

Tax Stuff You Think You Know

But May Not

Tax Stuff You Think You Know

- Schedule A
 - Sue has \$20,000 in legal fees to fight her real estate tax bill, can she deduct the legal fees?
 - Bob owns a vacation condo and he donates condo use to charity auction
 - Normally rents for \$3,000/week
 - Bidder paid \$4,000 for 1 week use
 - What is Victor's charity deduction?
 - What is Bidder's charity deduction?
 - Barry graduated from college and he has \$2,000 in job-seeking expenses and found great job he also purchased a house and itemizes deductions on his schedule A, Can Barry deduct his job-seeking expenses?

Tax Stuff You Think You Know

- Schedule A continued
 - Eddie Employee lives in San Diego and attends a conference for work held in San Diego
 - Eddie chooses to stay at hotel
 - Hotel cost \$800 for 4 nights
 - Can Eddie deduct?
 - What if he was self-employed?
 - What if SE and stayed 6 nights?
 - Sally Buys into lifetime care facility - \$150,000 and also pays \$1,000/month fee
 - Will get partial refund at death
 - Moves in this year
 - Currently healthy and needs no care
 - How much is tax deductible?

Tax Stuff You Think You Know

- Legal Fees
 - Lucy and Ricky divorced and fought over controlling business
 - Desi incurred legal fees - can he deduct these legal fees?
 - Lucy incurs legal fees to get alimony from Ricky, can she deduct?
 - Ricky has legal fees to avoid alimony, can he deduct?
 - Marilyn was treated badly by her Employer
 - She sued for sexual harassment and received \$100,000 settlement
 - She has attorney fees of \$30,000
 - How do you report on the tax return?

Tax Stuff You Think You Know

- Legal Fees continued
 - Ima Injured sued after a car accident and received a \$100,000 settlement
 - \$90,000 for pain and suffering
 - \$10,000 interest
 - Legal fees \$30,000
 - How much is Ima's legal fees deduction?
 - Muhammed sued for discrimination and won a \$100,000 award
 - Legal fees \$30,000
 - How do you report on his return?

Tax Stuff You Think You Know

- Odds and Ends
 - A kindergarten teacher had classroom supplies \$100 and professional education expenses of \$200
 - How much will be the Educator Expense deduction on front of 1040?
- Muhammed sued for discrimination and won a \$100,000 award
 - Legal fees \$30,000
 - How do you report on his return?
- Your client has a handicapped son. She needs a new automobile to transport him. The Dallas Morning News does a piece on them and people donate at GoFundMe.com
 - Raised \$30,000
 - Received a 1099-K
 - How do you report on tax return?

Tax Stuff You Think You Know

- Schedule C
 - Financial Fitness is a sole proprietor
 - Hired Handyman (another sole proprietor)
 - Paid Handyman \$1,500 bill by credit card
 - Must Financial Fitness issue a 1099-Misc?
 - Sean M. drives his motorcycle for 5,000 business miles, can he use standard mileage rate?
 - Client writes his memoirs and receives royalties
 - How do you report on return? Subject to SE tax?
 - Sarah, who is self employed, declared bankruptcy May 2015 the debt was discharged November 2015
 - Incurred NOL on 2015 tax return with no election to forego carryback
 - Becomes your client in 2016 - can you use NOL on 2016 return?

Tax Stuff You Think You Know

- ACA (aka Obamacare)
 - Client has 4 kids
 - Makes \$35,000
 - Spouse disabled
 - Gets 95% premium assistance
 - Spouse gets \$98,000 back pay Social Security disability award
 - How much of the Social Security is taxable?
 - How much premium assistance must be repayed?
- Your clients 25-year old Son lives with Mom & Dad who have a projected income of \$40,000
 - All 3 on one exchange policy with a monthly premium of \$1600 and advance credit of \$1450
 - Mom & Dad's return income ends up being \$100,000 for the year
 - Son's income \$8,000 and does not qualify as dependent
 - How do you report on returns?

Tax Stuff You Think You Know

- Interest
 - Client Refinances mortgage and uses same bank that held old loan
 - \$2,300 points remaining unamortized
 - How do you deduct?
 - Oprah & Stedman are not married and buy a home together
 - Both on \$1M mortgage note
 - Stedman has no income this year
 - Oprah pays entire house payment
 - \$55,000 interest
 - Can Oprah deduct all the interest?
 - Can she deduct all the RE taxes?

