Many homeowners, at different points in their lives, convert their primary residence to rental use or use as a second residence. The tax implications, including the residence interest deduction and the exclusion of gain on the sale of the property, can be very significant. Generally, the home must sell within three years after being made available to rent, or otherwise converted (unless it is designated as a second personal residence). This provides an overview of planning opportunities and risks when converting a principal residence.

INTRODUCTION

Homeowners frequently move to a new residence, but are not ready to part with the old property. Maybe they want the option to move back in, to retain the option to transfer the property to the children, or perhaps more commonly right now, they hope to wait until the housing market improves. These non-tax issues must be considered in light of the tax effects of the choice related to the residence. This paper examines four specific tax areas that could be affected: (1) loss of the exclusion of the gain on a principal residence (§121), (2) converting the property to a rental, more specifically, a rental to family members, (3) deducting mortgage interest on the residence, and (4) if the homeowners find themselves with levels of debt in excess of their basis in the home, how does discharge of the debt affect the after tax cost of the residence.

EXCLUSION OF GAIN ON SALE

Section 121 of the Internal Revenue Code states that “gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.” This exclusion is limited to $250,000 for a single taxpayer ($500,000 for married filing jointly), and except under special circumstances, may only be exercised on one sale every two years. Thus two of the more important requirements of §121 are that the dwelling be (1) owned and (2) used as a principal residence (Under §280A, a dwelling can be a house, condominium, mobile home, boat, or other similar property). These requirements are commonly referred to as the ownership and use tests.

For most home-owners, the ownership test is commonly focused on the time requirement (two out of five); however, ownership as defined for §121 is considered direct ownership (i.e., the dwelling is held directly in the taxpayer’s name), as a tenant-stockholder in a housing
cooperative, a grantor trust (under §§671-679, for example, a land trust), or a disregarded entity (for example, a single-member LLC) (See Reg. §1.121-1(c)(3)).

As mentioned previously, the more common portion of the ownership test relates to the amount of time the dwelling has been owned. The time requirement of the ownership and use tests are frequently considered contemporaneously as the time requirement under both is the same: two years (a full twenty-four months or 730 days). The two-year requirement must be met within five years ending on the date of sale. As a result, the dwelling need not have been owner or used as the principal residence (discussed below) in the two years leading up to the date of sale. This opens a window of planning opportunity for taxpayers to rent or use otherwise the dwelling for three years during the five-year window and still maintain (at least in part) the gain exclusion of §121. Since 2009 (P.L. 110-289), certain use of the dwelling as anything but the principal residence of the taxpayers is defined as “nonqualified” use. The ratio of the period of nonqualified use to total ownership period is then applied against the total realized gain. That product is not eligible for exclusion under §121. Nonqualified use is defined as any use after January 1, 2009, that is not use as a principal residence, but does not include any portion of the use test that occurs after the dwelling was last used as a principal residence.

For example, married filing joint taxpayers have owned a home in Seattle since 1995 and a second home in Phoenix since 2004. The Seattle home has been their principal residence since 1995. The taxpayers intend to retire to the Phoenix home in 2015 and plan to begin to claim principal residency in Phoenix in 2013. In 2015 when they sell the Seattle home, they will meet the ownership and use tests of the Seattle home for more than two years of the previous five (2010-2012) and we be eligible to exclude up to $500,000 of the realized gain. If in 2015, the taxpayers elect to downsize and sell the Phoenix home (realized gain of $200,000) they will have met the use and ownership tests for two of the previous five years (2013-2014) but will also have four years of nonqualified use (2009-2012) when the home was not the principal residence subsequent to January 1, 2009. Thus four of the twelve (2004-2015) years of ownership will be nonqualified and $66,667 ($200,000 x 33%) of realized gain will not be available for the exclusion under §121. The remaining gain of $133,333 is eligible for §121 exclusion.

TEMPORARILY RENTING THE PROPERTY

Given the recent housing market, a sale of a home used as a previous principal residence may not always make financial sense. Renting a former residence seems noncontroversial enough. The IRS categorizes rentals of homes in three ways: (1) residence with minimal rental, (2) residence with significant rental and (3) insignificant personal use. In moving from category one to category three, the rental use increases in number of days. For example, a minimal rental is one in which the home is rented for 14 or fewer days; whereas a insignificant personal use is where the rental period is at least one day and personal use does not exceed the greater of 14 days or 10% of the rental use (See §280A). For example, if a taxpayer rents a vacation home for six months of the year (180 days) and does not use the home personally for more than 18 days (10% of the rental use), then the home would be categorized as a non-residence. The above categorizations change the income tax treatment of the gross income and deductions from the
rental activities. In the case of a minimal rental neither the income nor any deductions associated with the rental period are recognized for tax purposes.

