**Basic Facts. I own a home with the following details:**

|  |  |  |
| --- | --- | --- |
| **FMV** | **$1,000,000** | **I bought the home for $600,000 and gave a mortgage of $600,000. I now have a mortgage balance $600,000, with an interest rate of 10%. I pay interest-only. The home value has increased from $600,000 to $1,000,000.** |
| **Cost** | **$600,000** | **I (or we) have owned this home & lived only in this home for five years.**  |

**Part 1. How much gain do I recognize on sale of home (etc.)? (Basic: Sec. 61, 1001)**

**Case 1.** I am single. The home is sold at FMV. **Sec. 121(a), (b)(1)
The gain on the sale is $400,000. I exclude gain of $250,000, and include gain of $150,000**

**Case 2.** I am single. The home is sold at FMV. (Assume I owned it for 1 year – discuss.)

**Sec. 121(a), (b)(1). Also Sec. 121(c), especially (c)(2)(B). Reg. 1.121-3(b)**

**The gain on the sale is $400,000. I exclude gain of $0, and include gain of $400,000, unless I have an acceptable “excuse” such as needing to move to a retirement home, etc. that case I exclude $125,000. See PowerPoint files showing computation of prorated gain.**

**Case 3.** My wife and I have owned and lived in the home for 5 years.
We file a joint return. We sell the home at FMV. **Sec. 121(a), (b)(2)(A)**

**Gain on the sale is $400,000. We exclude gain of $400,000 (up to $500,000), and include gain of $0**

**Case 4.** I have owned the home for 5 years. My wife and I have lived in the home for 5 years
We file separate returns. We sell the home at FMV. How much gain is included in my income?

**Sec. 121(a), (b)(1). The gain on the sale is $400,000. I exclude gain of $250,000, and include gain of $150,000.**

**Exclusion is limited to $250,000 on a separate tax return.**

**Case 5.** I have owned and lived in the home for 5 years. I was single until my wedding to Mary one year ago.
Mary moved into the house (from her apartment) immediately after our wedding.
We file a joint return. I sell the home at FMV. How much gain is included in our income?

**Sec. 121(a), (b)(1), Sec. 121(b)(2)(B).**

**The gain on the sale is $400,000. We exclude gain of $250,000, and include gain of $150,000.**

**Exclusion is limited to $250,000, because Mary has not lived in the house 2 years. See committee reports.**

**Sec. 121(b)(2)(B). Mary can take exclusion on her sale of a condo, even if I used the exclusion in last 2 yrs.**

**Case 6.** I have owned the home for 5 years. Mary and I had lived together in the house for five years.
We were married one year ago. Of course she has continued to live with me in the home.
We file a joint return for 2014. I sell the home at FMV. **Sec. 121(a), (b)(2)(A)**

**The gain on the sale is $400,000. We exclude gain of $400,000, and include gain of $0.**

**Exclusion is limited to $500,000, because Mary has lived in the house 2 years.**

**Case 7.** Taxpayer and wife owned and lived in the home for 5 years. They filed a joint return for 2016. They “planned to sell” the home at FMV. Wife had an auto accident and was killed in an auto accident in December, 2016. Taxpayer sells the house in January, 2017. **Sec. 121(a), (b)(1), (b)(4)**

**The gain on the sale is $400,000. Exclude gain of $400,000, and include gain of $0.**

**Exclusion is limited to $500,000. After death of one spouse, other spouse gets full exclusion.**

**Case 8.** We encounter an economic crisis and the value of the home falls to $500,000.
The bank agrees to allow me to sell the home for $500,000 and apply the $500,000 selling price to the $600,000 mortgage payable. The bank will forgive the remaining balance of the mortgage ($100,000). Do I recognize a loss on the sale? [Sec. 1221, 1211]
Do I recognize a gain on forgiveness of debt under **Sec. 61(a)(12)? Sec. 108(a)(1(E), (h)(2).**

Under the tax law that recently expired, this involved forgiveness of acquisition debt.

(Suppose we had paid the mortgage down to a $450,000 balance. Then we borrowed $150,000 for vacations. That increased the mortgage loan balance back to the $600,000 amount shown above.)

The extra $150,000 in borrowing is not acquisition debt. It was forgiven first, and was not subject to the exclusion. Not sure if Congress will reinstate this relief provision, since the recession (and hurting) is largely over.

**Part 2. How much mortgage interest do I deduct (assume home is not sold)?**

**Case 1.** I am single. How much mortgage interest expense is deducted on my return?

**Sec. 163(h)(1), Sec. 163(h)(2)(D), Sec. 163(h)(3)(A), (B).**

**An individual not filing a separate return may deduct interest on acquisition debt up to a mortgage balance of $1,000,000. I deduct 10% of the $600,000 balance which is acquisition debt. Deduct $60,000.**

**Case 2.** I am single. For this part only, assume that I borrowed $600,000 from my brokerage account to buy the home. The interest rate is 10% and I made interest payments only. No mortgage was given when I borrowed the money. How much interest is deducted on my return?

