limitations that apply and whether self-employment tax enters the picture. Treating a short-term rental like a standard long-term rental on the return is one of the more common and costly mismatches we see.

◆ 1031 exchanges

A properly structured like-kind exchange lets an investor defer gain on the sale of investment real estate by rolling proceeds into a replacement property, but the timeline is unforgiving: 45 days to identify a replacement property and 180 days to close, both starting the day the original property is sold, and the funds must pass through a qualified intermediary rather than through your own hands at any point.

◆ Key Takeaways

- Depreciation shelters rental income on paper each year without costing you a dollar in cash.
- Rental losses are generally passive and limited; real-estate-professional status can change what they're worth.
- A 1031 exchange runs on an unforgiving clock: 45 days to identify, 180 days to close.

How Emrys Can Help

We help real estate investors classify repairs versus improvements correctly, evaluate active and real-estate-professional status, and plan 1031 exchanges and short-term rental structures before the clock starts running, not after.



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