Identify what possible tax rules might apply to each of the following taxpayers and questions you’d ask to know how to apply the rules.

1. The Smiths own two houses that are always rented out.
   - First determine if the either house meets the “used as a residence” definition of §280A(d). If that definition is met, §280A(c)(5) is used to determine the allowable deductions. No loss can be reported under this provision. Instead, any loss carries forward to be used against future income from that house under §280A. It is possible that one of these houses might also be the Smith’s second residence for § 163(h) purposes such that the interest on the qualified residence debt attributable to personal use of the home may be deductible under §163(h).
   - If §280A(c)(5) is n/a, then consider if these rentals are a passive activity. Be sure to consider the rental exceptions.

2. Gary is a self-employed attorney.
   - Schedule C or other types of entity?
   - SE tax
   - Might generate an NOL
   - If he rents property to the activity in which he materially participates, the recharacterization rule of §1.1469-2(f)(6) may apply to treat any income generated as non-passive activity income.
   - Rev. Rul. 92-29 will allow tax prep costs related to his legal business to be deducted above the line.
   - If he borrows money, consider ways to optimize the result using the §1.163-8T tracing rules and §1.163-10T(o)(5) on electing to treat a debt as not secured by a qualified residence.

3. Sarah owns a 10% interest in the AB Partnership that operates a house cleaning service.
   - Determine nature of her partnership interest. If she is a limited partner, generally she is not a material participant, but see special rules at §1.469-5T(e).
   - Sarah will need to categorize any interest expense that flows through to her from the partnership.
   - If Sarah borrowed money to purchase her interest, she should use §1.163-8T as modified by Notice 89-35 to determine how to classify the interest expense.

4. The Markhams borrowed $70,000 in September 2008 secured by their principal residence. They also borrowed $30,000 from their bank in October 2008 to pay their child’s tuition and credit card debt (unsecured debt). Their AGI is typically around $400,000. Their home is worth $1.5 million and already had a $700,000 loan that was used to acquire the home; this was no other debt on the home.
   - Debt secured by the PR is likely AI or HEI. Be sure to find out if proceeds were used to substantially improve the residence in which case the debt would be AI. AI is better than HEI because there is no AMT adjustment and more of the $100,000 HEI limit remains available for future needs.
   - Find out what the $700,000 was used for. If for business expenses, may get better result to elect to treat the debt as not secured by the home and then applying the interest tracing rules to trace it to business expenses.
For the $30,000 of debt, it cannot be qualified residence debt because it is not secured by a principal or second residence. Consider whether it can become secured by the home. If not, consider the 30-day before and after and any account rule of Notice 89-35 to see if you can get a better result than personal interest.

5. Mary’s Schedule C interior decorating business has been hurt by the economic downturn and she has a loss this year. She borrowed against her stock portfolio to pay her employees this month.
   - Consider whether Mary has generated an NOL and if so, would she benefit from carrying it back. If she does not want to carry it back, she must timely elect to forego the carryback period.
   - Use the tracing rules (§1.163-8T and Notice 89-35) to determine the classification of the debt used to pay employees.

6. Tuan exercised 1,000 ISOs this year with a spread totaling $42,000.
   - The spread is included in calculating AMTI.

7. To enable the Greens to remain in their home, their lender forgave $200,000 of their mortgage debt.
   - Special temporary rules under §108 may make this non-taxable to the Greens for both federal and California. The basis of her home would be reduced (not below zero) by the amount of forgiven debt.

8. Tom, a computer science professor, occasionally makes extra money fixing computers.
   - Is this a trade or business under §1.469-1(e)(2) and -4(b)(1)? If yes, determine if Tom meets a material participation test.
   - If not a trade or business, hobby loss rules of §183 likely apply to enable Tom to determine his deductible expenses.
   - May owe SE tax.

9. The Bartons plan to make some extra money in 2009 by renting out their DC home for 8 days during the inaugural festivities.
   - Sounds like they will get the beneficial income exclusion of §280A(g). They will not be able to deduct any expenses associated with this short-term rental (other than items otherwise deductible, such as property taxes and qualified residence interest).

10. The Reades move out of their principal residence in which they have lived for 10 years to travel around the world. They rent out the home for 1 year and then sell it. The rental generated a loss of about $1,500 per month.
    - During the rental period, if they are active participants and have modified AGI under $150,000, they may be able to deduct up to $25,000 of the rental loss against any income.
    - Be wary of the revisions made to §121 in 2008 where periods of “nonqualified” use preceding a period of “qualified use” will limit the benefit of the §121 gain exclusion.
    - If they leave the home vacant, can it still be a principal residence?