

# Notice of Proposed Rulemaking and Notice of Public Hearing

## Exclusion of Gain From Sale or Exchange of a Principal Residence

REG-105235-99

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the exclusion of gain from the sale or exchange of a taxpayer's principal residence. These proposed regulations reflect changes to the law made by the Taxpayer Relief Act of 1997, as amended by the Internal Revenue Service Restructuring and Reform Act of 1998. These proposed regulations generally affect taxpayers who sell or exchange their principal residences.

DATES: Written or electronically generated comments must be received by January 9, 2001. Requests to speak (with outlines of oral comments) to be discussed at the public hearing scheduled for January 23, 2001 at 10 a.m., must be submitted by January 3, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG-105235-99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG-105235-99), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at [http://www.irs.gov/tax\\_regs/reglist.html](http://www.irs.gov/tax_regs/reglist.html). The public hearing will be held in the IRS Auditorium, Seventh Floor, Internal Revenue Service Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Sara P. Shepherd, (202) 622-4910; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, contact Treena

Garrett, (202) 622-7180 (not toll-free numbers).

### SUPPLEMENTARY INFORMATION:

#### Background

##### 1. Section 121 Exclusion

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 121 of the Internal Revenue Code relating to the exclusion of gain from the sale or exchange of a taxpayer's principal residence. These proposed regulations reflect changes to the law made by the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788 (TRA 1997)), as amended by the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105-206 (112 Stat. 805 (RRA 1998)).

Prior to the repeal by TRA 1997, section 1034 provided that gain from the sale or exchange of a principal residence (old residence) was recognized only to the extent that the taxpayer's adjusted sales price of the old residence exceeded the taxpayer's cost of purchasing a new residence within the replacement period (generally 2 years before or after the date of sale).

Prior to amendment by TRA 1997, former section 121 provided that a taxpayer could make a one-time election to exclude up to \$125,000 of gain from the sale or exchange of property. To qualify for the exclusion, the taxpayer must have (1) been age 55 or older on the date of the sale or exchange, and (2) owned and used the property as the taxpayer's principal residence for at least 3 years during the 5-year period ending on the date of the sale or exchange.

TRA 1997 amended section 121 and repealed section 1034 for sales and exchanges of principal residences after May 6, 1997 (except, at the election of the taxpayer, to a sale or exchange (1) made on or before August 5, 1997, (2) made pursuant to a binding contract in effect on August 5, 1997, or (3) that would qualify under section 1034 by reason of a new residence acquired on or before August 5, 1997 or pursuant to a binding contract in effect on August 5, 1997). Under section 121 as amended, a taxpayer generally excludes up to \$250,000 (\$500,000 for certain joint returns) of gain realized on the sale or exchange of property if the property was owned and used as the tax-

payer's principal residence for at least 2 years during the 5-year period ending on the date of the sale or exchange. The exclusion applies regardless of the age of the taxpayer, and the full exclusion can be used only once every 2 years. A taxpayer who fails to meet these requirements by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances may be entitled to a reduced exclusion.

RRA 1998 amended TRA 1997 to clarify that the reduced exclusion amount under section 121(c) is a portion of the maximum limitation amount (\$250,000 or \$500,000 for certain joint returns), not a portion of the realized gain. See H.R. Rep. No. 356, 105th Cong., 1st Sess. 17 (1997); S. Rep. No. 174, 105th Cong., 2d Sess. 150 (1998). In addition, the amendments provided that for married taxpayers filing jointly but failing to meet the ownership, use, or timing requirements of section 121(b)(2)(A), the maximum limitation amount will be the sum of each spouse's limitation amount determined on a separate basis as if they had not been married. S. Rep. No. 174, 105th Cong., 2d Sess. 151 (1998); H.R. Conf. Rep. No. 599, 105th Cong., 2d Sess. 337 (1998). Lastly, the amendments clarified that a taxpayer may elect to apply prior law under section 1034 or former section 121 to a sale or exchange occurring on as well as before the date of enactment, August 5, 1997. H.R. Rep. No. 356, 105th Cong., 1st Sess. 18 (1997); S. Rep. No. 174, 105th Cong., 2d Sess. 151 (1998).

