



OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Timeliness of I.R.C. § 121 Election

This Field Service Advice responds to your request for advice which was processed on February 9, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =
Year 1 =

ISSUE

Is an election to exclude gain on the sale of a principal residence under I.R.C. § 121 prior to its amendment by the Taxpayer Relief Act of 1997, timely if the taxpayer files a late return, electing the exclusion, after receiving a notice of deficiency and petitioning the United States Tax Court?

CONCLUSION

Taxpayer's election is timely, under I.R.C. § 6512(b)(3)(A), if a payment is made after the issuance of the deficiency notice.

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FACTS

Prior to changes made by the Taxpayer Relief Act of 1997 (“the 1997 Act”), taxpayers who sold a principal residence and purchased a new principal residence within two years could roll over all or part of the gain on the sale of the old residence under former section 1034. Under section 121, prior to its amendment by the 1997 Act, a taxpayer who had attained the age of 55 on the date of the sale also had a one-time election to exclude permanently a limited amount of gain on the sale of the taxpayer’s principal residence.

In your case Taxpayer, in Year 1, a year governed by former section 121, sold his principal residence and qualified to exclude the gain. However, originally he did not elect to exclude the gain. In fact, he filed no tax return, made no payments of tax, and had no withholding or other prepayment credits for the year. He did not purchase a qualifying replacement property under former section 1034. Six years later, in response to a notice of deficiency, Taxpayer petitioned the Tax Court and then filed a return electing the section 121 exclusion.

DISCUSSION

Section 121(c), as in effect prior to the 1997 Act, provided that the election to exclude gain from the sale or exchange of a principal residence may be made at any time before the expiration of the period for making a claim for credit or refund of the tax imposed for the year in which the sale or exchange occurred.

Under section 6511, a claim for credit or refund must generally be filed within three years from the time the return was filed, or two years from the time the tax was paid, whichever is later.

If Taxpayer had not filed a petition with the Tax Court, the election would have been timely. Just as the Service has three years from the filing of a late return to make an assessment, a taxpayer generally has three years from the filing of a late return (or, if longer, two years from a payment) to claim a refund. See Rev. Rul. 57-354, 1957-2 C.B. 913; Rev. Rul. 76-511, 1976-2 C.B. 428; Rev. Rul. 78-343, 1978-2 C.B. 326 (Situation 2).¹ Thus, had Taxpayer not filed a petition with the Tax Court,

¹ See also “Special Report: What To Do If You Haven’t Filed Your 1996 Income Tax Return,” IRS Digital Daily Website (www.irs.treas.gov/hot/tax-return96.html) (taxpayers had until April 15, 2000, to file delinquent returns claiming refunds of prepayment credits for 1996). The Service does not follow the stricter 2-year rule set forth in Miller v. United States, 38 F.3d 473, 475 (9th Cir. 1994). In dictum, the Supreme Court recently agreed with the Service’s reading of the statute. See Baral v. United States, 120 S.Ct. 1006, 1008 (February 22, 2000) (“Since Baral had filed his [delinquent] return on June 1, 1993, and had earlier received a 4-month extension from the initial due date, the relevant look-back period under section 6511(b)(2)(A) extended from June 1, 1993, back to February 1, 1990 (i.e., three years

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he would have had three years from the time he filed his late return to make the section 121 election. Alternatively, if Taxpayer had paid the deficiency, he would have had two years from that time to make the section 121 election and recover the payment.

The question is therefore whether the result should differ because Taxpayer filed a petition with the Tax Court, at which point the relevant limitations period on any refund is set by section 6512 rather than section 6511.

Section 6512 provides generally that if a taxpayer files a petition with the Tax Court, no credit or refund of tax for that tax year may be made except as to overpayments determined by the Tax Court. In making that determination, certain limits are imposed by section 6512(b)(3), which provides, in part, that to be refundable, the tax must have been paid:

(A) after the mailing of the notice of deficiency, [or]

(B) within the period which would be applicable under section 6511(b)(2), (c), or (d), if on the date of the mailing of the notice of deficiency a claim had been filed (whether or not filed) stating the grounds upon which the Tax Court finds that there is an overpayment,

Applying this provision to the present issue, the first question is whether the limitations period set by section 6512 is part of the "period for making a claim for credit or refund" within the meaning of former section 121(c). We conclude that it is. Although a "claim," as such, is unnecessary once a case is in Tax Court, section 6512 is closely correlated with section 6511, and performs an analogous function. See Commissioner v. Lundy, 516 U.S. 235, 241 (1996). Moreover, it would seem inconsistent with congressional intent to require taxpayers to forgo an otherwise allowable election in order to contest a deficiency in Tax Court.

The remaining question, therefore, concerns the application of sections 121(c) and 6512 to the present case.

Arguably, Taxpayer's section 121 election was timely under section 6512(b)(3)(B), on the theory that a claim based on the section 121 election would have been timely if it had been filed on the date of the deficiency notice. However, since no payments were made prior to the issuance of the deficiency notice, in order for this reasoning to apply, the claim arguably would have to be treated as having been filed within the 3-year period, rather than the 2-year period, in section 6511(a). In the Lundy case, however, the Court held that when a taxpayer does not file a return

plus four months.”).

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until after a deficiency notice is issued, for section 6512(b)(3)(B) purposes the taxpayer is not treated as having filed within the 3-year period in section 6511(a), and only the 2-year look-back period applies. Although Lundy was subsequently overruled by Congress in favor of a 3-year look-back period for taxpayers in Tax Court, see section 6512(b)(3) (last sentence), Taxpayer's case is governed by prior law.

While section 6512(b)(3)(B) may not apply, however, under section 6512(b)(3)(A) a refund or credit may be made of any amount that was paid "after the mailing of the notice of deficiency." Therefore, if Taxpayer pays an amount of tax, the refund period would be open under section 6512 and Taxpayer could make the section 121 election.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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