Tax Write-Offs for the Self Employed

Chris Bird
Chris Bird Seminars
Four Things Every Realtor Needs to Know to Get Ready for their Taxes for 2015 and get a Head Start on 2016

Federal and State Income taxes can be both a daunting and frustrating issue for all taxpayers, but even more so for the self employed professional. Excellent recordkeeping is a must, as well as the selection of competent tax professionals who understand the business that you are in. If you are an investor, your tax professional should be familiar with the type of investments that you are involved in, be it stocks, mutual funds, real estate etc. Here are some of the things that you should be thinking about right now to get ready to meet with your tax professional in the next several months:

1. Get your records organized. Contact your Tax Professional and request that they send you an organizer that will assist you in assimilating the records that both you and your preparer will need to prepare the 2014 return. This organizer will include both the items and the amounts that were entered on the 2013 return, which will serve as a reminder for which records to look for. And be sure NOT to just drop off you tax information to your preparer. Make sure that you have a discussion with them prior to completion of the return to make sure that you have included everything and that you have obtained answers to any and all questions that you might have.

2. DO NOT fudge on either income or deduction items. Do it right, and do it ethically, just like you do every day in your real estate practice. Even though the IRS audit rate is significantly decreased, unreported income that is found in an audit can result in FRAUD charges, which to say the least, is a career ending problem. I cannot tell you the number of times I have been contacted in the past several years by Realtors, and some from Minnesota, that have had severe problems with the IRS over unreported income or significant overstating of deductions.

3. Check and Double check that you are not missing legitimate deductions. Most self employed professionals have a general idea of the types of deductions that can be claimed, but are you considering everything? Have you considered the business promotion (100%) vs. entertainment (50%) issue, the Office in Home new safe harbor rule, the Heavy SUV or Pickup Truck Enhanced Write-Off, the possible deduction of Concealed Carry and Firearms Training issues, or the use of the Subchapter S Corporation for your business?????? These are all issues that I will cover in significant detail.
4. Do Not Wait until the Last Minute. It is a proven fact that the more rushed you are in preparing your information for tax preparation, the more lousy of a job you will do. This will result in missed deductions, and in some cases, estimating both income and expense items, which is always a bad thing to do.

TAX BRACKETS VS EFFECTIVE TAX RATE

Tax Brackets, for example 10%, 15% or 35% is the rate at which taxes are calculated for a taxable taxpayer's income. Each dollar or additional taxable income will cost the taxpayer the tax bracket rate in taxes, thus some people refer to tax brackets.

Effective tax rate changes with each $1.00 of increase or decrease in taxable income. The effective tax rate is calculated by dividing one's tax due by the amount of taxable income.

BEFORE TAX VS AFTER TAX

Because of the obligation to pay income taxes, most people and especially investors are concerned with before-tax and after-tax yields or returns on investment.

Real estate has been considered a tax advantaged investment in that depreciation or cost recovery where appropriate allows the taxpayer to reduce the amount of taxable income before computing the tax.

EXAMPLE

A Realtor purchases a new laptop for $800.00 and is in the 25% tax bracket. The after-tax cost of the laptop is only $600.00

TAXES AND THE REAL ESTATE AGENT
A. RECORD KEEPING

One of the reasons that salespeople are audited frequently is because they are notoriously poor record keepers. One of the great myths is that your accountant takes care of your taxes therefore we just turn everything over to him/her. That is not much different than saying our doctor takes care of our bodies or our mechanic takes care of our car. We are ultimately responsible for the information from which our accountant prepares our tax return. Therefore, if we learn to keep good records and adequate detail we will not only reduce our tax preparation bill but also be much better prepared if we are eventually audited. Remember you are responsible for the accuracy of your tax return and you attest to that fact when you sign your return.

By learning of those items which you may appropriately deduct as business expenses you may reduce your tax bill. By overlooking those expenses which are deductible we simply are willing to pay Uncle Sam more than we are obligated to do so.

As painful as it may be to keep good records, there simply is no substitute. Documentation is essential. Unlike our legal system where it is essential to prove one's innocence or guilt, with the IRS we must prove every deduction or it will be disallowed.

What is adequate documentation. We must provide conclusive evidence that the expenditure was appropriate. Our records must:

- Be permanent, accurate, and complete.
- Include invoices, receipts, canceled checks, etc.
- Include a record supported by documentary evidence for each expense.
- The recordation must be timely.