Tax Stuff You Think You Know

- Interest continued
 - Kurt and Goldie are not married and own a home together
 - \$2.2M mortgage with joint and several liability for debt
 - Interest \$110,000 for the year
 - Each paid half the payment
 - How much can each deduct?
 - Steve is a student and had a Stafford loan for college and his parents made all of the loan payments
 - Can Parents deduct all interest paid? What if they cosigned loan? What if guarantors on loan?
 - Your client is a veteran and bought a home
 - \$7,200 VA funding fee
 - How do you report on his return?
 - What if it was FHA insurance or PMI?
 - What if he refinanced 2 years later?

Tax Stuff You Think You Know

- Sale of Residence
 - Client purchased as vacation home on 01/01/2008 and began using as their personal residence on 01/01/2011
 - Property sold on 12/31/2016 for \$90,000 gain
 - What is the taxable amount of the gain?
- Newlyweds buy starter home 2001 then buy a new move-up home on 01/01/2015
 - Let starter home set vacant while trying to sell
 - Starter home finally sold on 12-31-2016 for a \$100,000 gain
 - What is taxable amount of gain?
 - What if starter home was rented instead of vacant?

Tax Stuff You Think You Know

- Sale of Residence
 - Client who is active military bought home on 01/10/2010 on 01/01/2011 received PCS orders
 - Rented out the home
 - On 07/16/2016 returned to live in home
 - Sold home 12/31/2016 for \$100,000 gain
 - What is taxable amount of gain?
 - Client purchased a rental on 01/01/2006 for \$400,000
 - Used as rental for 4 years
 - Claims \$20,000 depreciation
 - On 01/01/2011 client moves into home
 - On 01/01/2015 moves out, house vacant
 - On 01/01/2016 sells house for \$500,000
 - How is sale reported?

Tax Stuff You Think You Know But May Not

Answers
(no Peeking)

Schedule A

Legal Fees Related to Taxes

Individuals are entitled to deduct as nonbusiness expenses all ordinary and necessary expenses paid or incurred in connection with the determination, collection, or refund of any tax. The deduction is allowed even though the expense is in no way related to a trade or business.¹ Sue can deduct the \$20,000 of legal fees on Schedule A as a miscellaneous itemized deduction subject to the 2% of AGI limitation (and not deductible for AMT).

Charitable Deduction for Use of Property

Use by the successful bidder is considered personal use by the owner, even if the amount the bidder paid to the charity is more than fair market value. No charitable deduction is allowed for the use of property.² The owner gets his tax savings by not reporting income from the rental property for the week it was donated, reducing his tax liability. He does not get a double benefit by also deducting a charitable donation. Bidder can deduct \$1,000, the amount he paid (\$4,000) in excess of the fair market value of the property he received (\$3,000).

Job Seeking Expenses

An employee can deduct expenses of seeking new employment in the same trade or business, regardless of whether he gets the new job.³ The expenses are deducted as miscellaneous itemized deductions, subject to the 2% of AGI haircut.⁴ Job seeking expenses are not deductible if the taxpayer is seeking employment for the first time, or in a new trade or business.⁵

Deduction for Local Lodging

Local lodging expenses are generally nondeductible, but may be deductible under certain circumstances.⁶ A safe harbor rule allows the deduction if.⁷

1. The lodging is necessary for the individual to participate fully in or be available for a bonafide business meeting, conference, training activity, or other business function,
2. The lodging is for a period that does not exceed five calendar days and does not recur more frequently than once per calendar quarter,
3. If the individual is an employee, the employee's employer requires the employee to remain at the activity or function overnight, and
4. The lodging is not lavish or extravagant under the circumstances and does not provide any significant element of personal pleasure, recreation, or benefit.

Eddie's employer does not require that he stay at the event overnight, so he cannot deduct the expense incurred for local lodging. If Eddie was self-employed, he would be able to deduct the expense, assuming he has a bona fide reason for staying, and the accommodations are not lavish, etc. If Eddie was self-employed, and he stayed 6 nights, he may still be able to deduct the expenses. If a taxpayer meets the safe harbor requirements, the IRS assures they will not challenge the deduction. If a taxpayer does not meet the safe harbor requirements, they may still be allowed the deduction, but may have to justify it in an IRS audit. He does not meet the safe harbor, but can still take the deduction if the expense is an ordinary and necessary business expense.

