Legal Assistance Practice Points: Part 3: How to Handle the Sale of a Home That Was Previously a Rental Property

September 29, 2009

by Yosefi Seltzer

In the last two issues, I described possible tax liability for the sale of a Home and discussed how to calculate the Gain to determine whether it can be excluded from taxation. This final article will conclude the subject of sales of Homes by describing how the Sale of a Home is handled when it was previously a rental property. This topic is particularly relevant to military families who frequently relocate and decide to rent out their houses while they are stationed elsewhere.

As I stated in the previous article, the Internal Revenue Service (IRS)[1] permits individuals to exclude the Gain on a main home if it meets certain requirements. You may exclude up to $250,000 if single or $500,000 if married and filing a joint return of the Gain on the sale of your main home if: 1) you meet the Ownership Test (owned the home for at least 2 of the 5 years ending on the date of the sale); 2) you meet the Use Test (lived in the home as your main home for at least 2 years); and 3) during the 2 year period ending on the date of the sale, you did not exclude Gain from the sale of another home. Now that we have covered the basics, it makes sense to discuss the different manner in which a Home that was a rental property under the same owner is handled.

You may still be able to exclude Gain from the sale of a Home that was used for business or as a rental property but the Ownership and Use Tests must still be met. If the Ownership and Use Tests are not met, even while attempting to utilize the military suspension discussed in the previous article, the Gain cannot be excluded and is therefore completely taxable and must be reported on the tax return for the year in which the house was sold. If the Ownership and Use Tests are met, you can still exclude Gain up to $250,000 if you are single or $500,000 if you are married filing jointly but you cannot exclude the part of the Gain equal to the Depreciation claimed during the years the property was rented or could have been rented. **Depreciation is a highly complex matter**, but basically, it means you recover the cost of income producing property through yearly tax deductions by depreciating or deducting some of the cost on the tax return each year.[2] You can deduct Depreciation only on the part of your property used for rental purposes. You should claim the proper Depreciation amount each tax year because even if you did not, you must still reduce your basis in the property by the full amount of Depreciation you could have deducted.

If you were entitled to take Depreciation deductions because you used the Home for business or rental purposes, you cannot exclude the part of the Gain equal to the depreciation allowed or allowable as a deduction for periods after May 6, 1997. For example, if you owned and used a house as your Main Home from 2002 through 2005 and on January 1, 2006, moved to another state and rented the house from then until April 30, 2008 when you sold it, you owned and lived in the house for 32 months (more than 2 years) during the 5 year period ending in the date of the sale. However, because the house was a rental property during your ownership, you must report the sale on an IRS Form 4797. Because you met the Ownership and Use Tests, you can exclude the Gain of up to $250,000 ($500,000 if married filing jointly), but you cannot exclude the Gain equal to the depreciation you claimed or could have claimed for renting the house.

As you can see, the Sale of a Home can become complicated, in particular, if the Home was used as a rental property. This is an area of tax law where individuals routinely make mistakes in failing to adjust the basis, report depreciation or determine whether the Ownership and Use Tests are met. If you are planning to sell a home or sold one during the current tax year, feel free to contact our office to request assistance or consult commercial tax preparation professionals.[3]

Yosefi Seltzer is a Department of the Army civilian attorney in the Legal Assistance Branch of the Office of the Staff Judge Advocate at Fort George G. Meade. He is a former Active Duty Army Judge Advocate, achieving the rank of Major. The views expressed herein are his own. He may be reached at: Yosefi.Seltzer@us.army.mil.

---

[1] Internal Revenue Service (IRS) Publication 17, for use in preparing 2008 returns, was heavily consulted in the preparation of this article.

[2] Consult IRS Publication 527 for more information regarding depreciation and treatment of residential rental property.

[3] The Office of Legal Assistance is prohibited from providing legal advice and assistance for business activities, in accordance with Army Regulation 27-3, paragraph 3-8(a)(2). If your activities meet this definition, the Office of Legal Assistance will refer you to outside tax preparation professionals.