##### 2. Section 121 Exclusion in Individuals' Title 11 Cases

This document also contains proposed amendments to the Income Taxation Regulations (26 CFR part 1) under section 1398 of the Internal Revenue Code. Under the authority provided in section 1398(g)(8), the regulations add the section 121 exclusion to the list of tax attributes of the debtor that the bankruptcy estate of an individual in a chapter 7 or 11 bankruptcy case under title 11 of the United States Code succeeds to and takes into account in computing the taxable income of the estate. Although these regulations are proposed to be applicable on or after the date they are published as final regulations in the **Federal Register**, in view of the IRS's acquiescence in the case

of *Internal Revenue Service v. Waldschmidt (In re Bradley)*, AOD CC-1999-009 (August 30, 1999), and Chief Counsel Notice (35)000-162 (August 10, 1999), the IRS will not challenge the position taken prior to the effective date of these regulations that a bankruptcy estate may use the section 121 exclusion if the debtor would otherwise satisfy the section 121 requirements.

## Explanation of Provisions

### 1. Section 121 Exclusion

Section 1.121-1(b) of the proposed regulations addresses the definition of principal residence. This section provides that whether or not property is the taxpayer's residence, and whether or not property is used by the taxpayer as the taxpayer's principal residence (in the case of a taxpayer using more than one property as a residence), depends upon all the facts and circumstances. 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.

Section 1.121-1(c) of the proposed regulations addresses the use requirement under section 121(a). This section provides that, in order for a taxpayer to satisfy the use requirement under section 121(a), the taxpayer must occupy the residence (except for short temporary absences) for at least 2 years during the 5-year period ending on the date of the sale or exchange. See H.R. Rep. No. 148, 105th Cong., 1st Sess. at 348 (1997); S. Rep. No. 33, 105th Cong., 1st Sess. at 37 (1997); H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. at 386 (1997).

Section 1.121-1(d) provides that the section 121 exclusion does not apply to so much of the gain from the sale or exchange of property as does not exceed the portion of the depreciation adjustments (as defined in section 1250(b)(3)) attributable to periods after May 6, 1997, in respect of the property.

Section 1.121-1(e) of the proposed regulations provides that if a taxpayer satisfies the use requirement only with respect to a portion of the property sold or exchanged, section 121 will apply only to the gain from the sale or exchange allocable

to that portion. Thus, if the residence was used partially for residential purposes and partially for business purposes, only that part of the gain allocable to the residential portion is excludable under section 121. Furthermore, the section 121 exclusion does not apply to the extent that depreciation attributable to periods after May 6, 1997, exceeds gain allocable to the business-use portion of the property.

Under section 121(c), a reduced exclusion is available for a taxpayer who sells or exchanges property used as the taxpayer's principal residence but fails to satisfy the ownership and use requirements described in section 121(a) or the 2-year limitation described in section 121(b)(3). Section 1.121-3(a) of the proposed regulations provides that the reduced exclusion applies only if the sale or exchange is necessitated by a change in place of employment, health, or, to the extent provided in forms, instructions, or other appropriate guidance including regulations and letter rulings, unforeseen circumstances. The IRS and the Treasury Department request written comments regarding what should qualify as an unforeseen circumstance for purposes of determining whether a taxpayer is eligible to claim the reduced exclusion available under section 121(c).

Under section 121(d)(8), a taxpayer must make an election to have the section 121 exclusion apply to a sale or exchange of a remainder interest in the taxpayer's principal residence. Section 1.121-4(f)(3) provides that the taxpayer makes the election by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the remainder interest in the taxpayer's gross income.

Under section 121(f), a taxpayer must make an election to have the section 121 exclusion not apply to a sale or exchange of the taxpayer's principal residence. Section 1.121-4(h) 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 residence in the taxpayer's gross income.

