Case*Study*

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Converting a Residence to Rental Property

A taxpayer may decide to permanently convert a personal residence to rental property. The decision is often made as a result of the taxpayer's inability to sell the property at a gain or a desire to retain the property for future personal use. (If the residence would be sold at a gain, the ability to exclude up to $250,000 of gain ($500,000 on a joint return) under Sec. 121 may make the conversion option less attractive.)

Converting to Rental Property

The decision whether to convert a personal residence to rental property may be based on several nontax factors: needing the equity in cash from the old residence for a down payment on a new residence, problems that are sometimes encountered with renting property, sentimental reasons, and the strength of the local rental market. However, a decision to convert to rental also should consider economic factors such as the taxpayer's marginal tax rate, availability of excluding gain from the sale of a personal residence, expected growth rate of the rental property, length of time the house will be rented before being sold, cash flow from renting, effect of the passive activity rules, and rate of return on other invested funds.

Generally, the economic advantage of converting a personal residence to a rental rather than selling it increases as the marginal tax rate increases, the length of time rented decreases, the growth rate of the rental property increases, and the rate of return on other invested funds decreases. But each situation should be thoroughly analyzed given its particular facts and circumstances to determine the benefits of conversion versus outright sale.

If selling a personal residence would result in a nondeductible loss, the client should consider converting the residence to rental property since any loss realized while the home is a personal residence is never deductible. While tax savings opportunities are generally limited for residential rental conversions primarily because of the passive activity loss rules, converting a personal residence into rental property may allow the taxpayer to eventually recognize a loss on the property's subsequent sale if it continues to decline in value.

Caution: When a personal residence is converted to business use (or for use in the production of income), its starting point for basis for depreciation is the lower of (1) the adjusted basis on the date of conversion, or (2) the property's fair market value (FMV) at the time of conversion (Regs. Sec. 1.168(i)-4(b)).

Example 1: *J* purchased a home in Boston in 2004 for $250,000, of which $50,000 represented the cost of the land. *J* lived in the home until 2008, when he moved to New York. Rather than sell the house, he converted it to a rental property. The property's FMV, excluding the land, on its conversion to rental property was $185,000. *J*'s basis for depreciation is $185,000, the FMV at the time of conversion, since it was less than the adjusted basis. (Adjusted basis is generally the cost of the property plus amounts paid for capital improvements, less any depreciation and casualty losses claimed for tax purposes.)

Property converted from residential to rental use must be depreciated using the method and recovery period in effect in the year of conversion (Regs. Sec. 1.168(i)-4(b)). The method that applied in the year the property was originally acquired is irrelevant. Thus, a home that is converted from personal to rental use during 2008 is depreciated over 27.5 years (39 years if the rental is not residential) under the modified accelerated cost recovery system (Sec. 168(c)).

If the taxpayer intends to incur major renovation or remodeling costs, the costs should be incurred after the property has been placed into service (i.e., offered for rent). This may allow for a higher depreciable basis of the property and turn repairs into deductions.

Sale to Controlled Entity in Lieu of Conversion

Taxpayers may need the equity in cash from their current residence for a down payment on a new residence. Yet, for noneconomic reasons (e.g., sentimental value, future desire to move back in), they may want to retain the old residence. In

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this situation, they should consider selling the home to a newly formed controlled entity (for example, a wholly owned S corporation) at fair market value for a mortgage note. The residence can then be rented inside the S corporation and depreciated at the stepped-up FMV basis. The residence is effectively retained with no current tax cost because the gain on the sale is excluded under Sec. 121 (provided the requirements of Sec. 121 are met).

In Letter Ruling 8350084, the IRS ruled that the sale of a residence to a taxpayer's wholly owned corporation qualified for the former Sec. 1034 gain deferral. In that ruling, the IRS stated that there was no prohibition in the Sec. 1034 rules against selling the residence to a related party and excluding (deferring) the gain. The authors believe this same rationale can apply to the Sec. 121 gain exclusion rules.

Example 2: *T* and *J* own a house that they have lived in for 20 years. The house has a tax basis of $75,000 and an FMV of $275,000. They have decided to relocate in order to live closer to their only child and grandchildren. They need the value in cash from their old residence for a down payment on their new residence. However, because they hope to move back in a few years, they would prefer not to sell the old residence. They like the idea of renting the old house in order to retain it and still provide some tax benefits and possibly some cash flow.