- For example, if a taxpayer decides to only rent their home for the week prior and subsequent to the Superbowl for $5,000, none of the gross income is recognizable (nor are any associated deductions allowed).
- If, on the other hand a taxpayer had met the threshold for significant rental use, the gross income is fully includable and the expenses are deductible, beginning on the day the property is made available for rent, under §162 or §212. For depreciation purposes, the basis of the property is the lesser of the adjusted basis of the property under §1012, or the fair market value on the date of the conversion to a rental business.
- Insignificant personal use rentals can generate deductible losses (although they may be limited as discussed below). For homes that meet the significant rental categorization, gross income is includable but deductions are generally limited to the income generated by the property. Any direct expenses of the rental (e.g., advertising) may be deducted. Certain other expenses (property taxes and mortgage interest) are allocated between the personal use and rental use of the home and any other allowable deductible expenses are limited to the rental income. As a result, any deductions in excess of rental revenue are carried forward to the subsequent year.

Owners may be surprised, if this is their first landlord experience, to learn that their activity is a “passive” activity. As such, they can only deduct losses to the extent of “passive” income. However, the “active rental” exception will generally allow landlords to deduct up to $25,000, but this is reduced by 50% of adjusted gross income [AGI] in excess of $100,000. Taxpayers with AGI at or approaching $150,000 will not benefit from operating losses currently, but can carry them forward until there is passive income or the property is sold. This can be cumbersome if the owner(s) is “feeding” the property (i.e., there is negative cash flow) and there are no current tax savings.

An unintended consequence of the rental period is that the amount of any realized gain that results from the depreciation of the property is not eligible for exclusion under §121. Note that not electing to take depreciation is not a shield against this gain recognition. The basis of the home must be adjusted to reflect the depreciation allowed. Thus, homeowners that convert their residence into a rental may find themselves facing non-deductible losses due to passive loss limitations and the additional consequences of shifting a portion of their gain outside the relative comfort of the §121 exclusion. Given the relative importance of the categorization of a rental residence as mentioned above, the questions as to whether use is defined as “personal” use becomes critical. Under §280A(d), personal use is defined as a day for which any part of the day is used for personal purposes by the taxpayer or family member (The members of a family include only the taxpayer's wife or husband, brother or sister, including half-brother and half-sister, father, mother, grandparent, or any other “ancestor”, children, grandchildren, or any other “lineal descendants.”), any day in which the taxpayer swaps use of the residence for use of another dwelling, or any day that the residence is used by any other individual unless a fair rental is charged. Under 280A(d), the specific rental of the residence to another individual as
their principal residence at fair market value (whether a family member or not) precludes categorization of those days as “personal use” by the taxpayer/owner.

This leaves taxpayers with a reasonably complicated decision: whether to sell the home or convert to a rental. Under either choice, the non-tax issues are considerable and include market risks, including when rents and appreciation fail to meet expectations, unexpected extended vacancies, significant unanticipated maintenance expenses, extended market times when the property is finally placed on the market. Tax considerations include deductibility of rental expenses, passive loss limitations, conversion of use to nonqualified use, and gain generated by depreciation on the property being ineligible for exclusion.

**DEDUCTING MORTGAGE INTEREST**

Mortgage interest is one of the few individual deductions that remain applicable to a wide variety of individual taxpayers. Under the general rules of §163, personal interest is not deductible by individuals; however, a small number of interests remain deductible (student loan interest, investment interest) including mortgage interest or more specifically, “qualified residence interest.” Qualified residence interest is interest on debt used to acquire a qualified residence or a home equity loan with respect to a qualified residence. Interest on acquisition indebtedness and home equity is generally limited to debt levels of $1,000,000 and $100,000, respectively.

A qualified residence is defined by §163(h)(4) as a principal residence (under §121) and one other residence of the taxpayer. The “other” residence may not be a dwelling that is rented at any time during the year. Thus, a home that has no significant personal use (see discussion in Temporarily Renting the Property above) is not eligible for treatment as the “other” residence; however, a residence that is categorized as a substantial rental is eligible to have the personal portion of the residence interest deducted as an itemized deduction; while the portion associated with the rental is deductible under §162 or §212 (subject to the previously mentioned limitation on gross rental income). Interest that is deductible under §163, rather than §162 and §212, is deductible as an itemized deduction, rather than being deductible for AGI (See §62 for a definition of adjusted gross income (AGI)). As a result, if the residence continues to be rented after it is no longer a qualified residence, generally after three years, only that interest that is deductible under Section 162 or 212 will be allowed, and as a deduction for AGI.

**DEBT IN EXCESS OF BASIS**

In the build-up to the housing collapse, those who enjoyed substantial appreciation frequently took advantage of low interest rates and loose credit standards to refinance or take out home equity loans for a variety of goals, including education, property acquisitions and improvements, travel, and to pay off consumer debt. Of course, the loan transactions are generally not taxable events. Typical mortgages used for principal residence acquisition are non-recourse, that is, the lender can repossess the property but may not otherwise pursue against the homeowner. In a recourse loan, the borrower is personally liable, including responsibility for any deficit if the property is foreclosed. This recourse/nonrecourse determination is critical for tax purposes.
Recently, a number of homes have market values that have decreased not only below the taxpayer’s basis in the home, but also the amount of debt associated with the home. This often leaves a homeowner that wishes to live elsewhere with three choices: (1) continue to own the home as a rental, (2) proceed through foreclosure or (3) negotiate a “short sale” with the lender. As previously discussed, renting the home has certain advantages and disadvantages that need to be considered in each specific situation.

