



Homeowners Puzzle Over What's Better: To Sell Or Rent Out

Choice Greatly Affects Taxes

Leasing out your place until housing rebounds can add income, but it's at a price

BY JEFF SCHNEPPER FOR INVESTOR'S BUSINESS DAILY

Hold or fold?

Some would-be home sellers are hesitating in today's market, ruminating on how long it will be until prices rebound, how to hang onto a property until then, and if it's worth the trouble.

The choice can be tough if the owners must move to another city or they inherit a home where they don't plan to live.

One chewy question is whether to rent out. On the plus side, it can bring in the cash flow to cover that unneeded home's carrying costs. On the minus side, renting carries risks. Weigh pros and cons carefully before making a decision.

South Jersey money manager E.J. Paul considers cash flow the most important element to financial planning. Lack of it accounts for much of today's housing havoc.

"It doesn't help if the value of your house has skyrocketed, if your income hasn't increased and your taxes have doubled," he said. And it's even worse if you have to move and the real estate implosion makes a home hard to market.

Tenant Trouble

Yet some people won't rent, regardless of the cash flow. Philadelphia life insurance agent Sayes B. Block refused to rent his home before its sale.

"I'd rather have syphilis than tenants," he said.

You never know what you're getting into when you rent. Tenants, especially short-term tenants, are less concerned with long-term maintenance than owners are. That can lead to trouble: A small roof leak left unattended now can turn into a major roof repair before you can sell the house. Tenants also have been known to destroy property beyond the value of their security deposits.

An uncooperative tenant can make it harder to sell the property. An empty house is cleaner and easier to show than one that's cluttered with a renter's possessions. A renter who wants to stay can kill a potential deal by commenting that kids down the block sell drugs, or complaining that neighbors play loud music late at night, regardless of the truth of such allegations.

Will renting make financial sense for you? The answer depends on your tax situation and many variables to do with your mortgage and expenses. If you can tolerate the risk, the cash flow from renting can help you counter or at least trim your carrying costs.

No Easy Equation

But with renting comes caveats. Let's say in a single year you get \$10,000 in rental income, and spend \$500 on insurance, \$5,000 on property taxes, and are allowed \$500 in depreciation. You pay \$20,000 in mortgage interest, so end up with a \$16,000 loss. If you make less than \$150,000 a year, (your "modified adjusted gross income"), that loss potentially could be deducted.

But if your modified AGI is more than \$150,000, you can't deduct any of the rental loss in the current year. You can't benefit from the loss until you either sell the property or have positive income from the rental.

If you had used the home yourself or left it vacant instead of renting it and thus treated it as a personal, rather than rental, property, you could have taken the \$25,000 in interest and taxes as itemized deductions, even if your modified adjusted gross income topped \$150,000. Though

if you incurred the alternative minimum tax, that could trim some of your deductibility.

You'll have to do the math to see whether the deductions would benefit you more than the rental income. Other factors must be weighed, too.

Renting will complicate your tax return. Here's the basic rule, at least as of now: If the house was your principal residence for at least two of the five years prior to sale, you can exclude as much as \$250,000 (\$500,000 on a joint return) in capital gains. You can get the exclusion every two years.

But renting out your house makes it depreciable investment property. You'll have to file a Schedule E to report your rental receipts and costs, and any net gain will be taxable income. If you're in the 33% bracket, that means you only get to keep 67% of your rental income, after expenses. Also, any depreciation allowed will be taxable (at federal rates as high as 25%) when the house is sold, regardless of the capital gains exclusion.

Return Concerns

As mentioned earlier, if you have a rental loss, you might not be able to deduct it right away. The maximum loss allowed from rental real estate is \$25,000 a year, and you lose 50 cents of the deduction for each dollar of modified adjusted gross income (MGI) over \$100,000. MGI is your adjusted gross income without considering your real estate loss. So, if your MGI hits \$150,000, you get no current deduction.

The good news is that the deduction is only deferred, not lost. You can use these deferred losses to offset future rental profits, and claim any balance when the property is finally sold.

Renting also will confuse your deduction for mortgage interest and property taxes. Once you rent, they no longer are itemized deductions reported on Schedule A. They now belong on Schedule E as investment rental expenses. That is great if you're not subject to the above rental loss limitations.

If you typically end up having to pay the alternative minimum tax (AMT) each year, renting can be your friend. The rental real estate taxes you pay won't be disallowed by the AMT, as personal real estate taxes would be. If the house was a vacation home instead of principal residence, mortgage interest paid also would have raised your AMT exposure. Converting to a rental would eliminate this exposure.

Without the deduction for interest and taxes, your standard deduction may be higher than your itemized deductions. That means you get the full standard deduction plus you can deduct the rental taxes and interest on Schedule E.

Sale Strategy

Financial adviser Gayle Kesselman, of Estate Planning of Delaware Valley in Wilmington, Del., suggests that sophisticated taxpayers consider selling a principal residence as its appreciation nears the maximum capital gains exclusion, and move into their vacation home.

"After living there for two years, they can sell the vacation house and exclude another half million in gain," she said.

But this strategy is now in the cross hairs of Congress. A current bill would limit your exclusion based on years used as your principal residence compared with total years owned. So any period when the property is used as something other than a principal residence, such as a short-term rental, would reduce your gain exclusion.

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