### 2. Section 121 Exclusion in Individuals' Title 11 Cases

Section 1.1398-3 of the proposed regulations provides that the bankruptcy estate of an individual in a chapter 7 or 11 bank-

ruptcy case under title 11 of the United States Code succeeds to and takes into account the individual's section 121 exclusion if the individual satisfies the requirements of section 121.

### 3. Proposed Effective Date

These regulations are proposed to be applicable for sales or exchanges that occur on or after the date they are published as final regulations in the **Federal Register**.

## Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

## Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies of written comments) that are submitted timely (in the manner described in the ADDRESSES caption) to the IRS. The IRS and Treasury request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 23, 2001, beginning at 10 a.m. in the IRS Auditorium, Seventh Floor, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to

enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of the preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by January 3, 2001. A period of 10 minutes will be allotted to each person making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### Drafting Information

The principal author of these regulations is Sara P. Shepherd, Office of Assistant Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

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### Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805.\*\*\*

Section 1.1398-3 also issued under 26 U.S.C. 1398(g).

Par. 2. Sections 1.121-1, 1.121-2, 1.121-3 and 1.121-4 are revised to read as follows:

*§1.121-1 Exclusion of gain from sale or exchange of a principal residence.*

(a) *In general.* Section 121 provides that, under certain circumstances, gross income does not include gain realized on the sale or exchange of property that was owned and used by a taxpayer as the tax-

payer's principal residence. Subject to the other provisions of section 121, a taxpayer will exclude gain only if, during the 5-year period ending on the date of the sale or exchange, the taxpayer owned and used the property as the taxpayer's principal residence for periods aggregating 2 years or more.

(b) *Principal residence.* Whether or not property is used by the taxpayer as the taxpayer's residence, and whether or not property is used by the taxpayer as the taxpayer's principal residence (in the case of a taxpayer using more than one property as a residence), depends upon all the facts and circumstances. 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. 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 (as those terms are defined in section 216(b)(1) and (2)), if the dwelling that the taxpayer is entitled to occupy as a stockholder is used by the taxpayer as the taxpayer's principal residence. Property used by the taxpayer as the taxpayer's principal residence does not include personal property, that is not a fixture under local law.

(c) *Ownership and use requirements.* The requirements of ownership and use for periods aggregating 2 years or more may be satisfied by establishing ownership and use for 24 full months or for 730 days (365 x 2). The requirements of ownership and use may be satisfied during nonconcurrent periods if both the ownership and use tests are met during the 5-year period ending on the date of the sale or exchange. In establishing whether a taxpayer has satisfied the 2-year use requirement, occupancy of the residence is required. However, short temporary absences, such as for vacation or other seasonal absence (although accompanied with rental of the residence), are counted as periods of use.

(d) *Depreciation taken after May 6, 1997.* The section 121 exclusion does not apply to so much of the gain from the sale or exchange of property as does not exceed the portion of the depreciation ad-

justments (as defined in section 1250(b)(3)) attributable to periods after May 6, 1997, in respect of the property.

(e) *Property used in part as a principal residence.* If a taxpayer satisfies the use requirement only with respect to a portion of the property sold or exchanged, section 121 will apply only to the gain from the sale or exchange allocable to that portion. Thus, if the residence was used partially for residential purposes and partially for business purposes, only that part of the gain allocable to the residential portion is excludable under section 121. Furthermore, the section 121 exclusion does not apply to the extent that depreciation attributable to periods after May 6, 1997, exceeds gain allocable to the business-use portion of the property. See *Example 8* in paragraph (f) of this section.

(f) *Examples.* The provisions of paragraphs (a) through (e) of this section are illustrated by the following examples:

*Example 1.* Taxpayer A has owned and used his house as his principal residence since 1986. On January 1, 1998, A moves to another state. A leases his house from that date until April 18, 2000, when he sells it. A is eligible for the section 121 exclusion because he has owned and used the house as his principal residence for at least 2 years out of the 5 years preceding the sale.

