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A Primer on the Sale of Residence Tax Rules after the Proposed Regulations

by Wayne M. Gazur

The Internal Revenue Code ("Code") provides generous incentives to the owners of personal residences. While most consumer interest is now nondeductible,[1] the interest on a residential mortgage is largely deductible, subject to limits for mortgages in excess of $1 million[2] and second mortgages.[3] While prepaid interest generally can be deducted only in the periods to which it is allocable, loan discount "points" paid in connection with the purchase or improvement of a principal residence can be deducted in the year paid.[4] Unlike renters, homeowners can deduct real property taxes levied on the property.[5] In broader economic terms, the owner of a personal residence is not required to recognize income for the imputed rental value of the home, as compared with a renter, who must earn income from other sources that is likely to be taxed and then use after-tax dollars to pay nondeductible rent.

However, the greatest potential benefit to homeowners lies in the treatment of gains from the sale of a principal residence, which appear to be quite significant in Colorado. Reportedly, the average price of a home in the Denver metropolitan area has increased 120 percent in the past ten years, with the average price of such a home reaching $253,282 in February 2001.[6] Compared with the income tax generally imposed on the sale of most other assets, gains on the sale of a principal residence have enjoyed extraordinary treatment for some time.[7]

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Prior to the changes introduced by the Taxpayer Relief Act of 1997 ("97 Act"),[8] the Code already allowed two principal benefits on the sale of a principal residence —Code §§ 1034, enacted in 1951 (the rollover rule), and 121, enacted in 1964 (the age 55 exemption). In the 97 Act, Congress repealed the longstanding rollover rule, substituting for it an expanded Code § 121 that allows a greater exemption amount to be used by taxpayers of any age and as often as every two years.

Certain aspects of the new regime were clarified in the 1998 Internal Revenue Service Reform and Restructuring Act[9] ("IRS Reform Act"), but, otherwise, taxpayers had been left with little guidance in applying the new provisions. On October 10, 2000, the Internal Revenue Service ("IRS") issued proposed regulations interpreting amended Code § 121.[10] While a taxpayer generally cannot rely on proposed regulations,[11] such regulations do offer a sense of the current IRS views. Accordingly, they provide potential guidance in planning sales of personal residences. Real estate lawyers are encouraged to visit the IRS website and download a copy of the proposed regulations so that they can create a checklist of issues to consider in advising clients.[12] This article focuses on developing such a checklist in view of the proposed regulations.

The 1997 Changes

The 97 Act repealed Code § 1034 in its entirety for sales and exchanges after May 6, 1997, with some transitional rules.[13] In general, Code § 121 was expanded to provide for a $250,000 exclusion (or possibly a $500,000 exclusion on a joint return). The exclusions can be used by taxpayers of any age, as often as every two years (and in some cases even more frequently), so long as the home is owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more during a five-year period ending on the date of sale.

The expanded exclusion eliminates the tax incentive produced by the former rollover rule that encouraged home sellers to "trade up" in purchasing a replacement residence.[14] On the other hand, the 97 Act can treat the seller of a highly appreciated and valuable home less favorably. The 97 Act repealed Code § 1034, which offered the option of deferring all of the gain through reinvestment in an equally expensive replacement home. The flat dollar exemption under the current law might be easily exceeded in such circumstances.

Practitioner's Checklist

A number of details exist in the statute and the proposed regulations, but some basic questions capture many of the pivotal issues:

1. What is the sales price of the client's home?
2. What is the adjusted basis of the client's home?
3. If the client has multiple residences, is this home the client's principal residence?
4. Does the client have special circumstances such as a farmer or rancher living on a portion of a larger parcel?
5. Has the client lived in this particular home for two out of the five years preceding the date of sale?

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6. Has the client previously used the exemption within the past two years?

7. If the client has not lived in this home for at least two years or has used the exemption within the past two years, is the current sale on account of special employment, health, or other circumstances?

8. Has the client been married for more than two years, been recently married, recently suffered the loss of a spouse, been in the process of dissolution of marriage, been considering a nursing home,[15] or been considering bankruptcy?

9. Has the client made rental or business use of the residence or is a real estate investor dealing with shifting residential rental properties?

10. Has the client's personal residence been destroyed, seized, or condemned, and the client may not rebuild or replace the residence completely?

A brief discussion of each question is presented below.

Questions 1 and 2: Sales Price and Adjusted Basis

Clients always should try to keep reliable information as to an estimated selling price as well as the costs of sale. The adjusted basis of the property to be sold is a particularly complicated issue for many older homeowners because the repealed Code § 1034 rollover rules reduced the basis of replacement residences by the deferred gain.[16] That lower basis amount still applies on a post-1997 sale of a Code § 1034 regime replacement residence. Accounting for capital improvements made to the current house after its acquisition also is a consideration. An aim of the 97 Act was to limit these concerns, which it did if the taxpayer is clearly under the $250,000/ $500,000 exclusion.[17]

In the past, taxpayers had to include Form 2119 in their income tax return, reporting information such as the sales price of the old residence, its basis, and the purchase price of the replacement residence. Prior to the 97 Act, Form 2119 was required even if no taxable gain was recognized, but it is no longer used by the IRS. Apparently, no form or statement is now required for a nontaxable sale. However, if the exclusion does not apply or is exceeded, the gain is reported on Form 1040, Schedule D, Capital Gains and Losses. Likewise, while a Form 1099-S, Proceeds from Real Estate Transactions, is required to be filed by the real estate closing agent for the sales of other types of real estate, a Form 1099-S generally is not filed for the sale of a residence if the seller can provide assurances (of a nontaxable disposition) to the closing agent.[18]

Question 3: Principal Residence

The proposed regulations state that whether or not a particular property is used as the taxpayer's residence[19] or *principal* residence "depends upon all the facts and circumstances."[20] 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."[21]

The IRS provides twenty-one examples distributed among the four sections of the proposed regulations.[22] The remainder of the article covers twelve of the examples, using the numbering scheme of the proposed regulations.