Bear in mind that should an audit take place, that it is usually months if not years after the expenses have been incurred, hence the importance of having
timely and accurate records. Many people make the mistake of thinking that cancelled checks will suffice. This is not true, checks simply show that an item was paid for. Receipts may verify you paid for a business item. If there is the possibility that the item may be used for personal use as well, then it will be important to document the purpose of and for whom the expenditure was made.

SUGGESTION: Keep a diary, planner or other similar business record and save receipts regularly. Write on your receipts what and/or for whom the expense made. You are required to be able to support your expenses for three years.

Figure 3.1: How to Prove Certain Business Expenses
Source: Internal Revenue Service

<table>
<thead>
<tr>
<th>If you have expenses for...</th>
<th>THEN you must keep records that show details of the following elements...</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
</tr>
<tr>
<td>Travel</td>
<td>Cost of each separate expense for travel, lodging, and meals. Incidental expenses may be totaled in reasonable categories such as taxis, fees and tips, etc.</td>
</tr>
<tr>
<td>Entertainment</td>
<td>Cost of each separate expense. Incidental expenses such as taxis, telephones, etc., may be totaled on a daily basis.</td>
</tr>
</tbody>
</table>
date, place, nature, and duration of the business discussion, and the identities of the persons who took part in both the business discussion and the entertainment activity.

**Relationship:**
Occupations or other information (such as names, titles, or other designations) about the recipients that shows their business relationship to you. For entertainment, you must also prove that you or your employee was present if the entertainment was a business meal.

<table>
<thead>
<tr>
<th>Gifts</th>
<th>Cost of the gift.</th>
<th>Date of the gift.</th>
<th>Description of the gift.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transportation</td>
<td>Cost of each separate expense. For car expenses, the cost of the car and any improvements, the date you started using it for business, the mileage for each business use, and the total miles for the year.</td>
<td>Date of the expense. For car expenses, the date of the use of the car.</td>
<td>Your business destination.</td>
</tr>
</tbody>
</table>

**How Long to Keep Records**

<table>
<thead>
<tr>
<th>IF you...</th>
<th>THEN the period is...</th>
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1. Owe additional tax and situations (2), (3), and (4), below, do not apply to you 3 years

2. Do not report income that you should report and it is more than 25% of the gross income shown on the return 6 years

3. File a fraudulent return Not limited

4. Do not file a return Not limited

5. File a claim for credit or refund after you filed your return Later of: 3 years or 2 years after tax was paid

6. File a claim for a loss from worthless securities or a bad debt deduction 7 years

Why is the S-corporation the Entity of Choice by so many tax professionals?

Here is an example of how an S-corporation could save you in SE taxes if you were a one person S-corporation.

Example: The taxable income generated by your S-corporation business is estimated to be $100,000 for 2015 before you pay yourself. You take a $50,000 salary. Only that amount is hit with the 15.3 percent federal Social Security and Medicare tax, which amounts to $7,650. You can withdraw the remaining corporate cash flow in the form of distributions to yourself that will not be subject to SE taxes (this will be added to your personal income on which you will pay tax at your current tax bracket).

If you operate the same business as an LLC or sole proprietorship (assuming one owner) where each member is subject to SE taxes, you owe SE tax on your entire $100,000 profit, for a total of $14,130 ($100,000 × .9235 = $92,350 × 15.3%). Operating as an S-corporation could save you thousands ($14,130 — $7,650 = $6,480).

Remember: You must be able to show that a $50,000 salary is reasonable. If the IRS thinks it's too low, it may try to reclassify all or part of your purported cash distributions as disguised wages.
Common Red Flags that Can Put You on the IRS RADAR

1. Making Too Much Money

Although the overall individual audit rate is about 1.03%, the odds increase dramatically for higher-income filers. 2012 IRS statistics show that people with incomes of $200,000 or higher had an audit rate of 3.70%, or one out of every 27 returns. Report $1 million or more of income? There's a one-in-eight chance your return will be audited. The audit rate drops significantly for filers making less than $200,000: Less than 1% (0.94%) of such returns was audited during 2012, and the vast majority of these exams were conducted by mail.

