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Tax Rules Relating to the Sale of a Principal Residence

The proposed regulations to IRS Code Section 121 offer detailed guidance on how to take advantage of the exclusion from gross income when the principal residence is sold. Every elder law attorney who advises clients regarding the use, occupancy, and disposition of a principal residence must become familiar with these proposed regulations.

By Bradley J. Frigon

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On October 10, 2000, the Internal Revenue Service (IRS) published proposed regulations relating to the exclusion of gain from the sale or exchange of a taxpayer's principal residence.[1] The purpose of the new proposed regulations is to provide additional guidance on the amendment of Code Section 121 by the Taxpayer Relief Act of 1997[2] and by the Internal Revenue Service Restructuring and Reform Act of 1998.[3]

The Taxpayer Relief Act of 1997 amended Code Section 121[4] and repealed Code Section 1034 for sales and exchanges of a principal residence that occur after May 6, 1997. Under the new Section 121, a taxpayer can generally exclude up to $250,000 ($500,000 for married couples filing a joint return) of gain realized on the sale or exchange of the taxpayer's principal residence if for at least two years out of the five-year period immediately preceding the date of sale, the taxpayer owned and used the property as a principal residence. The exclusion from gross income applies regardless of the age of the taxpayer, and the full exclusion can be used once every two years.

Definition of Principal Residence

Section 1.121-1(b) of the proposed regulations provides that a facts and circumstances test will be used to determine whether or not property is used as the taxpayer's principal residence.[5] If a taxpayer alternates between two properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year will ordinarily be considered the taxpayer's principal residence.[6]

Example: Taxpayer L owns two residences, one in Virginia and one in Maine. During 1999 and 2000, L lives

in the Virginia residence. During 2001 and 2002, L lives in the Maine residence. During 2003, L lives in the Virginia residence. L's principal place of residence during 1999, 2000 and 2003 is the Virginia residence. L's principal residence during 2001 and 2002 is the Maine residence. Either residence would be eligible for the 121 exclusion if it were sold during 2003.[7]

A principal residence may include a houseboat, a house trailer, or stock held by a tenant-stockholder in a cooperative housing corporation.[8] Unless the property is defined as a fixture under local law, the exclusion from gross income under Section 121 does not include proceeds from the sale of personal property that is located in the taxpayer's principal residence.[9]

Ownership and Use

The requirements of ownership and use for periods aggregating two or more years may be satisfied by establishing ownership and use for twenty-four months or for 730 days. The requirements of ownership and use may be satisfied during nonconcurrent periods if both the ownership and use tests are met during the five-year period ending on the date of sale.

Example: Taxpayer C lived in a townhouse that he rented from 1993 through 1997. On January 1, 1998, he purchased the townhouse that he had been renting since 1993. On February 1, 1998, C moved into his daughter's home. On March 1, 2000, while still living in his daughter's home, C sold his townhouse. The Section 121 exclusion will apply to gain from the sale because C owned the townhouse for at least two years out of the five years preceding the sale (from January 1, 1998 until March 1, 2000) and he used the townhouse as his principal residence for at least two years during the five-year period preceding the sale (from March 1, 1995 until February 1, 1998).[10]

In establishing whether a taxpayer has satisfied the two-year use requirement, occupancy of the residence is required. Nevertheless, short temporary absences, such as for vacation or other seasonal absence, even if the property is rented during such temporary absence, will be counted as periods of use.

Example: Taxpayer D, a college professor, purchased and moved into a house on May 1, 1997. He used the house as his principal residence continuously until September 1, 1998, when he went abroad for a one-year sabbatical leave. On October 1, 1999, one month after returning from the leave, D sold the house. Because his leave is not considered to be a short temporary absence for purposes of Section 121, the period of leave may not be included in determining whether D used the house for periods aggregating two years during the five-year period ending on the date of the sale. Consequently, D is not entitled to exclude gain under Section 121 because he did not use the residence for the requisite period.[11]