*Example 2.* Taxpayer B owned and used a house as her principal residence from 1986 to the end of 1997. On January 1, 1998, B moved to another state and ceases to use the house. B's move was not necessitated by a change in place of employment, health, or unforeseen circumstances. B's son moved into the house in March 1999 and used the residence until it was sold on July 1, 2001. Taxpayer B may not exclude gain from the sale under section 121 because she did not use the property as her principal residence for at least 2 years out of the 5 years preceding the sale.

*Example 3.* Taxpayer C lived in a townhouse that he rented from 1993 through 1997. On January 1, 1998, he purchased this townhouse. On February 1, 1998, C moved into his daughter's home. On March 1, 2000, while still living in his daughter's home, C sold his townhouse. The section 121 exclusion will apply to gain from the sale because C owned the townhouse for at least 2 years out of the 5 years preceding the sale (from January 1, 1998 until March 1, 2000) and he used the townhouse as his principal residence for at least 2 years during the 5-year period preceding the sale (from March 1, 1995 until February 1, 1998).

*Example 4.* Taxpayer D, a college professor, purchased and moved into a house on May 1, 1997. He used the house as his principal residence continuously until September 1, 1998, when he went abroad for a 1-year sabbatical leave. On October 1, 1999, 1 month after returning from the leave, D sold the house. Because his leave is not considered to be a short temporary absence for purposes of section 121 (see paragraph (c) of this section), the period of

the leave may not be included in determining whether D used the house for periods aggregating 2 years during the 5-year period ending on the date of the sale. Consequently, D is not entitled to exclude gain under section 121 because he did not use the residence for the requisite period.

*Example 5.* Taxpayer E purchased a house on February 1, 1998, that he used as his principal residence. During 1998 and 1999, E left his residence for a 2-month summer vacation. E sold the house on March 1, 2000. Although, in the 5-year period preceding the date of sale, the total time E used his residence is less than 2 years (21 months), the section 121 exclusion will apply to gain from the sale of the residence because the 2-month vacations are short temporary absences and are counted as periods of use in determining whether E used the residence for the requisite period.

*Example 6.* On July 1, 1999, Taxpayer F moves into a house that he owns and had rented to tenants since July 1, 1997. F took depreciation deductions totaling \$14,000 for the period that he rented the property. After using the residence as his principal residence for 2 full years, F sells the property on August 1, 2001. F's gain realized from the sale is \$40,000. F had no capital losses for 2001. Only \$26,000 (\$40,000 gain realized - \$14,000 depreciation deductions) may be excluded under section 121. The \$14,000 of gain recognized by F is unrecaptured section 1250 gain within the meaning of section 1(h).

*Example 7.* Taxpayer G, an attorney, uses a portion of her principal residence as a law office for a period in excess of 3 years out of the 5 years preceding the sale of the property. Because G did not use the law office portion of the property as her residence, the section 121 exclusion does not apply to the gain from the sale that is allocable to the law office portion of the property.

*Example 8.* Taxpayer H buys a house in 1998. For 5 years, H uses a portion of the property as his principal residence and a portion of the property for business purposes. H claims depreciation deductions of \$20,000 for the business use of the property. H sells the property in 2003, realizing a gain of \$50,000. H had no other section 1231 or capital gains or losses for 2003. H determines that \$15,000 of the gain is allocable to the business-use portion of the property and that \$35,000 of the gain is allocable to the portion of the property used as his residence. H must recognize \$15,000 of the gain allocable to the business-use portion of the property. This \$15,000 of gain is unrecaptured section 1250 gain within the meaning of section 1(h). In addition, the section 121 exclusion does not apply to the extent that H's post-May 6, 1997 depreciation (\$20,000) exceeds the gain allocable to the business-use portion of the property (\$15,000). Therefore, H may exclude \$30,000 of the gain from the sale of the property. The remaining \$5,000 of gain is recognized by H as unrecaptured section 1250 gain within the meaning of section 1(h).

