REACTIONS TO KEMP REPORT P. 605

tax notes℠

Volume 70, Number 5 • Monday, January 29, 1996

SPECIAL REPORTS
- Proposals on Short Against the Box & Other Hedging .. 581
- Problems With Current Law on Sales of Residences .. 589
- Final Rules on Redemption Premiums Abate Dangers .. 597

IRS NEWS
- Disturbing Tale of the Agency's Former Historian 479
- Report Shows Major Problems With Modernization ... 485
- Deadline Passes for Naming Commission on IRS Reform .. 486
- Regs on Nonqualified Deferred Compensation Plans .. 526

POLICY
- Brookings Panel Drills Holes in Kemp Report 487
- Figuring Out the Rate for the Flat Tax 490
- Flat Tax Fever Hits the Internet 491

TAX BILL
- New Plan: Cap. Gains & Child Credit in Debt Bill 492
- Expired Provisions Make for Rough Filing Season 493

COURTS
- Late Breaking: Tax Court Reversed in *Brown Group* .. 478
- Transfers to Trust Included in Gross Estate 553
- Battered Wife Wins Innocent Spouse Relief 555

PRACTICE
- Allocating Individual Tax Deficiency Interest 573

CONFERENCES
- New York Lawyers 'Deconstruct' Treasury Proposals .. 498
- Private Tax Collectors Not Popular at ABA Meeting ... 501
- *UNUM* Will Be Appealed, ABA Tax Section Told 503

COMMENTARY
- The Capital Gains Debate That Wasn't 603
- Policy Specialists Evaluate Kemp Commission Report .. 605

DEPARTMENTS

- Accounting News 576
- Applicable Federal Rates 531
- Benefit News 571
- Bibliography 569
- Calendar 619
- Code Section Index 624
- Congressional Press Releases 563
- Congressional Tax Correspondence 565
- Court Opinions 547
- Economic Perspective 603
- Focus on Congress 563
- Focus on the IRS 531
- Focus on Treasury 519
- IRS Letter Rulings 537
- IRS Litigation Guideline Memos 532
- IRS News 531
- IRS Regulations 525
- IRS Tech Advice Memos 535
- Labor Department Documents 572
- Letters to the Editor 615
- News In Brief 515
- Pension News 571
- Practice News 573
- Press Watch 567
- Special Reports 581, 589, 597
- Summary of Contents 474
- This Week's Tax News 477
- Treasury News Releases 519
- Treasury Reports 519
- Viewpoints 605

CORRECTIONS TO SECTIONS 1034 AND 121: VICTIMS OF THE BALANCED BUDGET

by Sheldon D. Pollack

Sheldon D. Pollack is assistant professor in the Department of Accounting in the College of Business and Economics at the University of Delaware. He is the author of *Revenue and Politics: The Failure of U.S. Tax Policy*, to be published by Penn State University Press in 1996.

In this article, Professor Pollack examines several problems that can arise in attempting to effect a tax-free "rollover" under section 1034 within the context of a pending marriage between individuals who each own a "principal residence" or a divorce involving a division of marital property that includes the former marital residence. Other problems can arise where taxpayers attempt to make use of section 121, which provides an exclusion for $125,000 of gain derived from the sale of a principal residence. These problems would have been resolved under technical corrections included in the Seven-Year Balanced Budget Reconciliation Act of 1995 (H.R. 2491), which was passed by the 104th Congress, but thereafter vetoed by President Clinton. As a result of the president's veto, Pollack explains, these issues will continue to be decided under the case law and IRS rulings discussed in this article. He argues here that these proposed clarifications and corrections represent sound policy measures and should be included in any future technical corrections bill.

Table of Contents

Introduction 589
Section 1034 590
Marriage Penalty Under Section 121 591
Keeping the Marital Residence 592
Rollovers Pursuant to Divorce 592
'Principal Residence' of Separated Spouses? 593
Rollover of Each Spouse's Share of Realized Gain ...595
Miscellaneous Technical Corrections 595
Conclusion 595

Introduction

Section 1034 of the Internal Revenue Code provides an exception to the general rule that gain realized on the sale or exchange of a "principal residence" is recognized under section 1001 and includable in income under section 61. This special tax preference was first adopted by Congress in the Revenue Act of 1951,[1] and has been a staple in the repertoire of tax planning ever since. But even while section 1034 has been a major presence on the tax landscape for nearly 45 years, a number of technical glitches remain in its application — especially when a principal residence is purchased or sold pursuant to a marriage or divorce. Several such technical glitches would have been corrected under provisions included in the Seven-Year Balanced Budget Reconciliation Act of 1995 (H.R. 2491), which emerged from conference committee and was passed by the 104th Congress on November 17, 1995.[2] However, as this massive budget and revenue reconciliation bill was vetoed by President Clinton on December 6, 1995, these issues remain unresolved — presumably, still governed by the hodgepodge of case law, regulations, and miscellaneous IRS rulings generated over the years.

