

Section 121.—Exclusion of Gain From Sale of Principal Residence

26 CFR 1.121-3: Reduced maximum exclusion for taxpayers failing to meet certain requirements.

T.D. 9152

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Reduced Maximum Exclusion of Gain From Sale or Exchange of Principal Residence

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the exclusion of gain from the sale or exchange of a taxpayer's principal residence. The final regulations apply to a taxpayer who has not owned and used the property as the taxpayer's principal residence for two of the preceding five years or who has excluded gain from the sale or exchange of a principal residence within the preceding two years. The final regulations reflect changes to the law by the Taxpayer Relief Act of 1997, as amended by the Internal Revenue Service Restructuring and Reform Act of 1998, and the Military Family Tax Relief Act of 2003.

DATES: *Effective Date:* These final regulations are effective August 13, 2004.

Applicability Date: For dates of applicability, see §§1.121-3(h) and 1.121-5(e).

FOR FURTHER INFORMATION CONTACT: Sara Paige Shepherd, (202) 622-4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR Part 1. On December 24, 2002,

the IRS and Treasury Department published in the **Federal Register** a notice of proposed rulemaking (REG-138882-02, 2003-1 C.B. 522 [67 FR 78398]) by cross reference to temporary regulations (T.D. 9031, 2003-1 C.B. 504 [67 FR 78367]) under section 121(c) of the Internal Revenue Code (Code). The regulations relate to the exclusion of gain from the sale or exchange of the principal residence of a taxpayer who has not owned and used the property as the taxpayer's principal residence for two of the preceding five years or who has excluded gain on the sale or exchange of a principal residence within the preceding two years. Written and electronic comments were received. No public hearing was requested or held.

After considering all of the comments, the proposed regulations are adopted as amended by this Treasury decision, and the corresponding temporary regulations are removed.

Explanation and Summary of Comments

1. *Facts and Circumstances Test*

Under section 121(a), a taxpayer may exclude up to \$250,000 (\$500,000 for certain joint returns) of gain realized on the sale or exchange of the taxpayer's principal residence if the taxpayer owned and used the property as the taxpayer's principal residence for at least two years during the five-year period ending on the date of the sale or exchange. Section 121(b)(3) allows the taxpayer to apply the maximum exclusion to only one sale or exchange during the two-year period ending on the date of the sale or exchange. Section 121(c) provides that a taxpayer who fails to meet any of the conditions by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances, may be entitled to an exclusion in a reduced maximum amount.

The temporary regulations provide, as a general definition, that a sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances only if the taxpayer's primary reason for the sale or exchange is a change in place of employment, health, or unfore-

seen circumstances. The temporary regulations provide factors that may be relevant in determining the taxpayer's primary reason for the sale or exchange.

One commentator asserted that the factors are beyond Congressional intent, unnecessary, and overbroad. The final regulations retain the list of factors because it is helpful in determining the taxpayer's primary reason for the sale or exchange.

For each of the three grounds for claiming a reduced maximum exclusion, the temporary regulations provide a general definition and one or more safe harbors. Under the temporary regulations, if a safe harbor applies, the taxpayer's "primary reason" for the sale or exchange is deemed to be change in place of employment, health, or unforeseen circumstances. For greater simplicity, the final regulations delete the primary reason test from the safe harbors and provide that, if a safe harbor applies, the sale or exchange is deemed to be "by reason of" a change in place of employment, health, or unforeseen circumstances. If a safe harbor does not apply, the taxpayer may be eligible to claim a reduced maximum exclusion if the taxpayer establishes, based on the facts and circumstances, that the taxpayer's primary reason for the sale or exchange is a change in place of employment, health, or unforeseen circumstances.

2. *Unforeseen Circumstances*

The temporary regulations provide that a sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence. One commentator asserted that this definition is beyond Congressional intent and would allow any circumstance giving rise to the sale or exchange of property to qualify for a reduced maximum exclusion.

The final regulations revise the definition of a sale or exchange by reason of unforeseen circumstances from "an event that the taxpayer did not anticipate" to "an event that the taxpayer could not reasonably have anticipated" before purchasing

and occupying the residence. Additionally, the final regulations clarify that a sale or exchange by reason of unforeseen circumstances (other than a sale or exchange within a safe harbor) does not qualify for the reduced maximum exclusion if the primary reason for the sale or exchange is a preference for a different residence or an improvement in financial circumstances. The final regulations provide additional examples illustrating the application of the reduced maximum exclusion rules to situations outside of the unforeseen circumstances safe harbors.