*Example 9.* Taxpayer J buys a house in 1998. For 5 years, J uses a portion of the property as her principal residence and a portion of the property for business purposes. J claims depreciation deductions of \$10,000 for the business use of the property. J sells the property in 2003, realizing a gain of \$50,000. J had no other section 1231 or capital gains or losses for 2003. J determines that

\$15,000 of the gain is allocable to the business-use portion of the property and that \$35,000 of the gain is allocable to the portion of the property used as her residence. J must recognize the \$15,000 of gain allocable to the business-use portion of the property (\$10,000 of which is unrecaptured section 1250 gain within the meaning of section 1(h), and \$5,000 of which adjusted net capital gain). J may exclude \$35,000 of the gain from the sale of the property.

*Example 10.* Taxpayer K owns two residences, one in New York and one in Florida. From 1999 through 2003, he lives in the New York residence for 7 months and the Florida residence for 5 months. Thus, K used the New York residence a majority of the time in each year from 1999 through 2003. Therefore, in the absence of facts and circumstances indicating otherwise, the New York residence is his principal residence, and only the New York residence would be eligible for the 121 exclusion if it were sold at the end of 2003.

*Example 11.* Taxpayer L owns two residences, one in Virginia and one in Maine. During 1999 and 2000, she lives in the Virginia residence. During 2001 and 2002, L lives in the Maine residence. During 2003, she lives in the Virginia residence. Her principal residence during 1999, 2000, and 2003 is the Virginia residence. Her principal residence during 2001 and 2002 is the Maine residence. Either residence would be eligible for the 121 exclusion if it were sold during 2003.

(g) *Effective date.* This section and §§1.121-2 through 1.121-4 are applicable for sales and exchanges that occur on or after the date these regulations are published as final regulations in the **Federal Register**.

### *§1.121-2 Limitations.*

(a) *Dollar limitations.* A taxpayer may exclude from gross income up to \$250,000 of gain from the sale or exchange of the taxpayer's principal residence. If taxpayers jointly own a principal residence but file separate returns, each taxpayer will exclude from gross income up to \$250,000 of gain that is attributable to each taxpayer's interest in the property, if the requirements of section 121 have otherwise been met.

(b) *Special rules for joint returns—*  
(1) *In general.* A husband and wife who make a joint return for the year of the sale or exchange may exclude up to \$500,000 of gain if—

(i) Either spouse meets the 2-year ownership requirements of §1.121-1(a);

(ii) Both spouses meet the 2-year use requirements of §1.121-1(a); and

(iii) Neither spouse excluded gain from a prior sale or exchange of property under section 121 within the last 2 years

(as determined under paragraph (c) of this section).

(2) *Other joint returns.* For taxpayers filing jointly, if the spouses fail to meet the requirements of paragraph (b)(1) of this section, 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. For this purpose, each spouse will be treated as owning the property during the period that either spouse owned the property.

(3) *Examples.* The provisions of this paragraph (b) are illustrated by the following examples:

*Example 1.* Married taxpayers H and W sell their residence and the gain realized from the sale is \$256,000. H and W meet the requirements of section 121 and file a joint return for the year of the sale. The entire amount of gain from the sale of their principal residence is excluded from gross income because the gain realized from the sale does not exceed the limitation amount of \$500,000 available to taxpayers filing a joint return.

*Example 2.* During 1999, married taxpayers H and W each sell a residence that each had separately owned and used as a principal residence before their marriage. Each spouse meets the ownership and use tests for his or her respective residence. Neither spouse meets the use requirement for the other spouse's residence. H and W file a joint return for the year of the sales. The gain realized from the sale of H's residence is \$200,000. The gain realized from the sale of W's residence is \$300,000. Because the ownership and use requirements are met for each residence by each respective spouse, H and W are eligible to exclude up to \$250,000 of gain from the sale of each of their residences. However, W may not use H's unused exclusion to exclude gain in excess of her exclusion amount. Therefore, H and W must recognize \$50,000 of the gain realized on the sale of W's residence.