In Example ten,[23] the taxpayer owned residences in New York and Florida. From 1999 through 2003, the taxpayer lived in the New York residence for seven months and the Florida residence for five months. The example concludes that, in the absence of facts and circumstances indicating otherwise, the taxpayer "used the New York residence a majority of the time in each year from 1999 through 2003" and the New York residence was the taxpayer's principal residence. Only the New York residence would be eligible for the Code § 121 exclusion if sold. This example may be of special interest to nonresident taxpayers who are considering selling their second homes in Colorado. Note that the taxpayer in Example ten split time between two residences during each year, rather than living in one or the other continuously for a period exceeding a year. Example eleven addresses the latter situation.

In Example eleven,[24] the taxpayer owned residences in Virginia and Maine. During 1999 and 2000, the taxpayer lived in the Virginia residence. During 2001 and 2002, the taxpayer lived in the Maine residence. During 2003 the taxpayer lived in the Virginia residence. The IRS concluded that the taxpayer's principal residence during 1999, 2000, and 2003 was in Virginia. The taxpayer's principal residence during 2001 and 2002 was the Maine residence. Either residence would be eligible for the Code § 121 exclusion if it were sold during 2003, but *both* could not be sold in 2003 because the exclusion does not apply if it was claimed on any other sale during the two-year period ending on the date of the second sale.[25]

Question 4: Surrounding Land

In some cases, a taxpayer will want to claim that all of the surrounding lots, acreage, and water rights are part of the principal residence and eligible for the Code § 121 exclusion. On the other hand, if the gain from the sale of the surrounding land would exceed the exclusion, a taxpayer might instead assert that it is eligible for a Code § 1031 like-kind exchange due to an investment or business use. Thoughtful analysis is important in these mixed-use situations. For example, as discussed below, under Question 9, the IRS maintains that business use of a portion of a personal residence is inconsistent with the Code § 121 exclusion.[26]

Question 5: Periods Aggregating Two Years or More

The proposed regulations provide that the two-year requirement can be satisfied "by establishing ownership and use for 24 full months or for 730 days (365 x 2)."[27] Considering the language of the statute regarding "periods aggregating 2 years or more,"[28] it would seem that the full twenty-four months could be met by adding or "aggregating" unconnected periods of use within the five-year period. However, that would be assuming that the multiple residence issue above is not raised (which apparently would preclude principal residence status for a residence not used for a majority of the calendar year).[29]

Temporary Absences

Occupancy of the residence is required, but "short temporary absences, such as for vacation or other seasonal absences (although accompanied with rental of the residence) are counted as periods of use."[30] The IRS received comments at the public hearing on January 23, 2001, that the use requirements are too strict, and taxpayers on temporary assignments of almost any duration should be able to treat the unoccupied home as a principal residence as long as they intend to return.[31] Indeed, the regulations as proposed in the following examples are somewhat unforgiving.

In Example four,[32] a college professor purchased a house, occupying it from May 1, 1997, until September 1, 1998, when he went abroad for a one-year sabbatical leave. The taxpayer sold the house on October 1, 1999, one month after returning from the leave. The IRS concluded that "[b]ecause his leave is not considered to be a short temporary absence, . . . the period of the leave may not be included in determining whether [the taxpayer] used the house for periods aggregating two years."

In Example five,[33] the taxpayer purchased a house on February 1, 1998, and during 1998 and 1999 he left his residence for a two-month summer vacation. The IRS concluded that a sale of the house qualified for the exclusion "because the 2-month vacations are short temporary absences and are counted as periods of use in determining whether [the taxpayer] used the residence for the requisite period."

Aggregating Periods of Use

The requirements of ownership and use may be satisfied by nonconcurrent periods and need not be uninterrupted. This should not be confused with the issue discussed in Question 3. In that context, aggregation of residency time over several years may not be enough because the taxpayer generally must reside in a home a majority of the time *during a given year* for it to be considered a principal residence. Example three of the proposed regulations suggests that both the ownership *and* use need not be present at the same time.

In Example three,[34] the taxpayer lived in a townhome that he rented from 1993 through 1997. On January 1, 1998, he purchased the townhome. One month later, on February 1, 1998, he moved into his daughter's home. On March 1, 2000, while still living with his daughter, the taxpayer sold the townhome. The example concludes that Code § 121 applies because the taxpayer owned the townhome for at least two years out of the five years preceding the sale (from January 1, 1998, to March 1, 2000), and he used the town home as his principal residence for at least two years during the five-year period preceding the sale (from March 1, 1995, to February 1, 1998).