This article discusses some of these technical problems arising under section 1034, as well as others arising under section 121 (which provides a one-time exclusion of $125,000 of gain from the sale of a principal residence). The state of current law with respect to these issues is examined below, as are the solutions that would have been implemented under the recently proposed tax legislation. These and other technical corrections undoubtedly will be resurrected at some future date (witness the subchapter S simplification provisions included in the bill, which have been kicking around for years now). However, when and in what form is anyone's guess. So the vagaries of current law

[1]Pub. L. No. 82-183, 65 Stat. 452; *see also* Conference Report on the Revenue Act of 1951, 82d Cong., 1st Sess. (October 15, 1951), House Document No. 1179; Joint Committee Staff Summary of Provisions of the Revenue Act of 1951, 1951-2 C.B. 287, 309-310.

[2]Technically, the House and Senate passed the conference report to H.R. 2491 on November 17, 1995, but the Senate added an amendment, which was thereafter agreed to by the House on November 20, 1995.

must still be discerned and navigated in any of the transactions contemplated below until such time as statutory corrections are enacted.

Section 1034

Section 1034 allows for a deferral of recognition of the gain realized on the sale or exchange of a principal residence. This mandatory provision applies when the seller purchases a "replacement" principal residence within 24 months following the date of the sale (i.e., the date when title transfers) or 24 months prior to the sale of the "old" principal residence. No gain is recognized to the extent that the purchase price of the replacement principal residence is equal to or greater than the "adjusted sales price" of the old principal residence.[3] The adjusted sales price is the amount realized on the sale (e.g., the selling price minus selling expenses), less any "fixing-up" expenses incurred to facilitate the sale.[4] In common tax parlance, section 1034 allows for a tax-free "rollover" of the sale proceeds realized on the sale of a principal residence.

On account of section 1034, most taxpayers are able to avoid paying federal income tax on the gain realized on the sale of what is, for most individuals, the most significant and expensive capital asset they will ever own — their home. The gain that is not recognized on account of a section 1034 rollover is not exempt from taxation, but merely deferred since the basis of the replacement residence is reduced by the amount of the gain not recognized.[5] The gain will ultimately be recognized if the taxpayer ever sells or exchanges the replacement principal residence in a sale transaction that does not qualify (either in full or in part) under section 1034. However, taxpayers are also provided under section 121 with a one-time exclusion of up to $125,000 of capital gain realized on the sale of a principal residence. To qualify for this exclusion, the taxpayer must have reached the age of 55 years before the date of the sale (i.e., the date that title transfers[6]) and must have used the home as a principal residence during at least three of the five years immediately prior to the sale date.[7] When property is jointly owned by a husband and wife who file a joint tax return, it is sufficient that only one of the spouses has reached the age of 55 prior to the date of the sale.[8]

The section 121 exclusion can be used in conjunction with a section 1034 rollover, thereby allowing the taxpayer to purchase a replacement principal residence that costs as much as $125,000 less than the amount of the sale proceeds realized on the sale of the old principal residence without recognizing any taxable gain on the transaction.[9] Furthermore, a taxpayer who dies owning a principal residence with built-in gain (attributable either to appreciation or prior section 1034 rollovers) will obtain relief from income taxation under the long-standing doctrine that such gain is not taxable to the estate of the decedent taxpayer, and beneficiaries will obtain a "stepped-up" basis in the asset under section 1014.[10] As a result of the interaction of these various provisions, few taxpayers ever pay federal income tax on the gain realized on the sales of their principal residences throughout the course of their lifetimes, as well as upon death.