Under the temporary regulations, a taxpayer's primary reason for the sale or exchange is deemed to be unforeseen circumstances if one of the following safe harbor events occurs during the taxpayer's ownership and use of the property: (1) involuntary conversion of the residence, (2) a natural or man-made disaster or act of war or terrorism resulting in a casualty to the residence, and (3) in the case of a qualified individual, (a) death, (b) the cessation of employment as a result of which the individual is eligible for unemployment compensation, (c) a change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household, (d) divorce or legal separation under a decree of divorce or separate maintenance, (e) multiple births resulting from the same pregnancy, or (f) an event determined by the Commissioner to be an unforeseen circumstance. A taxpayer who does not qualify for a safe harbor may demonstrate that, under the facts and circumstances, the primary reason for the sale or exchange is unforeseen circumstances.

Commentators suggested that marriage, bankruptcy of the taxpayer's employer not resulting in the loss of the taxpayer's employment, and the adoption of a family member should be additional unforeseen circumstances safe harbors that qualify for the reduced maximum exclusion.

The final regulations do not adopt these comments. Marriage and adoption are voluntary events that typically lack the degree of unforeseeability common in the other unforeseen circumstances safe harbors, and bankruptcy of the taxpayer's employer unaccompanied by a change in employment status of the taxpayer does not impact the taxpayer's current ability to pay

housing costs. However, these events may still qualify for the reduced maximum exclusion under the facts and circumstances test if, as a result of such an event, the taxpayer's primary reason for the sale or exchange is a change in place of employment, health, or unforeseen circumstances.

For purposes of the reduced maximum exclusion by reason of unforeseen circumstances, the temporary regulations provide that a *qualified individual* includes the taxpayer, the taxpayer's spouse, a co-owner of the residence, and a person whose principal place of abode is in the same household as the taxpayer.

A commentator suggested that the unforeseen circumstances exception should be limited to events involving only the taxpayer and the taxpayer's spouse. The commentator stated that, under this narrower exception, a safe harbor for death would be unnecessary because little, if any, gain would result as a consequence of the step-up in basis provisions of the Code. The commentator also asserted that the safe harbor for involuntary conversions is redundant and unnecessary because section 1033 already provides for non-recognition of gain in such circumstances.

The final regulations do not adopt these comments. The inclusion in the safe harbors of events affecting co-owners and co-inhabitants is appropriate because these events may affect the taxpayer's ability to pay housing costs. The involuntary conversion safe harbor is also appropriate, as both the non-recognition provisions of section 1033 and the exclusion provisions of section 121 may apply to a conversion of property. See section 121(d)(5).

The temporary regulations provide that unforeseen circumstances include events determined by the Commissioner to be unforeseen circumstances to the extent provided in published guidance of general applicability or in a ruling directed to a specific taxpayer. The final regulations clarify that taxpayers may rely on only those determinations made by the Commissioner in published guidance of general applicability. A ruling directed to a specific taxpayer does not establish a safe harbor of general applicability.

3. Health Exception

The temporary regulations provide that a sale or exchange of a residence is by rea-

son of health if the primary reason for the sale or exchange is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. A sale or exchange that is merely beneficial to the general health or well-being of the individual is not a sale or exchange by reason of health. This definition is based on the definition of medical care under section 213.

A commentator suggested eliminating the term *diagnosis* from the definition of sale or exchange by reason of health because taxpayers rarely would sell a residence merely to obtain a diagnosis of a disease, illness, or injury. The final regulations do not adopt this suggestion because, while such sales are likely to be uncommon, they may occur. In addition, retaining *diagnosis* in the general definition of sale or exchange by reason of health maintains uniformity with the definition of medical care under section 213 and reduces complexity.

4. Statute of Limitations

A commentator suggested that the regulations should clarify that, under section 6501, the statute of limitations on assessments arising from the use of the exclusion begins to run from the filing date for the year of the sale or exchange. The final regulations do not address this issue because the issue is well-settled by statute and rules regarding the statute of limitations on assessments are outside the scope of these regulations.