1 IRC 212(3)

2 Revenue Ruling 89-51)

3 Reg 1.12-32(a); Reg 1.262-1(b)(5)

4 Reg 1.162-32(a)

5 Bigdeli, Javad (2013)

6 Reg 1.162-32(a)

7 Reg 1.162-32(b)

Buy-In Fees to Elder Care Facilities

When medical care is a principal reason that a person stays in a nursing home or assisted living facility, the entire cost of the stay qualifies as a medical expense, including the cost allocable to food and lodging.⁸ The IRS and the courts have issued several rulings explaining how to determine the deductible portion of these “buy-in” fees. It is clear that a large portion of the fees is deductible, but how the calculation is performed can change the amount of the deduction by thousands of dollars. Two methods that have been clearly defined include:

- Facility’s medical expenses/total expenses.
- Portion historically used to pay for medical care/entire fee.

The facility will normally provide all the figures needed to calculate the deduction using each of the different methods. Check out all the methods before deciding which one to use, because the end result can vary greatly.⁹

Legal Fees

Origin of Lawsuit Determines Deductibility

The origin and character of the lawsuit determines whether and where the legal fees are deductible. In this case the origin of the suit was a divorce proceeding, which is personal. Therefore, the legal fees are nondeductible irrespective of any possible business consequences.¹⁰

Legal Fees for the Production of Taxable Income

Legal fees for the production of taxable income are deductible as a miscellaneous itemized deduction subject to the 2% of AGI limitation. Lucy’s legal fees are deductible because they were to produce alimony, which is taxable income. Ricky’s legal fees were to avoid paying a tax-deductible item, but that is not the same as producing taxable income, so his legal fees are not deductible.¹¹

Sexual Harassment and Emotional Distress Awards

Damages received in a settlement are generally taxable unless received for personal injury,¹² but personal injury is generally limited to physical injury. Damages received on account of personal nonphysical injuries or nonphysical sickness are not excluded from gross income.¹³ Thus, damages received based on a claim of employment discrimination, or injury to reputation, are not excluded from gross income.¹⁴ Damages for personal injury do not include punitive damages, which therefore are not excludable from income.¹⁵ Emotional distress is not considered a physical injury or physical sickness.¹⁶ Emotional distress includes physical symptoms (e.g. insomnia, headaches, stomach disorders, depression, sleep disorders, high blood sugar) that can result from the emotional distress. The \$100,000 sexual harassment settlement award does not qualify as a physical injury award, and must be included in income. Legal fees for the production of taxable income are deductible as a miscellaneous itemized deduction subject to the 2% of AGI limitation. (However, if he is subject to AMT, he will lose any benefit.)¹⁷

Legal Fees to Win Nontaxable Settlement

\$90,000 of the settlement is a physical injury award, so will not be included in income. Since only 10% of the award is taxable, only 10% of the legal fees (\$3,000) will be deductible.¹⁸

⁸ Reg § 1.213-1(e)(1)(v)

⁹ Rev Rul 75-302; Baker (2004); Rev Rul 76-481; Finzer (2007); Letter Ruling 8213102; Smith (1982); Rev Rul 67-185; Rev Rul 75-303

¹⁰ US vs. Gilmore (1963)

¹¹ Reg 1.262-1(b)(7); IRC §212(1); IRC §71(e); G. G. Wolfson v. Comm’r (166)

¹² IRC §104(a)(2)

¹³ Rev Rul 2007-14; TC Memo 2007-286

¹⁴ H Rept No 104-586 (PL 104-188) p144

¹⁵ IRC §104(a)(2)

¹⁶ IRC §104(a); H Rept No. 104-586 (PL 104-188) p144

¹⁷ Burke (1992); Green (2007); Bagley (1995)

¹⁸ Church Wade (1983); Kovacs (1993); Foster (2000)

Legal Fees for Discrimination Award

Legal fees in connection with an action involving unlawful discrimination (age, sex, race, sexual orientation, handicap, etc.) are deductible from gross income on the front page of the 1040.¹⁹ The deduction is limited to the amount includible in the taxpayer's income for the year resulting from the claim. (A miscellaneous itemized deduction may be allowed for the excess.)

19 IRC §62(a)(20); Com v. Bankd (2005); IRS Letter Ruling 201015016

This & That

Educator Expenses

An eligible educator (i.e., a kindergarten through grade 12 teacher, instructor, etc.) is allowed an above-the-line deduction for otherwise allowable trade or business expenses paid:

- (1) by reason of participation in professional development courses that are either related to the curriculum in which the taxpayer provides instruction or related to these students for whom instruction is provided, and
- (2) in connection with books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used in the classroom.²⁰

The deduction cannot exceed \$250 per year, per taxpayer (\$500 if both taxpayers are eligible educators). The \$250 cap is indexed for inflation. For tax years beginning before 2016, expenses for professional development courses were not included as eligible expenses, and no inflation adjustment was allowed. The teacher can deduct both the classroom supplies and the continuing education class, but is limited to \$250.