Ironically, the Contract With America bill that passed the House last January (H.R. 1215) included a provision permitting a deduction for a loss realized on the sale of a principal residence.[11] That provision had strong support from Ways and Means Committee Chairman Bill Archer, R-Texas, and made it into H.R. 2491. Although the Senate bill included no comparable provision, House Republicans were successful in conference committee in having it retained in the final version of the bill.

> ***When tax is owed on gain from the sale of a principal residence, it is usually attributable to a failure to comply with one of the technical requirements of section 1034.***

But for the president's veto, this loss deduction would be law already. And that may happen yet as published reports suggest that this provision would likely be included in any compromise bill worked out between the White House and congressional leadership.[12] Yet, because so few taxpayers ever pay tax on the capital gain realized on the sale of a principal residence, such a loss deduction would not appear justified by considerations of either tax policy or equity. Of course, taxpayers who have suffered significant economic losses on houses purchased at the height of the real estate boom of the last decade will undoubtedly disagree with that assessment of the dictates of justice. In addition, the asymmetry in the treatment of capital losses realized with respect to personal assets (nondeductible) as compared with the treatment of capital gains realized with respect to the same assets (taxable) has always struck taxpayers as "unfair." Notwithstanding that there are sound principles supporting such a

---

[3] *See generally* sections 1034(a) and (b).

[4] Such "fixing-up" expenses must be incurred with respect to services performed during the 90-day period ending on the date of the execution of the contract for the sale and actually paid within 30 days of closing. Section 1034(b)(2); Treas. reg. section 1.1034-1(b)(6).

[5] Section 1034(e).

[6] Section 121(a)(1); Treas. reg. section 1.121-1(a)(1); Rev. Rul. 68-210, 1968-1 C.B. 61; Rev. Rul. 77-382, 1977-2 C.B. 51.

[7] Section 121(a)(2); Treas. reg. section 1.121-1(a)(2).

[8] Section 121(d)(1); Treas. reg. section 1.121-5(a)(1).

[9] Treas. reg. section 1.121-5(g)(2), Examples 1 and 2.

[10] Section 1014.

[11] Section 6316 of H.R. 1215 provided that the loss from the sale or exchange of a principal residence be treated as a deductible capital loss, rather than as a nondeductible personal loss as under current law.

[12] "Relief May Be Coming," *The Wall Street Journal*, November 29, 1995, p. A1, col. 5.

rule, the perceived inequity obviously makes for a good political issue.

If there must be such a loss provision for political reasons, any compromise version that emerges from a White House-congressional powwow should include one new limitation: losses realized on the sale of a principal residence shall be deductible *only* to the extent that the taxpayer has recognized gain from the sale of a principal residence. Losses could be carried back (say, three years) and forward indefinitely (which is probably what would happen in most cases). This rule should satisfy the interests and goals of federal legislators, who would be cultivating the *appearance* that they have solved the problem for their constituents, but without actually costing the Treasury much (if any) revenue. After all, it is highly unlikely that those few taxpayers who recognize a gain on the sale of a principal residence are also among the unfortunate who realize a loss from the sale of a principal residence. This amendment should make it easy for the revenue estimators in the Congressional Budget Office to score the entire proposal as "revenue neutral," albeit politically enriching.

When tax is owed on gain from the sale of a principal residence, it is usually attributable to a failure to comply with one of the technical requirements of section 1034. For example, problems in complying with section 1034 often occur where the principal residence is sold or an interest transferred pursuant to a pending divorce proceeding and/or property settlement effected between former spouses who jointly owned the former marital residence. Some of these technical problems that arise where a tax-free rollover is made pursuant to a divorce are considered below. In addition, reliance upon section 121 can be problematic in at least one situation discussed below. The legislative solutions to such problems proposed under H.R. 2491 should be included in any future technical corrections and/or tax simplification bill. Of course, this assumes that the income tax itself is not repealed by the 104th Congress. If a national sales tax or a flat consumption tax is adopted, gains realized by individuals on the sale or exchange of a capital asset such as a personal residence will not be taxed at all. In that case, we won't need provisions such as sections 1034 and 121, and life will be simple and "fair."

