IRS EXAMINATION QUESTIONS
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Depreciation deductions (2005, Part 1, #31)

In January of 2009, Mrs. Black purchased an office building and used office furnishings. The used office furnishings consisted of chairs, desks, and file cabinets. $900,000 of the purchase price was allocated to the office building and $50,000 of the purchase price was allocated to the used office furnishings. According to the General Depreciation System (GDS) under MACRS for depreciation, what recovery period must she use for the purchased items?

a. 27.5 years for the entire asset, building and furnishings

b. 39 years for the building and 5 years for the used office furnishings

c. 27.5 years for the building and 7 years for the used office furnishings

d. 39 years for the building and 7 years for the used office furnishings

Solution: The correct choice is "d."

According to the General Depreciation System (GDS) under the modified accelerated cost recovery system (MACRS), the cost of an asset is recovered over a predetermined period that is generally shorter than the useful life of the asset or the period the asset is used to produce income. The MACRS rules were designed to encourage investment, improve productivity, and simplify the law and its administration.

MACRS provides separate cost recovery tables for various classes of personal property (such as machinery and equipment used in a trade or business) and of real property (such as buildings). Cost recovery deductions are not allowed for land because it does not have a determinable useful life.

Under MACRS, most machinery and equipment, including office furniture, fixtures, and equipment are depreciated over a seven-year useful life beginning with the year the property is placed into service. The MACRS tables are calculated using the double-declining balance method in the early years and switching to the straight-line method in the later years. Moreover, the mid-year convention is employed (i.e., a half year of depreciation is claimed in the first year, regardless of when the machinery and equipment were actually placed into service). Furthermore, the Economic Stimulus Act of 2008 and the American Recovery and Reinvestment Act of 2009 provide for additional first-year "bonus" depreciation. For new property placed in service from 1/1/08 through 12/31/10, taxpayers can claim an additional 50% cost recovery deduction in the year the property is placed in service. Property that has been previously used, even though new to the taxpayer, does not qualify.

The cost recovery period for buildings is generally divided into two categories:

1. Residential rental real estate.
2. Nonresidential real estate.

Under MACRS, the cost recovery period for residential real estate is 27.5 years, and the straight-line method is used for computing the cost recovery allowance table based on a mid-month convention (i.e., the property is deemed to have been placed in service at the middle of the month regardless of when during the month it was actually placed in service. Residential real estate generally includes property for which 80% or more of the gross rental revenues are from nontransient dwellings, such as apartment buildings. Hotels and motels are not residential real estate. Nonresidential real estate, such as office buildings and warehouses, has a recovery period of 39 years, and deductions are calculated using the straight-line method and the mid-month convention.

Accordingly, because Mrs. Black purchased in 2009 an office building and used office furnishings, consisting of chairs, desks, and file cabinets, she must depreciate these assets separately. The office building is nonresidential property and must be depreciated over a 39-year period. The used office furnishings are depreciated over a seven-year life. Bonus depreciation cannot be claimed because the office furnishings are not new. Mrs. Black could, however, elect to expense the office furnishings under Section 179, as both new and used equipment qualify for this election in the year the equipment is placed into service.

Passive activity losses (2005, Part 1, #28)

Tom Brown, who is single, owns a rental apartment building property. This is the only rental property that Tom owns. He "actively participates" in this rental activity as he collects the rents and performs ordinary and necessary repairs. In 2008, Tom had a loss of $30,000 on this rental activity and had no reportable

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passive income. His adjusted gross income, without regard to this rental loss, is $138,000. How much of the rental loss may Tom deduct on his 2008 return?

a. $30,000
b. $25,000
c. $0
d. $6,000

Solution: The correct choice is "d."

Losses from passive activities generally can be deducted against only income generated from other passive activities (Section 469). In general, a passive activity is any one of the following:

1. A trade or business in which the taxpayer does not materially participate.
2. Any rental activity.

A major exception to this general rule applies for rental real estate. A taxpayer can deduct up to $25,000 of losses as a deduction from ordinary income with respect to a rental real estate activity in which he or she "actively participates." If the taxpayer's AGI exceeds $100,000, however, the special deduction is reduced by 50 cents for each dollar of AGI above $100,000. This AGI base amount is the same for both single and married taxpayers. (Married taxpayers filing separately are allowed a maximum deduction of $12,500 and reduce the deduction when AGI exceeds $50,000.) Thus, when the taxpayer's AGI exceeds $150,000, the special $25,000 deduction is fully phased out.

A taxpayer is deemed to "actively participate" in a rental real estate activity if he or she owns 10% or more of the activity and participates in management decisions such as approving new tenants, deciding on rental terms, and approving capital or repair expenditures.

For purposes of this rental real estate exception, AGI is defined as adjusted gross income other than, among others, the following items:

1. Taxable Social Security benefits.
2. The exclusion allowed for interest income earned on U.S. savings bonds used to pay for higher education tuition and fees.
3. Deductions for IRAs and other pension plans.
4. Rental real estate losses allowed to real estate professionals.
5. Deductions attributable to domestic production activities under Section 199.
6. Deductions for one-half of self-employment taxes.
7. Deductions for interest on student loans.
8. Deductions for higher education expenses.
9. Any deductions for passive activity losses.

Losses from passive activities that are not currently deductible are not lost forever. Instead, the losses remain "suspended" and are carried over to future years. The suspended losses can be used to offset income generated from passive activities in any future year. In the year that the taxpayer disposes of the activity in a taxable transaction, the taxpayer may use all remaining suspended losses as a deduction against all types of income in the following order:

1. Any gain recognized on the disposition of the passive activity.
2. The net income from the passive activity generated in the current year.
3. Net income generated in the current year from other passive activities.
4. Income or gain from any nonpassive activity.

Accordingly, since Tom Brown actively participates in the rental apartment building that he owns and he incurred a $30,000 loss in 2008, he is eligible for the special $25,000 real estate deduction. However, because his AGI is over $100,000, he is required to reduce the $25,000 deduction by 50% of the $38,000 excess AGI, or $19,000. Thus, he can deduct $6,000 ($25,000 - 19,000) on his 2008 tax return and carry over the remaining $24,000 ($30,000 - 6,000) of suspended losses to the future years. ■

The problems presented in this column are adapted from the official, verbatim texts of IRS Special Enrollment Examination questions and are identified by the examination date and question number. The answers were prepared by Prof. Blumenfrucht. The examination covers tax topics about which the IRS expects tax practitioners to be extremely knowledgeable.

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