Tax Tips

Converting a Home into Rental Property

You have decided to move to another residence, but find it difficult to sell your present home. One way to weather a soft residential selling market is to rent out your present home until the market improves. If you are thinking of taking this step, you no doubt are fully aware of the economic risks and rewards. However, you also should be aware that renting out your personal residence carries potential tax benefits and pitfalls.

You generally are treated like a regular real estate landlord once you begin renting your home to others. That means you must report rental income on your return, but also are entitled to offsetting landlord-type deductions for the money you spend on utilities, operating expenses, and incidental repairs and maintenance (e.g., fixing a leak in the roof). Additionally, you can claim depreciation deductions for your home. You can fully offset your rental income with otherwise allowable landlord-type deductions. However, under the tax law passive activity loss (PAL) rules, you may not be able to currently deduct the rent-related deductions that exceed your rental income unless an exception applies. Under the most widely applicable exception, the PAL rules won't affect your converted property for a tax year in which your adjusted gross income doesn't exceed $100,000, you actively participate in running the home-rental business, and your losses from all rental real estate activities in which you actively participate don't exceed $25,000.

You should also be aware that potential tax pitfalls may arise from the rental of your residence. Unless your rentals are strictly temporary and are made necessary by adverse market conditions, you could forfeit an important tax break for home-sellers if you finally sell the home at a profit. In general, you can escape taxation on up to $250,000 ($500,000 for certain married couples filing joint returns) of gain on the sale of your home. However, this tax-free treatment is conditioned on your having used the residence as your principal residence for at least two of the five years preceding the sale. So renting your home out for an extended time could jeopardize a big tax break. Even if you don't rent out your home so long as to jeopardize your principal residence exclusion, the tax break you would have gotten on the sale (i.e., exclusion of gain up to the $250,000/$500,000 limits) will not apply to the extent of any depreciation allowable with respect to the rental or business use of the home for periods after May 6, 1997, or to any gain allocable to a period of nonqualified use (i.e., any period during which the property is not used as the principal residence of the taxpayer or the taxpayer's spouse or a former spouse, such as a rental) after December 31, 2008. A maximum tax rate of 25% applies to this gain (attributable to depreciation deductions).

Some homeowners who bought at the height of a market may ultimately sell at a loss. In such situations, the loss is available for tax purposes only if the owner can establish that the home was in fact converted permanently into income-producing property, and isn't merely renting it temporarily until he can sell. Here, a longer lease period helps an owner. However, if you are in this situation, you should be aware that you probably won't wind up with much of a loss for tax purposes. That's because basis (cost for tax purposes) is equal to the lesser of actual cost or the property's fair market value when it's converted to rental property. So if a home was bought for $300,000, converted to rental property when it's worth $250,000, and ultimately sold for $225,000, the loss would be only $25,000.

Since the question of whether to turn a principal residence into rental property isn't easy to resolve, you should consider getting counsel from your tax adviser before consummating such a conversion.

If you have any questions regarding the above discussed topic or any other tax matter, please feel free to give me a call at (562) 698-9891.

Richard Scrivanich, Partner
For Harvey & Parmelee LLP