Marriage Penalty Under Section 121

As noted above, a taxpayer (or his spouse) must have reached the age of 55 years to qualify for the exclusion of $125,000 of gain under section 121. If the section 121 exclusion is claimed by a married couple in such a case, both spouses will thereafter be precluded from claiming the exclusion again. Furthermore, if one of the spouses previously claimed the exclusion (for instance, before the marriage or in a prior marriage), the couple is precluded from making the section 121 election again during that marriage.[13] In other words, taxpayers who are married are allowed only one $125,000 exclusion, while two unmarried taxpayers living in sin can both claim separate $125,000 exclusions. This is but one of the many serious drawbacks (to say nothing of expenses) of marriage.

Taxpayers who are married are allowed only one $125,000 exclusion, while two unmarried taxpayers living in sin can both claim separate $125,000 exclusions.

To say the least, there is a potential pitfall here for the unwary. For example, consider two individuals living in comfortable retirement. Each is 55 years or older and owns a separate principal residence, the fair market value of which exceeds such property's adjusted basis (whether because of appreciation or previously deferred gain rolled over into that property). The two are contemplating marriage. But before taking the great plunge, they would be well-advised to consult their tax advisers as there is a significant tax savings to be reaped if they sell their residences *before* marrying. If they wait to sell their residences *after* their marriage, they will have only one $125,000 exclusion available between the two of them.[14] Conversely, if the properties are sold before the marriage, each would be entitled to claim a $125,000 exclusion of gain under section 121.[15] So with some basic tax planning (or else living in sin) the retiree lovebirds can realize a potential tax savings of as much as $35,000 attributable to making use of each individual's section 121 exclusion.[16] Talk about a marriage penalty!

This peculiar result would have been corrected under H.R. 2491, which included a provision (which also originated in the House bill, H.R. 1215) making the section 121 exclusion available to any otherwise qualified individual, notwithstanding that the spouse of such individual previously claimed the section 121 exclusion in a prior marriage, so long as the individual held the relevant sale property for at least three years

[13]Treas. reg. section 1.121-2(b)(1)(i) and (ii).

[14]Treas. reg. section 1.121-2(b)(1)(i) and (ii); *see also* Treas. reg. section 1.121-2(b)(2), Example 1.

[15]Treas. reg. section 1.121-2(b)(2), Example 2; *see also* GCM 39722, *88 TNT 81-32* (April 1, 1988) (single individuals who sold principal residences before marriage may each claim $125,000 exclusions, and the total $250,000 can be reported on a joint return).

[16]The easiest tax plan would likely involve both individuals selling their respective residences to trigger gain to claim both section 121 exclusions. Alternative plans may involve one of the individuals selling his or her residence for a gain and then purchasing a share of the residence of the spouse-to-be (i.e., before the marriage). The specific details would depend upon the values and bases of the respective properties.

prior to the marriage to the "tainted" individual.[17] Until this or a comparable provision is enacted, those contemplating marriage or remarriage in their golden years (i.e., that precious time left to a taxpayer after the children have left the principal roost) will need to consult with a tax adviser before consolidating residences with their Significant Other.

Keeping the Marital Residence

Often in a divorce settlement, one of the divorcing spouses (most often the wife) will keep the jointly owned marital residence that previously was the principal residence of the married couple. In such a case, the division of the marital property will reflect the fact that that spouse is keeping this major asset. But an additional and often unforeseen consequence is that the spouse who retains the principal residence will become liable for all of the built-in gain inherent in the residence. This is because the spouse who retains the residence will take a carryover basis in the property as a result of the mandatory application of section 1041, which provides that any transfer of property between spouses during a marriage or transfer of property between former spouses pursuant to a divorce decree or settlement, is treated for purposes of federal income tax as a "gift" from the one spouse to the other.[18] The application of this provision results in the transferee spouse taking a carryover basis in the property with no tax recognized on the transfer.[19]

Legal counsel representing the parties in the divorce must recognize that this contingent liability for the tax potentially due on the gain inherent in the asset reduces the fair market value of the property — although precisely on account of sections 1034 and 121, such tax liability may in fact never become due. Hence, while some reduction in the value attached to the property by the parties pursuant to the division of property is appropriate, the reduction should reflect an amount less than the maximum amount of tax due on the built-in gain in a taxable sale or exchange. The precise amount of the reduction is a matter for negotiation between the parties.

