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Fundamentals of Deferring Home Sale Gain

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Despite the rules having been eliminated from federal tax law in 1997, practitioners still receive questions about how the "rollover" rule of former §1034 and the "over-55 exclusion" of former §121 apply to shelter gain from the sale of a taxpayer's personal residence. In fact, neither rule is embodied in current law, and instead, current law §121 generally allows a taxpayer to exclude up to $250,000 ($500,000 for certain married taxpayers) of home sales gain once every two years. In general, §121 provides a much more comprehensive set of rules than was contained in either former §1034 or former §121.

PRE-1997 LAW

The rollover rule of former §1034 allowed a taxpayer to defer home sale gain so long as the amount of the sale proceeds was reinvested in a new residence within a specified period. The over-55 exclusion was contained in former §121 and allowed a taxpayer over 55 years of age to exclude $125,000 of home sale gain, provided the home had been the taxpayer's primary residence for a specified period of time. The rollover rule and the over-55 exclusion could be used in conjunction.

LEGISLATIVE HISTORY OF THE 1997 CHANGE

In 1997, §1034 was repealed and §121 rewritten, eliminating both the rollover and the over-55 exclusion. Since 1997, revised §121 has permitted a taxpayer to exclude up to $250,000 of home sale gain (and up to $500,000 for married taxpayers), provided the home has been owned and used as the taxpayer's primary residence for specified time periods.

The old tax regime — particularly the rollover rule — was venerable and firmly ingrained in the minds of taxpayers and practitioners alike. So, why was the tax regime changed so drastically in 1997? In the simplest terms, Congress was concerned that the rollover rule and the over-55 exclusion, whether considered separately or in tandem, did not adequately address the tax needs of America's older homeowners. At some point as they age, most homeowners downsize by selling their existing home and moving into a smaller residence. Congress reasoned that the smaller new residence would cost less than the old had sold for, and so the rollover rule of §1034 would not shelter all of the gain. Moreover, some older homeowners terminate their homeownership entirely and change to a different type of residential arrangement, such as an apartment or an assisted care living facility. For these taxpayers, the rollover rule provided no benefit, and Congress viewed the $125,000 exclusion as often inadequate.

Could the rollover rule have been left in place, coupled with an expanded exclusion rule (i.e., with an increased exclusion amount for those over 55 or some other age)? Absolutely. The fact that Congress chose to not proceed in this fashion indicates that Congress also was concerned with tax simplification and, presumably, preferred that only one Code section govern the home sale exclusion. Accordingly, Congress repealed §1034 and rewrote §121 to provide that any homeowner, regardless of age, could claim an exclusion of up to $250,000 ($500,000 for certain married taxpayers) of gain, provided the home had been owned and used as the primary residence for specified time periods.

REQUIREMENTS OF CURRENT §121

What are the most critical requirements under current §121? Under §121(a), a taxpayer must own the residence for at least two years during the last five years ("ownership period"), and must also use the home as a primary residence for at least two years during the last five years ("use period"). These rules are sometimes referred to as the "two-in-five" rules. The ownership period and the use period do not have to overlap. In the case of married taxpayers, up to $500,000 of gain may be excluded if: (i) either spouse satisfies the ownership rule, (ii) both spouses satisfy the use rule, and (iii) a joint return is filed for the year of sale.

> *Example:* Husband and Wife are married and file a joint return. Husband has owned a house as his separate property (i.e., wife has no ownership interest therein) for the past 6 years. Husband purchased the home for $200,000. Husband and Wife have used the house as their principal residence for the last 3 years. Husband and Wife decide to sell the house in 2011 for $650,000. Husband and Wife may exclude the entire $450,000 gain on the sale under §121 despite the fact that Wife has no ownership interest in the residence.

The exclusion is allowed each time a taxpayer meets the eligibility requirements, but under

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§121(b)(3) no more frequently than once every two years. It is not necessary that the taxpayer use the property as a principal residence at the time of the sale. Unmarried joint owners are each potentially able to claim the full $250,000 §121 exclusion.[1]

Section 121 contains two additional rules — the "qualified facility rule" and the "fractional exclusion" — that help taxpayers when they fail to satisfy the ownership and/or use rules.

QUALIFIED FACILITY RULE

First, under §121(d)(7), if a taxpayer becomes incapable of self-care, a taxpayer's use period for a principal residence includes certain periods during which the taxpayer resides in a qualified facility any time during the five-year period before the sale or exchange of the residence. A qualified facility is defined as any institution, including a nursing home, licensed by a state or political subdivision to care for incapacitated individuals. This rule makes considerable sense in view of the earlier observation that the 1997 revision was directed, at least in part, at older taxpayers who are downsizing or will no longer own a home.

> *Example:* T purchased a house on December 31, 2008, which he used as his principal residence until June 30, 2010, when T became physically unable to care for himself. At that time, T moved to a state-certified nursing home to receive treatment. On January 1, 2011, T sold his residence. T's period of use of the residence includes the period during which he resided in the nursing facility. Thus, T's use period equaled two years (one and one-half years actual use, plus one-half year use during T's out-of-residence care).

FRACTIONAL RULE

Second, if a taxpayer's ownership period and/or use period does not satisfy the two-in-five rule, §121(c) allows a portion of the $250,000 exclusion (or the $500,000 exclusion in the case of married taxpayers that otherwise satisfy the §121 requirements) to shelter home sales gain, if the sale was due to a change in place of employment, health, or unforeseen circumstance. In most cases, the exclusion is the amount arrived at by multiplying the "full" exclusion by a fraction, the numerator of which is the shorter of the time periods that the taxpayer owned or used the property as his principal residence during the five-year period ending on the date of sale, and the denominator of which is two years.