Question 6: Once Every Two Years

Ignoring the married homeowner aspects for now, the statute generally limits the use of the exclusion to once every two years (barring application of the change of circumstances rule discussed in the section referring to Question 7 below). Code § 121(b)(3)(A) states:

> [The exclusion] shall not apply to any sale or exchange by the taxpayer if, during the two-year period ending on the date of such sale or exchange, there was any other sale or exchange by the taxpayer to which [the exclusion] applied.

With the uncertainties of differing housing markets, it is possible that a use of the exclusion at the earlier point in the two-year period could be less beneficial (that is, eliminate less gain) than another use of the exclusion later in the two-year period. Consequently, the statute permits a taxpayer to elect that Code § 121 not apply to a given sale or exchange.[35] The proposed regulation provides that the taxpayer makes the election by "filing a return for the taxable year of the sale or exchange that includes the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income."[36]

Question 7: Employment, Health, or Unforeseen Circumstances

Unforeseen circumstances could force a taxpayer to sell a residence before the two-year ownership and use period is met or within two years of a sale of a prior residence. The statute provides a reduced exclusion if the failure to satisfy those conditions is due to a "change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances."[37] As clarified by the IRS Reform Act, a fraction of the $250,000/$500,000 exclusion is allowed, computed as the ratio of:

1) the shorter of:
   a) the aggregate periods during the five-year period ending on the date of the sale or exchange that the property was owned and used by the taxpayer as the taxpayer's principal residence; or
   b) the period after the date of the most recent prior sale or exchange by the taxpayer to which the exclusion applied and before the date of the recent sale or exchange;[38] to
2) two years.

The proposed regulations state that the numerator and denominator may be expressed in either months or days.[39] The proposed regulations repeat the exception for employment or health reasons, without elaboration, and leave "unforeseen circumstances" to interpretation in "forms, instructions, or other appropriate guidance including regulations and letter rulings."[40] In this respect, the proposed regulations add frustratingly little.

Question 8: Married Homeowners

The 97 Act changes impacting married homeowners, which are probably the most complex,[41] are discussed below. If a husband and wife file a joint return for the year of sale, they may exclude up to $500,000 in gain. However, the exclusion is contingent on the following: (1) *either* spouse meets the two year *ownership* requirement; (2) *both* spouses meet the two year *use* requirement; *and* (3) *neither* spouse excluded gain from a prior sale or exchange of property under Code § 121 within the last two years.[42]

Newly Married Homeowners

If one of a newly married couple owned a home prior to the marriage, the above paragraph suggests that the couple may need to wait at least two years after marriage to qualify for a full $500,000 exclusion on a sale of the home. Otherwise, the maximum limitation amount to be claimed by the couple will be the sum of each spouse's limitation amount determined on a separate basis as if they had not been married (a maximum of $250,000).[43] This is confirmed in Example three of the proposed regulations.[44]

If both prospective spouses own separate homes at the time of the marriage, there are several possibilities. First, if each spouse has owned and used his or her respective home for the required two-year period, both homes could be sold immediately, and up to a $250,000 exclusion could be claimed by each spouse on his or her respective home. This is demonstrated in Example two of the proposed regulations.[45] Even if one of the spouses sold his or her home and claimed the exclusion prior to marriage, the other spouse could still sell his or her home during the marriage and claim up to a $250,000 exclusion.

Second, if each spouse has owned a home to be sold and one of the homes has not been held for the requisite two-year period, it would seem that (at least from an income tax perspective) the residential use should continue on the home that has not been held for the full two years, and the other should be sold. Third, if each spouse has owned a home to be sold and if a $500,000 exclusion is sought on one home, the $250,000 exclusion home should be sold first, and the $500,000 home should be sold two years later (so that both spouses have two years of use and it is more than two years after the sale of the first home).

Fourth, if each spouse has owned a home to be sold and if a $500,000 exclusion is sought on both, the holding and use rules described above would complicate matters for the married couple. In this situation, both homes would need to be held another two years to meet the use requirement, and both spouses would need to prove that each home was a primary residence. The spouses would need to focus on one home, establishing joint use of it for two years, before selling the home. The spouses would then move into the other home, establishing joint use of it for two years and simultaneously permitting two years to lapse since the joint sale of the other home. The possibility of exempting $500,000 in gain from each home (for a total of $1 million) at even a 20 percent capital gains rate (plus any Colorado income taxes) could be a tempting reward for such inconvenient living arrangements.