There would appear to be grounds here for an amendment to section 1034 providing a new election under which the divorcing couple in the situation described above (i.e., where one spouse is keeping the former marital residence) would be permitted to divide and assume their respective shares of the gain inherent in the former shared principal residence. Essentially, such an election would be the flip side of the election now permitted under section 1034(g) (discussed further below) and would allow the parties to allocate between themselves any built-in unrecognized gain attributable to market appreciation or prior section 1034 rollovers of jointly owned residences. Presumably, the departing spouse (the spouse who moves out of the former marital residence) would need to purchase a new residence within the statutory replacement period or else his or her share of the built-in gain would become due. If a replacement residence is purchased by such individual, its cost basis would need to be reduced by the amount of that spouse's share of the built-in gain carried over from the former marital residence on account of this new election. While the determination of the amount of such built-in gain would obviously require a valuation of the former marital residence, such valuation would already have been made to effect the division of the marital property pursuant to the divorce, and hence, would not impose any new expense or obligation upon the parties.

The equities in favor of such election are that the departing spouse (most often the husband) is freed from worrying about complying with section 1034 when purchasing a new principal residence. Since there was no sale or exchange of the "old" principal residence pursuant to the division of the marital property, that spouse has no time or price requirements with respect to purchasing a new residence. Conversely, the spouse who keeps the former marital residence is buying into a future confrontation with section 1034 in which it will be that much more difficult to purchase a replacement principal residence when, if ever, the retained residence is sold. The proposed election would reduce the maximum liability that the remaining spouse would face in the event of a failure to comply with section 1034 on a subsequent sale of the former marital residence.

Rollovers Pursuant to Divorce

When the marital residence is sold by the divorcing parties, which occurs most often for financial reasons, additional tax issues must be confronted in making a section 1034 rollover. These problems arise because section 1034 was drafted with only the basic transaction in mind wherein a single taxpayer sells a principal residence and purchases a replacement residence within the statutory replacement period. The statute deals awkwardly with the situations that arise when a marrying or divorcing couple is involved. For instance, the aforementioned section 1034(g) provides authority to the Treasury Secretary to promulgate rules dealing

[17]Title XIV (Tax Simplification), Subpart A, Part I, Sec. 14103 ("One-Time Exclusion of Gain From Sale of Principal Residence for Certain Spouses"), of the Seven-Year Balanced Budget Reconciliation Act of 1995 (H.R. 2491), providing the following addition to section 121(b)(2): "For purposes of applying the preceding sentence to individuals who are married to each other, an election by one individual with respect to a sale or exchange occurring before the marriage shall be disregarded for purposes of permitting an election with respect to property owned and used by the other individual as his principal residence throughout the 3-year period ending on the date of the marriage."

[18]Pub. L. No. 98-369, 98 Stat. 494, Section 421(a) of the Tax Reform Act of 1984, Division A of the Deficit Reduction Act of 1984. For a full discussion of how section 1041 applies in the context of a divorce, see Sheldon D. Pollack, "Qualifying for Nonrecognition Under Section 1041," 15 *Taxation for Lawyers* 332 (April 1989).

[19]Section 1041(b)(2) provides for a carryover basis in such property.

with the case where a married couple purchases a new replacement principal residence jointly, but where the old principal residence was owned by only one of the spouses alone (for instance, when it was purchased prior to the marriage). These rules are set forth in Treasury reg. section 1.1034-1(f)(1) and are further described in IRS Publication 523 ("Tax Information on Selling Your Home"). The regulations allow for an election under which both spouses consent to share (in proportion to their respective ownership interest in the replacement residence) the basis reduction carried over to the replacement residence pursuant to the rollover. As a consequence of this election, which can be made on IRS Form 2119 ("Sale or Exchange of Principal Residence"), the liability for the tax on the gain inherent in the jointly owned replacement residence will become a liability shared by the two spouses. The regulations specifically provide that the election can be made "only if the old residence and the new residence are each used by the taxpayer and his same spouse as their principal residence."[20]

Section 1034 deals awkwardly with the situations that arise when a marrying or divorcing couple is involved.