5. Military Exception

Numerous commentators suggested that members of the uniformed services should be accorded a special exception to the use requirement because they are often required to be away from home for extended periods of time and unable to use a property as their principal residence for at least two years during the five-year period prior to a sale or exchange. The final regulations reflect enactment of the Military Family Tax Relief Act of 2003 Public Law 108-121, section 101 (117 Stat. 1335) (MFTRA). The MFTRA amends section 121 to provide that a taxpayer serving (or whose spouse is serving) on qualified

official extended duty as a member of the uniformed services or Foreign Service may elect to suspend the running of the 5-year period for up to 10 years. The election may be made with respect to only one property at a time.

The taxpayer makes an election by filing a return for the taxable year of the sale or exchange of the taxpayer's principal residence that does not include the resulting gain in the taxpayer's gross income. A taxpayer who would qualify to exclude gain under section 121 as a result of the amendments made by the MFTRA but is barred by operation of any law or rule of law may nonetheless claim a refund or credit of an overpayment of tax if the taxpayer files the claim before November 11, 2004.

6. *Effective Dates*

Section 1.121-3 of the final regulations, relating to the reduced maximum exclusion, applies to sales and exchanges on or after August 13, 2004. For sales or exchanges before August 13, 2004, and on or after May 7, 1997, taxpayers may elect to apply the rules retroactively in accordance with §1.121-4(j) and will be afforded audit protection in accordance with §1.121-4(k). Section 1.121-5 of the final regulations, relating to the suspension of the 5-year period for certain members of the uniformed services and Foreign Service, applies to sales and exchanges on or after May 7, 1997.

Special Analysis

It has been determined that this Treasury decision 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 Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Drafting Information

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

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

Par. 2. Section 1.121-3 is amended by:

1. Adding paragraphs (b), (c), (d), (e), and (f).
2. Removing paragraphs (h), (i), (j), and (k).
3. Redesignating paragraph (l) as paragraph (h) and revising it.

The revisions and additions read as follows:

§1.121-3 Reduced maximum exclusion for taxpayers failing to meet certain requirements.

* * * * *

(b) *Primary reason for sale or exchange.* In order for a taxpayer to claim a reduced maximum exclusion under section 121(c), the sale or exchange must be by reason of a change in place of employment, health, or unforeseen circumstances. If a safe harbor described in this section applies, a sale or exchange is deemed to be by reason of a change in place of employment, health, or unforeseen circumstances. If a safe harbor described in this section does not apply, a sale or exchange is by reason of a change in place of employment (within the meaning of paragraph (c) of this section), health (within the meaning of paragraph (d) of this section), or unforeseen circumstances (within the meaning of paragraph (e) of

this section). Whether the requirements of this section are satisfied depends upon all the facts and circumstances. Factors that may be relevant in determining the taxpayer's primary reason for the sale or exchange include (but are not limited to) the extent to which—

(1) The sale or exchange and the circumstances giving rise to the sale or exchange are proximate in time;

(2) The suitability of the property as the taxpayer's principal residence materially changes;

(3) The taxpayer's financial ability to maintain the property is materially impaired;

(4) The taxpayer uses the property as the taxpayer's residence during the period of the taxpayer's ownership of the property;

(5) The circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and

(6) The circumstances giving rise to the sale or exchange occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

(c) *Sale or exchange by reason of a change in place of employment—(1) In general.* A sale or exchange is by reason of a change in place of employment if, in the case of a qualified individual described in paragraph (f) of this section, the primary reason for the sale or exchange is a change in the location of the individual's employment.

(2) *Distance safe harbor.* A sale or exchange is deemed to be by reason of a change in place of employment (within the meaning of paragraph (c)(1) of this section) if—

(i) The change in place of employment occurs during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence; and

(ii) The qualified individual's new place of employment is at least 50 miles farther from the residence sold or exchanged than was the former place of employment, or, if there was no former place of employment, the distance between the qualified individual's new place of employment and the residence sold or exchanged is at least 50 miles.

(3) *Employment.* For purposes of this paragraph (c), *employment* includes the commencement of employment with a new employer, the continuation of employment with the same employer, and the commencement or continuation of self-employment.