Crowd Funding

The amounts received are gifts, not income. Gifts are not taxable. The IRS will be looking for the income on the return because of the 1099-K. Always give the IRS's computer what it is looking for, so report the \$30,000 on Schedule C and list an expense as "Gifts received reported on 1099-K", making the net income -0-.

Schedule C

Overlap of Forms 1099-MISC AND 1099-K

The credit card processing company will report the payment on Form 1099-K. If the business also issues a 1099-MISC, the IRS will think that the handyman made twice as much money as he actually made.²¹ Businesses need to keep records that will separate payments made with cash or a check versus payments made by credit card, debit card, PayPal, etc.

The business should not issue any 1099 or reporting document for the payment. Handyman will receive a 1099-K reporting the payment.

Standard Mileage Rate for Motorcycles

Taxpayers can only use the standard mileage rate in computing the deductible costs of operating automobiles (including vans, pickups, or panel trucks) they own or lease,²² so Marty cannot use the standard mileage rate. He can deduct actual expenses for the motorcycle miles.

20 IRC sec 62(a)(2)(D)

21 Reg § 1.6041-1(a)(1)(iv); Reg § 1.6041A-1(d)(4)(i)

22 Rev Proc 2010-51, Sec. 3.01

Optional Method for SE Tax

To use the optional SE tax method, the taxpayer must be regularly self-employed. This requirement is met if actual net earnings from self-employment were \$400 or more in 2 of the 3 years before this year. The nonfarm optional method can only be used for 5 tax years (do not have to be consecutive).²³

Generally, a taxpayer who elects the optional method will pay self-employment tax on \$5,040 (the 2016 amount). For 2016, the amount of earnings required for a quarter of coverage is \$1260, so paying SE tax on \$5,040 would give the taxpayer 4 quarters of coverage for 2016. The SE tax due on \$5,040 of earnings would be \$771. Taxpayers must have 40 quarters of coverage to qualify for Social Security retirement benefits. Disability benefits can be obtained with less than 40 quarters of coverage, but the amount of the benefit increases with the number of quarters of coverage.

When thinking about who might benefit by using the Optional SE Tax method we generally think of people nearing retirement age who do not have the required 40 quarters of social security coverage. Do not overlook younger people who need disability coverage.

Self-Employment Tax on Patents and Copyrights

Self-employment tax only applies if the income is received from a trade or business carried on by an individual with continuity and regularity and primarily for income or profit.²⁴

This client is not engaged in the trade or business of writing, because he did it sporadically. The income is not subject to self-employment tax.

NOL Carryovers

An individual debtor cannot carry back, to a tax year that preceded the tax year in which the bankruptcy case was commenced, any net operating loss (NOL) or credit carryback from a tax year ending after commencement of the bankruptcy case.²⁵ Sarah's post-petition NOL (from 2015) cannot be carried back to any year before 2015 (pre-petition years), so it must be carried forward to 2016. (Be certain to spell this out clearly in any correspondence with the IRS, because they will likely notify you that the NOL must be carried back because no election to forego the carryback period was made.)

ACA

Social Security Benefits Affect ACA Credit

The lump sum social security award is not taxable, because they can determine the tax as if the payments had been received in the correct prior years. However, the full amount of the payment must be added to modified AGI for purposes of determining the amount of premium credit. Wilma will have to repay all of the premium assistance they received.²⁶

Allocating Premiums and Credits

The taxpayers may agree on any allocation percentage from 0 – 100%.²⁷ The same allocation percentage must be used for all policy amounts (premiums and APTC) in a month. If the taxpayers cannot agree on an allocation percentage, the allocation percentage is equal to the number of individuals enrolled claimed on the return divided by the total number of individuals enrolled in the same policy.

²³ IRC§1402(a)(vi)

²⁴ IRC§1401; IRC§1402(a), (b) and (c); Groetzinger (1987)

²⁵ IRC §1398(j)(2)(B); 1398(j)(2)(c)(i)

²⁶ IRC§36B(d)(2)(B)

²⁷ Reg 1.36B-4(a)(1)(ii)

Allocating Premiums and Credits con't

Son, Mom and Dad can divide the premiums and advance credit between the 3 of them in any way they can agree. Any portion allocated to Mom & Dad will have to be repaid because their income was so high. Any portion allocated to Son will not have to be repaid, and he will qualify for additional credit on his return because his income is so low.