Despite the rather straightforward language of the regulations and Publication 523, taxpayers often misunderstand the requirements and consequences of making this election. Consequently, taxpayers may find that they failed to satisfy section 1034 in a subsequent transaction. Witness the unfortunate fate of the taxpayer in the recently decided Tax Court case, *Snowa v. Commissioner*.[21]

The taxpayer/petitioner (Mrs. Snowa) was previously married to Mr. Spivey, and during their marriage the two owned their principal residence as joint tenants. This residence was sold in 1989, apparently pursuant to the couple's impending divorce. The petitioner properly reported her $178,056 one-half share of the net sale proceeds on IRS Form 2119, which was filed along with her 1989 tax return. Her basis in her one-half share of the house was $108,538, meaning she realized $69,518 of gain on the sale. In 1991, within the two-year statutory replacement period, the petitioner remarried (becoming Mrs. Snowa) and purchased a new jointly owned principal residence for a total purchase price of $180,668. This purchase was reported to the Commissioner on IRS Form 2119, on which the section 1034(g) election was also made.

On audit, the Service concluded that Mrs. Snowa's share of the purchase price of the new jointly owned residence was only $90,334 (or one half of the total purchase price of $180,668). Furthermore, the section 1034(g) election made in 1991 was deemed invalid and of no effect because Mr. Snowa had not used the old principal residence as his principal residence (as surely Mr. Spivey would have objected to that), even while he did use the new replacement residence as his principal residence. Hence, the plain language of the statute (requiring that *both* spouses must have used *both* the old and replacement residences as their principal residences to make the election) was not satisfied. Presumably, Mrs. Snowa could have purchased the residence herself, using the sale proceeds from the sale of her old principal residence and charged Mr. Snowa a fair market rent for his use of the property. If this course had been followed, no tax would have been due on the transaction. (Of course, we do not know what Mr. Spivey did with his half interest in the sale proceeds from the old residence, but that is his problem.)

No technical correction would seem to be warranted to deal with this situation. While Mrs. Snowa deserves some sympathy (after all, she sold a principal residence for $178,056 and purchased a new one for $180,668), she certainly failed to satisfy the rules under section 1034. In this respect, she is but one of the many taxpayers who run afoul of the statute. Next time she purchases or sells a principal residence, she must either learn to read Treasury regulations more carefully or else engage tax counsel. Of course, an exclusion for 50 percent of the capital gain recognized on such a failed section 1034 transaction would certainly go a long way in easing the burden of taxpayers such as Mrs. Snowa.

'Principal Residence' of Separated Spouses?

Another issue that commonly arises when the principal residence is sold pursuant to a divorce is whether both spouses must actually be occupying the old residence on the date that it is sold for it to qualify as each spouse's "principal residence." The problem arises when the marriage is in the process of dissolution and one spouse has already departed from the marital residence, perhaps pursuant to a legal separation in anticipation of divorce. In such a case, that spouse's ability to rely upon section 1034 on a subsequent sale of the marital residence can be problematic. If that spouse (or former spouse) is no longer living in the residence at the time of the sale, it may not qualify as his principal residence under the regulations, and hence, that spouse is not selling his principal residence. If not, the transaction cannot qualify for a section 1034 rollover, at least with respect to that spouse's share of the net sale proceeds.

H.R. 2491 also would have provided a statutory solution to this problem. The bill included a safe harbor (which also originated in the House bill, H.R. 1215) for taxpayers in establishing their principal residence in connection with a divorce or separation. This safe harbor provides that a residence qualifies as a taxpayer's principal residence at the time of its sale so long as (1) the residence is being sold pursuant to a divorce or marital separation, and (2) the taxpayer used the

[20] Treas. reg. section 1.1034-1(f)(1).

[21] 70 T.C. Memo 1995-336, *95 TNT 145-12* (No. 9553-93, July 25, 1995).

residence as his or her "principal residence" at any time during the two-year period ending on the date of the sale.[22] In light of the president's veto of H.R. 2491, the determination must be made under current law — which offers no great certainty.

The determination of which residence is a taxpayer's principal residence is made under all the relevant facts and circumstances.[23] Under the regulations, taxpayers can have only one principal residence, even if they own more than one residence. Yet, the one residence that is ultimately determined to be the taxpayer's principal residence need not be the one in which he or she is residing at that particular moment. There is authority supporting the general proposition that a taxpayer *need not* occupy his old residence on the date of the sale to qualify it for a section 1034 rollover. For example, where a taxpayer purchases a new residence *prior* to selling his old residence, the regulations specifically provide that:

> The mere fact that property is, or has been, rented is not determinative that such property is not used by the taxpayer as his principal residence. For example, if the taxpayer purchases his new residence before he sells his old residence, the fact that he temporarily rents out the new residence during the period before he vacates the old residence may not, in light of all of the facts and circumstances in the case, prevent the new residence from being considered as property used by the taxpayer as his principal residence.[24]

