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Turning a residence into investment property

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Despite the upturn in the real estate market, some home owners still find themselves owning a residence with a fair market value that is less than their initial purchase price for the home. In a "loss" position, some owners are attempting to convert their residences into investment properties. Here are a few words of caution and tips.

First, the loss on the sale of a residence that you use as a home cannot be deducted. That said, it is true that the loss on a sale of an investment property can be deducted for tax purposes. However, when the property is in a loss position at the time of the conversion to investment property, the basis of the property for tax purposes is reduced from the initial purchase price to the fair market value of the house at the time of the conversion. For example, if you bought the home for $2 million, you convert it to an investment property when the home's fair market value is only $1.5 million, and you ultimately sell the residence for $1 million, then your loss will be limited to $500,000, the difference between $1.5 million and $1 million.

If you do expect further deterioration in the value of the residence, then converting the residence into an investment property makes sense. In order to convert it to an investment property, you will need to establish to the Internal Revenue Service's satisfaction that you have in fact treated the residence as an investment property. How can that be done?

You should move out of the residence and make the property available for rent by publishing advertisements in local newspapers. Be sure to keep copies of the advertisements. When you do find suitable renters, you should enter into long-term leases, preferably of a term of one year or more, in order to establish a permanency to the rental business. Make sure that all tax reporting is consistent with the rental purpose. Report all rental income on your tax return as a rental business, and be sure to deduct all maintenance, utility and operating expenses. You may also take depreciation deductions on the residence.

Converting the residence to an investment property is not without its disadvantages. If you do so and the property ultimately regains its value, you will have lost the ability to exclude some of the gain under the personal exclusion of gain on a primary residence, which currently permits the exclusion of $250,000 of gain for an individual and $500,000 for a married couple.

If you are thinking about converting your residence, you should talk with a tax professional first.

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