

Conversion of Residence to Rental

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Trisha has owned her home for over 20 years. She originally purchased her home for \$100,000 and there is not currently a loan on the home. Her home is estimated to be worth \$300,000.

Trisha wants to move closer to her only grandchild and needs the cash from her current home in order to put money down on her new home. Trisha has strong ties to this area and hopes to move back here in a few years, so she doesn't want to sell her home. Trisha is thinking of renting her current home instead of selling it.

If Trisha simply converts her home to a rental property the property's basis would be the lower of cost or market value, and in her case this would be \$100,000.

Trisha should consider forming a wholly owned S corporation and having the S corporation purchase the home from her at fair market value, with the help of a bank loan. Trish should contribute enough cash to the S corporation to make the minimum down payment that would be required by a bank.

This way, Trisha would receive \$300,000 from the sale of her home to her S corporation (and net \$240,000 if she contributed \$60,000 to her S corporation), and the \$200,000 gain on the sale of her principal home (\$300,000 fair market value sales price less \$100,000 original purchase price) is excluded from tax (sale of her primary residence). Therefore, this transaction is accomplished at no tax cost. This money could now be used as a downpayment of a home near her grandchild.

The S corporation can now rent the house and take depreciation deductions on the stepped up fair market value of \$300,000 cost allocated to the house (the portion allocated to the land is not depreciable). If the S corporation is able to rent the house in excess of the cash outlay for mortgage payments, insurance, taxes and operating costs, this could provide Trisha some continued cash flow and possible tax benefits associated with residential rental properties. Any gain or loss from the rental activity would be passed through to Trisha, subject to the passive activity rules.

If the house was subsequently sold by the S corporation for a gain, the gain would be taxed at capital gains rates (15%) and possibly some depreciation recapture at 25%. However, if she is only going to be gone a couple of years, the gain, will most likely not be that large, due to the step up in basis.

Gina L. Gwozdz is a CPA who has chosen to specialize in taxes. Visit her website at <http://GLGcpa.com> to view more Tax Tip Articles.