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NEW LAW EXCLUDES GAIN ON SALE OF RESIDENCE

A generous new exclusion relieves most homesellers of the possibility of owing tax and the chore of calculating their precise basis.

SHELDON D. POLLACK, Attorney

Included in the Taxpayer Relief Act of 1997[1] is a complete reworking of Section 121, significantly changing the tax treatment of gain recognized on the sale or exchange of a principal residence. The new rules apply to transactions closing after 5/6/97. New Section 121 provides taxpayers with an exclusion of up to $250,000 of gain ($500,000 for married taxpayers filing jointly) realized on the sale or exchange of what is, for most individuals, the most significant and expensive capital asset they will ever own—their home.

Few taxpayers actually pay income tax on gain from the sale of a principal residence. Indeed, in those rare instances when tax is due, it is usually because of a failure to comply with the many technical requirements imposed under prior law. (The House Report to the 1997 Act referred to these technical requirements as "tax traps for the unwary."[2])

Perhaps the most attractive feature of the new approach to taxing the sale of homes is that it now simplifies the recordkeeping requirements for most taxpayers. Furthermore, the new provision resolves some technical glitches arising under prior law. (Losses incurred on the sale of a principal residence, however, remain nondeductible as a personal expense.)

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Prior law

For decades, Section 1034 provided the general framework for the tax treatment of gain recognized on the sale or exchange of a "principal residence." (Whether a dwelling is used by a taxpayer as a principal residence depends on all the facts and circumstances.[3]) This provision still applies to sales closing before 5/7/97. In addition, taxpayers may elect to apply prior law to sales closing after 5/6/97 and before 8/5/97, as well as to sales closing after 8/4/97 that were subject to a binding contract on or before 8/5/97.

Thus, in those limited circumstances in which the old rules provide a more favorable result, eligible taxpayers may opt for treatment under Section 1034. Prior law may be preferable, for example, when the gain exceeds the new exclusion and a new principal residence is purchased in a transaction that would defer tax under Section 1034.

Example. Linda and Tom purchased a house with a big yard in the suburbs many years ago for $50,000. As the nearby city grew, their property exploded in value and they are now going

to sell it for $750,000 (i.e., a $700,000 gain) and purchase another residence for $750,000. Under prior law, they would owe no tax under Section 1034, but now they will be taxed on $200,000 of their home sale gain ($700,000 realized gain less $500,000 exclusion).

Section 1034 provides an exception to the general rule that gain recognized on the sale or exchange of a principal residence is includable in income under Section 61. At the heart of this provision is a special tax preference first adopted by Congress in the Revenue Act of 1951, which thereafter became a staple in the repertoire of tax planning. The preference defers the recognition of gain if a replacement principal residence is purchased within 24 months following or preceding the date of the sale (i.e., the date when title transfers) of the taxpayer's 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.[4] 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 (within 90 days prior to the execution of the sales contract) to facilitate the sale. In common tax parlance, Section 1034 allows for a tax-free "rollover" of the sale proceeds realized on the sale of a principal residence.

Under Section 1034(e), gain that is not recognized on account of a Section 1034 rollover reduces the basis of the replacement residence. Accordingly, the gain would ultimately be recognized if the taxpayer ever sold or exchanged the replacement principal residence in a transaction not covered by Section 1034. Former Section 121, however, also provided taxpayers with a one-time exclusion of up to $125,000 of capital gain recognized on the sale of a principal residence.

To qualify for this exclusion (which also was repealed by the new statute), the taxpayer must have reached age 55 years before the date of the sale (i.e., the date that title transfers[5]) and must have used the home as a principal residence during at least three of the five years immediately prior to the sale date.[6] For a residence sold by a husband and wife filing a joint tax return, only one of the spouses needed to have reached age 55 prior to the date of the sale.[7]

Under prior law, the $125,000 exclusion could 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 sale proceeds realized on the sale of the old principal residence without recognizing any taxable gain on the transaction.[8] Furthermore, a taxpayer who dies owning a principal residence with built-in gain (attributable to either appreciation or prior Section 1034 rollovers) benefits from the long-standing doctrine that such gain is not taxable to the estate of the deceased taxpayer, and beneficiaries obtain a stepped-up basis in the asset under Section 1014.

Because these various provisions resulted in few taxpayers ever paying tax on sales of a principal residence, some commentators suggested that the whole idea of taxing these transactions be abandoned.[9] Others, including this author, proposed complicated technical corrections to rectify the numerous glitches arising under the statutes.[10] For example, problems could arise under prior law when taxpayers attempted to effect a tax-free rollover within the context of a pending marriage where the spouses-to-be already owned their own principal residences, or within the context of a divorce involving a division of marital property including the former marital residence. Other problems could arise when previously married taxpayers attempted to make use of the $125,000 exclusion following a second marriage. If one of the newlyweds (or his or her former spouse) had previously claimed the exclusion, the new spouse would be barred from making the election. Likewise, two "senior" taxpayers contemplating marriage would be better off selling their respective residences *prior* to a marriage (or not getting married at all), so each could claim his or her own $125,000 exclusion. If they married before making the Section 121 election, the couple would "lose" one of the two $125,000 exclusions for which they would otherwise be eligible.