2. Failing to Report All Taxable Income

The IRS gets copies of all 1099s and W-2s you receive, so make sure you report all required income on your return. IRS computers are pretty good at matching the numbers on the forms with the income shown on your return. A mismatch sends up a red flag and causes the IRS computers to spit out a bill. If you receive a 1099 showing income that isn't yours or listing incorrect income, get the issuer to file a correct form with the IRS.

3. Taking Large Charitable Deductions

We all know that charitable contributions are a great write-off and help you feel all warm and fuzzy inside. However, if your charitable deductions are disproportionately large compared with your income, it raises a red flag.

4. Claiming Rental Losses

Normally, the passive loss rules prevent the deduction of rental real estate losses. But there are two important exceptions. If you actively participate in the renting of your property, you can deduct up to $25,000 of loss against your other income. But this $25,000 allowance phases out as adjusted gross income exceeds $100,000 and disappears entirely once your AGI reaches $150,000.

5. Deducting Business Meals, Travel and Entertainment

Schedule C is a treasure trove of tax deductions for self-employeds. But it's also a gold mine for IRS agents, who know from experience that self-employeds sometimes claim excessive deductions. History shows that most underreporting of income and overstating of deductions are done by those who are self-employed. And the IRS looks at both higher-grossing sole proprietorships and smaller ones.
6. Writing off a Loss for a Hobby Activity

Your chances of "winning" the audit lottery increase if you have wage income and file a Schedule C with large losses. And if the loss-generating activity sounds like a hobby -- horse breeding, car racing and such -- the IRS pays even more attention. Agents are specially trained to sniff out those who improperly deduct hobby losses. Large Schedule C losses are always audit bait, but reporting losses from activities in which it looks like you're having a good time all but guarantees IRS scrutiny.

7. And Others

TAX WRITEOFFS FOR THE SELF EMPLOYED
Business Expenses

You are allowed to deduct those business expenses which are “ordinary and necessary.” However, you must be engaged in a business with the purpose of producing a profit. Since “ordinary and necessary” are general terms, it might be helpful if we expand that definition. Those expenses which are helpful, needed, appropriate, customary, usual, or normal have been generally accepted as business expenses.

Ask yourself: does this expense help me in the production of income? Is it needed? Is it an appropriate expense? If you can answer yes to any of those questions, then record and document the expense.

An exception to the above broadened definition is if the expenses are for personal, family or living expenses, then they will be personal expenses.

Advertising/Promotion Expenses

Expenses paid by a self-employed individual to promote himself/herself or a property are deductible. They may include:

- Auto graphics
- Name riders
- Digital photography
- Fact sheets or property flyers
- Business cards
- Personal advertising
- Giveaways such as those used in farming, e.g. pens, pencils, calendars, potholders, etc.
- Literally, anything spent on advertising/promoting of the business

Note: As discussed later in this material, a decision will have to be made by the business owner as to whether a given expense is advertising/promotion or entertainment.
Vehicle Expenses

You have a choice of either deducting the actual operating costs of your car when used for business or using a flat IRS allowance based on the business mileage traveled during the year. The allowance is in lieu of deducting your actual expenses, however, you may add business parking fees, tolls and the business interest expense on the car loan to the mileage allowance. Should you choose to deduct actual expenses the first year you own the car, then you may not use the auto allowance in later years for that car.

For tax purposes, the miles you drive your car are classified in one of three categories:

- Personal
- Commuting
- Business

Recordkeeping to appropriately classify the miles driven in a given tax year is the responsibility of the taxpayer. Now the IRS wants contemporaneous records. The simplest way to keep accurate records is to record your odometer reading at the beginning and end of each business day. It may be presumed that those miles driven before the start or after the end of each day are personal miles. It is also important to record the odometer reading at the beginning and end of each year. This will enable the taxpayer to determine the total miles driven in a year. Your daily record will allow you to determine the business miles driven.

The following is an excerpt from IRS Publication 463 regarding the use of SAMPLING for keeping records on the use of the vehicle for business. Note that this “sampling” only applies to the use of a business vehicle, and not to other business recordkeeping requirements.

Sampling. You can keep an adequate record for parts of a tax year and use that record to prove the amount of business or investment use for the entire year. You must demonstrate by other evidence that the periods for which an adequate record is kept are representative of the use throughout the tax year.