> *Example:* T purchased a house on September 1, 2010, and used it as his principal residence until August 31, 2011, when he sold it due to his transfer of employment across the country. He sold the residence for $600,000, when his basis was $300,000. Because T's sale of his principal residence was due to a change in place of employment, T is eligible for a prorated exclusion. Specifically, because the time T owned and used the residence was only one-half of the required two years, T may exclude $125,000 ($250,000 multiplied by one-half) of gain under §121. The remaining $175,000 of gain must be recognized as income.

For the fractional rule to apply, it must be clear, based on all of the facts and circumstances, that a change in place of employment, health, or unforeseen circumstance was the primary reason behind the decision to sell. The following is a short list of some of the IRS rulings confirming the facts that will constitute unforeseen circumstances.

PLR Number	Circumstance
200947024	unexpected post-retirement military assignment requiring taxpayer to live in government quarters
200820016	change of school districts due to problems of taxpayer's child arising from sexual assault while riding school bus
200826024, 200725018	change in owner's marital status and need for larger home to accommodate blended family
200702032	taxpayer conducted reasonable pre-purchase investigation of residence, and evidence demonstrated that taxpayer reasonably did not anticipate airport noise before purchasing and occupying residence
200652041	unexpected pregnancy of unmarried taxpayer
200630004	criminal attack
200615011	explicit death threat to kill police officer in his home, made by associates of a drug dealer whom police officer had arrested
200613009	move to larger house due to adoption of foreign child where state law requires child to have her own room

[1] Regs. §1.121-2(a)(2).

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200601023	sale to assist daughter, who needed to live with taxpayer but was unable to because of age restrictions of his community forcing taxpayer to relocate to daughter's state
200601009	assaults on taxpayer and taxpayer's child, along with criminal nature of neighborhood
200504012	selection of taxpayer as K-9 officer requiring maintenance of dog kennel in townhouse, which was forbidden by homeowners' association
200403049	parolee was harassed and threatened, and parole officer believe moving would improve chances of reducing probation and ending house arrest

INTERACTION BETWEEN §121 AND §1031

In most cases, §121 will be the exclusive nonrecognition provision that governs the treatment of gain when a residence is sold. In limited circumstances, §1031 also may apply, if there has been rental use of the residence. In recent years, the interaction between §121 and §1031 has been the subject of considerable discussion among tax professionals. Due both to IRS pronouncements and to statutory amendments, the rules governing this interaction have changed since the original enactment of §121. Generally, three common fact patterns present the potential overlap between §§121 and §1031.

Rental Property Acquired in a Non-§1031 Transaction: If a taxpayer owns rental property that was acquired in a non-§1031 transaction, the taxpayer can benefit from §121 by moving into the property and using it as a principal residence for at least 24 months prior to a sale (thereby satisfying the two-in-five use and ownership rules). If the two-in-five rules are met, §121 will be the controlling provision and not §1031, because the property will be personal use property (and not held for investment purposes) at the time of the sale. The §121 exclusion will have to be prorated under §121(b)(4) due to the period of rental use after January 1, 2009. In addition, §121(d)(6) will require the recognition of gain, to the extent of post-1997 depreciation.

Rental Property Acquired in a §1031 Transaction: If a taxpayer acquires property in a §1031 transaction, the tax rules are more complex. First, to ensure that the acquisition qualifies under §1031, the taxpayer would typically want to use the property as a rental property for at least 24 months before converting it to personal residential use.[2] Second, under §121(d)(10), §121 will not apply to any disposition of the property within five years after its acquisition in the original §1031 transaction. Third, once the taxpayer's ownership exceeds the five-year period of §121(d)(10) and the two-in-five rules are satisfied, §121 and not §1031 will be the controlling provision, because the property will be personal use property at the time of the sale (and not held for investment purposes). However, due to the rental use after January 1, 2009, the §121 exclusion will have to be prorated under §121(b)(4). In addition, §121(d)(6) will require the recognition of gain to the extent of post-1997 depreciation.

Personal Use Residence Converted to Rental Use: If a taxpayer converts his or her existing residence to a rental property and then eventually disposes of the property, §1031 and §121 conceivably both apply. First, for §121 to apply, the disposition must be timed to comply with the two-in-five rules. Second, for §1031 to apply, the rental use must occur for at least 24 months after the conversion.[3] Assuming the other requirements of both §1031 and §121 are met, Rev. Proc. 2005-14[4] confirms that the §121 exclusion is applied first to realized gain and then §1031 applies, including with respect to gain attributable to depreciation deductions. Any boot received in the exchange for the relinquished rental property is taken into account only to the extent the boot exceeds the §121 excluded gain.

CONCLUSION

Under current law, §121 provides a much more comprehensive set of rules than did former §1034 or former §121. For the vast majority of taxpayers, the application of current §121 is straightforward and presents few planning opportunities, but the comprehensive set of rules brings with it occasional planning opportunities, along with potential traps for the unwary. As a result, there can be a considerable premium on understanding the numerous technical rules of §121.

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[2] *See* Rev. Proc. 2008-16, 2008-10 I.R.B. 547.

[3] *Id.*

[4] 2005-7 I.R.B. 528.

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