Allocate 100% of the premiums and advance credit to Son. Fantastic result!

Planning for next year – This was a great outcome, so the taxpayers may be tempted to just leave things as they are at the Exchange, but if Son is not a dependent, and is not living in the household, Mom and Dad are committing fraud if they indicate to the Marketplace that they will claim an exemption for him. However, the rule that children can stay on their parents' policy until age 26 may often result in the ability to use this money-saving rule

Interest

Unamortized Points at Refi

When a mortgage loan is repaid early with the proceeds of a refinancing loan, the capitalized and unamortized points on the repaid loan are deductible in the year the mortgage loan is repaid. BUT...the IRS says if the mortgage loan is refinanced with the same lender, the remaining balance of capitalized points must be deducted over the term of the new loan, not in the year the first mortgage ends.²⁸ This client cannot deduct the remaining points in the current year because he refinanced with the same lender, and he must amortize the remaining amount over the term of the new loan, which will extend the time period over which they are deducted!

Interest Paid by One Joint Owner

Where mortgaged property is owned jointly, and the joint owners are also jointly liable on the mortgage, each owner is entitled to a deduction for the mortgage interest that he actually paid out of their own funds.²⁹

Where a co-tenant pays all (or a disproportionate share) of taxes on co-owned property to avoid personal liability or to preserve his interest in the property, he is entitled to a deduction for the full amount of the payment.³⁰ Thus, the Tax Court allowed a full deduction to a tenant in common who paid 100% of the taxes on only a 1/6 ownership share. The court reasoned that the taxpayer had a beneficial interest in the entire property (right to occupy) and the payment was needed to protect this interest, even without joint and several liability.

Oprah can deduct all of the interest and real estate taxes that she pays.

Qualified Residential Interest Dollar Limits for Unmarried Co-Owners

The amount of residence debt that can generate Qualified Residence Interest is limited to \$1 million of acquisition indebtedness (\$500,000 for marrieds filing separately), and \$100,000 of home equity indebtedness (\$50,000 for marrieds filing separately). The Ninth Circuit, reversing the Tax Court, has held that where a qualified residence is co-owned by taxpayers who are not married to each other, the QRI debt limits are applied on a per-taxpayer, and not on a per-residence, basis.³¹

Kurt and Goldie can each deduct the full \$55,000 of mortgage interest they paid.

²⁸ IIRS Pub No. 936, (2012), p. 8

²⁹ Castaneda-Benitez, Miguel, (TC Memo 1981-157)

³⁰ James (TC Memo 1995-562)

³¹ Voss, Bruce H. v. Comm, (2015, CA9)

Parents Payment of Student's Loan Interest

To claim the deduction for student loan interest, the taxpayer must be legally obligated to make interest payments under the terms of the qualified student loan.³² Parents may not deduct the interest paid for the Stafford loan as Steve is the obligor for that loan. The payments of the Stafford loan by Parents are actually gifts to Steve.

Cosigner - Private student loans (as opposed to government guaranteed loans) usually require a co-signer. Had Steve's loan been a private student loan and Parents cosigned for the loan, both parties would be liable for repayment. (Note that there is a difference between being a cosigner and being a guarantor. A cosigner is jointly liable for the debt; a guarantor is only secondarily liable for the debt.) Interest paid by a student's parent on a loan made to the student, evidenced by a negotiable promissory note cosigned by the parent, is deductible by the parent for the taxable year in which it is paid.³³

Guarantor - When a taxpayer makes a payment of interest on a debt under his obligation as a guarantor, endorser, indemnitor, or other type of secondary obligor, he is not entitled to an interest deduction, but must treat the payment as a worthless business or nonbusiness debt.³⁴ The courts have held that a deduction for interest is only permitted for those who are primarily liable for the underlying debt.³⁵

Parents will not be able to deduct the interest until Steve declares bankruptcy or some other event occurs to make them primarily liable for his debt (but the nonbusiness bad debt deduction is interesting...)

Deductibility of Mortgage Insurance

Premiums for qualified mortgage insurance in connection with acquisition indebtedness with respect to the taxpayer's qualified residence are treated as qualified residence interest, subject to a phase-out based on the taxpayer's AGI.³⁶ Qualified mortgage insurance includes mortgage insurance provided by the Department of Veterans Affairs (VA funding fee), the Federal Housing Administration (FHA), the Rural Housing Service, and private mortgage insurance (PMI).

