APRIL 2000 Income Tax PUBLICATION 1375

A Reprint from *Tierra Grande*, the Real Estate Center Journal

Former Residence . . . Rent or Sell?

By Jerrold J. Stern

A tax twist you should know about.

For a variety of reasons, homeowners may want to rent a former residence to others. Typically, the fair market value of a residence exceeds its tax basis. Tax savings can be maximized in these cases by selling a residence to a taxpayer-controlled entity (such as a limited liability company, S corporation or regular corporation) prior to rental. The sale increases the tax basis subject to future depreciation deductions, up to the property's fair market value, while tax on gains from the sale are avoided with the help of the sale of principal residence rules.

Why would homeowners want to rent their residence rather than sell it? They may desire to keep the residence in the family long term, but no family member needs or wants to live there presently. For instance, the homeowners one day may want to retire to the home. Perhaps the homeowners want to sell the property but need more time to find a suitable buyer. Alternatively, the homeowners simply may want to own a single-family rental property as an income-producing investment.

Tax on all or part of the gain from selling the residence to a controlled entity is avoided under the sale of principal residence rules. These rules enable a married couple to avoid tax on as much as $500,000 of gain. Single taxpayers pay no tax on gains up to $250,000. The only stipulation is that the home has been the taxpayer's principal residence for at least two years of the five-year period preceding the date of sale. Tax-free gains are allowed by the Internal Revenue Service (IRS) even though the sale is to a controlled entity.

The gain exclusion rules particularly are helpful as the tax basis of the home may be quite low as the result of the postponement of tax on gains from selling previous homes. If the homeowner provides financing to the controlled entity and the gain exceeds the $500,000 (or $250,000) exclusion, the taxable portion of the gain can be spread over a number of years by using the installment sales method.

The most rapid depreciation available for residential rental property is straight line depreciation over 27½ years. A 40-year write-off period also is available. Depreciation computations are based on the purchase price (i.e., fair market value) paid by the controlled entity. Other expenses incurred in connection with the rental property are fully deductible. Such expenses may include maintenance, utilities and insurance.

An example helps. Assume John's home has a value of $385,000 and a tax basis of $100,000. If John simply rents the property, depreciation deductions are based on $100,000. Alternatively, if John establishes a limited liability company (or another controlled entity) to purchase the property for $385,000, that price becomes the depreciable basis, and depreciation deductions are $14,000 per year ($385,000 divided by 27½ years). If rental income exceeds depreciation and other expenses, the net income is taxable. If a net loss results, it flows through to John and is deductible on his personal tax return (subject to the passive activity loss limitation rules).

The controlled entity can be a new or existing entity. If there is no existing entity, a limited liability company (taxed as a partnership) or an S corporation is recommended because both are flow-through entities, enabling losses to pass through to the owner. If a C corporation (regular corporation) already exists, it can be used to purchase the residence and net losses will be deductible from its other income rather than flowing through to the seller.

Another feature of this plan is that the residence can be rented to a family member. However, a fair market rent has to be charged in order for any net losses to be deductible.

There are two potential costs that need to be considered. First, if there is a mortgage balance on the home, it likely will need to be paid off at the time of sale to the controlled entity. Second, if the property is later sold, any gain will be fully taxable. Gain up to the total amount of depreciation deductions is taxed at 25 percent. Gain in excess of depreciation is taxed at 20 percent.

Tax planning for this type of transaction can be complicated. Consultation with an accountant, attorney or commercial real estate professional is recommended.

Dr. Stern is a research fellow with the Real Estate Center at Texas A&M University and a professor of accounting in the Kelley School of Business at Indiana University.

REAL ESTATE CENTER

Tierra Grande (ISSN 1070-0234), formerly *Real Estate Center Journal*, is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115.

Subscriptions are free to Texas real estate licensees. Other subscribers, $30 per year, including 12 issues of *Trends*.