If the forecloses, the homeowner treats the transaction somewhat differently depending on whether the financing was recourse or non-recourse. If the debt is recourse debt, the lender’s repossession is treated as a sale of the property and could result in gain realization (however, the gain exclusion under §121 is likely to eliminate any recognized gain). In addition, any loan amount forgiven above the fair market value of the home is treated as forgiveness of debt income and is taxable; however, between January 1, 2007 and December 31, 2012, a portion or all of that forgiveness of debt income may be excludable from taxable income (see below). If the home was subject to non-recourse debt, the debt in excess of the market value does not result in forgiveness of debt income. Instead the entire amount of debt is treated as the amount realized for calculating the gain or loss on the sale of the residence and the sale remains eligible for §121 exclusion (assuming it qualifies as a principal residence). In any case, losses are non-deductible personal losses.

Typically, in a short sale, the homeowner negotiates with the bank to sell the home for a price less than the outstanding debt on the home. Under the typical rules of §108, when the recourse debt is forgiven, the taxpayer includes the forgiveness of debt as income (this does not apply to non-recourse debt). The amount of the gain or loss is calculated similarly to that described above for foreclosures.

However, through December 31, 2012, under special provisions of §108 incorporated in the tax law since 2007, taxpayers are eligible to exclude forgiveness of debt related to a qualified residence. Income from cancelled debt can be excluded from income if the debt is qualified principal residence debt. Qualified principal residence debt is any mortgage taken out to build, buy, or substantially improve your principal residence. It also includes any debt secured by your residence that was used to refinance the original qualified debt, but only up to the amount of the original debt. For example, a taxpayer buys a home for $600,000, puts $120,000 down and borrows $480,000. Subsequently, when the outstanding principal of the mortgage is $450,000, the taxpayer refinances and borrows $500,000 (the fair market value of the home had risen to $700,000) and uses the $50,000 additional to pay off consumer debt and student loans. The taxpayer’s qualified principal residence debt is $450,000.

If a taxpayer excludes forgiveness of debt income under §108, the amount excluded reduces the taxpayer’s basis in the home. However, due to the application of the exclusion of the gain under §121, the gain is not likely to be taxable.
Clark and Kathy purchased their residence while in their thirties. Now in their sixties, after raising three children and paying for two college educations, they are contemplating moving out and establishing an attractive senior lifestyle at the beach. Their residence originally cost $125,000 and they made improvements costing $25,000. When they made the improvements, they refinanced, consolidating residence, education, auto, and other consumer obligations into a single $275,000 mortgage. Their home value had increased to $325,000 when they refinanced, but has decreased substantially to only $240,000 (below the current balance of the mortgage of $270,000). Now what?

Clark and Kathy consider their property to be unique, especially to them and the children who were raised there, yet they understand that the §121 exclusion provides value for them. How long can they wait? What if they rent the property before selling the home?

Let’s assume that Clark and Kathy are near the top of the 25 percent tax bracket. Under current law any taxable gain would be a 15 percent long-term capital gain, except for any depreciation recapture. If they reside in a state that would tax the gain at 8 percent, their composite tax rate is approximately 21% \[15\% + 8\% \times (1 – 25\%)]\]. The estimated value of the §121 exclusion for Clark and Kathy is $18,900 \[$90,000 \times 21\%\]; for those eligible to exclude the maximum gain of $500,000, tax savings equals $105,000 \[$500,000 \times 21\%\]. The 15 percent capital gains rate is set to expire at the end of 2012. As rates increase, the tax savings generated by the §121 exclusion increases. There are additional questions to consider.

§121 Exclusion

- Can Clark and Kathy sell the home currently and still retain some form of control over its use (sale to related parties, including family owned LLCs, family partnerships, or trusts)?
- What are the consequences of an early sale versus a deferred sale, assuming housing market increases/decreases and if the capital gain rate increases or stays the same?

Temporary Rental

- How to maximize the after tax cash flows from the rental by adjusting rental income (reasonably close to fair market value) by renting to a related party.
- Dealing with the passive loss limitations and the allocation of deductible interest between itemized personal interest and interest related to the rental activity.

How does the rental period affect the §121 exclusion?

- The gain associated with depreciation may be taxed at varying rates in the future – what effect does this have?
Debt Issues

- What is the best strategy for dealing with an underwater residence?
- What are the outcomes from a short-sale? foreclosure?
- How does the issuance of recourse v. non-recourse debt affect the outcome?

CONCLUSION

This paper provides a measured but valuable amount of tax law required to understand most issues associated with the pending decision facing many taxpayers in the United States – how to deal with the ultimate disposition of the principal residence given the real estate bubble and related extension of residence-related debt. We provide a comprehensive example that shows some of the more common alternatives and what the after-tax impact of those choices could be.

REFERENCES


U. S. Treasury Regulations, § 1.121-1(c)(3)