Example. Carol Madison took out a $100,000 mortgage loan on January 1, 2008, to buy a house she will use as a rental during 2008. The loan is to be repaid over 30 years. During 2008 Carol paid $10,000 of mortgage interest (stated interest) to the lender. When the loan was made, she paid $1,500 in points to the lender. The points reduced the principal amount of the loan from $100,000 to $98,500, resulting in $1,500 of OID. Carol determines that the points (OID) she paid are *de minimis* based on the following computation.

Redemption price at maturity (principal amount of the loan) . . .	$100,000
Multiplied by: The term of the loan in complete years	× 30
Multiplied by	× .0025
***De minimis* amount**	$ 7,500

The points (OID) she paid ($1,500) are less than the *de minimis* amount ($7,500). Therefore, Carol has *de minimis* OID and she can choose one of the four ways discussed earlier to figure the amount she can deduct each year. Under the straight line method, she can deduct $50 each year for 30 years.

Constant-yield method. If the OID is not *de minimis*, you must use the constant-yield method to figure how much you can deduct each year.

You figure your deduction for the first year in the following manner.

1. Determine the issue price of the loan. If you paid points on the loan, the issue price generally is the difference between the principal and the points.
2. Multiply the result in (1) by the yield to maturity (defined below).
3. Subtract any qualified stated interest payments (defined below) from the result in (2). This is the OID you can deduct in the first year.

Yield to maturity (YTM). This rate is generally shown in the literature you receive from your lender. If you do not have this information, consult your lender or tax advisor. In general, the YTM is the discount rate that, when used in computing the present value of all principal and interest payments, produces an amount equal to the principal amount of the loan.

Qualified stated interest (QSI). In general, this is the stated interest that is unconditionally payable in cash or property (other than another loan of the issuer) at least annually over the term of the loan at a fixed rate.

Example—Year 1. The facts are the same as in the previous example. The yield to maturity on Carol's loan is 10.2467%, compounded annually.

She figured the amount of points (OID) she could deduct in 2008 as follows.

Principal amount of the loan	$100,000
Minus: Points (OID)	− 1,500
Issue price of the loan	$ 98,500
Multiplied by: YTM	×.102467
Total	10,093
Minus: QSI	− 10,000
Points (OID) deductible in 2008	$ 93

To figure your deduction in any subsequent year, you start with the adjusted issue price. To get the adjusted issue price, add to the issue price figured in Year 1 any OID previously deducted. Then follow steps (2) and (3) above.

Example—Year 2. Carol figured the deduction for 2009 as follows.

Issue price	$98,500
Plus: Points (OID) deducted in 2008	+ 93
Adjusted issue price	$98,593
Multiplied by: YTM	×.102467
Total	10,103
Minus: QSI	− 10,000
Points (OID) deductible in 2009	$ 103

Loan or mortgage ends. If your loan or mortgage ends, you may be able to deduct any remaining points (OID) in the tax year in which the loan or mortgage ends. A loan or mortgage may end due to a refinancing, prepayment, foreclosure, or similar event. However, if the refinancing is with the same lender, the remaining points (OID) generally are not deductible in the year in which the refinancing occurs, but may be deductible over the term of the new mortgage or loan.

Repairs and Improvements

You can deduct the cost of repairs to your rental property, but you cannot deduct the cost of improvements. The cost of improvements is recovered by taking depreciation (see chapter 2).

Repairs. A repair keeps your property in good operating condition. It does not materially add to the value of your property or substantially prolong its life. Repainting your property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs.

If you make repairs as part of an extensive remodeling or restoration of your property, the whole job is an improvement.

Improvements. An improvement adds to the value of property, prolongs its useful life, or adapts it to new uses. Table 1-1 shows examples of many improvements.

If you make an improvement to property, the cost of the improvement must be capitalized. The capitalized cost can generally be depreciated as if the improvement were separate property.

Example. You repair a small section on one corner of the roof of a rental house. You deduct the cost of the repair as a rental expense. However, if you completely replace the roof, the new roof is an improvement because it increases the value and lengthens the life of the property. You depreciate the cost of the new roof.

RECORDS

Separate the costs of repairs and improvements, and keep accurate records. You will need to know the cost of improvements when you sell or depreciate your property.

Table 1-1. Examples of Improvements

Caution. *Work you do (or have done) on your home that does not add much to either the value or the life of the property, but rather keeps the property in good condition, is considered a repair, not an improvement.*

Additions	**Miscellaneous**	**Plumbing**
Bedroom	Storm windows, doors	Septic system
Bathroom	New roof	Water heater
Deck	Central vacuum	Soft water system
Garage	Wiring upgrades	Filtration system
Porch	Satellite dish	
Patio	Security system	**Interior Improvements**
		Built-in appliances
Lawn & Grounds	**Heating & Air Conditioning**	Kitchen modernization
Landscaping	Heating system	Flooring
Driveway	Central air conditioning	Wall-to-wall carpeting
Walkway	Furnace	
Fence	Duct work	**Insulation**
Retaining wall	Central humidifier	Attic
Sprinkler system	Filtration system	Walls, floor
Swimming pool		Pipes, duct work