Example: Taxpayer E purchased a house on February 1, 1998, that he used as his principal residence. During 1998 and 1999, E left his residence for a two-month summer vacation. Taxpayer E sold the house on March 1, 2000. Even though E used his residence less than two years (twenty-one months) in the five-year period preceding the date of sale, the Section 121 exclusion will apply to gain from the sale of the residence because the two-month vacation is considered a short temporary absence and is counted as part of the period of use in determining whether E used the residence for the requisite period.[12]

Determination of Use During Out-Of-Residence Care

If a taxpayer is physically or mentally incapable of self-care and owns and uses the property as the taxpayer's principal residence for periods aggregating at least one year during the five-year period, then the taxpayer will be treated as using such property as the taxpayer's principal residence during the five-year period in which the taxpayer owns the property and resides in any facility (including a nursing home) licensed by a state or political subdivision.[13]

Limitation on Who May Claim the Exclusion

Generally, the ownership test will require the taxpayer to own the property directly and not through an entity. For example, the IRS has refused to allow a taxpayer to satisfy the ownership test if the principal residence was owned by a family limited partnership[14] or partnership.[15] If the home is owned by a trust, the exclusion will be available only to the extent the taxpayer is considered an owner of the trust under the grantor trust rules.[16] Thus, the Section 121 exclusion is available to the settlor of a revocable living trust[17] and to the surviving spouse of a marital trust.[18] However, the IRS ruled in Private Letter Ruling (PLR) 200104005 that the exclusion from gain from the sale of a personal

residence is available to the beneficiary of a non-marital bypass trust only to the extent the beneficiary has a right to withdraw trust corpus.[19]

The facts of PLR 200104005 are as follows: Prior to the death of the wife, both the husband and wife had conveyed their principal residence to a trust they had established. The husband and wife had owned and used the residence as their principal residence for more than thirty years prior to the date of the wife's death. The husband continued to use and occupy the house as his principal residence after the death of the wife. Due to health reasons, it was necessary for the husband to move out of the house and into an assisted living facility.

The trust that owned the house was revocable until the death of the wife. Upon the death of the wife, the trust was divided into two trusts, Trust A and Trust B. Trust A, which remained revocable by the husband, contained all the husband's interest in the community property estate, plus a portion of the wife's interest in the community property, to satisfy the maximum marital deduction formula that was used in the trust document. The balance of the community estate, including the entire value of the principal residence, was allocated to Trust B. After the death of the wife, the husband did not have the authority to revoke or amend Trust B.

The terms of Trust B provided that the husband had the power to withdraw from the principal of Trust B, in each calendar year, an amount that did not exceed $5,000 or five percent of the then aggregate market value of all property in Trust B.[20] Trust B specifically provided that the husband had the right to occupy the residence and to direct the trustee to sell the residence and replace it with or rent or lease another residence of comparable or lesser value as selected by the husband.

The IRS ruled that the exclusion from gross income for the sale of a principal residence was not available to Trust B. The husband may exclude a portion of the gain under Section 121 to the extent the husband is deemed to be an owner of Trust B under the grantor tax rules. The husband's right to vest a portion of the corpus of Trust B to himself by reason of the five and five power makes the husband an owner of that portion of the trust under Section 678(a)(1).

Because Trust B granted the husband the annual right to exercise, release or allow his five and five power to lapse, his ownership interest in the corpus of Trust B, for purposes of the grantor trust rules, will increase each year. The husband's annual ownership increase is calculated by multiplying that portion of the corpus of Trust B that the husband could withdraw by a fraction, the numerator of which is the portion of the trust corpus that the husband is not already treated as the owner, and the denominator of which is the total trust corpus from which the withdrawal could be made.

The IRS went on to state the power granted to the husband under Trust B to "occupy all real property owned by the trust estate being used for residential purposes and to direct the trustee to sell the property and replace it with rent, or lease another residence selected by the taxpayer of comparable or lower value," is not a power to vest the corpus in the husband. As a result, the husband will not be treated as an owner of any additional portion of the corpus of Trust B under Section 678(a)(1).

