

§121 and Personal Residences Recent Developments

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Topics to Be Covered

- Final Regulations—All Issues Except Prorated Gain
- Proposed and Temporary Regulations on Prorated Gain
- Case law: *Guinan* case

Opportunities and Traps

- New rules give us many ways to serve our clients and reduce their tax burden
- However, there are also a number of potential traps, where tax could have been avoided under §121 had proper steps been taken

Home Sale Rules

- Prior to 1997, Two Rules
 - §1034 Replacement Deferral Rule
 - No limit on amount deferred
 - Had to reinvest proceeds
 - §121 Once in a Lifetime Exclusion
 - Had to meet age and use tests
 - Amount of exclusion limited
 - No reinvestment required

1997 Tax Act and Home Sales

- Repeal of §1034
- Expansion of §121
 - No age limit
 - Gain exclusion raised to \$250,000 (\$500,000 for joint filers)



Basic Provisions of §121

- Exclude up to \$250,000 of gain (\$500,000 on a joint return) for qualified sale
 - Own the property and use it as principal residence for 2 years of 5 years prior to sale
 - No other exclusion in two years prior
- If fail above might qualify for prorated gain
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Prorated Gain (§121(c))

- Failure due to:
 - Ownership and use requirement or
 - Had another excluded sale in two years prior
- Qualify for proration if sale due to
 - Change of place of employment
 - Health
 - *To extent provided in regulations, unforeseen circumstances*

Special Rules

- Use and ownership by spouses and former spouses
- Taxpayers in long term care facilities
- Remainder interests
- Beginning in 2010, for property acquired from estates
- Depreciation

Depreciation—Old Law §1034



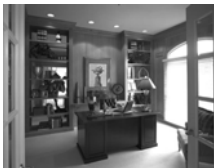
- No business use at time of sale no recapture
- Otherwise, prorated §1231 gain
- Disqualify under §280A in final year

Depreciation—Old Law §121



- Still had a 5 year test period
- If business use for more than 3 years, partial gain exclusion only (Old §121(d)(5))

Depreciation—New §121(d)(6)



- §121(a) does not apply to any depreciation taken after May 6, 1997
- Unanswered questions about application

IRS Guidance

- Had informal guidance from 1997 until late 2002
- Proposed regulations eventually issued, but not temporary regulations
- Limited guidance related to sales due to September 11, 2001 terrorist attacks and “unforeseen circumstances” rule

December 24, 2002 Regulations

- Final Regulations except for prorated gain factors under §121(c)
- Temporary and Proposed Regulations for §121(c) factors



December 24, 2002 Regulations

- Generally were a Christmas gift
- Most changes were taxpayer friendly changes
- Especially true in business use area



Definition of Principal Residence

- Regulation §1.121-1(b) defines a principal residence
- Can be any of the following:
 - Houseboat
 - House trailer
 - Co-op house or apartment



Multiple Residences

- By definition, can only have one "principal" residence at a time
- General rule of the final regulations: where taxpayer spends the largest portion of the year will be the taxpayer's principal residence for that year
- Specifically rejected day by day test

Multiple Residences

- However, other factors can also influence the finding
 - Place of employment
 - Where family members live
 - Address on tax returns, drivers license, auto registration and voter registration
 - Where bills and correspondence go to
 - Banks, religious organizations, clubs

Multiple Residences

- *Guinan* case decided in April of this year
- Illustrates trade-offs you should make client aware of



Guinan Case

- Sold Wisconsin house at a substantial gain
- Attempted to treat as principal residence on 1040X
- Lost in court



Guinan Case Facts

- Had residences in Arizona and Wisconsin
- Also had a previous residence in Georgia in the five year testing period
- Over the past five years had spent more time in the Wisconsin residence than any other

Guinan Case Facts

- Additional Factors in Guinans' favor
 - Wisconsin residence was much larger than either the Arizona or Georgia residence
 - Served on board of Wisconsin homeowners' association
 - Returned to Wisconsin in winter for major holidays and for Green Bay Packers games

Guinan Case Facts

- However, there were some problems
 - Only one year spent more time in Wisconsin home than any other
 - Filed as Georgia, then Arizona residents and never filed a Wisconsin income tax return in the five years
 - Registered to vote in Georgia, then Arizona

Guinan Case Facts

- Even more problems...
 - Had Georgia, then Arizona drivers licenses, but no Wisconsin driver's license
 - Deferred gain on sale of Georgia residence under §1034, and claimed the Arizona residence was the replacement