Death of a Married Taxpayer

Examples four and five[46] are applicable to a married couple that has met the ownership and use requirements, but what happens if one spouse then dies and the survivor sells the home later in the same year? The examples conclude that the survivor and the executor may file a joint return to claim an exclusion of up to $500,000. However, if the survivor sells in a later year (not filing a joint return with the decedent), the survivor is eligible for an exclusion of up to only $250,000. On the other hand, while a sale in a later year may be eligible only for up to a $250,000 exclusion, the survivor, if still unmarried, can tack on the ownership and use history of the deceased as the survivor's own ownership or use. For example, a newly married but then newly widowed spouse could add the ownership and use time accumulated by the decedent.[47] This latter provision was already in the 97 Act statute; therefore, the proposed regulations in this instance add no substantive law.[48]

Although the proposed regulations suggest that a sale in the same year can be advantageous for a highly appreciated home, if the decedent passed away late in the taxable year, such a sale may not be feasible. In addition, the surviving spouse would need to consider the implications of the manner in which the property was titled and the role of the "at death" basis adjustment.[49]

Dissolution of Marriage

If the divorcing homeowners are comfortable with remaining married and filing a joint income tax return for the year of the sale, the $500,000 exclusion under the married homeowner rules could be available. However, practical realities (such as unwillingness to sign a joint tax return or inability to cooperate on a joint sale) may dictate a sale of the home only after the divorce, or only one of the spouses may retain the home (for example, to provide a regular home for dependent children).

If a taxpayer obtains property from a spouse or former spouse in a transaction that falls within the nonrecognition provisions of Code § 1041,[50] the period that the taxpayer owns the property will include the period that the spouse or former spouse owned the property.[51] Furthermore, a taxpayer is treated as using property as the taxpayer's principal residence for any period that the taxpayer has an ownership interest in the property and the taxpayer's spouse or former spouse is granted use of the property under a divorce or separation instrument, provided that the spouse or former spouse uses the property as a principal residence.[52] This provision also was included in the 97 Act and is explained in the proposed regulations.[53]

Accordingly, in a sharp break with prior law, if the nonresiding spouse and his or her former spouse jointly own the residence and agree to sell the family residence only after the children have been emancipated, the nonresiding spouse may still qualify for the exclusion. In addition, because the transferor's ownership period is extended to the transferee in a Code § 1041 transfer, there is a tax incentive to convert sole ownership of a family residence to joint ownership.

This is true if the total appreciation exceeds the $250,000 exemption that would apply to a subsequent sale of the home by either of the divorcing couple as an unmarried seller of the entire property. Furthermore, if one of the divorcing spouses retains sole ownership of a highly appreciated residence, remarriage can present the opportunity for a $500,000 exemption for the new household, provided that the new spouse meets the two-year use requirement and has not used the exclusion within the two years prior to the sale, as discussed above.

Bankruptcy

The proposed regulations resolve a controversy in the bankruptcy courts as to whether the bankruptcy estate of an individual taxpayer can claim the Code § 121 exclusion.[54] The proposed regulations add Regulation 1.1398-3, which generally provides that the bankruptcy estate of an individual can claim the benefits of Code § 121 on a sale of the taxpayer's personal residence.[55]

Question 9: Use of the Residence for Profit-Seeking Activities

If the taxpayer has previously claimed depreciation deductions on the residence, rented the residence, or used the residence for other business purposes, such as a home office or storage space, a number of issues are raised. These are discussed below.

Recognition of Gain Attributable to Depreciation

The statute provides that the exclusion shall not apply to "so much of the gain from the sale of any property as does not exceed the portion of the depreciation adjustments . . . attributable to periods after

May 6, 1997, in respect of such property."[56] Initially, it appears that this is simply a recapture provision. Congress does not want taxpayers to claim depreciation expense deductions and later exclude the gain created by the downward basis adjustment. If this were the only consequence, it would seem that the statute presents no significant mischief. However, the nature of the activity that produced the depreciation adjustments could jeopardize the overall applicability of Code § 121. That issue is discussed below in the context of rental and business use of a residence.

Rental Use of the Residence

While depreciation adjustments claimed for rental activity will be subject to the rule described in the preceding paragraph, the rental activity itself will not preclude the use of the exclusion if the taxpayer otherwise has met the two-year ownership and use requirements.[57] In Example one[58] the taxpayer owned and used his house as a principal residence since 1986. On January 1, 1998, he moved to another state, leasing his house from that date until April 18, 2000, when he sold it. The regulation concludes that the taxpayer can use the Code § 121 exclusion because he owned and used the house as his principal residence for at least two years out of the five years preceding the sale.

Example six[59] demonstrates the reverse situation. On July 1, 1999, the taxpayer moved into a house that he had owned and rented to tenants since July 1, 1997. The taxpayer took depreciation deductions totaling $14,000 for the period that he rented the property. After using the property as his residence for two full years, the taxpayer sold the property on August 1, 2001. The taxpayer's gain realized on the sale was $40,000. However, only $26,000 ($40,000 gain realized minus $14,000 depreciation deductions) may be excluded under Code § 121.

While moving into rental property more than two years prior to sale will not exempt gain to the extent of past (but post-May 6, 1997) depreciation deductions, other economic appreciation in the property is purged. However, if an owner wants to sell rental property, the following options are available: (1) an owner of one or several fully depreciated rental properties can exchange it or them for a single, more expensive house using a Code § 1031 like-kind exchange,[60] rent the replacement house long enough to be considered an investment property for Code § 1031 purposes, and then convert it to a principal residence eligible for the exclusion; (2) taxpayers could simply gift selected rental properties to their children for their use as principal residences; or (3) using Code § 1031, a taxpayer could exchange the currently owned rental properties for different homes, hold them as an investment for a period, and ultimately gift the replacement homes to the children.[61]

Business Use of the Residence

The use of a portion of a residence for business purposes (for example, the home office, workshop, or storage area) alongside personal use can produce unfavorable income tax results. The IRS takes the position that the portion of the home used for business purposes during the qualifying use period does not qualify as a principal residence, and the gain attributable to that portion must be recognized.

