PRIMARY RESIDENCE©

WHAT PEOPLE THINK

People think their home is worth $500,000 but they cannot sell it for more than $300,000. Or they think it is worth $1,000,000, but cannot sell it for more than $800,000.

So they decide to rent it out for a few years until the market goes back to what they think the value is.

What is wrong with that? EVERYTHING.

1. The home is only worth what a buyer is willing to pay, not more, not what anyone wishes it to be.

2. Renting it out means being in the real estate business, with all the headaches of such business.

3. Failing to make a better investments.

4. Potential loss of some tax effects.

RECOMMENDATION

Do not rent your home out. Sell it.

IF YOU SELL

If you sell your primary residence, not a vacation or second home, and the gain is $250,000 or less, then the gain is not taxed. Double the exclusion if you are filing a joint tax return. You must meet 3 tests:

1. Ownership. Must own the home for 2 of the 5 years prior to sale.
2. Use. Must be the primary residence for 2 of the 5 years prior to sale.
3. Prior exclusion. There cannot have been an exclusion during the 2 years prior to sale.

It may be possible for a reduced exclusion if the failure is due to a change in place of employment, health reasons, or unforeseen circumstances.[1]

BASIS

Basis is thought of as cost, but not always. Your basis in your home is the lower of:

1. The home's initial purchase price (plus any improvements), or
2. Its fair market value at the time of conversion.

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[1] Examples of unforeseen circumstances are natural or man-made disasters, acts of war or terrorism, death, unemployment, change of employment resulting in an inability to pay reasonable basic living expenses, divorce or legal separation, multiple births resulting from the same pregnancy, and any other event the IRS determines to be an unforeseen circumstance.

The reduced maximum exclusion is computed by multiplying the maximum dollar limitation ($250,000 or $500,000) by a fraction.
The numerator of the fraction is the shortest of the following time periods:
1) the taxpayer's ownership of the property during the five-year period ending on the date of the sale or exchange, or
2) the taxpayer's use of the property as the taxpayer's principal residence during the five-year period ending on the date of the sale or exchange, or
3) the length of time between the date of a prior sale of property for which the taxpayer excluded gain and the date of the current sale or exchange.
The denominator of the fraction is 730 days or 24 months (depending on whether the numerator is measured in days or months).

DEPRECIATION ON PROPERTY BEING RENTED

You can depreciate the basis of the house, not the land, over 27½ years. Depreciation reduces your basis.

IF YOU RENT IT AND LATER SELL IT FOR A GAIN

If you are not able to meet use test, you will not be able to use the $250,000/$500,000 exclusion.

Depending on depreciation recapture and state taxes, that may mean a 25% tax instead of 0%. On a $250,000/$500,000 exclusion, that is $62,500/$125,000.

IF YOU RENT IT AND LATER SELL IT FOR A LOSS

Calculating basis as fair market value at the time of conversion means that any decrease in value that occurred *while the home was a primary residence* is never permitted as a loss.

Only the decline in value that occurred after the home was converted into a rental is allowed as a tax loss.

Unless you have your home appraised, how would you know what the fair market value was at the time of conversion? In effect, without an appraisal, no loss deduction.