A VA funding fee or Rural Housing Service guarantee fee can be deducted in full in the year in which the mortgage insurance contract is issued (and the premium is paid).³⁷ A special allocation rule applies to prepaid premiums for mortgage insurance provided by the FHA and for PMI.³⁸ The premiums must be allocated ratably over the shorter of the stated term of the mortgage or 84 months.³⁹ No deduction is allowed for the unamortized balance of premiums that were capitalized if the mortgage is satisfied before the end of its term.⁴⁰

The veteran can deduct the entire VA funding fee in the year it was incurred. If it had been FHA insurance or PMI he would have to amortize it over 84 months. If he refinanced the mortgage 2 years later, any unamortized amount would be lost. (Unlike points, the unamortized amount cannot be deducted if the loan is paid off early).

³² Reg 1.221-1(b)(1)

³³ Rev Rul 71-179

³⁴ Reg 1.166-9(a); Reg 1.166-p(b)

³⁵ Abdalla (1981); Nelson (1960); Rushing (1972)

³⁶ IRC§163(h)(3)(E)(i); Reg 1.163-11(a)(1)

³⁷ Reg 1.163-11(b)

³⁸ Reg 1.163-11(b)

³⁹ Reg 1.163-11(a)(1)

⁴⁰ IRC§163(h)(4)(F)

Sale of Residence

Nonqualified Use of Principal Residence

Gain on the sale of a principal residence must be allocated if there were any periods of nonqualified use, making part of the gain on the sale taxable. A “period of nonqualified use” is any period after during which the property is not used as the principal residence of the taxpayer or the taxpayer's spouse or former spouse.⁴¹

Use before Jan. 1, 2009 does not count as nonqualified use, so the 2008 vacation home usage is not considered nonqualified. 2009 and 2010 would be nonqualified use – 2 years. Gain shall be allocated to periods of nonqualified use based on the ratio which the aggregate periods of nonqualified use bears to the period such property was owned by the taxpayer.⁴²

Divide by total ownership period - 9 years
 $2/9 \times \$90,000 = \$20,000$ taxable gain on the sale

Use After Last Use as a Residence

A period of nonqualified use will not include any period which is after the last date that the property is used as the principal residence of the taxpayer or the taxpayer's spouse.⁴³ Thus, any period after the last date the property was used as the principal residence of the taxpayer or his spouse (regardless of use during that period) is not taken into account in determining periods of nonqualified use. Even though the newlyweds did not use the starter home as their residence in 2015-2016, the use is not nonqualified because it was after the owner's last use as a principal residence. This rule applies even if the property was rented out during that time. The only income to be reported would be the recapture of depreciation to the extent of income.

Qualified Official Extended Duty

A period of nonqualified use will not include any period (not to exceed an aggregate period of ten years) during which the taxpayer or the taxpayer's spouse is serving on qualified official extended duty.⁴⁴ This provision applies to:

- A member of the uniformed services,
- A member of the Foreign Service, or
- An employee of the intelligence community. The use while Marty Marine was on qualified official extended duty is not nonqualified, so the only income that must be reported is depreciation recapture to the extent of income.

Coordination with Depreciation Recapture

The rule providing that depreciation must be recaptured to the extent of income applies *before* the rule providing that gain allocated to periods of nonqualified use does not qualify for the IRC sec 121 exclusion.⁶²

The total gain is \$120,000. The depreciation recapture rule is applied first. Report the \$20,000 depreciation recapture and subtract it from the gain to determine the amount of gain subject to the nonqualified use rules.

2006-2008 are not nonqualified use because they were before the rule was enacted in 2009. 2009-2010 are nonqualified use years. Lucy lived in the house from 2011-2014, so that use was qualified. 2015 is not nonqualified because it was after the taxpayer's last use of the property as a principal residence.

⁴¹ Code Sec. 121(b)(4)(C)(i)

⁴² Code Sec. 121(b)(4)

⁴³ Code Sec. 121(b)(5)(C)(ii)(I)

⁴⁴ IRC sec 121(b)(5)(C)(ii)

⁴⁵ IRC sec 121(b)(5)(D)

Coordination with Depreciation Recapture con't

Total nonqualified years are 2. Divide by the total 10 year period the property was owned, including years before the 2009 enactment of this rule.

$\$100,000 \text{ gain} \times 2/10 \text{ nonqualified use} = \$20,000 \text{ taxable gain.}$

Total taxable gain = \$40,000 (\$20,000 depreciation recapture + \$20,000 nonqualified use gain)