(4) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1. A is unemployed and owns a townhouse that she has owned and used as her principal residence since 2003. In 2004 A obtains a job that is 54 miles from her townhouse, and she sells the townhouse. Because the distance between A's new place of employment and the townhouse is at least 50 miles, the sale is within the safe harbor of paragraph (c)(2) of this section and A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 2. B is an officer in the United States Air Force stationed in Florida. B purchases a house in Florida in 2002. In May 2003, B moves out of his house to take a 3-year assignment in Germany. B sells his house in January 2004. Because B's new place of employment in Germany is at least 50 miles farther from the residence sold than is B's former place of employment in Florida, the sale is within the safe harbor of paragraph (c)(2) of this section and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 3. C is employed by Employer R at R's Philadelphia office. C purchases a house in February 2002 that is 35 miles from R's Philadelphia office. In May 2003, C begins a temporary assignment at R's Wilmington office that is 72 miles from C's house, and moves out of the house. In June 2005, C is assigned to work in R's London office. C sells her house in August 2005 as a result of the assignment to London. The sale of the house is not within the safe harbor of paragraph (c)(2) of this section by reason of the change in place of employment from Philadelphia to Wilmington because the Wilmington office is not 50 miles farther from C's house than is the Philadelphia office. Furthermore, the sale is not within the safe harbor by reason of the change in place of employment to London because C is not using the house as her principal residence when she moves to London. However, C is entitled to claim a reduced maximum exclusion under section 121(c)(2) because, under the facts and circumstances, the primary reason for the sale is the change in C's place of employment.

Example 4. In July 2003 D, who works as an emergency medicine physician, buys a condominium that is 5 miles from her place of employment and uses it as her principal residence. In February 2004, D obtains a job that is located 51 miles from D's condominium. D may be called in to work unscheduled hours and, when called, must be able to arrive at work quickly. Because of the demands of the new job, D sells her condominium and buys a townhouse that is 4 miles from her new place of employment. Because D's new place of employment is only 46 miles farther from the condominium than is D's former place of employment, the sale is not within the safe harbor of paragraph (c)(2) of this section. However, D is entitled to claim a reduced maximum exclusion under section 121(c)(2) because, under the facts and circumstances, the primary reason for the sale is the change in D's place of employment.

(d) *Sale or exchange by reason of health*—(1) *In general.* A sale or exchange is by reason of health if the primary reason for the sale or exchange is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual described in paragraph (f) of this section, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. A sale or exchange that is merely beneficial to the general health or well-being of an individual is not a sale or exchange by reason of health.

(2) *Physician's recommendation safe harbor.* A sale or exchange is deemed to be by reason of health if a physician (as defined in section 213(d)(4)) recommends a change of residence for reasons of health (as defined in paragraph (d)(1) of this section).

(3) *Examples.* The following examples illustrate the rules of this paragraph (d):

Example 1. In 2003, A buys a house that she uses as her principal residence. A is injured in an accident and is unable to care for herself. A sells her house in 2004 and moves in with her daughter so that the daughter can provide the care that A requires as a result of her injury. Because, under the facts and circumstances, the primary reason for the sale of A's house is A's health, A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 2. H's father has a chronic disease. In 2003, H and W purchase a house that they use as their principal residence. In 2004, H and W sell their house in order to move into the house of H's father so that they can provide the care he requires as a result of his disease. Because, under the facts and circumstances, the primary reason for the sale of their house is the health of H's father, H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 3. H and W purchase a house in 2003 that they use as their principal residence. Their son suffers from a chronic illness that requires regular medical care. Later that year their son begins a new treatment that is available at a hospital 100 miles away from their residence. In 2004, H and W sell their house so that they can be closer to the hospital to facilitate their son's treatment. Because, under the facts and circumstances, the primary reason for the sale is to facilitate the treatment of their son's chronic illness, H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 4. B, who has chronic asthma, purchases a house in Minnesota in 2003 that he uses as his principal residence. B's doctor tells B that moving to a warm, dry climate would mitigate B's asthma symptoms. In 2004, B sells his house and moves to Arizona to relieve his asthma symptoms. The sale is within the safe harbor of paragraph (d)(2) of this section and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 5. In 2003, H and W purchase a house in Michigan that they use as their principal residence.

H's doctor tells H that he should get more outdoor exercise, but H is not suffering from any disease that can be treated or mitigated by outdoor exercise. In 2004, H and W sell their house and move to Florida so that H can increase his general level of exercise by playing golf year-round. Because the sale of the house is merely beneficial to H's general health, the sale of the house is not by reason of H's health. H and W are not entitled to claim a reduced maximum exclusion under section 121(c)(2).

(e) *Sale or exchange by reason of unforeseen circumstances*—(1) *In general.* A sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence. A sale or exchange by reason of unforeseen circumstances (other than a sale or exchange deemed to be by reason of unforeseen circumstances under paragraph (e)(2) or (3) of this section) does not qualify for the reduced maximum exclusion if the primary reason for the sale or exchange is a preference for a different residence or an improvement in financial circumstances.