**Sec. 163(h)(3)(B)(i)(II).
Deduct $0. This is not debt on a home mortgage where the debt is secured by a mortgage.**

**Case 3.** My wife and I have owned and lived in the house for 5 years.
We file a joint return. How much interest is deducted on my return?

**Sec. 163(h)(1), Sec. 163(h)(2)(D), Sec. 163(h)(3)(A), (B)**

**On a joint return, we will deduct interest on acquisition debt up to a mortgage balance of $1,000,000.
We deduct 10% of the $600,000 balance. We deduct $60,000 of interest on acquisition debt.**

**Case 4.** My wife and I have owned and lived in the house for 5 years. We refinanced the loan on the first day of the year, borrowing $900,000, (1) paying off the $600,000 mortgage, and (2) using $300,000 to make gifts to our wonderful children. We file a joint return. How much is our interest is deduction?

**Sec. 163(h)(1), Sec. 163(h)(2)(D), Sec. 163(h)(3)(A), (B)(i)(II)**

**On a joint return, we will deduct interest on acquisition debt up to a mortgage balance of $1,000,000.
We deduct 10% of the $600,000 balance. We deduct $60,000 of interest on acquisition debt.**

**On a joint return, we will deduct interest on home equity debt up to a mortgage balance of $100,000.
We deduct 10% of the $100,000 balance. Deduct $10,000 of interest on home equity debt. Total $70,000.**

**Case 5.** (Ignore change in Case 4.) My wife and I have owned and lived in the house for 5 years. I pay the interest. We file separate returns. How much interest is deducted on my return?

**Sec. 163(h)(1), Sec. 163(h)(2)(D), Sec. 163(h)(3)(A), (B)(i), (ii)**

**On a separate return, I will deduct interest on acquisition debt up to a mortgage balance limit of $500,000.
I deduct 10% of $500,000 balance. Deduct $50,000 of interest on acquisition debt.**

**On a separate return, I will deduct interest on home equity debt up to a mortgage balance of $50,000.
I deduct 10% of the $50,000 balance. Deduct $5,000 of interest on home equity debt. Total: $55,000.**

**Case 6**. I was married throughout the year, until my divorce became final on December 31.
I own the house, I make mortgage principal and interest payments.
I live in California. How much interest is deducted on my return?

This is an interesting case to introduce the concept of community property where each spouse is treated as earning 50% of the amount of direct earnings of the other spouse. So, I would only be treated as making half of the actual payments. Community property is complicated and not covered in detail in this course. See page 3.

**Case 7.** My wife and I have owned and lived in the house for 5 years. We file a joint return.
On the first day of the year, we bought a “second” home for $750,000, paying $50,000 down and giving a mortgage of $700,000.
Interest rate is 10% on the mortgage on the second home. How much interest is deducted on my return?
What issues are encountered if the mortgage on the second home has an interest rate of 6%?

**On a joint return, we will deduct interest on acquisition debt up to a mortgage balance of $1,000,000.
We deduct 10% of the $600,000 acquisition debt on the first home. Deduct $60,000 of interest on acquisition debt.**

**We will deduct 10% of $400,000 acquisition debt on the second home. We deduct $40,000.**

**We will deduct 10% of $100,000 home equity debt on the second home. We deduct $10,000.
Total: $110,000 deduction.**

A divorced husband, filing a separate return for the year in which his divorce became final, was not entitled to a full deduction for mortgage expenses paid out of **community property** funds. The individual purchased the **residence** before getting married and retained sole ownership of it after the divorce. During the marriage, however, mortgage payments were made from the husband's earnings. Since under state (California) law the earnings constituted **community property**, and since the source of the funds rather than the ownership interest determined the allocation of the deduction, the deduction had to be divided equally between the husband and wife, regardless of who actually owned the **residence**.

*S.L. Keeter,* DC Calif., 97-2 ustc ¶50,940.

Plaintiff Sewell L. Keeter purchased a residence in his name alone in May 1978. In November 1986, Keeter married Virginia Cocciola. Keeter did not add his wife’s name to the title. She testified that she did not make any payments on the mortgage during their marriage. The mortgage payments were made from earnings and plaintiff agrees that earnings during the marriage are community property.

Mr. Keeter and his wife divorced in 1991. When the divorce became final as of December 31, 1991, the residence was entirely the separate property of Mr. Keeter.

Plaintiff filed a tax refund claim for the tax year ending December 31, 1991. On September 24, 1992, he filed a claim for a refund which the IRS rejected by letter dated December 16, 1994. On October 7, 1996, plaintiff filed this suit alleging, *inter alia*, that there was an incorrect allocation of his separate property deductions to his spouse.