One commentator has noted the impossibility of occupying the principal residence in this particular case: "Clearly, if a taxpayer acquires a new principal residence, moves in, leaves his old residence vacant or temporarily rents it out, and then sells it, all within the statutory period, the sale will qualify under section 1034."[25] Furthermore, there is case law supporting the proposition that a taxpayer who has moved out of his residence may still treat it as his or her principal residence when it is sold at a later date.[26] This authority suggests that a spouse may temporarily "abandon" his principal residence (i.e., his interest in the jointly held marital residence) prior to its sale and still qualify to make a rollover under section 1034 with respect to his share of the net sale proceeds.

However, the issue becomes considerably more problematic when the departed spouse has not lived in the former marital residence for more than two years prior to the sale. The significantly greater time lapsing between the date of the abandonment of the marital residence and the subsequent sale of the property may take the sale transaction out of section 1034. The case law concerning this issue is extremely fact specific, and it is difficult to identify the relevant factors that are most important. The most than can be said is that taxpayers have lost arguments along these lines when the period of abandonment was for significant periods of time (i.e., 7 and 13 years).[27] In one case, *Rogers v. Commissioner*,[28] the Tax Court indicated that if the period of abandonment was greater than the statutory replacement period, the transaction could not qualify under section 1034. In that case, the court held that section 1034 was inapplicable because the spouse had abandoned the residence "more than 18 months [the statutory replacement period under then applicable law] prior to . . . purchase" of a new principal residence. Under this standard, the failure of the departed spouse to purchase a new principal residence within two years of the abandonment of the old marital residence pursuant to the separation would bar reliance upon section 1034. This time limitation would appear to be an insurmountable obstacle for nonrecognition of the gain realized by the spouse who moved out of the marital residence more than two years before its sale. Of course, other courts might be less inclined to rigidly adhere to this two-year rule.

A similar rule was provided in the proposed safe harbor included in H.R. 2491, which required that the spouse must have used the sold residence as a principal residence *within two years* of the date of the sale. This offered a reasonable solution overall; however, there are two technical problems with this provision as currently drafted. First, it is unclear whether the failure to meet this requirement would entirely preclude reliance upon section 1034 or merely take the taxpayer out of the safe harbor, still leaving open the possibility that the old case law might support a qualified rollover under some favorable facts and circumstances. Second, rather than refer to use of the residence as a principal residence by the taxpayer within two years of the sale, it would be more prudent to cross-reference the time period in the safe harbor to the statutory replacement

[22] Title XIV (Tax Simplification), Subpart A, Part I, Sec. 14102 ("Special Rules in Case of Divorce"), of the Seven-Year Balanced Budget Reconciliation Act of 1995 (H.R. 2491), providing the following addition to section 1034(c): "If a residence is sold by an individual pursuant to a divorce or marital separation, and the taxpayer used such residence as his principal residence at any time during the 2-year period ending on the date of such sale, for purposes of this section, such residence shall be treated as the taxpayer's principal residence at the time of such sale."

[23] *See* Treas. reg. section 1.1034-1(c)(3)(i) ("Whether or not property is used by the taxpayer as his residence . . . depends upon all of the facts and circumstances in each case, including the good faith of the taxpayer."); *see also* LTRs 8015017 and 8337050. A taxpayer has only one "principal residence," even if the taxpayer owns more than one residence.

[24] Treas. reg. section 1.1034-1(c)(3)(i).

[25] R. Arnold Handler, "Acquisition, Financing, Refinancing, and Sale or Exchange of Residence," 179-4th *BNA Portfolio*, "Sale of Principal Residence," at A-10 to A-11. Handler's excellent study is the most comprehensive analysis of the various code provisions discussed herein, and the author acknowledges his reliance upon it in preparing this article.

[26] *Corker v. Commissioner*, 34 TCM 1357 (1975), *aff'd* 571 F.2d 338 (6th Cir. 1978).

[27] *See Rogers v. Commissioner*, 45 TCM 318 (1982); *Dementer v. Commissioner*, 30 TCM 863 (1971).