Examples eight and nine[62] of the proposed regulations demonstrate this principle, but Example eight is most dramatic. The taxpayer purchased a house in

1998. For five years the taxpayer used a portion of the property for business purposes, claiming depreciation deductions of $20,000 for the business use. The taxpayer sold the property in 2003, realizing a gain of $50,000, $35,000 of which was allocable to the residence portion and $15,000 was allocable to the business portion.

The regulation concludes that the taxpayer must recognize, without the benefit of Code § 121, the $15,000 allocable to the business portion. Moreover, because the post-May 6, 1997, depreciation of $20,000 exceeded the $15,000 gain that was recognized on the business-use portion of the residence, the $5,000 excess is applied to deny $5,000 of the exclusion applicable to the $35,000 gain on the principal residence portion. The taxpayer is required to recognize $20,000 of gain on the sale of the home.

While some might consider this result to be the product of overreaching on the part of the IRS, it took a similar position in the prior Code §§ 1034 and 121 regulations.[63] For taxpayers who foresaw the tax consequences prior to a sale, a common solution was to cease the claimed deductions for the business use of the property for the year of the sale, such that no portion of the residence was ostensibly being used for business purposes at the time of the sale.[64] The IRS accepted this approach in a ruling addressing Code § 1034.[65] The new statute makes this patch a little more difficult because the taxpayer must abstain from business use for two full years of the five years preceding the sale.

Question 10: Destruction Or Condemnation

If a client's personal residence is destroyed or condemned and the client plans not to completely rebuild or replace the original property, practitioners are faced with the overlap of Code §§ 121 and 1033 (dealing with the replacement of property that is involuntarily converted). Generally, Code § 121 is applied first. Code § 1033 then applies to any insurance or condemnation proceeds in excess of the Code § 121 exclusion. The proposed regulations provide several valuable examples of the application of these provisions that should be reviewed by attorneys faced with extraordinary events of this nature.[66]

Planning at the Limits

Some taxpayers are reportedly concerned that the $250,000/$500,000 exclusion is not adequate for the following: (1) residences with basis figures already eroded by prior Code § 1034 rollovers; (2) expensive residences where even a 5 percent per year appreciation rate produces a substantial sum; and (3) residences in particularly buoyant real estate markets. One solution is to turn over the principal residence more frequently, but that produces some personal dislocation. For some homeowners, the potential tax basis adjustment on death can be a consideration.[67] Nevertheless, permanent exclusions, such as Code § 121, probably invite more aggressive planning than the former rollover regime, and some possible techniques are briefly discussed in the next sections.

Sales to Related Parties

There could be some promise in selling residences between related individuals. The statute and the proposed regulations place limitations on related party sales in terms of the sales of remainder interests. However, there are no stated limitations on broader applications.[68] Nevertheless, transactions lacking substance could be subject to IRS scrutiny[69] and the possible imposition of a gift tax if bargain prices are used.[70]

Use of the Elective Recognition Provision

In the overall 1997 tax legislation, Congress provided a transitional rule that permits taxpayers to recognize the gain inherent in property as of January 1, 2001, thereby starting a new holding period for purposes of the new post-2001 reduced long-term capital gains rate of 8 percent or 18 percent. This provision is not found in the Code, but is found in § 311(e) of the 97 Act. The literal language of the election suggests that a taxpayer can treat a capital asset, such as a home, as being sold at its fair market value as of January 2, 2001, with the adjusted basis of the residence becoming its fair market value on that date.

Unlike repealed Code § 1034, which operated as a gain *nonrecognition* provision, new Code § 121 is structured as an *exclusion* from gross income of certain gain otherwise recognized on the sale or exchange of a principal residence. The technical (and more uncertain) argument is that the exclusion language of Code § 121 can therefore operate to override the language of 97 Act § 311(e)(2)(A) (while still producing an increase in the home's adjusted basis to fair market value), which states: "Any gain resulting from an election . . . shall be recognized notwithstanding any provision of the Internal Revenue Code of 1986." This surely is an unintended consequence, but the proposed regulations do not address it. Practitioners should check whether the final regulations address this apparent loophole.[71]

Conclusion

The amended 97 Act likely is an improvement over Code § 1034 because it probably has fewer traps. Nevertheless, it requires its own fair share of technical maneuvering. The proposed regulations do provide some guidance in this area and demonstrate some interesting twists, such as the nonconcurrent use rules. However, in the author's view, the final regulations require some additional changes, such as addressing amended return elections, employment/health moves, unforeseen circumstances, and the January 1, 2001, gain recognition election. The IRS announced that it has placed the proposed regulations on its priority list for 2001. Accordingly, practitioners should expect further developments in this area.

NOTES

1. IRC § 163(h)(1). The Taxpayer Relief Act of 1997 ("97 Act") reinstated a limited deduction for interest on education loans. *See* IRC § 221.