*Example 3.* Married taxpayers H and W sell their residence and file a joint return for the year of the sale. Section 1.121-3 (relating to the reduced exclusion) does not apply to the sale of their residence. W, but not H, satisfies the requirements of section 121. They are eligible to exclude up to \$250,000 of the gain from the sale of the residence because that is the sum of each spouse's dollar limitation amount determined on a separate basis as if they had not been married (\$0 for H, \$250,000 for W).

*Example 4.* Married taxpayers H and W have owned and used their principal residence since 1998. On February 16, 2001, H dies. On September 21, 2001, W sells the residence and realizes a gain of \$350,000. Pursuant to section 6013(a)(3), W and H's executor make a joint return for 2001. All \$350,000 of the gain from the sale of the residence may be excluded.

*Example 5.* Married taxpayers H and W have owned and used their principal residence since 1998. On February 16, 2001, H dies. W sells the residence on March 30, 2002. Because W's filing

status for the taxable year of the sale is single, the special rules for joint returns under paragraph (b) of this section do not apply and W may exclude only \$250,000 of the gain.

(c) *Application of section 121 to only 1 sale or exchange every 2 years*—(1) *In general.* Except as otherwise provided in §1.121-3 (relating to the reduced exclusion), a taxpayer may not exclude from gross income gain from the sale or exchange of a principal residence if, during the 2-year period ending on the date of the sale or exchange, the taxpayer sold or exchanged other property for which gain was excluded under section 121. For purposes of this paragraph (c)(1), any sale or exchange before May 7, 1997 is disregarded.

(2) *Example.* The following example illustrates the rules of this paragraph (c):

*Example.* Taxpayer A owned a townhouse that he used as his principal residence for two full years, 1998 and 1999. A then bought a house in 2000 that he owned and used as his principal residence. A sells the townhouse in 2002 and excludes gain realized on its sale under section 121. A sells the house in the next year, 2003. Section 1.121-3 (relating to the reduced exclusion) does not apply to the sale of the house. Although A meets the 2-year ownership and use requirements of section 121, A is not eligible to exclude gain from the sale of the house because A excluded gain within the last 2 years under section 121 from the sale of the townhouse.

### §1.121-3 Reduced exclusion.

(a) *Reduced exclusion for taxpayers failing to meet certain requirements: In general.* A reduced exclusion is available for a taxpayer who sells or exchanges property used as the taxpayer's principal residence but fails to satisfy the ownership and use requirements described in §1.121-1(a) or the 2-year limitation described in §1.121-2(c). This reduced exclusion applies only if the sale or exchange is necessitated by a change in place of employment, health, or, to the extent provided in forms, instructions, or other appropriate guidance including regulations and letter rulings, unforeseen circumstances. The reduced exclusion is computed by multiplying the maximum dollar limitation of \$250,000 (\$500,000 for certain joint filers) by a fraction. The numerator of the fraction is the shortest of the period of time that the taxpayer owned the property as the taxpayer's principal residence during the 5-year period ending on the date of the sale or exchange; the period of time that the taxpayer used the property during the 5-year period ending

on the date of the sale or exchange; or the period of time between the date of a prior sale or exchange of property for which the taxpayer excluded gain under section 121 and the date of the current sale or exchange. The numerator of the fraction may be expressed in days or months. The denominator of the fraction is 730 days or 24 months (depending on the measure of time used in the numerator).

(b) *Examples.* The following examples illustrate the rules of this section:

*Example 1.* Taxpayer A purchases a house that she uses as her principal residence. Twelve months after the purchase, A sells the house due to a change in place of her employment. A has not excluded gain under section 121 on a prior sale or exchange of property within the last 2 years. A is eligible to exclude up to \$125,000 of the gain from the sale of her house ( $12/24 \times \$250,000$ ).

*Example 2.* (i) Taxpayer H owned a house that he used as his principal residence since 1996. On January 15, 1999, H and W marry and W begins to use H's house as her principal residence. On January 15, 2000, H sells the house due to a change in H's and W's place of employment. Neither H nor W has excluded gain under section 121 on a prior sale or exchange of property within the last 2 years.