Lessons from Guinan

- The problem of planning via current year only
 - 1997 Maximum Wisconsin rate: 6.93%
 - 1997 Maximum Arizona rate: 5.17%
- Importance of "smell test"
- Will have difficulty if amending to identify a different residence as principal
- Counsel clients on new tests

Vacant Land Rule §1.121-1(b)(3)

- Can combine sale of land and home if
 - Adjacent to dwelling
 - Owned as part of principal residence
 - Sell residence within 2 years and meet all §121 requirements
 - Land sale itself meets §121



Two Year Periods for Ownership and Use

- Two options
 - Show 24 full months or
 - 730 days
- No need for concurrency
- Inheritance/gift opportunity



Taxpayer in Care Facility Regulation §1.121-1(c)(2)(ii)

- Time in care facility counts as use if
 - Facility licensed
 - Must spend at least one year out of prior five actually living in the residence



Taxpayer in Care Facility Regulation §1.121-1(c)(2)(ii)

- Essentially have four years to sell
- However, if miss that still consider possibilities under §121(c) for reduced exclusion



**Ownership by Entities
Regulation §1.121-1(c)(3)**

- Entities that can hold in addition to an individual
 - Grantor trusts under IRC §§671-679
 - Ignored single owner entities under Regulation §301.7701-3
- Other entities will not generally qualify
 - Trusts that are not grantor trusts
 - Partnerships

**Business Usage and Gain
Regulation §1.121-1(d)**

- Key question: Did Congress intend for §121(d)(6) to be the sole tax imposed on business use or does the old usage analysis still apply?
 - First view is that Congress liberalized the law, primarily looking at old §121
 - Second view sees this as a “loophole closer” to remove the “disqualify in final year” out

**Business Usage and Gain
Regulation §1.121-1(d)**

- In initial proposed regulations and informal guidance, IRS suggested the first view
- Portion used for business under §280A was not used as a principal residence and, therefore, not eligible for §121(a)
- Rather, a prorated portion of gain was §1250 and §1231 gain

**Business Usage and Gain
Regulation §1.121-1(d)**

- IRS generally reverses position in final regulations
- Can defer all but post May 6 depreciation as long as office part of the “dwelling unit”
- If not part of dwelling unit, then have to prorate the sale between business and nonbusiness portion

**Business Usage and Gain
Regulation §1.121-1(d)**

- Note that separate dwelling units are treated more liberally under §280A
- Another trade-off here—qualify for better §280A treatment and pay tax on appreciation when selling
- See example in regulations for what happens if you change from a separate dwelling unit

**Married Couples
Regulation §1.121-2(a)**



- Joint Return \$500,000 exclusion
- Only one spouse need meet ownership test
- Both must meet use test

**Married Couples
Regulation §1.121-2(a)**



- If don't meet tests, limit is then total of each one's separate exclusion
- Check for §121(c) partial relief for non-qualifying spouse

**One Exclusion Every Two Years
Regulation §1.121-2(b)**

- Limited to one exclusion every two years
- However, see Regulation §1.121-4(g) for option to retroactively revoke application of §121(a) to prior sale or to remove an election out
- Will need to run the numbers to see which sale is the one you should exclude

**Computation of Prorated Gain
Regulation §1.121-3(g)**

- Only final portion of the regulations under §121(c)
- Can use either number of days (730 as denominator) or number of months (24 as denominator) to prorate
- Temporary regulations deal with qualifying for this proration

**Divorced Spouses
Regulation §1.121-4(b)**

- Property acquired from former spouse in divorce
 - Ownership period of former spouse counts
 - Must still satisfy use test



**Divorced Spouses
Regulation §1.121-4(b)**

- Property used by former spouse
 - Count ex-spouse's use for use test
 - Must be part of divorce or separation agreement per §71(b)(2)



**Divorced Spouses
Regulation §1.121-4(b)**

- Property used by former spouse
 - Can into an “once every two years” problem
 - Run numbers to see if taxpayer should elect out of first sale
 - Any §121(c) help?