2. The aggregate amount treated as acquisition indebtedness for any period shall not exceed $1 million ($500,000 in the case of a separate return by a married individual). *See* IRC § 163(h)(3)(B)(ii). However, a taxpayer may be able to treat up to $100,000 of the excess on a first mortgage as deductible home equity indebtedness under IRC § 163(h)(3)(C). *See* Notice 88-74, 1988-2 C.B. 385; *John L. Seymour v. Comm'r*, 109 T.C. 279 (1997).

3. A common tax planning structure is to repay nondeductible interest-bearing consumer debt on credit cards and automobiles using a home equity loan that meets the $100,000 second mortgage requirements of IRC § 163(h)(3)(C). In computing the alternative minimum tax, however, the interest deduction for home equity mortgages is essentially disallowed. *See* IRC §§ 56(b)(1)(C)(i) and 56(e).

4. IRC § 461(g). Rev. Proc. 94-27, 1994-1 C.B. 613 states the IRS position on when points are deductible.

5. IRC § 164(a)(1). However, in computing the alternative minimum tax, the real property tax deduction is disallowed. *See* IRC § 56(b)(1)(A)(ii).

6. Arellano, "Savvy Homeowners Can Drop Mortgage Insurance," *The Denver Post* (Mar. 25, 2001) at K4.

7. Several other asset classes enjoy partial or total exclusions of gain. *See* IRC § 1202 (certain corporate stock); § 1400B (DC Zone assets). Although legislation is perennially intro-

duced to correct this problem, losses on the sale of a principal residence are not deductible from income. Treas.Reg. § 1.165-9(a).

8. Pub.L.No. 105-34, §§ 312(a), 312(b), 111 Stat. 836 (1997).

9. Pub.L.No. 105-206, § 6005(e)(1) and (2), 112 Stat. 741 (1998).

10. Thirteen witnesses appeared at a public hearing held on January 23, 2001, and the proposals may be modified before they are finalized, which may be in 2001. *See* Hembera, Jr., "Witnesses Urge Modification of Proposed Residence Sale Regs.," *Tax Notes Today* (Jan. 24, 2001).

11. Occasionally, the preamble to proposed regulations will state that a taxpayer can rely on the proposed regulations until final regulations are issued. These proposed regulations do not make such a statement, except for the portion applying to bankrupt taxpayers. The proposed regulations are stated to be effective for sales or exchanges that occur on or after the date they are published as final regulations. It has been observed that proposed regulations, as a general matter, are not authoritative. *See, e.g.*, Tech. Adv. Mem. 9651005 (Dec. 20, 1996); *Garvey, Inc. v. U.S.*, 726 F.2d 1569 (Fed.Cir. 1984). On the other hand, the Tax Court has occasionally declined to follow proposed regulations to the taxpayer's benefit. *See, e.g., John E. Greene v. Comm'r*, T.C. Mem. 1988-331. Nevertheless, a taxpayer may point to proposed regulations as "substantial authority" to counter the imposition of a penalty. *See* Treas.Reg. § 1.6662-4(d)(3)(iii).

12. 65 Fed.Reg. 60,136 (Oct. 10, 2000) (proposed regulations); 66 Fed.Reg. 14,512 (March 13, 2001) (minor corrections); www.irs.gov (click on "Tax Regs in English"); www.nara.gov/fedreg/index.html (click on "Online Publications via GPO Access"); www.access.gpo.gov/su_docs/aces/aces140.html.

13. If a sale occurred prior to August 5, 1997, a taxpayer could elect to apply the old rules. Further, if the taxpayer was under a binding contract to sell the property, a replacement property had already been acquired, or the taxpayer was under a binding contract to acquire a replacement property, the taxpayer could elect to apply the old rules.

14. "[Taxpayers] felt compelled to reinvest in a more expensive home." Hymel, "The Population Crisis: The Stork, The Plow and the IRS," 77 *N.C. L.Rev.* 13, 114 (1998). "[T]he rollover rule created a powerful incentive for home sellers to buy up to qualify for tax deferral." Klein, "A Requiem for the Rollover Rule: Capital Gains, Farmland Loss, and the Law of Unintended Consequences," 55 *Wash. & Lee L.Rev.* 403, 405 (1998). The legislative history of the 1997 legislation echoed this point. "[P]resent law encourages some taxpayers to purchase larger and more expensive houses than they otherwise would in order to avoid a tax liability, particularly those who move from areas where housing costs are high to lower-cost areas." Committee on Ways and Means Report, *reprinted in* 1997-4 C.B. 607, 669 ("House Report").

15. The legislative history observed that the $125,000 exclusion "may discourage some older taxpayers from selling their homes. . . . By raising the $125,000 limit and by allowing multiple exclusions, this constraint to the mobility of the elderly would be removed." House Report, *supra*, note 14 at 669. Amended IRC § 121 addresses some specific elder taxpayer issues. For example, if a taxpayer owns a home and uses it as a principal residence for at least one year, then residence in a nursing home (if occasioned by physical or mental incapability of self-care) can be treated as use of the principal residence by the taxpayer. IRC § 121(d)(7). Further, if a taxpayer sells a remainder interest in a principal residence to other than certain related persons, the exclusion can apply. IRC § 121(d)(8).

16. IRC § 1034(e).

17. "By excluding from taxation capital gains on principal residences below a relatively high threshold, few taxpayers would have to refer to records in determining income tax consequences of transactions related to their house." House Report, *supra*, note 14 at 669.