Example. You use your car to visit the offices of clients, meet with suppliers and other subcontractors, and pick up and deliver items to clients. There is no other business use of the car, but you and your family use the car for personal purposes.
You keep adequate records during the first week of each month that show that 75% of the use of the car is for business. Invoices and bills show that your business use continues at the same rate during the later weeks of each month. Your weekly records are representative of the use of the car each month and are sufficient evidence to support the percentage of business use for the year.

When you leave home, you are commuting to your office or to your first business stop. However, when you go from one business activity to another you are incurring business mileage.

In 1990 the Internal Revenue Service issued Revenue Ruling 90-23 which states that if your first stop is for an appointment, then your mileage from your residence to the first stop and afterwards is considered business mileage. Ditto for the trip home, assuming you make a genuine business stop. However, in the case of a qualified Office In Home, Revenue Ruling 90-23 is not needed, as the minute you leave your qualified office in home, you are on the business clock, even if going directly to another office. You are now traveling between offices and it is totally deductible. Also keep in mind that in order to claim a qualified home office, strict requirements must be met. These requirements are covered later in this material.

Business vs. Personal

Once we have determined how many miles we have driven in a year and how many of those miles are either commuting or personal, we know that the balance must have been business. Now we are able to select one of two methods to determine our business expense deduction on Schedule C or other business tax return.

IRS Optional Mileage Rates

Commencing in 2015 the standard mileage rate is 57.5 cents per mile. In addition to the standard cents per mile allowance, you can deduct the business parking, tolls, AND the business percentage of the vehicle interest expense on the loan, if applicable.
Actual Costs

As an optional approach to using the mileage rates, a taxpayer may keep a record of all expenses associated with the operation of the car. Then the taxpayer may deduct that percentage of expenses which is for business. The business percentage is established by dividing the total business miles driven in the tax year by the total miles driven.

For example:

Business miles driven: 18,000
Total miles driven: 24,000
Business percentage: 75%

Examples of actual expenses are licenses, taxes, car washes, repairs, insurance, interest, oil and lube, fuel costs, depreciation etc.

Cost Recovery or Depreciation

In addition to those actual expenses incurred in operating your business car, you may add to your expenses a deduction for cost recovery or depreciation. If you use your car more than 50% for business usage then you are allowed to use the MACRS (Modified Accelerated Cost Recovery System). This system is accelerated in a fashion, in that it allows you to deduct larger amounts in the first three years of owning the car. However, after the third year the taxpayer's deduction is limited until the car is fully depreciated. Should you use the business car less than 50% then you are limited to a straight line cost recovery. The useful life of a car is 5 years.

The 2014/15 Luxury Vehicle Depreciation Limits

Luxury autos (Note: the definition of “luxury” is not by vehicle, but by the cost of the vehicle)

The new law also raises the Code Sec. 280F limitations on “luxury” auto depreciation. Ordinarily, the first-year limit on depreciation for passenger automobiles cannot exceed $3,160 (inflation adjusted). The new law raises the cap once again, this time to $8,000 if bonus depreciation is claimed for a qualifying vehicle (for a maximum first-year depreciation of no more than $11,160; $11,360 for vans or trucks). If the vehicle is not predominantly used for business in a subsequent year, then bonus depreciation must be recaptured. The depreciation cap was enacted because Congress did not
want the Code subsidizing the use of luxury vehicles by businesses. These numbers all reflect 2013 and 2014 numbers. We do not know what these numbers will look like for 2015 until Congress decides to extend certain tax provisions.

To put all this in perspective, assume that you spend $60,000 today on a 100 percent business-use vehicle and you want to deduct as much as possible this year. Your first-year deduction for both depreciation and expensing is:

- $60,000 on a new or used qualifying pickup truck;
- $46,000 on a new qualifying SUV
- $32,000 on a used qualifying SUV
- $11,160 on a new car
- $3,160 on a used car

Home Office

A home office deduction may include real estate taxes, insurance, mortgage interest, utility costs, etc. In addition, depreciation may be included. To figure depreciation, the basis of the home is the lower of the fair market value of the entire house at the time you started to use a part of it for business, or its adjusted basis. Only that part of the cost basis allocated to the office is depreciable.