Dollar Limitation

The amount of gain that a taxpayer can exclude from gross income on the sale or exchange or a principal residence is $250,000.[21] The exclusion is increased to $500,000 for married taxpayers filing a joint return if the following criteria are met:

1. either spouse satisfies the ownership requirements of Section 121(a) with respect to the property;
2. both spouses satisfy the use requirements of Section 121(a) with respect to the property; and
3. neither spouse is ineligible under Section 121(a) by reason of the one sale every two years rule.[22]

If a married couple filing a joint return does not meet all three requirements for claiming the $500,000 exclusion as required under Code Section 121 (b)(2)(A), the couple can exclude the sum of the amounts that each spouse would be entitled to claim if such spouse had not been married.[23] In other words, the maximum exclusion that may be claimed by the couple is the sum of each spouse's maximum exclusion determined on a separate basis.

Example: Married taxpayers H and W sell their residence and file a joint return for the year of the sale.

Proposed Regulation Section 1.121-3 (relating to the reduced exclusion) does not apply to the sale of their residence. The requirements of Section 121 are satisfied by W, but not by H. Consequently, they are eligible to exclude up to $250,000 of the gain from the sale of the residence because that is the sum of each spouse's dollar limitation amount, determined on a separate basis, as if they had not been married (i.e., $0 for H and $250,000 for W).[24]

One Sale Every Two Years

The exclusion under Section 121 does not apply to any sale of a principal residence if, during the two-year period ending on the date of sale, the taxpayer sold their principal residence in which gain was excluded under Section 121.[25] The measuring period for the two-year rule is the actual time between sales, not taxable years. For example, a taxpayer who sold a principal residence on April 1, 2000, and excluded all the gain under Section 121, would not be eligible to claim the benefits of Section 121 until April 2, 2002. Any sale that occurred prior to May 7, 1997 will be disregarded for purposes of determining the once every two-year rule.[26]

A reduced exclusion is available for a taxpayer who does not satisfy the ownership and use requirements described in Code Section 121(a) or the two-year limitation described in Code Section 121(b)(3). The reduced exclusion applies if the sale of the principal residence is necessitated by a change in place of employment, health, or to any other unforeseen circumstances.[27] The proposed regulations do not provide any guidance or examples of what the IRS would consider as an unforeseen circumstance.[28]

The reduced exclusion is computed by multiplying the maximum dollar limitation of $250,000 ($500,000 for certain joint filers) by a fraction. The numerator of the fraction is the shortest period of time that the taxpayer owned the property as the taxpayer's principal residence during the five-year period ending on the date of the sale, or the period of time between the date of a prior sale of property for which the taxpayer excluded gain under Section 121 and the date of the current sale.[29] The denominator of the fraction is 730 days or twenty-four months, depending on whether days or months are used in the numerator.[30]

Example: Taxpayer A purchases a house that she uses as her principal residence. Twelve months after the purchase, A sells the house due to a change in place of her employment. A has not excluded gain under Section 121 on a prior sale or exchange of property within the last two years. A is eligible to exclude up to $125,000 of the gain from the sale of her house as illustrated by the following calculation: (12/24 x $250,000).[31]

Special Rules Applicable For Husbands and Wives

If the home is transferred to a spouse or former spouse pursuant to a decree of divorce, the period of time that the taxpayer making the transfer owned the property will be added to the time that the spouse or former spouse who received the property owns the property.

Example: The terms of Bob and Linda's divorce decree require Bob to quit claim his interest in the home to Linda. Under Section 121(d)(3)(A), Bob's ownership interest will carryover to Linda. However, Linda must satisfy the two out of five-year use test on her own to qualify for the entire exclusion. The time Linda occupied the home as her principal residence prior to and after the divorce will count toward the two-year use test.