18. The 1997 legislation also amended IRC § 6045(e) by adding paragraph (5), which provides that if the selling price is $250,000 or less, no reporting is necessary if the closing agent receives "written assurance" in a form acceptable to the IRS from the seller that such residence is the principal residence of the seller, and the full amount of the gain is excludable from gross income under IRC § 121. If the assurance includes information that the seller is married, the $250,000 condition is increased to $500,000. The IRS gave further information as to what is "written assurance" in Announcement 97-106, 1997-45 I.R.B. 11 (Nov. 10, 1997). An interesting issue is what income tax return disclosures, if any, should be made by a taxpayer who reasonably believes that the exclusion applies, but it is not absolutely certain of that. Some witnesses at the IRS hearing on the proposed regulations stated that "practitioners would like the IRS to provide a specific form that can be used to report the exclusion." *See* Goldwyn, "Tax Exclusions: Witnesses on Sale of Residence Tell IRS to Broaden Rules on Use, Partial Exclusions," *Bureau of National Affairs Daily Tax Report* (Jan. 24, 2001).

19. "A property used by the taxpayer as the taxpayer's principal residence may include a houseboat, a house trailer, or stock held by a tenant-stockholder in a cooperative housing corporation. . . . Property used by the taxpayer as the taxpayer's principal residence does not include personal property that is not a fixture under local law." Prop. Treas.Reg. § 1.121-1(b).

20. Prop. Treas.Reg. § 1.121-1(b).

21. *Id.* This is consistent with the IRS position in interpreting IRC § 1034, in which time was the most determinative factor. *See, e.g.*, Rev.Rul. 77-298, 1977-2 C.B. 308 ("a taxpayer may have only one principal residence at any one time. . . . [T]he property that the taxpayer occupies a majority of the time will ordinarily be considered the taxpayer's principal residence.").

22. If the proposed regulations, denoted Prop. Treas.Reg. §§ 1.121-1 through 1.121-4, are finalized, they will revise the existing regulations at Treas.Reg. §§ 1.121-1 through 1.121-4 in their entirety and delete existing Treas.Reg. § 1.121-5.

23. Prop. Treas.Reg. § 1.121-1(f).

24. *Id.*

25. *See* IRC § 121(b)(3).

26. The proposed regulations leave open the highly factual issue of the boundaries of a principal residence in terms of acreage and water rights, a significant issue for resident farmers, ranchers, and large estate owners. *See generally* Daughtrey, Messina, and Harris, "How Much Acreage Can be Included under the New Sale of Principal Residence Rules?" 90 *J. Tax'n* 294 (1999); Megaard and Megaard, "Reducing Taxes on the Disposition of a Personal Residence with Acreage," 20 *J. Real Est. Tax'n* 269 (1993).

27. Prop. Treas.Reg. § 1.121-1(c).

28. IRC § 121(a).

29. "Read together, the regs appear to hold that someone may live in a property for 730 days (two years) as a residence over a five year period by residing for 150 days each year. However, unless he or she has no other residence that he used more often each year, the residence would not be the principal residence and the test under the regs would not be met." Editor, "IRS Expands Rules on Exclusion of Principal-Residence Gain for Short Period Ownership/Use," *Standard Federal Tax Reports—Tax-*

es on *Parade*, Vol. 87, No. 43, Report 43 (Oct. 12, 2000).

30. Prop. Treas.Reg. § 1.121-1(c).

31. Goldwyn, *supra*, note 18.

32. Prop. Treas.Reg. § 1.121-1(f).

33. *Id.*

34. Prop. Treas.Reg. § 1.121-1(f).

35. IRC § 121(e).

36. Prop. Treas.Reg. § 1.121-4(h). It is hoped that the final regulations will specifically add clarifying language after "return" stating "including an amended return."

37. IRC § 121(c)(2).

38. IRC § 121(c)(1).

39. Prop. Treas.Reg. § 1.121-3(a).

40. *Id.* At the public hearing on January 23, 2001, the testimony was mixed regarding the shape that the unforeseen circumstances exception should take. Some of the suggested events included loss of job, significant cut in pay, death of a co-owner or co-occupant, health changes of a nonowner or family member not in the household, fear of harassment or physical harm because of neighborhood demographics, and change in local laws that would affect the taxpayer's customary lifestyle. *See* Hembera, Jr., *supra*, note 10.

41. Prior law permitted unmarried co-tenants each to apply IRC §§ 1034 or 121, and the same treatment should apply to the new statute. *See, e.g.*, Rev.Rul. 67-235, 1967-2 C.B. 79 (brother and sister who jointly owned property could each use IRC § 121 on their shares of the sale proceeds).

42. Prop. Treas.Reg. § 1.121-2(b).

43. Prop. Treas.Reg. § 1.121-2(b)(2).

44. Prop. Treas.Reg. § 1.121-2(b)(3). The IRS Restructuring and Reform Act of 1998 added a new IRC § 121(b)(2)(B) that specifically clarified this point.