To calculate that portion of the above mentioned expenses which would be for business, a business percentage must be determined. This is figured by dividing the area used for the home office by the total area of the home. If the rooms of the home are about the same size then the number of rooms may be used to determine a percentage.

The expenses which would be deductible under the home office rules would be shown on the appropriate lines of Schedule C.

You may operate your business from your home; however, in order to deduct your expenses associated with your home office you must be able to prove that you use the home area designated as your home office exclusively for business and on a regular basis. In addition, the tax law change of 1998 removed the “principal place of business” test and replaced that test with a more relaxed requirement that the office in home be used on a substantial basis.
for the management and administrative tasks of running the business. This new “substantial” requirement also means that there is no other space where the self-employed person performs “substantial” management and administrative tasks of running the business. The compliance with the above tests must be strictly adhered to. If your office is not where you perform the substantial management or administrative tasks of running the business and you do not use it exclusively, then your deduction will be lost. Note: many accountants tell their clients that if they have an office to go to, for example, the brokers office, that the home office deduction is not allowable. That is not what the law says, and careful adherence to the rules would allow the deduction. Also note that the new regulations dated 12/23/02 do not require the allocation of the gain between the office and residence when the home is sold. This is truly a win-win situation for the self-employed, inasmuch as the only amount of gain on the sale of the residence that will probably be taxable is due to any depreciation claimed on the home office after 5/6/97. And that amount is generally a very small number.

Since the burden of proof is on the taxpayer, you must be able to prove that your home office qualifies. The IRS suggests that you keep a daily planner noting the hours you spend on the business each day, especially if you have another office that you can use. Furthermore, the taxpayer's total deduction may not create a business loss. In other words, your home office expenses are limited to the amount of income produced. However, unused home office expenses may be carried forward to a tax year in which they can be used.


The Home Office Deduction 2.0
Most practitioners have regarded the Home Office deduction as a red flag for an IRS audit. In fact, this deduction seems to make every top ten list of issues that the IRS targets. In early January, 2013, the IRS issued Revenue Procedure 2013-13, announcing a so-called safe harbor home office deduction. The reasoning behind the issuance of this Revenue Procedure is to reduce the administrative, recordkeeping, and compliance burdens of determining the allowable deduction for certain business use of a residence under §280A.

This material covers this Revenue Procedure and provides a comparison of the new vs. the old rules.

This revenue procedure provides an optional safe harbor method that individual taxpayers may use to determine the amount of deductible
expenses attributable to certain business use of a residence during the taxable year. This safe harbor method is an alternative to the calculation, allocation, and substantiation of actual expenses for purposes of satisfying the requirements of §280A of the Internal Revenue Code. The basic premise of this Revenue Procedure provides a deduction based on $5.00 per square foot, with a maximum of 300 square feet limitation. Therefore, the maximum deduction that can be claimed under this safe harbor is $1,500.00. This revenue procedure is effective for taxable years beginning on or after January 1, 2013.

Travel, Meals, and Entertainment

Business trip expenses while away from home are deductible. These would include:

- Transportation
- Hotel and lodging
- Meal costs (50%)
- Tips and baggage charges
- Taxis and or bus fares
- Telephone
- Cleaning and laundry

You must meet the “away from home overnight” test in order for these costs to be deductible. Lavish or extravagant or personal expenses while on vacation are not allowed.

Only 50% of the cost of meals and entertainment may be deducted. Receipted bills are required if the expense is $75 or more.

Reciprocal meals are not deductible. That is when taxpayers trade off buying lunch for each other.

Note: As mentioned earlier in the material, situations will arise where money has been spent, and the question comes up as to whether the expense is entertainment (50%) deductible, or advertising/promotion, which would be 100% deductible. An excellent example of this would be a client appreciation event, where food, music, entertainment, etc. is provided. Is this entertainment or is it advertising/promotion. You should have a thorough discussion with your tax professional about this question.

Business Gifts
Deductions for gifts to business customers and clients are limited to $25 per person. You and your spouse are treated as one person. A partnership for this rule is also considered one person.

Exceptions to the $25 limitation would be advertising items which costs less than $4, i.e. potholders, pens, pencils, etc., or incidental costs of wrapping, insuring or mailing the gift. Theater or sporting event tickets where you accompany your customer or client are entertainment, not gifts. If you do not accompany them, you may elect to treat the tickets either as gifts subject to the $25 limitation or as entertainment subject to the 50% limitation.