(ii) Because H and W have not both used the house as their principal residence for at least 2 years during the 5-year period preceding its sale, the maximum dollar limitation amount that may be claimed by H and W will not be \$500,000, but the sum of each spouse's limitation amount determined on a separate basis as if they had not been married. (See §1.121-2(b)(2).)

(iii) H is eligible to exclude up to \$250,000 of gain because he meets the requirements of section 121. W is not eligible to exclude the maximum dollar limitation amount. Instead, W is eligible to claim a reduced exclusion. Because the sale of the house is due to a change in place of employment, W is eligible to exclude up to \$125,000 of the gain ( $365/730 \times \$250,000$ ). Therefore, H and W are eligible to exclude up to \$375,000 of gain ( $\$250,000 + \$125,000$ ) from the sale of the house.

### §1.121-4 Special rules.

(a) *Property of deceased spouse*—(1) *In general.* For purposes of satisfying the ownership and use requirements of section 121, a taxpayer is treated as owning and using property as the taxpayer's principal residence during any period that the taxpayer's deceased spouse owned and used the property as a principal residence before death if—

(i) The taxpayer's spouse is deceased on the date of the sale or exchange of the property; and

(ii) The taxpayer has not remarried at the time of the sale or exchange of the property.

(2) *Example.* The provisions of this

paragraph (a) are illustrated by the following example:

*Example.* Taxpayer H has owned and used a house as his principal residence since July 1, 1987. H and W marry on July 1, 1999 and from that date they use H's house as their principal residence. H dies on August 15, 2000, and W inherits the property and continues to use the property as her principal residence. W sells the property on September 1, 2000, at which time she has not remarried. Although W has owned and used the house for less than 2 years, W will be considered to have satisfied the ownership and use requirements of section 121 because W's period of ownership and use includes the period that H owned and used the property before death.

(b) *Property owned by spouse or former spouse*—(1) *Property transferred to individual from spouse or former spouse.* If a taxpayer obtains property from a spouse or former spouse in a transaction described in section 1041(a), the period that the taxpayer owns the property will include the period that the spouse or former spouse owned the property.

(2) *Property used by spouse or former spouse.* 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 (as defined in section 71(b)(2)), provided that the spouse or former spouse uses the property as a principal residence.

(c) *Tenant-stockholder in cooperative housing corporation.* A taxpayer who holds stock as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)) may be eligible to exclude gain under section 121 on the sale or exchange of the stock. In determining whether the taxpayer meets the requirements of section 121, the ownership requirements are applied to the holding of the stock and the use requirements are applied to the house or apartment that the taxpayer was entitled to occupy by reason of the taxpayer's stock ownership.

(d) *Involuntary conversions*—(1) *In general.* For purposes of section 121, the destruction, theft, seizure, requisition, or condemnation of property is treated as a sale of the property.

(2) *Application of section 1033.* In applying section 1033 (relating to involuntary conversions), the amount realized from the sale or exchange of property used as the taxpayer's principal residence

is treated as being the amount determined without regard to section 121, reduced by the amount of gain excluded from the taxpayer's gross income under section 121.

(3) *Property acquired after involuntary conversion.* If the basis of the property acquired as a result of an involuntary conversion is determined (in whole or in part) under section 1033(b) (relating to the basis of property acquired through involuntary conversion), then for purposes of satisfying the requirements of section 121, the taxpayer will be treated as owning and using the acquired property as the taxpayer's principal residence during any period of time that the taxpayer owned and used the converted property as the taxpayer's principal residence.

(4) *Example.* The provisions of this paragraph (d) are illustrated by the following example:

*Example.* (i) On February 18, 1999, fire destroys Taxpayer A's house that had an adjusted basis of \$80,000. A had owned and used this property as her principal residence for 20 years prior to its destruction. A's insurance company paid A \$400,000 for the house. Thus, A realized a gain of \$320,000 (\$400,000 - \$80,000). On August 27, 1999, A purchases a new house at a cost of \$100,000.