TAXPAYERS NEED NO LONGER WORRY ABOUT REINVESTING THE PROCEEDS FROM A SALE OF A PRINCIPAL RESIDENCE.

Rather than enacting a patchwork of technical corrections, Congress opted for a White House proposal offering the $250,000/$500,000 exclusion in lieu of the more limited $125,000 exclusion, and repealing Section 1034.

New $250,000 exclusion

Under the new tax rules, taxpayers need no longer be concerned about reinvesting the proceeds from a sale of a principal residence. Neither need taxpayers plan to delay the sale of their

Curiously, new Section 121 does not include a definition of "principal residence." Presumably, the case law that evolved with respect to determining whether a property was used as a taxpayer's principal residence for purposes of the old rollover provision and $125,000 exclusion is still applicable.

home until they (or their spouses) reach age 55. As noted above, new Section 121 excludes up to $250,000 of gain ($500,000 for married taxpayers filing jointly) realized on the sale of a principal residence.

THE EXCLUSION GENERALLY MAY BE INVOKED ONLY ONCE EVERY TWO YEARS.

This new tax break is not a deferral of gain, but rather a permanent exclusion of the gain. Taxpayers who previously claimed the $125,000 exclusion are nevertheless eligible to claim the new $250,000 exclusion. With the new exclusion, elderly homeowners need no longer hold onto their home until death to avoid income tax. Most important, the new exclusion is not a one-time option, as was the $125,000 exclusion. Taxpayers may exclude gain from successive sales of principal residences—regardless of their age and regardless of whether the sale proceeds are reinvested in a new residence. Furthermore, taxpayers may exclude gain that is attributable to prior tax-free rollovers effected under Section 1034.

Since there is a cap on the gain that can be excluded for each sale, taxpayers who have owned expensive homes for many years may end up owing tax on a home sale, while those who sell more frequently would not owe tax on any of their home sales.

Several requirements are imposed on taxpayers who would make use of the new $250,000 exclusion. First, the exclusion generally may be invoked only once every two years. The two-year rule is applied, however, without regard to any sale or exchange occurring prior to 5/7/97.[11] This means that a sale of a principal residence within the two-year period ending on the May 7 effective date of the new provision will not bar a taxpayer from claiming the new $250,000 exclusion.

In addition, to qualify for the exclusion, selling taxpayers must have owned and used the residence as their principal residence for periods aggregating at least two years during the five years ending on the date of the sale. (Section 121(d)(7) contains an exception for taxpayers who become physically or mentally incapable of caring for themselves and have owned the property during the five-year period prior to the sale and used it as a principal residence for periods aggregating at least one year; the time spent in a licensed facility such as a nursing home during such five-year period counts toward fulfilling the two-year personal-use requirement.)

Under certain circumstances a partial exclusion is allowed. These include situations where the taxpayer fails to meet the use and ownership requirements, as well as sales within the two-year period, occasioned by health reasons, a job relocation, or (to the extent provided in future Regulations) other "unforeseen circumstances."[12] The partial exclusion of gain is determined by reference to the time the taxpayer used the residence as a principal residence, as compared to the two-year period otherwise applicable.[13]

Section 121(d)(6) provides that the new exclusion for gain recognized on a sale of a principal residence does not apply to gain attributable to depreciation adjustments for periods after 5/6/97. Therefore, when a portion of a principal residence is used as a home office after that date, and depreciation adjustments are claimed, the gain recognized on a subsequent sale of the property attributable to the depreciation adjustments cannot be sheltered under new Section 121, even if the space used as the home office is converted back to personal use before the residence is sold.

Married taxpayers

As noted above, married taxpayers are eligible to claim a $500,000 exclusion on the sale of their jointly owned principal residence. (Joint filers not sharing a principal residence may each claim the $250,000 exclusion on the sale of his or her respective residence.) When married taxpayers wish to make use of the $500,000 exclusion (or the partial exclusion), some special rules in Section 121(b)(2) apply:

1. The couple must file a joint return for the year of the sale.
2. Both spouses must meet the use requirement with respect to the property.
3. At least one of the spouses must meet the ownership requirement with respect to the property.
4. Neither spouse can be ineligible to claim the exclusion by virtue of failing to meet the rule allowing only one exclusion every two years. If this requirement is not met by one spouse (perhaps on account of having claimed the $250,000 exclusion

on a sale prior to the marriage and within two years of the sale at issue), the other spouse may claim the $250,000 exclusion, if otherwise eligible.