Communications

Those expenses associated with business telephone may also be deducted. This would include long distance business calls from home. Pay phone costs, if any does this anymore, beeper costs, cellular telephone costs (unless used for personal reasons), voice mailbox, etc., are deductible. Note that the IRS has won many court cases on the disallowance of personal use of the cell phone as a business write-off, so recordkeeping is essential on this issue. My personal recommendation is to NEVER claim 100%, instead use a realistic business percentage that fits your situation. Again, a discussion with your tax professional is recommended.

Hiring Your Family Members

Hiring your family members (spouse and children) as employees of your real estate business can provide you with significant tax benefits.

There are many business-related jobs family members can perform which you may pay for and deduct the cost thereof. For example, opening your business mail, writing checks, filling invoices, organizing client lists and customer files, cleaning your business office or business car, assisting in obtaining comparables, stuffing envelopes, etc.

One of the primary benefits of hiring children is that you pay them deductible salaries instead of giving them non-deductible allowances.

The employment must be a bona fide employer/employee relationship and the wages paid must be reasonable in relation to the services rendered.
The wages that you pay to your children under 18 are not subject to Social Security (FICA) and Federal Unemployment Taxes. In 2015 each person, as a single taxpayer, is allowed a standard deduction of $6,300 against earned income. Therefore, you may pay up to $6,300 of tax deductible (to you) wages before your child must pay any tax on that income.

You may further increase your tax deductions by having your child contribute the maximum amount of $5,500 to an IRA.

The IRC 105 Medical Reimbursement Plan

For those of you lucky enough to be covered under a spouse’s employer-provided group medical insurance plan, consider yourself lucky and this topic is not that relevant to you. However, for those of us in the room that are paying dearly for medical insurance, the question and tax issue of getting the best deduction for these costs is of pivotal importance. On top of that, for the roughly 14% of you listening to this seminar that have no medical insurance, obtaining the insurance coverage is of first importance, and having the IRS partially subsidize the cost through tax deductions is the second issue.

The basics of the IRC 105 medical plan:

This is not a government insurance plan—in fact, I wish it were. It is merely an IRS approved method of getting the biggest tax savings that you can, if you are eligible and you are willing to “jump through the hoops” in terms of paperwork.

The three basic requirements for using this technique are:

1. You must be married. Sorry singles, but I did not write this law.
2. You must be paying your own health insurance.
3. You must be self-employed.

In order to qualify, the self-employed individual must hire their spouse as an employee and pay wages commensurate with the work performed. By doing so, the employer spouse can be covered under the health insurance of the employee spouse and the entire amount of health insurance premiums plus
out-of-pocket unreimbursed medical expenses are deductible as business expenses on the business tax return.

The key to this issue is that the expenses are deductible on the business tax form, which means that the deduction will save both income taxes as well as social security taxes, and possibly state income taxes. The alternative to this is claiming the deduction on the front page of the 1040, which in 2015 is a deduction of 100% of the medical insurance premiums, but the unreimbursed out of pocket medical expenses are deductible as an itemized deduction on Schedule A of the tax return, and are only deductible if they exceed 7.5%/10% of adjusted gross income. (In other words, probably no deduction).

The following example illustrates how a typical compensation package is determined:

Todd owns his own business. Todd’s wife, Amy, provides a valuable service to the business by keeping the books, answering the phones, typing, filing, and so on. Todd decides to formally employ Amy and take advantage of a Section 105 medical plan. While establishing a compensation package for Amy, Todd evaluates her experience and the vital role she plays in the business. Todd compensates Amy $16,000 total per year in the following way:

1. Reimbursement for family health insurance premiums $10,000
2. Reimbursement for uninsured medical expenses $3,000
3. W-2 cash wage $3,000
   TOTAL $16,000

By allowing for a 100% federal, state, and FICA tax deduction of the $13,000 of reimbursed expenses, Todd would receive significant tax savings by taking advantage the Section 105 plan.

Other taxation issues that you need to consider:

1. Concealed carry licensing/training/annual proficiency costs
2. 1099 Miscellaneous and W-9 for non-employees that work for you
3. New Rule on deducting capital improvements to rental property