T and *J* can form a wholly owned S corporation and have the S corporation buy the residence for its value ($275,000) on a third-party mortgage note. (*T* and *J* should contribute the minimum amount of down payment into the S corporation necessary for the S corporation to purchase the residence.) *T* and *J* would receive cash of $275,000, and the $200,000 gain ($275,000–$75,000) is excluded under Sec. 121. Therefore, this is accomplished at no current tax cost.

The S corporation can begin to rent the house and take depreciation deductions on the portion of the $275,000 cost allocated to the house (some portion should be allocated to the land). This could provide some continued cash flow (depending on the rental rate versus monthly cash outlay for mortgage payments, insurance, taxes, and operating costs) and possible tax benefits associated with residential rental properties.

Note: The rental activity inside the S corporation also may generate a loss passed through to the taxpayer (assuming the taxpayer has enough basis), subject to the passive activity rules, or may even generate passive income that could be absorbed by other passive losses of the taxpayer. Also, if gain from the sale of the residence to the controlled entity exceeds the maximum Sec. 121 exclusion, the excess is taxable as ordinary income (rather than capital gain) because the controlled entity (related-party) purchaser will depreciate the property (Sec. 1239(a)).

If the S corporation ultimately sells the residence, any gain would be taxed at capital gains rates (currently 0% or 15%), subject to a 25% rate for unrecaptured Sec. 1250 gain (i.e., gain attributable to depreciation allowed or allowable on the residence for periods after May 6, 1997).

Exhibit 1: *M*'s gain on sale of residence

(1) Original cost	$50,000
(2) Conversion value	60,000
(3) Depreciation taken	9,000
(4) Adjusted basis for determining gain: (1) – (3)	41,000
(5) Adjusted basis for determining loss: lesser of (1) or (2) – (3)	41,000
(6) Sales price	65,000
(7) Recognized gain: (6) – (4)	$24,000

Calculating Gain/Loss on Subsequent Sale of Rental Property

If a residence converted to rental property is later sold at a gain, the basis in the converted property is the original cost or other basis plus amounts paid for capital improvements, less any depreciation taken. If the sale results in a loss, however, the starting point for basis is the lower of the property's adjusted cost basis or FMV when it was converted from personal to rental property (Regs. Sec. 1.165-9(b)(2)). This rule is designed to ensure that any decline in value occurring while the property was held as a personal residence does not later become deductible on the sale of the rental property.

Exhibit 2: *M*'s loss on sale of residence

(1) Original cost	$50,000
(2) Conversion value	45,000
(3) Depreciation taken	8,000
(4) Adjusted basis for determining gain: (1) – (3)	42,000
(5) Adjusted basis for determining loss: lesser of (1) or (2) – (3)	37,000
(6) Sales price	40,000
(7) Recognized gain: (6) – (4), but not less than zero	-0-
(8) Recognized loss: (6) – (5), but not more than zero	-0-

Example 3: *M* converted her personal residence to income-producing property in 2000. The house had a $50,000 original cost, and the property's FMV was $60,000 when it was converted to rental use. Over the eight-year rental period, a total of $9,000 in depreciation was taken. In 2008, *M* sold the property for $65,000.

Her gain is computed as in Exhibit 1.

Example 4: *M*'s property's FMV at conversion was $45,000 rather than $60,000, the total depreciation taken was $8,000 rather than $9,000, and the sales price was $40,000 instead of $65,000. The loss would then be computed as in Exhibit 2.

No reportable gain or loss occurs because (1) no gain results when the original cost is used in the gain computation, and (2) no loss results when using the lower of cost or market basis for determining loss.

Note: The fact that a residence is rented at the time of a sale does not automatically preclude gain attributable to such use from being excluded under Sec. 121. The taxpayer must still meet the ownership and use and the one-sale-in-two-years tests of Secs. 121(b) and (c), and under Sec. 121(d)(6), gain cannot be excluded to the extent of depreciation adjustments attributable to periods after May 6, 1997. **TTA**