Involuntary Conversions under §1033

- Involuntary conversion is a sale
- Gain excludable under §121 reduces amount considered realized for purposes of §1033
- If basis of converted property is computed in whole or part by reference to §1033(b), then ownership and use period “tack on” for §121 purposes

Sale of Partial Interests Other Than Remainder Interests

- §121 applies to such sales
- \$250,000/\$500,000 limitation applies to aggregate of all sales of partial interests in a particular property
- Spouse on joint return deemed to have used ½ of exclusion used in such sale
- Modification to once every two years rule

Sale of Remainder Interests Regulation §1.121-4(e)(2)

- Can elect to apply §121 unless sold to certain related parties
- If elected, *no other exclusion will be available when selling any other interest in the property*
- Election made by simply not reporting the gain
- Note the potential trap here

Sales Before December 24, 2002



- Can elect to retroactively apply these regulations
- Audit protection for “reasonable, good faith effort” to comply for prior sales

Sales Before December 24, 2002



- If you followed the old proposed regulations, you generally are considered to have made the good faith effort

Sales Before December 24, 2002



- Note that you may need to amend previously filed returns to claim refunds under these regulations (especially for business use)

Temporary and Proposed Regulations Under §121(c)(2)

- IRS did not finalize guidance for the circumstances that trigger a prorated gain
- Identical temporary and proposed regulations were issued with the remainder of the regulations under §121

Qualifying Individuals



- Special definition that applies to the exceptions
- Need to be in this class to have the "event" qualify

Qualifying Individuals



- Taxpayer
- Spouse
- Co-owner of residence
- Person with place of abode in same household

Additional Individuals for Health Related Exception



- Relationship described in §152(a)(1) through 152(a)(8) even if not a dependent and
- Descendant of grandparent

Health Related Move Relationship List

- Son or daughter, or descendant of either
- Stepson or stepdaughter
- Brother, sister, stepbrother or stepsister
- Father or mother, or ancestor of either
- Stepfather or stepmother
- Son or daughter of a brother or sister
- Brother or sister of father or mother

Health Related Move Relationship List

- Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law
- Previously mentioned descendant of grandparent
- Remember, this additional list *only* works for the health exception, and not for any other

Employment Safe Harbor Regulation §1.121-3T(c)

- Change of employment occurs during period of ownership and use of the property
- Meet 50 mile test



50 Mile Test

- New place of employment 50 miles farther from residence sold than was former place of employment or, if no former place of employment
- Distance between individual's new place of employment and residence sold is at least 50 miles
- Note difference from moving expense

What is Employment?

- Commencement of employment with new employer
- Continuation of employment with the same employer
- Commencement or continuation of self-employment

Health Safe Harbor Regulation §1.121-3T(d)

- Sale undertaken to
 - Obtain, provide or facilitate the diagnosis, cure, mitigation or treatment of disease, illness or injury of a qualified individual



**Health Safe Harbor
Regulation §1.121-3T(d)**

- Sale undertaken to
 - Obtain or provide medical or personal care for a qualified individual suffering from a disease, illness or injury
- Not just general health and well-being



**Health Safe Harbor
Regulation §1.121-3T(d)**

- Key to link the recommendation to a specific disease, illness or injury and one of the “key” actions—check adequacy of physician’s statement



**Unforeseen Circumstances
Regulation §1.121-3T(e)**

- General qualifying event category
- IRS provided a safe harbor list of items that will qualify for this purpose in the temporary regulation

**List of Unforeseen
Circumstances**

- Involuntary conversion of the residence
- Natural or man-made disasters, acts of war or terrorism that result in a casualty to the residence without regard to deductibility under IRC §165(h)

List of Unforeseen Circumstances

- In the case of a qualified individual (remember, this is the *short* list)
 - Death
 - Cessation of employment and becomes eligible for unemployment compensation
 - Change in employment or self-employment that renders individual unable to pay
 - Divorce or legal separation

List of Unforeseen Circumstances

- In the case of a qualified individual (remember, this is the *short* list)
 - Multiple births resulting from a single pregnancy



List of Unforeseen Circumstances

- Event determined by the Commissioner
 - Published guidance of general applicability (notice, ruling, etc.)
 - Ruling directed to a specific taxpayer
- The last exception indicates you can apply for a private letter ruling on a particular situation

Facts and Circumstances Test Regulation §1.121-3T(b)

- Close time relationship between event and sale or exchange
- Suitability of residence materially changes
- Financial ability materially changes
- Taxpayer actually uses the property as residence during period of ownership

**Facts and Circumstances Test
Regulation §1.121-3T(b)**

- Circumstances giving rise were not reasonably foreseeable when taxpayer began using the property as a principal residence
- Circumstances actually arise during the period of use of the residence
- A number of examples are given

Any Questions?