

Sell or Rent: Deciding What to Do With Your Home

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–Elaine Floyd, CFP

The decision on whether to sell or rent your home is trickier than other financial decisions because of the emotional ties you have to your home. To make the best decision possible, evaluate the income, growth, and tax advantages of selling vs. renting and how it would advance your long-term goals.

If you are relocating due to a job change or retirement, you may want to keep your present home and rent it out rather than selling it and transferring the equity to a new home or reinvesting the proceeds.

The first question to ask is yourself is why are you considering this strategy? Here are some of the more common reasons:

1. Your home has appreciated considerably and you don't want to sell while prices are still in an uptrend.
2. You would enjoy receiving rental income as a supplement to other retirement income.
3. You are not sure the relocation is permanent and want to keep the home in case you decide to move back.
4. You want to keep the home in the family for children or grandchildren.

Understanding your long-term objectives will provide direction in analyzing the sell-versus-rent question.

Appreciation

If your main objective is further price appreciation, when will you know when it's time to sell? In other words, what is your exit strategy? If you see the home as a growth investment, is this the best growth investment right now, considering your objectives and the rest of your portfolio? If you had a lump sum of cash equal to the equity in the home, would you buy this home and rent it out or invest in something else?

The purpose in this line of questioning is to find out if you have an unhealthy attachment to the home as an investment—not uncommon when a particular asset has “been good” to you. If emotions are clouding your judgment, try viewing this asset within the context of other possible investments and ask yourself how much more you think the house might appreciate. If it's already worth far more than you ever imagined, you

might deem the house overvalued and reconsider the wisdom of keeping it.

Or it could be that your home hasn't appreciated very much. In the event you have a loss on the home, you may be better off converting it to a rental before selling, since a loss on a personal residence is not tax deductible. Maintaining it as a rental may give the home time to appreciate. If it doesn't, you could go ahead and sell it after renting it for a while and claim the loss on your tax return. (Be aware, however, that the IRS has disallowed loss deductions for rentals preceding a sale on the ground that there was no "profit motive" for the rental.) The property's basis would be the lesser of adjusted cost basis or fair market value at the time of conversion and would need to be documented in order to claim the loss. Their expense, as they were the ones that were on the hook for the damages.

Income

Rental income can be a good source of retirement income—as long as the numbers work. One advantage of rental income is that it generally rises with inflation. However, the ability to raise rents varies with supply and demand in the local area, and this may change during the ownership period.

If you are keeping the house for income, you will need to do a market analysis to determine the appropriate amount of rent to charge and you will also need to fully understand the costs of ownership (maintenance, repairs, insurance, and so forth) in order to determine your net cash flow. Consultation with real estate agents and CPAs may be necessary.

There are numerous online calculators that can help you decide if your home is the best source of income or if you could do better with another investment. Most calculators will ask you for the expected monthly rent, ownership costs (taxes, capital improvements, and monthly maintenance costs), and the likely sale price of the home in order to calculate the "capitalization rate," which you can then compare with the rate on long-term Treasuries.

If the cap rate is higher than the current rate on Treasuries, keeping the home as a rental is a good

deal; if not, it's not. Make sure you are not forcing the numbers to work by assuming too-high rent or too-low expenses. Accurate assumptions are crucial to understanding the investment merits of the deal. In the end, the sell-versus-rent decision will hinge on the ratio of rents to prices in the your neighborhood. Low rents and high home prices do not bode well for a client who's thinking of leveraging his equity for an ongoing income stream.

In addition to the ratio of rents to prices, you need to understand the tax rules pertaining to income property. Rental income is taxable; however, the following expenses are deductible from rental income on Schedule E of Form 1040:

- Real estate taxes
- Management expenses
- Maintenance expenses
- Traveling expenses to look after the property
- Legal expenses
- Mortgage interest
- Insurance premiums
- Depreciation of the building (not the land) based on a 27½ year recovery period
- Depreciation of furniture, carpeting, and appliances based on a five-year recovery period

These tax breaks may make the deal more attractive than you had anticipated. On the other hand, the above list may make you aware of expenses you hadn't thought about when calculating net cash flow. If you are investing for income, you need to be realistic about how much that net income will be.

Temporary rental

If you aren't sure that the relocation will be permanent and you want to have the option of moving back into the home, renting it out for a period of time may be a good solution. However, you should keep an eye on the calendar and, if you're going to sell, do it within three

years in order to qualify for the \$250,000 / \$500,000 capital gains tax exclusion. According to the rules, even if a home has been converted to a rental, sellers can qualify for the capital gains tax exclusion if they've lived in the home as a principal residence two out of the five years preceding sale. Be sure you allow enough time to get the house on the market, sold, and closed before the three-year window closes.

Leaving it to heirs

As more young people get priced out of the housing market, you may want to keep your home for your children and grandchildren, renting them to the kids or to unrelated tenants. This is also a good tax-planning strategy because your heirs will receive a step-up in basis when they inherit the property. Remember, if you are renting the house to family members at below-market rates, you may only deduct expenses to the extent of the actual rent received (i.e., you can't claim excess losses).

Analyzing the investment merits of a principal residence converted to a rental property is slightly trickier than analyzing any other investment because of your emotional connection to the property. You've enjoyed living in the home, made money on the home, and now want to keep the home as an investment. But as with any investment, it must be evaluated on the basis of its economic merits in light of your personal objectives and taking into account the property's prospects for income, growth, and/or tax advantages.

Elaine Floyd, CFP®, is the Director of Retirement and Life Planning, Horsemouth, LLC., where she focuses on helping people understand the practical and technical aspects of retirement income planning. Horsemouth is an independent organization providing unique, unbiased insight into the most critical issues facing financial advisors and their clients.