(ii) Because the destruction of the house is treated as a sale for purposes of section 121, A will exclude \$250,000 of the realized gain from A's gross income. For purposes of section 1033, the amount realized is then treated as being \$150,000 (\$400,000 - \$250,000) and the gain realized is \$70,000 (\$150,000 amount realized - \$80,000 basis). A elects under section 1033 to recognize only \$50,000 of the gain (\$150,000 amount realized - \$100,000 cost of new house). The remaining \$20,000 of gain is deferred and A's basis in the new house is \$80,000 (\$100,000 cost - \$20,000 gain not recognized).

(iii) A will be treated as owning and using the new house as A's principal residence during the 20-year period that A owned and used the destroyed house.

(e) *Determination of use during periods of out-of-residence care.* If a taxpayer has become physically or mentally incapable of self-care and the taxpayer sells or exchanges property that the taxpayer owned and used as the taxpayer's principal residence for a period aggregating at least 1 year during the 5-year period preceding the sale or exchange, the taxpayer is treated as using the property as the taxpayer's principal residence for any period of time during the 5-year period in which the taxpayer owns the property and resides in any facility (including a nursing home) licensed by a State or political subdivision to care for an individual in the taxpayer's condition.

(f) *Sales of remainder interests—(1) In general.* A taxpayer may elect to have the section 121 exclusion apply to gain from the sale or exchange of a remainder interest in the taxpayer's principal residence.

(2) *Limitations—(i) Sale or exchange of any other interest.* If a taxpayer elects to exclude gain from the sale or exchange of a remainder interest in the taxpayer's principal residence, the section 121 exclusion will not apply to a sale or exchange of any other interest in the residence that is sold or exchanged separately.

(ii) *Sales to related parties.* Paragraph (f)(1) of this section will not apply to a sale or exchange by any person who bears a relationship to the taxpayer which is described in section 267(b) or 707(b).

(3) *Election.* The taxpayer makes the election under this paragraph (f) by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the remainder interest in the taxpayer's gross income.

(g) *No exclusion for expatriates.* The section 121 exclusion will not apply to any sale or exchange by an individual if the treatment provided by section 877(a)(1) (relating to the treatment of expatriates) applies to the individual.

(h) *Election to have section not apply.* A taxpayer may elect to have the section 121 exclusion not apply to a sale or exchange of property. 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.

(i) *Residences acquired in rollovers under section 1034.* If a taxpayer acquires property (section 121 property) in a transaction that qualifies under section 1034 for the nonrecognition of gain realized on the sale or exchange of another property (section 1034 property) and later sells or exchanges the section 121 property, in determining the period of the taxpayer's ownership and use of the sold or exchanged section 121 property, the taxpayer may include the periods that the taxpayer owned and used the section 1034 property as the taxpayer's principal residence (and each prior residence taken into account under section 1223(7) in deter-

mining the holding period of the 1034 property).

## **§1.121-5 [Removed]**

Par. 3. Section 1.121-5 is removed.

Par. 4. Section 1.1398-3 is added to read as follows:

### *§1.1398-3 Treatment of section 121 exclusion in individuals' title 11 cases.*

(a) *Scope.* This section applies to cases under chapter 7 or chapter 11 of title 11 of the United States Code, but only if the debtor is an individual.

(b) *Definition and rules of general application.* For purposes of this section, section 121 exclusion means the exclusion of gain from the sale or exchange of a debtor's principal residence available under section 121.

(c) *Estate succeeds to exclusion upon commencement of case.* The bankruptcy estate succeeds to and takes into account the section 121 exclusion with respect to the property transferred into the estate.

(d) *Effective date.* This section is applicable for sales or exchanges that occur on or after the date these regulations are published as final regulations in the **Federal Register**.

Robert E. Wenzel,  
Deputy Commissioner  
of Internal Revenue.

(Filed by the Office of the Federal Register on October 6, 2000, 8:45 a.m., and published in the issue of the Federal Register for October 10, 2000, 65 F.R. 60136)