(2) *Specific event safe harbors.* A sale or exchange is deemed to be by reason of unforeseen circumstances (within the meaning of paragraph (e)(1) of this section) if any of the events specified in paragraphs (e)(2)(i) through (iii) of this section occur during the period of the taxpayer's ownership and use of the residence as the taxpayer's principal residence:

(i) The involuntary conversion of the residence.

(ii) Natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence (without regard to deductibility under section 165(h)).

(iii) In the case of a qualified individual described in paragraph (f) of this section—

(A) Death;

(B) The cessation of employment as a result of which the qualified individual is eligible for unemployment compensation (as defined in section 85(b));

(C) A change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household (including amounts for food, clothing, medical expenses, taxes, transportation, court-ordered payments, and expenses reasonably necessary to the production of income, but

not for the maintenance of an affluent or luxurious standard of living);

(D) Divorce or legal separation under a decree of divorce or separate maintenance; or

(E) Multiple births resulting from the same pregnancy.

(3) *Designation of additional events as unforeseen circumstances.* The Commissioner may designate other events or situations as unforeseen circumstances in published guidance of general applicability and may issue rulings addressed to specific taxpayers identifying other events or situations as unforeseen circumstances with regard to those taxpayers (see §601.601(d)(2) of this chapter).

(4) *Examples.* The following examples illustrate the rules of this paragraph (e):

Example 1. In 2003, A buys a house in California. After A begins to use the house as her principal residence, an earthquake causes damage to A's house. A sells the house in 2004. The sale is within the safe harbor of paragraph (e)(2)(ii) of this section and A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 2. H works as a teacher and W works as a pilot. In 2003, H and W buy a house that they use as their principal residence. Later that year W is furloughed from her job for six months. H and W are unable to pay their mortgage and reasonable basic living expenses for their household during the period W is furloughed. H and W sell their house in 2004. The sale is within the safe harbor of paragraph (e)(2)(iii)(C) of this section and H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 3. In 2003, H and W buy a two-bedroom condominium that they use as their principal residence. In 2004, W gives birth to twins and H and W sell their condominium and buy a four-bedroom house. The sale is within the safe harbor of paragraph (e)(2)(iii)(E) of this section, and H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 4. In 2003, B buys a condominium in a high-rise building and uses it as his principal residence. B's monthly condominium fee is \$X. Three months after B moves into the condominium, the condominium association replaces the building's roof and heating system. Six months later, B's monthly condominium fee doubles in order to pay for the repairs. B sells the condominium in 2004 because he is unable to afford the new condominium fee along with a monthly mortgage payment. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale, the doubling of the condominium fee, is an unforeseen circumstance because B could not reasonably have anticipated that the condominium fee would double at the time he purchased and occupied the property. Consequently, the sale of the condominium is by reason of unforeseen circumstances and B is entitled to

claim a reduced maximum exclusion under section 121(c)(2).

Example 5. In 2003, C buys a house that he uses as his principal residence. The property is located on a heavily traveled road. C sells the property in 2004 because C is disturbed by the traffic. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reason for the sale, the traffic, is not an unforeseen circumstance because C could reasonably have anticipated the traffic at the time he purchased and occupied the house. Consequently, the sale of the house is not by reason of unforeseen circumstances and C is not entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 6. In 2003, D and her fiancé E buy a house and live in it as their principal residence. In 2004, D and E cancel their wedding plans and E moves out of the house. Because D cannot afford to make the monthly mortgage payments alone, D and E sell the house in 2004. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale, the broken engagement, is an unforeseen circumstance because D and E could not reasonably have anticipated the broken engagement at the time they purchased and occupied the house. Consequently, the sale is by reason of unforeseen circumstances and D and E are each entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 7. In 2003, F buys a small condominium that she uses as her principal residence. In 2005, F receives a promotion and a large increase in her salary. F sells the condominium in 2004 and purchases a house because she can now afford the house. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reason for the sale of the house, F's salary increase, is an improvement in F's financial circumstances. Under paragraph (e)(1) of this section, an improvement in financial circumstances, even if the result of unforeseen circumstances, does not qualify for the reduced maximum exclusion by reason of unforeseen circumstances under section 121(c)(2).

