

Should You Turn Your Low-Rate COVID-Era Home Into a Rental?

By Tim Spurrier, CPA, Little Tree Financial

If you bought or refinanced a home when mortgage rates were around 3%, giving up that loan today can be a tough pill to swallow. So when it comes time to move, the obvious answer might seem to be: keep the house and turn it into a rental.

It's a conversation I hear all the time: "I'd never sell that house—I have a 3% mortgage. I'll just rent it out." The mortgage is cheap, the tenant helps pay down the loan, and the home may continue increasing in value. It sounds like a no-brainer.

But a great mortgage doesn't automatically make a great investment. So, there's an important question to ask yourself:

If you didn't already own this house, would you use your current equity to buy it today as a rental?

Suppose your home is worth \$450,000 and you only owe \$250,000. That's roughly \$200,000 of equity – the difference between what your home is worth and what you still owe.

Making \$500 or \$800 per month after the mortgage sounds great, but that's not necessarily your investment return.

Property taxes, insurance, repairs, vacancies, and major replacements all matter. More importantly, so does having \$200,000 tied up in one property. What else could that money be doing for you?

Then there's another important piece of the equation: Taxes.

Your Home Has a Tax Benefit You May Be Giving Up

One of the biggest tax benefits of owning a primary residence actually comes when you sell it. Section 121 of the tax code allows qualifying homeowners to exclude up to \$250,000 of gain from federal taxable income, or up to \$500,000 for certain married couples filing jointly. To qualify, you generally need to have owned the home and used it as your primary residence for at least two of the five years leading up to the sale.

That creates an important planning window when a former home becomes a rental.

You don't immediately lose the exclusion when you move out. Someone who lived in the home for several years may be able to rent it for a period and still satisfy the two-out-of-five-year test when they sell.

But hold it long enough and that can change.

Think about what that means: your home may have increased significantly in value since you bought it, and some or all of that profit could potentially be tax-free if you sold today. Convert the home to a rental and hold it beyond your Section 121 window, and that same profit may eventually become taxable when you sell.

Of course, rental ownership can come with tax benefits of its own. Depreciation is one of the most commonly discussed, but also one of the most misunderstood. While it can reduce taxable rental income, that doesn't always mean you'll receive an immediate tax benefit. Depending on your income and other circumstances, tax rules may limit your ability to deduct rental losses in the current year. Although those losses aren't necessarily lost and can generally be carried forward to offset rental income in future years, it's important to understand that you may not see the tax savings right away.

So while depreciation can be valuable, don't automatically assume that every dollar of depreciation creates tax savings today.

So how should you think about the decision?

I like to break it into three broad time horizons.

1 Short term

Maybe you want to test being a landlord for a few years. Depending on your circumstances, you may be able to generate rental income, benefit from an increase in the home's value, and still sell within your Section 121 window.

2 Long term

Maybe your goal is 15 or 20 years. You're intentionally building a real-estate investment and believe years of rental income, mortgage paydown, and growth in the home's value will justify keeping your money tied up for the long haul.

3 The awkward middle

This is where I think homeowners should stop and run the numbers.

You may have moved beyond your Section 121 window, meaning profit that could once have qualified for the home-sale exclusion may now be taxable when you sell. You've had years of equity tied up in the property, and some of the tax benefits you expected along the way may have been limited or delayed. At the same time, you may not have held the investment long enough for the growth in value, cash flow, and mortgage paydown to clearly justify the tradeoff.

That doesn't make years 5 through 15 "bad." It makes them worth projecting.

Run the numbers. What is your actual return after expenses? How much equity is tied up? What might your tax bill look like if you sell in year 3, year 8 or year 20? And what could that same equity potentially accomplish elsewhere?

The answer may very well be: keep the house.

But make that decision because the numbers support it, not simply because owning a rental sounds like a good idea.

A 3% mortgage is a valuable asset. It just isn't an investment strategy by itself.

If this sounds like a decision you are facing, or you would like to explore other tax planning opportunities, feel free to reach out.



GUEST COLUMNIST

Tim Spurrier, CPA

Little Tree Financial

Email: Tim@littletreefinancial.com

Website: Littletreefinancial.com

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