45. *Id.*

46. *Id.*

47. Prop. Treas.Reg. § 1.121-4(a).

48. IRC § 121(d)(2).

49. *See* IRC § 1014 (generally producing an adjusted basis of property included in a decedent's taxable estate equal to the fair market value of the property at date of death or alternate valuation date); IRC § 2040(b) (providing that half of a spousal joint tenancy is included in the decedent's estate and is therefore eligible for IRC § 1014 adjustment); *compare*, the *Gallenstein v. U.S.*, 975 F.2d 286 (6th Cir. 1992) line of cases, which may produce a different result for joint tenancies created prior to the amendments to IRC § 2040. The new tax legislation signed by President Bush on June 6, 2001, however, would limit the at death adjustment to basis for individuals dying after 2009.

50. Code § 1041 generally provides that no gain or loss shall be recognized on a transfer of property from an individual to: (1) a spouse; or (2) a former spouse (but only if the transfer is incident to divorce). Such transfers are essentially treated as nontaxable gifts for income tax purposes. *See* Hembera, *supra*, note 10; House Report, *supra*, note 14; *infra*, note 70.

51. Prop. Treas.Reg. § 1.121-4(b)(1) (already in the 1997 statute). IRC § 121(d)(3)(A).

52. Prop. Treas.Reg. § 1.121-4(b)(2).

53. IRC § 121(d)(3)(B).

54. *See, e.g., In Re Bradley*, 245 B.R. 533 (M.D. Tenn., Feb. 22, 1999). According to the preamble of the proposed regulations, the IRS acquiesced in the case's result and will not challenge it in other cases pending the effective date of the proposed regulations.

55. There are other "entity" issues not addressed by the proposed regulations. For example, the IRS had previously ruled that grantor trusts holding the principal residence of a beneficiary could qualify for the home sale exclusions. With the use of the revocable or living trust for estate planning purposes, this is an important issue. *See, e.g.*, Rev.Rul. 66-159, 1966-1 C.B. 162; Rev.Rul. 85-45, 1985-1 C.B. 183 (marital deduction trust).

56. IRC § 121(d)(6).

57. The law under old IRC § 1034 could be complex in this regard. *See, e.g., Bolaris v. Comm'r*, 776 F.2d 1428 (9th Cir. 1985).

58. Prop. Treas.Reg. § 1.121-1(f).

59. *Id.*

60. For an explanation of the mechanics of IRC § 1031 like-kind exchanges, *see* Walker, "Real Estate Exchanges in the 1990s: Lessons from the Front," 25 *The Colorado Lawyer* 3 (March 1996) at 1.

61. The use of IRC § 1031 can be perilous in a transaction without much substance in terms of the established investment use and marked by a transparent gifting plan. *See, e.g., Wagensen v. Comm'r*, 74 T.C. 653 (1980) (taxpayer prevailed); *Click v. Comm'r*, 78 T.C. 225 (1982) (IRS prevailed).

62. *Id.*

63. *See* Treas.Reg. §§ 1.1034-1(c)(3)(ii) and 1.121-5(e). *See, e.g., Aagaard v. Comm'r*, 56 T.C. 191 (1971) (permitting use of IRC § 1034 with respect to one unit of a rental four-plex).

64. A taxpayer might still be considered to use a property for business purposes even if the taxpayer does not claim the associated expenses such as depreciation, allocable repairs, and utilities. The safer route is actually to find somewhere else to run the business. However, in a case under the prior statute, the court found that the use of a personal residence basement to store building tools and materials was "too insignificant" on the facts to make an allocation to business use. The taxpayer had not claimed depreciation deductions with respect to any part of the home. *Grace v. Comm'r*, T.C. Mem. 1961-252.

65. *See* Rev.Rul. 82-26, 1982-1 C.B. 114.

66. Prop. Treas.Reg. § 1.121-4(d).

67. *See* note 49, *supra*.

68. IRC §121(d)(8)(B); Prop. Treas.Reg. § 1.121-4(f)(2)(ii).

69. A parent's outright sale of a personal residence to a child should be unquestioned. However, if sales are based on an understanding that personal residences will be later swapped or one will be sold back to the parent at a later time (such that the full benefits of appreciation or unfettered ownership might not fully accrue to the child) or the parent defrays the child's expenses of holding the property (such that the child does not bear the full burdens of ownership), it could raise the issue of whether a sale really occurred for tax purposes or whether this is simply, in substance, the shuffling of real estate titles. For a general discussion of the substance-over-form and sham doctrines, *see* Bittker and Lokken, *Federal Taxation of Income, Estates and Gifts*, Vol. 1 (Boston, MA: Warren, Gorham & Lamont, 1999) at ¶ 4.3.3.

70. Sales between spouses are problematic because IRC § 1041 treats the transaction as a gift, not as a sale. *See* note 50, *supra*. Two Private Letter Rulings interpreting IRC § 1034 permitted the sale of principal residences to corporations wholly owned by the taxpayers. *See* Priv. Ltr. Ruls. 8350084 and 8946021. An immediate problem is that the corporation would not qualify for the IRC § 121 exclusion on its subsequent resale of the residence.

71. The regulation must be considered an implementation of the congressional mandate in a reasonable manner. *See, e.g., U.S. v. Correll*, 389 U.S. 299 (1967). The Supreme Court's enthusiasm for loophole closing in the face of literal IRC language has recently been quite restrained. *See, e.g., David A. Gitlitz v. Comm'r*, 531 U.S. 206 (2001). ■