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Tax Implications of Converting Your Home Into Rental Property

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Converting your home into rental property could be the right approach given you could have income from your new rental property and purchase another home in this down market with the rent. However, some relatively complex tax issues should be considered.

The complexity is derived from different tax treatment of sale of personal residence as opposed to sale of rental property. As such, when a personal residence is converted into rental property, the whole calculation of gains and losses are distorted.

To clarify the difference in tax treatment, let's first review some of the basics.

BASICS

1. Losses in Sale of Personal Residence

You might remember that when you sell your home you cannot take losses for less than what your tax basis is in the property. Usually, tax basis is the purchase price of the personal residence PLUS the cost of any improvements (not including any normal repairs and maintenance). In fact, taking losses is a privilege reserved for sales of property as a result of business or investment purposes only.

For example, if you bought your home for $400,000 and spent another $20,000 on adding a deck and pool, your tax basis is $420,000. If you sell it for $250,000, you cannot take any losses.

2. Losses in Conversion of Personal Residence Into Rental Property

One inference could be if you convert your home into a rental property, upon sale you can take losses even if the losses are less than your tax basis in the property. However, this inference is inaccurate. There is a special tax-basis rule that prevents such tax-payer friendly rule.

Rule for Losses Upon Conversion from Personal Residence Into Rental Property

The rule says that if you convert your home into rental property and sell it your tax basis for calculating losses in a sale is the ***lesser*** of:

1. *The property's tax basis on the conversion date under the normal rules*. This means your tax basis is whatever you had bought the property PLUS the cost of improvements until

the time of conversion. For example, if you had bought your home for $300,000 and the cost of improvements until the conversion was $50,000. Your tax basis would be $350,000, upon the sale of the newly converted rental property for tax loss purposes.

2. *The property's Fair Market Value on the conversion date.* That is why it is so important to ask a local realtor upon conversion to provide you with some record to keep as to how much an able buyer is willing to pay for the property.

This is important to note the IRS by this special basis rule aims to prevent any decline in value that occurs *before the conversion* date. However, a *post-conversion decline* in value results in tax loss to the extent such losses are not offset by depreciation deductions.

3. Tax Basis for Gains Are Different In a Conversion

Let's say you sell your newly converted rental property at a profit. What tax basis would you use?

The answer is you would use the *usual tax basis rule*. This means your basis for gains purposes would be your purchase price PLUS the cost of any improvements MINUS any depreciation deductions.

Depreciation deductions are allocable to the building not the land over 27.5 years.

4. Examples

To illustrate the rather complex tax issues just explained, it would be helpful to provide some examples.

A. When There is Tax Loss on Sale

Let's say you purchased your home for $300,000. You spent another $50,000 on improvements. So, your usual tax basis would $350,000. At the time of conversion, your home fair market value is $250,000. Eventually, you sell your newly converted rental property for $200,000 after taking $15,000 in depreciation write offs during the rental period.

Explanation

It is obvious you incurred losses. Your usual tax basis would be $350,000. But, because of the conversion, your tax basis is the lesser of either $350,000 (the purchase price PLUS Improvement costs) or $250,000 (fair market value on the date of conversion). So, your tax basis for losses would be $250,000. However, you also took advantage of depreciation deductions in the amount of $15,000. So, your losses would be $250,000 (the tax loss basis with depreciation)-$200, 00 (the sale amount)-$15,000 (depreciation deduction) =$35,000. So, your tax loss is $35,000.

B. When There is Tax Gain on Sale

Let's say you bought your home for $250,000. You spent $50,000 on improvements. At the time of conversion, your property's fair market value is $280,000. You eventually sell the property for $320,000 after taking advantage of $10,000 in depreciation deductions.

Explanation

Now, your tax basis for gains purposes is $300,000 ($250,000 purchase price+$50,000 cost of improvements). You also took advantage of the depreciation deduction.

As such, your gain would be $320,000 (the sale price)-$300,000 (basis for tax gain) -$10,000 (depreciation deductions) =$10,000 of gain.

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