Example. In 1970, John and Mary purchased their residence for $100,000. They spent $15,000 for the new roof and driveway in 1975. In 1984, they sold the home for $240,000. (John and Mary were each under age 55 at the time of sale.) In 1985, they purchased a new principal residence for $260,000. This was sold for $400,000 on 8/6/97.

John and Mary had a tax basis of $115,000 in their old residence (i.e., $100,000 cost plus $15,000 of capitalized expenses). Thus, they had a $125,000 gain on the sale in 1984 (i.e., the excess of the $240,000 sales price over the $115,000 adjusted basis). Tax on this gain was deferred by the rollover. The tax basis in the new principal residence was $135,000 (the $260,000 cost reduced by the $125,000 gain deferred by the rollover). When this house was sold for $400,000 on 8/6/97, there was $265,000 of gain (i.e., the excess of the $400,000 sales price over the $135,000 adjusted basis). Under the new Section 121 exclusion, John and Mary (filing a joint tax return for 1997) can exclude up to $500,000 of gain—regardless of their ages. Thus, no tax will be owed on the sale. They need not purchase a new residence. If they do, a new $500,000 exclusion can be claimed should they sell it after 8/6/99.

Divorced taxpayers. Several technical rules apply to the transfer of a principal residence pursuant to a divorce or legal separation. For instance, new Section 121 provides that a taxpayer who owns a residence is treated as having used that property as his or her principal residence while the taxpayer's spouse or former spouse was granted use of the property under a divorce decree or separation agreement.[14] This rule solves the problem faced by separated or divorced spouses who previously moved out of the former marital residence, and accordingly, could not claim the property as a principal residence at the time of a subsequent sale for purposes of making a tax-free rollover or claiming the old $125,000 exclusion for their share of the gain.

Widowed taxpayers. If a taxpayer's spouse has died prior to the sale of the couple's residence, the period the surviving spouse owned

ONEROUS RECORD-KEEPING SHOULD NOT BE NECESSARY FOR MOST TAXPAYERS.

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and used the former marital residence is deemed to include the period during which the deceased spouse owned and used the property.[15] This rule allows the surviving spouse to make use of the exclusion, even if he or she did not use the residence as a principal residence during the five-year period prior to the sale. It also would appear that the surviving spouse can claim the full $500,000 exclusion on a joint tax return filed for the year of death reporting the sale of the former marital residence.

Conclusion

The new exclusion for gain recognized on the sale or exchange of a principal residence is an improvement over prior law, assuming one accepts the underlying premise that all or a portion of such gain should be exempt from tax. While such an exclusion is not justified by economic theory, it does seem to have irresistible political support and is likely to be enshrined in the Code for the foreseeable future. Assuming there is to be such an exclusion, taxpayers should not be obligated to preserve for decades records of purchases and capital expenditures relating to their homes in order to claim this exclusion on a future sale. This was required under prior law.

With the new, higher exclusion, such onerous recordkeeping should not be necessary for most taxpayers—absent a period of extraordinary inflation in home values, as was experienced in the 1980s. Of course, taxpayers cannot know in advance whether such inflation will occur. Thus, they may still need to keep records in case their home sale gain exceeds the exclusion amounts. Also, if a taxpayer chooses at some time in the future to convert a personal residence to rental property, the taxpayer will need records of capital expenditures in order to determine his or her basis in order to calculate depreciation deductions and gain or loss on the eventual sale of the property. ■

NOTES

1 P.L. 105-34, 8/5/97.

2 H. Rep't No. 105-148, 105th Cong., 1st Sess. 86 (1987).

3 See Reg. 1.1034-1(c)(3)(i); H. Rep't No. 586, 82d Cong., 1st Sess. (1951), 1951-2 CB 355, 436; Roth, TCM 1997-17; Evans, TCM 1962-61 ; Rev. Rul. 77-298, 1977-2 CB 308.

4 See generally Sections 1034(a) and (b).

5 Section 121(a)(1); Reg. 1.121-1(a)(1); Rev. Rul. 68-210, 1968-1 CB 61; Rev. Rul. 77-382, 1977-2 CB 51.

6 Section 121(a)(2); Reg. 1.121-1(a)(2).

7 Section 121(d)(1); Reg. 1.121-5(a)(1).

8 Reg. 1.121-5(g)(2), Examples 1 and 2.

9 See, e.g., Sheppard, "Should Sales of Personal Residences Be Exempt From Tax?," 50 Tax Notes 1433 (3/25/91).

10 See Pollack, "Corrections to Sections 1034 and 121: Victims of the Balanced Budget," 70 Tax Notes 589 (1/29/96).

11 Section 121(b)(3)(B).

12 Section 121(c)(2)(B).

13 Section 121(c)(1).

14 Section 121(d)(3)(B).

15 Section 121(d)(2).