There is no carryover of the use requirement between spouses or former spouses unless both parties continue to co-own the home after the divorce and the spouse receiving the property uses the property as his or her principal residence, even though Section 121(d)(3)(A) allows a carryover of the "ownership" interest between spouses and former spouses. If the parties do not co-own the property, the spouse or former spouse transferring the property must satisfy the two-year use requirement on his or her own to qualify for the full exclusion.[32]

Example: Bob and Linda's divorce decree gives occupancy of the home to Linda until their youngest child reaches the age of twenty-one. When their youngest child reaches the age of twenty-one, the home is to be sold and the proceeds divided between Bob and Linda. At the time of the divorce, the youngest child is twelve years old. Provided Linda uses the home as her principal residence during this period, Linda's use of the property as her principal residence will be imputed to Bob even though Bob has not used the property as his principal residence for more than five years. As a

result, Bob will be entitled to claim the exclusion under Section 121 when the property is sold.

It is critical to incorporate language in the divorce decree that requires the occupying spouse to continue to use the property as his or her principal residence. Otherwise, the non-occupying spouse may lose the exclusion and be required to pay tax on his or her share of the sale proceeds.

Deceased Spouse

An unmarried individual will be treated as owning and using the property as his or her principal residence during any period that the taxpayer's deceased spouse owned and used the property as a principal residence before death if the following criteria are met:

1. the taxpayer's spouse is not living on the date of the sale; and
2. the taxpayer has not remarried at the time of the sale of the property.[33]

While the date of death basis rules under Section 1014 may eliminate most or all of the unrealized gain, the $500,000 exclusion is only available in the year the surviving spouse files a joint return.[34]

Example: Taxpayer H has owned and used a house as his principal residence since January 1, 1987. H and W marry on January 1, 1999 and from that date they use H's house as their principal residence. H dies on January 15, 2000, and W inherits the property and continues to use the property as her principal residence. W sells the property on August 31, 2000, at which time she has not remarried. Although W has owned and used the house for less than two years, W will be considered to have satisfied the ownership and use requirements of Section 121 because W's period of ownership and use includes the period that H owned and used the property before death.[35]

Exclusion Extended to Estates, Heirs and Revocable Trusts

To minimize the impact of the modified carryover basis rules created by the Economic Growth and Tax Reconciliation Act of 2001,[36] a new paragraph nine was added to Section 121(d).[37] Effective for decedents dying after December 31, 2009,[38] the $250,000 exclusion is extended to estates, heirs and certain revocable trusts. Under new Section 121(d)(9), an estate or heir can exclude $250,000 of gain if the decedent used the property as his or her principal residence for two or more years during the five-year period prior to the sale.[39] In addition, if an heir occupies the decedent's home as his or her principal residence, the decedent's period of ownership and occupancy can be added to the heir's subsequent ownership and occupancy in calculating the two out of five years ownership and use test.

Under Section 121(d)(9)(C), the $250,000 exclusion is also extended to property sold by a trust provided that the trust was a qualified revocable trust, as defined under Section 645(b)(1), immediately prior to the decedent's death. Any period of occupancy and ownership of the decedent can be extended to an heir's subsequent ownership and use regardless of whether the principal residence was owned by a trust established by the decedent.

Recognition of Gain Attributable to Depreciation

Section 121(d)(6) provides that the exclusion under Section 121 will not apply to the extent that depreciation attributable to periods after May 6, 1997 exceeds the gain allocated to the business-use portion of the property.[40] Although gain must be recognized, pursuant to Section 121(d)(6), the fact that a taxpayer uses the residence as a rental does not preclude the application of the Section 121 exclusion.

Example: Taxpayer A has owned and used his house as his principal residence since 1986. On January 1, 1998, A moves to another state. A leases his house from that date until April 18, 2000, when he sells it. A is eligible for the Section 121 exclusion because he has owned and used the house as his principal residence for at least two years out of the five years preceding the sale.[41]

Property Used Partially as Business and Partially as Principal Residence

Additional issues occur if the taxpayer uses a portion of the residence as a home office, workshop or storage area. The IRS takes the position that the Section 121 exclusion is not available for any portion of the residence used for business purposes during the qualifying use period.[42]