Example 8. In April 2003, G buys a house that he uses as his principal residence. G sells his house in October 2004 because the house has greatly appreciated in value, mortgage rates have substantially decreased, and G can afford a bigger house. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reasons for the sale of the house, the changes in G's house value and in the mortgage rates, are an improvement in G's financial circumstances. Under paragraph (e)(1) of this section, an improvement in financial circumstances, even if the result of unforeseen circumstances, does not qualify for the reduced maximum exclusion by reason of unforeseen circumstances under section 121(c)(2).

Example 9. H works as a police officer for City X. In 2003, H buys a condominium that he uses as his principal residence. In 2004, H is assigned to City X's K-9 unit and is required to care for the police service dog at his home. Because H's condominium association does not permit H to have a dog in his condominium, in 2004 he sells the condominium and buys a house. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale,

H's assignment to the K-9 unit, is an unforeseen circumstance because H could not reasonably have anticipated his assignment to the K-9 unit at the time he purchased and occupied the condominium. Consequently, the sale of the condominium is by reason of unforeseen circumstances and H is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 10. In 2003, J buys a small house that she uses as her principal residence. After J wins the lottery, she sells the small house in 2004 and buys a bigger, more expensive house. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reason for the sale of the house, winning the lottery, is an improvement in J's financial circumstances. Under paragraph (e)(1) of this section, an improvement in financial circumstances, even if the result of unforeseen circumstances, does not qualify for the reduced maximum exclusion under section 121(c)(2).

(f) *Qualified individual.* For purposes of this section, qualified *individual means*—

- (1) The taxpayer;
- (2) The taxpayer's spouse;
- (3) A co-owner of the residence;
- (4) A person whose principal place of abode is in the same household as the taxpayer; or

(5) For purposes of paragraph (d) of this section, a person bearing a relationship specified in sections 152(a)(1) through 152(a)(8) (without regard to qualification as a dependent) to a qualified individual described in paragraphs (f)(1) through (4) of this section, or a descendant of the taxpayer's grandparent.

* * * * *

(h) *Effective dates.* Paragraphs (a) and (g) of this section are applicable for sales and exchanges on or after December 24, 2002. Paragraphs (b) through (f) of this section are applicable for sales and exchanges on or after August 13, 2004.

§1.121-3T [Removed]

Par. 3. Section 1.121-3T is removed.

Par. 4. Section 1.121-5 is added to read as follows:

§1.121-5 Suspension of 5-year period for certain members of the uniformed services and Foreign Service.

(a) *In general.* Under section 121(d)(9), a taxpayer who is serving (or whose spouse is serving) on qualified official extended duty as a member of the uniformed services or Foreign Service of the United States may elect to suspend the running of the 5-year period of ownership and use

during such service but for not more than 10 years. The election does not suspend the running of the 5-year period for any period during which the running of the 5-year period with respect to any other property of the taxpayer is suspended by an election under section 121(d)(9).

(b) *Manner of making election.* The taxpayer makes the election under section 121(d)(9) and this section by filing a return for the taxable year of the sale or exchange of the taxpayer's principal residence that does not include the gain in the taxpayer's gross income.

(c) *Application of election to closed years.* A taxpayer who would otherwise qualify under §§1.121-1 through 1.121-4 to exclude gain from a sale or exchange of a principal residence on or after May 7, 1997, may elect to apply section 121(d)(9) and this section for any years for which a claim for refund is barred by operation of any law or rule of law by filing an amended return before November 11, 2004.

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

Example. B purchases a house in Virginia in 2003 that he uses as his principal residence for 3 years. For 8 years, from 2006 through 2014, B serves on qualified official extended duty as a member of the Foreign Service of the United States in Brazil. In 2015, B sells the house. B did not use the house as his principal residence for 2 of the 5 years preceding the sale. Under section 121(d)(9) and this section, however, B may elect to suspend the running of the 5-year period of ownership and use during his 8-year period of service with the Foreign Service in Brazil. If B makes the election, the 8-year period is not counted in determining whether B used the house for 2 of the 5 years preceding the sale. Therefore, B may exclude the gain from the sale of the house under section 121.

(e) *Effective date.* This section is applicable for sales and exchanges on or after May 7, 1997.

Nancy Jardini,
*Acting Deputy Commissioner for
Services and Enforcement.*

Approved July 29, 2004.

Gregory F. Jenner,
Acting Assistant Secretary of the Treasury.