[28] *Rogers v. Commissioner, supra* note 27 at 321; *see also Andrews v. Commissioner*, 41 TCM 1553 (1981).

period found in section 1034(a). That way, if the statutory replacement period is ever changed (as it has been twice before, from one year to 18 months, and then from 18 months to two years), the safe harbor will not need to be amended. This of course, assumes that the two-year rule adopted in the safe-harbor has some relation to the statutory replacement period — which is not at all certain.

Rollover of Each Spouse's Share of Realized Gain

Another problem often arises with respect to satisfying the requirements of section 1034 in the midst of a pending divorce. For both divorcing spouses to effect a tax-free rollover, each must reinvest his or her respective share of the sale proceeds from the old marital residence — determined by reference to each spouse's respective ownership interest in the property. For instance, where the spouses held the marital residence as tenants-in-the-entirety and contributed equal amounts toward the purchase of the property, each would be entitled to one-half of the sale proceeds. The Service has held that when two former spouses purchase new principal residences within the statutory replacement period, with each new residence costing as much as that spouse's respective share of the sale proceeds from the sale of the former joint principal residence, section 1034 would apply to each separate transaction.[29] (Conversely, the Service has also ruled that where two individuals own their own individual principal residences, marry and purchase a new single principal residence costing more than the total of the sale prices of the separate residences, section 1034 would apply to defer gain on both sales.[30]) Thus, in the typical case where the married couple owned the marital residence jointly, each can roll over their respective share of the sale proceeds into a new principal residence.

These rules seems straightforward enough, but there are many taxpayers who misunderstand the requirements of section 1034 in such cases. (Mrs. Snowa again comes to mind here.) For this reason, an amendment to the statute codifying these rules already adopted and applied by the Service would appear both warranted and prudent.

Miscellaneous Technical Corrections

Several other technical corrections to section 1034 were included in H.R. 2491. One attempted to provide a rule under which gain realized with respect to the sale of a principal residence attributable to depreciation deductions (which could arise, for instance, when a portion of the property had been previously used as a home office for which a depreciation deduction was allowable) would not qualify for nonrecognition under a section 1034 rollover.[31] Certain technical flaws in this provision were noted by practitioners and reported in the most esteemed tax journals.[32] In light of these criticisms, the provision should perhaps be reworked before it is resurrected in the next tax simplification or technical corrections bill.

An additional provision amending section 1034 would require that for noncitizens and nonresidents, their replacement residence must be located in the United States to effect a tax-free rollover of the sale proceeds from the sale of their old principal residence. In the case of a married couple filing a joint return, it is sufficient that one spouse be a citizen at the time of the sale of a jointly owned principal residence.[33] This provision also makes good sense from the perspective of protecting the Treasury and should be included in any future bill.

Conclusion

Problems remain in complying with the requirements of section 1034 pursuant to a divorce or where individuals sell their old residences, marry, and then purchase a new joint residence. There is at least one potential pitfall in complying with section 121 when two residences are sold prior to a marriage and purchase of a joint residence. These problems would have been solved under technical corrections included in H.R. 2491. Any future technical corrections bill should include these or similar provisions, and perhaps others as well (such the new section 1034 election and the codification of the rules suggested above). Of course, if the income tax itself is repealed and a national sales tax or a flat consumption tax is adopted, gains realized by individuals on the sale or exchange of a capital asset such as a personal residence will not be taxed at all. In that case, we won't need provisions such as sections 1034 and 121, and life will be simple and "fair."

---

[29]Rev. Rul 74-250, 1974-1 C.B. 202.

[30]Rev. Rul. 75-238, 1975-1 C.B. 257.

[31]Title XIII (Revenue Reconciliation), Subtitle F, Part V, Sec. 13628 ("No Rollover or Exclusion of Gain on Sale of Principal Residence Which is Attributible to Depreciation Deductions") of the Seven-Year Balanced Budget Reconciliation Act of 1995 (H.R. 2491).

[32]*See* Rod Garcia, "Kink in Rollover Provision Spotlights Planning Opportunity," *Tax Notes*, Oct. 9, 1995, p. 130.

[33]Title XIII (Revenue Reconciliation), Subtitle F, Part V, Sec. 13629 ("Nonrecognition of Gain on Sale of Principal Residence by Noncitizens Limited to New Residences Located in the United States") of the Seven-Year Balanced Budget Reconciliation Act of 1995 (H.R. 2491).