> **Example**: Taxpayer H buys a house in 1998. For five years, H uses a portion of the property as his principal residence and a portion of the property for business purposes. H claims depreciation deductions of $20,000 for the business use of the property. H sells the property in 2003 realizing a gain of $50,000. H had no other Section 1231 gains or capital gains or losses for 2003. H determines that $15,000 of the gain is allocable to the business-use portion of the property and that $35,000 of the gain is allocable to the portion of the property used as his residence. H must recognize $15,000 of gain allocable to the business-use portion of the property. In addition, the Section 121 exclusion does not apply to the extent that H's post-May 6, 1997 depreciation deduction of $20,000 exceeds the gain allocable to the business-use portion of the property ($15,000). Therefore, H may exclude $30,000 of the gain from the sale of the property under Section 121 and must recognize $20,000 of gain.[43]

Although similar rules applied to business use of a residence under prior Sections 1034 and 121, a taxpayer could avoid the recognition of gain by stopping all business use of the property immediately prior to sale.[44] Under current law, a taxpayer must cease all business use of the property two full years prior to the sale to avoid recognition of gain under Section 121.

Sale or Remainder Interest

A taxpayer can elect to apply the Section 121 exclusion to the sale of a remainder interest in the taxpayer's principal residence.[45] However, other sales of partial interests, such as a term of years or an undivided percentage interest in the house as tenants in common, are not eligible for non-recognition under Section 121 if sold separately,[46] unless the purchaser is related to the taxpayer within the meaning of either Section 267(b) or 707(b).[47]

Although it is not specifically addressed in the proposed regulations, it seems clear that the "sold separately" language is referring to a sale in which the taxpayer sells a partial interest while retaining a partial interest.[48] If the taxpayer originally acquired a partial interest, such as an undivided fifty percent interest, and then sold the entire fifty percent interest in one transaction, the sale should be excluded from income under Section 121 provided all other requirements of the statute are satisfied.

It is less clear whether Section 121 will apply to a sale of a partial interest where the taxpayer at some time had owned the entire interest in the property. For example, if a retained life estate was sold by a taxpayer who had previously elected to exclude the sale of the remainder interest in that property in a previous transaction, the partial interest rule under 121(d)(8)(A) may deny the application of the exclusion.

Use of the Elective Recognition Provision

Section 311(e) of the Tax Relief Act of 1997 allows a non-corporate taxpayer holding a capital asset on January 1, 2001, to treat that asset as having been sold and reacquired on that date for an amount equal to its fair market value. The taxpayer must recognize gain equal to the difference between the fair market value of the property on the date of the election, less the property's adjusted basis, but the taxpayer receives a corresponding tax benefit by starting the new holding period for post-2001 with reduced long-term capital gains rates of eight percent and 18 percent. There is no language under Section 311(e) to prevent a taxpayer from making a deemed sale election of the taxpayer's principal residence. The issue that arises is whether a taxpayer making a Section 311(e) election on his or her principal residence can exclude the mandated gain recognition by reason of the Section 121 exclusion.

The IRS held in Revenue Ruling 2001-57[49] that a taxpayer cannot exclude from gross income under Section 121 any of the gain resulting from the deemed sale. The IRS based its ruling on the premise that the application of Section 121 to a Section 311(e) election would otherwise prevent the intended consequences of the mandated recognition under Section 311(e).

Reporting Requirements

Under pre-1997 Act law, taxpayers were required to report the sale price of the old residence, its basis, and the purchase price of the new residence on Form 2119. Form 2119 is no longer used by the IRS; therefore, no information is required to be filed with a taxpayer's return if all of the gain is excluded under Section 121.

If Section 121 does not exclude all of the gain from the sale, the recognized gain is reported on Schedule D. In addition, no Form 1099-S, Proceeds from Real Estate Transactions, is required to be filed by the closing agent if the seller can provide "written assurances" to the closing agent that the transaction is non-taxable.[50]

Conclusion

The proposed regulations to Code Section 121 offer detailed guidance on how to take advantage of the exclusion from gross income when the principal residence is sold. Every elder law attorney who advises clients regarding the use, occupancy and disposition of a principal residence must become familiar with the new proposed regulations to Code Section 121.

