

Rental Property Basis and Depreciation

When you own a rental property, **basis** determines how much you can depreciate and how gain or loss is calculated when you sell. Accurate tracking of **basis**, **depreciation**, and **operating expenses** ensures you take every deduction allowed — and stay compliant when it's time to sell.

1. Rental Property Basis: What It Includes

Category	Examples	Notes
Purchase Price	Amount paid for the property (cash, loan, or assumption of debt)	Starting point for cost basis
Closing Costs (Capitalized)	Title fees, recording fees, transfer taxes, legal fees	Add to basis (not deducted as expenses)
Improvements	Roof replacement, new HVAC, additions, remodeling	Must extend life or add value — not maintenance
Land Value	Portion of purchase price allocated to land	Not depreciable
Depreciable Basis	Total basis minus land value	Used to calculate annual depreciation
Adjustments Over Time	Later improvements or damage losses	Keep basis updated annually

2. Depreciation Overview

Property Type	Depreciation Method	Recovery Period	Notes
Residential Rental	Straight-Line (MACRS)	27.5 years	Applies to dwellings with $\geq 80\%$ rental use
Commercial Property	Straight-Line (MACRS)	39 years	Offices, warehouses, or mixed-use ($< 80\%$ residential)
Land	N/A	Not Depreciable	Only building & permanent improvements qualify

3. Common Rental Expenses (Schedule E Reference)

Expense Category	Examples
Advertising	Listings, rental websites, signs
Auto & Travel	Mileage for property visits, supply runs, tenant meetings
Cleaning & Maintenance	Lawn care, pest control, minor repairs
Commissions	Leasing or property management fees
Insurance	Property, liability, flood, and landlord insurance
Legal & Professional Fees	Attorneys, accountants, or property management services
Mortgage Interest	Interest on rental mortgage loans
Repairs	Fixing leaks, replacing broken fixtures, repainting
Supplies	Tools, light bulbs, small equipment
Taxes	Real estate taxes, personal property tax on furnishings
Utilities	Water, electric, trash if paid by landlord
Depreciation Expense	Annual depreciation from Form 4562
Other Expenses	HOA fees, software subscriptions, safety inspections

4. Security Deposits (Balance Sheet Item)

Item	Treatment	Notes
Security Deposits Received	Record as a liability on your balance sheet	Not income when received — belongs to the tenant until forfeited
Security Deposits Returned	Decrease the liability when refunded	Not an expense when returned
Forfeited Deposits	Reclassified from liability to rental income	Only taxable if tenant forfeits their deposit

5. Example Calculation

Purchase price: \$300,000

Land value: \$60,000

Depreciable basis: \$240,000

Depreciation (Residential): $\$240,000 \div 27.5 = \$8,727$ per year

6. Key Takeaways

Keep accurate records of both basis and operating expenses. Only buildings and qualifying improvements are depreciable — not land. Track operating expenses monthly to match Schedule E categories. Security deposits belong on your balance sheet, not your income statement. Depreciation reduces taxable income now but may trigger recapture when you sell.