

Converting a Residence to Rental Property:

For various reasons, you may consider converting your personal residence to rental property. This decision is often made as a result of the inability to sell the property at a gain, the desire to retain the property for future personal use, or the strength of the rental market in your area. However, a decision to convert to rental also should consider economic factors such as your marginal tax rate and the potential loss of your ability to exclude up to \$250,000 (\$500,000, if married) of gain from the sale of your principal residence for federal income tax purposes.

Other economic factors to consider include the expected growth rate for rental property in your area, length of time the house will be rented before being sold, cash flow from renting, effect of the passive activity rules (which limit and defer tax deductions), and the expected rate of return available on other investments.

Generally, the economic advantage from converting a personal residence to a rental rather than selling it is increased as your marginal tax rate increases, the growth rate of the rental property increases, and the rate of return on alternative investments decreases. But, each situation should be thoroughly analyzed given its particular facts and circumstances. If selling your personal residence would result in a nondeductible loss, you can seriously consider converting the residence to a rental property. 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 you to eventually recognize a loss on the property's subsequent sale if the property continues to decline in value. The fact that a residence is rented at the time of the sale does not automatically preclude gain from being excluded under the gain exclusion rules. Instead, the exclusion of gain depends on whether the taxpayer meets the ownership and use requirements and the one-sale-in-two-years test at the time of the sale. In all cases, however, gain exclusion cannot be claimed to the extent of depreciation adjustments attributable to periods after May 6, 1997. The decision to convert your residence to rental property is complex and the ramifications of this decision are far-reaching. Please call us to thoroughly explore the numerous tax and economic issues related to such a conversion.