Endnotes

1. Proposed Treasury Regulation, Exclusion of gain from sale or exchange of a principal residence, 65 Fed. Reg. 60,136 (October 10, 2000).
2. Taxpayer Relief Act of 1997, No. 105-34, §312(d)(2) & (4).
3. Internal Revenue Service Restructuring and Reform Act of 1998, No. 105-206, §6005(e)(1) & (2) (1998).
4. All code section references are to the Internal Revenue Code of 1986, as amended.
5. The IRS will not issue rulings or determination letters concerning whether property qualifies as the taxpayer's principal residence for purposes of Code Section 121. Rev. Proc. 2000-3, 2000-1 I.R.B. 103, Section 3.01(6). The proposed regulations do not address how much property surrounding the structure itself can be excluded under Section 121. For a discussion of this issue, *see generally*, Daughtrey et al., *How Much Acreage Can be Included Under the New Sale of Principal Residence Rules?*, 90 J. TAX'N 294 (1999); Megaard & Megaard, *Reducing Taxes on the Disposition of a Personal Residence with Acreage*, 20 J. REAL EST. TAX'N 269 (1993).
6. Prop. Treas. Reg. §1.121-1(c), 65 Fed. Reg 60, 136 (October 10, 2000).
7. *Id.* at §1.121-1(f), Example 11.
8. *Id.* at §1.121-1(b). Under Proposed Reg. Section 1.121-1(b), the ownership test is applied to the taxpayer's ownership of the stock, and the use requirement is applied to the home or apartment that the taxpayer is entitled to occupy as the stockholder.
9. *Id.*
10. *Id.* at §1.121-1(f), Example 3.
11. *Id.* at Example 4.
12. *Id.* at Example 5.
13. *Id.* at §1-121-4(e).
14. Priv. Ltr. Rul. 200029046 (April 24, 2000).
15. Priv. Ltr. Rul. 200119014, *revoking* Priv. Ltr. Rul. 200004022.
16. Rev. Rul. 85-45, 1985-1 C.B. 183.
17. Rev. Rul. 66-159, 1966-1 CB 162.
18. Rev. Rul. 85-45, 1985-1 C.B. 183.
19. Priv. Ltr. Rul. 200104005 (September 11, 2000).
20. Under Section 2041(b), a lapse of a power of appointment does not occur to the extent such power of appointment does not exceed the greater of $5,000 or five percent of the aggregate value at the time of such lapse of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied.
21. I.R.C. §121(b)(1) (1986).
22. *Id.* at §121(b)(2)(A).
23. *Id.* at §121(b)(2)(B).
24. Prop. Treas. Reg. §1.121-2(b)(3), Example 3.
25. I.R.C. §121(b)(3)(A).
26. *Id.*
27. Prop. Treas. Reg. §1.121-3.
28. *Id.*
29. *Id.* at §1.121-3(a)
30. *Id.*
31. *Id.* at §1.121-3(b), Example 1.
32. *Id.* at §1.121-4(b)(2).
33. *Id.* at §1-121-4(a)(1).
34. *Id.* at §1.121-2(b)(3), Examples 4 and 5.
35. *Id.* at §1-121-4(2).

36. H.R. 1836 P.L. 107-16, 115 Stat. 38.

37. *Id.* at §542(c).

38. *Id.* at §901 (providing that provisions of Section 121(d)(9) will not apply to estates or decedents dying after December 31, 2010).

39. I.R.C. §§121(d)(9)(A) and (d)(9)(B).

40. Prop. Treas. Reg. §1.121-1(e).

41. *Id.* at §1.121-1(f), Example 1.

42. *Id.* at §1.121-1(e).

43. *Id.* at §1.121-1(f), Example 8.

44. Rev. Rul. 82-26, 1982-1 C.B. 114.

45. I.R.C. §121(d)(8)(A).

46. *Id.* at §121(d)(8)(B).

47. Under Code Sections 267(b) and 708(b), the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

48. Prop. Treas. Reg. §1.121-4(f).

49. Rev. Rul. 2001-57, 2001-46 I.R.B 488.

50. I.R.C. §6045(e)(5) (*see* Announcement 97-106, 1997-45 I.R.B. 11 (Nov. 10, 1997) for information on what the IRS considers sufficient "written assurances").