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Shedding Doubts about Selling Your Home to Your S Corporation

Are you looking to make some cash by turning your home into rental property? If you do this the right way, you can increase your cash flow with almost no additional effort.

In Sell Home to S Corporation and Then Make It Rental Property, you learned one of our strategies for getting the most bang for your buck on your rental property. Specifically, you learned that your first step is to sell your home to your S corporation and why that beats simply converting your home to a rental property.

We did hear some concerns and doubts about this approach. First, we want to thank those who voiced their concerns. In this article, we'll address those concerns and doubts and put them to rest.

The Strategy in Action

Selling your home to your S corporation puts money in your pockets because of these two great benefits:

1. You avoid taxes by using the home-sale profit exclusion of up to $250,000 ($500,000 if you're married).[1]

2. You create an increase in your rental property's depreciable basis that generates an increase in depreciation deductions.

Example. You and your spouse bought your home 20 years ago for $250,000. You did not make improvements, so the basis in your home at the time of sale is $250,000. You sell the home to your S corporation for the current fair market value of $750,000 and use the $500,000 home-sale exclusion to avoid taxes on the $500,000 gain ($750,000 - $250,000).

The sale to your S corporation increases the basis in the rental property. This means bigger depreciation deductions every year you rent out the property. To visualize the positive effect of the additional depreciation, see the table below:

	Home Converted to Rental: $250,000 Basis	Home Sold to S Corporation: $750,000 Basis

Year 1	$8,712	$26,136
Year 2	$9,091	$27,273
Year 3	$9,091	$27,273
Total	**$26,894**	**$80,682**

In the first three years, you can deduct $53,788 more in depreciation ($80,682 - $26,894) than if you just converted the home to rental property. You are going to deduct this additional depreciation either currently or at some later time if you suffer from the passive loss rules.

Let's say when you deduct the depreciation you are in the 39.6 percent tax bracket. The added depreciation puts $21,300 more in your pockets during just the first three years of depreciation.[2]

Doubt 1. Increased Property Taxes

Reader comment. "The sale will increase my property taxes on the home."

This may or may not be true, depending on where you live. Remember, you are selling the home to your S corporation for its fair market value. The property tax appraisal may reflect the fair market value already.

In California, you benefit from Proposition 13, which keeps your property taxes at a lower rate than the rate that would apply to the new buyer such as your S corporation. In this case, you need to consider the property tax increase.

Let's say that the property taxes jump from $4,000 to $12,000 after the sale. Let's also say that when you consider both your federal and your state taxes, you are in the 50 percent tax bracket. This means your net out-of-pocket cost of the property taxes is $4,000 ($8,000 increase less $4,000 tax benefit).

On the original sale to the S corporation, you avoided taxes on a $500,000 gain. If your federal and state taxes on the gain are 28 percent, you saved $140,000 on the transfer.

It would take you 35 years of paying the bigger property taxes to match the tax savings you received from the home-sale profit exclusion.

In addition, you have the added benefit of the increased depreciation deductions attributable to the $500,000 increase in basis. At the time of sale, you will lose some of this added benefit to the federal 25 percent unrecaptured Section 1250 capital gains tax on the sale.

The bottom line is that any increase in the property taxes will reduce the benefits of the "sell your home to your S corporation" strategy. But the net benefits are still significant and continue to make this option a go-to strategy.

Doubt 2. Homestead Exemption

Reader comment. “I lose the benefits of the homestead exemption if I sell the home.”

Homestead exemptions lower property taxes by sheltering a portion of a home’s value from tax. The majority of states have some form of homestead exemption law, but the details vary by state.

For example, California exempts $7,000 of the assessed value of your principal place of residence.[3] Sounds like a good deal. You must save a lot in property taxes, right? Not exactly—it’s a savings of approximately $70. This is peanuts compared with the thousands you save with the sale.

But it’s actually a moot point anyway. California, like other states, allows the homestead exemption only on your principal place of residence. Once the home converts to rental property, you can’t use the homestead exemption anyway.

Doubt 3. Related-Party Sale

Reader comment. “Will the sale to my S corporation trigger a red flag for the IRS because it’s a related-party sale?”[4]

No, the IRS does not know that you sold your home to a third party. There is no required tax form, disclosure, or election that applies to this type of sale.

Also, keep in mind that sales between related parties are valid under tax law. If you suffer an audit for some reason other than this sale, the IRS may identify the sale as a related-party sale and then scrutinize it closer than if it were between third parties. But if you do what we always recommend (that is, dot the i’s and cross the t’s), then you won’t have anything to worry about.

The key is to conduct the sale to the S corporation as the related-party sale it is. This means you should follow the steps you would follow if you were selling to a third party:

- Hire an appraiser to assess the fair market value, and sell it for that price.
- Hire a title company or attorney to transfer the title to the S corporation.
- Get an inspection on the home, and decide what you need to fix.
- Put everything in writing, so any IRS examiners would see that everything is in proper order.

Remember, as discussed in Sell Home to S Corporation and Then Make It Rental Property, any gain on the sale of the home to the S corporation is an ordinary gain. But (as is also discussed in that article) you use the home-sale exclusion to avoid ordinary gain treatment on up to $500,000 of gain ($250,000 if you're single).

Takeaways

Make your wallet happy. Don't convert your home into a rental property.

If you want your home to be a rental property, sell it to your S corporation and reap the benefits of (a) using the $250,000 ($500,000 if married) home-sale exclusion and (b) realizing a higher depreciation basis.

If the sale to your S corporation will cause your property taxes to increase, factor that increase into the equation. In most cases, the benefits of both the home-sale exclusion and the increased depreciation basis will outweigh any increase in property taxes.

The loss of the homestead exemption on the sale of the home to the S corporation is a nonfactor. If you simply converted your home directly to a rental, your homestead exemption would also disappear. This makes the homestead exemption a nonfactor in deciding whether to convert the home to a rental or use the strategy of selling the home to your S corporation.

Finally, you need not worry about the IRS flagging your return due to the related-party sale. You don't report related-party sales to the IRS on your tax return. Even so, under the law, you must treat the sale to your S corporation as a related-party sale, and you should create evidence that proves you followed the rules for a sale to a related party.

1 IRC Section 121.
2 You might be thinking that the Section 1250 unrecaptured gain, which is taxed at rates of up to 25 percent at the time sale of this property, destroys some of the depreciation benefit. That's true if you sell when you are in the 15 percent-or-greater tax bracket. But you don't have to sell. You could use a Section 1031 tax-deferred exchange rather than sell, so as to continue to defer the taxes. The longer you defer, the more valuable the deductions are. Also, you realize the deductions at 39.6 percent, and you pay (at most) only 25 percent in recapture tax in some later year—perhaps much, much later.
3 California Constitution, Article XIII Section 3(k).
4 IRC Section 267(e)(1)(B)(ii).