Consider Taxes before Converting Your Home to a Rental Property

Have you ever thought about becoming a landlord? This option may be tempting if your local real estate market is surging and rental rates are strong, especially if you're already planning to relocate or downsize to a smaller home.

Ideally, you'll be able to shelter most or all of the rental income with tax deductions and eventually sell the property for a higher price than you originally paid. In the meantime, however, it's important to understand the confusing tax rules that apply when a personal residence is converted into a rental.

Special Basis Rule

Once you become a landlord, you can depreciate the tax basis of the building part of a residential rental property (not the basis of the land) over 27.5 years. In plain English, this means you can deduct from your taxable income a portion of the building's value every year for the next 27.5 years. However, a special basis rule applies to a rental property that was formerly a personal residence.

Under the special rule, the initial tax basis of the building portion of the property for purposes of calculating your postconversion depreciation write-offs equals the lower of:

- The building's fair market value (FMV) on the conversion date; or
- The building's regular basis on the conversion date.

Regular basis usually equals original cost plus the cost of any improvements (excluding any normal repairs and maintenance).

When You Sell

The rules become really confusing when you sell the property. To determine if you have a deductible *loss*, a similar special basis rule applies. That is, you must use the lower of:

- The property's FMV on the conversion date; or
- The property's regular basis on the conversion date.

In addition, you must reduce the initial basis by depreciation deductions taken during the rental period. The special basis rule and the depreciation deductions greatly reduce the odds of having a deductible loss on a sale, especially when property values are below historical levels. With property values recovering in many areas, however, the chances of reporting a taxable gain have increased.

Your tax basis for purposes of calculating whether you have a taxable *gain* on a sale is simply the property's regular basis on the sale date. Regular basis generally equals the original cost of the land and building, plus the cost of any improvements minus depreciation deductions claimed during the rental period.

Sellers in Limbo

When a converted property is sold, you must use the *special basis* rule to determine if you have a deductible loss on the sale, but you must use the *regular basis* rule to determine if you have a taxable gain. Following two different basis rules can sometimes cause sellers to have neither a taxable gain nor a deductible loss. This happens whenever the sale price falls between the two basis numbers.

Confused? Here are some examples of how to calculate gains and loss to help clarify.

Example 1: No tax gain or loss on sale

To illustrate how this works, suppose you convert your home to a rental while the market is recovering — but it hasn't returned to its previous peak by the time you sell. Here's how the numbers might shake out:

Regular basis on conversion date	$300,000
Postconversion depreciation deductions	($13,000)
Regular basis for tax gain	$287,000
FMV on conversion date	$235,000
Postconversion depreciation deductions	($13,000)
Special basis for tax loss	$222,000

If the net sale price is between $222,000 and $287,000, you have no tax gain or loss, because the sale price falls between the two basis numbers.

Example 2: Modest gain on sale

Alternatively, suppose you convert a property in a market that's still in the early stages of recovery, and you intend to hang onto it for a while before selling.

Regular basis on conversion date	$300,000
Postconversion depreciation deductions	($32,000)
Regular basis for tax gain	$268,000
FMV on conversion date	$285,000
Postconversion depreciation deductions	($32,000)
Special basis for tax loss	$253,000

If the net sales price is above $268,000, you have a taxable gain. For example, with a net sale price of $345,000, you must report a taxable gain of $77,000 ($345,000 – $268,000). That is because, in this example, the postconversion depreciation deductions reduced the regular basis and the value of the property jumped. As a result, the sale price exceeds the regular basis, which produces a modest taxable gain on the sale.

Example 3: Big gain on sale

Now, let's suppose you convert a property in a strong market. You've owned it for years and its FMV never fell below what you paid for it. In this case, the special basis rule for determining if you have a tax loss does *not* apply.

Regular basis on conversion date	$235,000
Postconversion depreciation deductions	($26,000)
Regular basis for tax gain	$209,000
FMV on conversion date	$285,000

Assuming the property is sold for $360,000, your taxable gain would be a whopping $151,000 ($360,000 – $209,000). In this example, the postconversion depreciation deductions reduced the property's basis and the value jumped after the conversion. So the sales price substantially exceeds the basis, generating a significant taxable gain on the sale.

Principal Residence Gain Exclusion

Fortunately, some landlords may be able to shelter their gain on the sale of a recently converted property with the principal residence gain exclusion. When allowed, the gain exclusion really helps: Unmarried property owners can potentially exclude gains of up to $250,000, and married joint-filing couples can potentially exclude up to $500,000.

Important note: If you qualify for the gain exclusion, you can't use it to shelter the part of a gain that's attributable to depreciation deductions. In the previous example, if the gain exclusion applied, the taxpayer must still report a taxable gain of $26,000, which equals the amount of the postconversion depreciation deductions. But that's much less than the total gain of $151,000.

To qualify for this exclusion, the tax rules require that you use the property as your principal residence for at least two years during the five-year period ending on the sale date. So, it's impossible to meet the two-year usage requirement once you've rented the property for more than three years during that five-year period.

Thus, this tax break is allowed only if you've rented the property for no more than three years after the conversion date at the time you sell.

Ready to Convert?

Home-to-rental conversions can be a lucrative financial proposition for some property owners. But the tax rules can be confusing. To help understand the rules and evaluate whether you should become a landlord, please contact your tax advisor. He or she can help decide what's best for your situation. Beyond taxes, your tax pro will help you factor other considerations into your decision.

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