Acquisition vs Operational Expenses

The distinction between acquisition costs and operational expenses is defined by the property’s "in-service" date. Acquisition costs and pre-service renovations must be capitalized and depreciated over time, whereas operational expenses are deductible once the property is ready and available for rent. A critical trap for investors is that pre-in service "holding costs" such as HOA dues, insurance, and utilities are generally lost forever (neither deductible nor capitalized) unless they are directly tied to a specific capital improvement or construction project.

Key Rules

Acquisition & Construction Costs Increase Basis
Costs required to acquire or prepare the property including closing costs, transfer taxes, and pre service renovations must be capitalized and depreciated.

Operational Deductions Wait For "In Service"
Routine operating expenses are typically non deductible until the property is ready and available for rent. These costs are effectively "lost" (neither deductible nor capitalized) if incurredduring the pre in service phase, unless tied directly to a specificcapital improvement.

Exceptions For Mortgage Interest & Taxes
While you cannot claim pre service interest and property taxes against rental income, these costs are rarely lost. They can generally be claimed as itemized deductions on your individual tax return (Form 1040, Schedule A) as second home expenses until the property is officially placed in service.

Top FAQs

Can I deduct costs incurred before I select a property?
Yes. Investigatory travel, education, and entity setup fees are considered "Startup Expenses." You may deduct up to $5,000 of these costs once the business becomes active.

Does "In Service" mean the property is occupied?
No. It means the property is ready and available. You can begin deducting operational expenses as soon as the unit is advertised for rent, even if without a tenant or guest stay.

Can pre in service utilities ever be capitalized?
Broadly, utilities, insurance and HOA dues are required to keep the property in good order, and can be deducted if in service or capitalized and depreciated if connected to an improvement such as a renovation or new construction.

Timing is everything. Categorize expenses based on the property’s "In Service" date to protect your deductions. Be wary of the pre in service "dead zone" where holding costs are lost, but take advantage of startup expense rules to capture early costs.

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