

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

26 CFR 1.121-1: Exclusion of gain from sale or exchange of a principal residence.

T.D. 9030

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Exclusion of Gain From Sale or Exchange of a 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. These 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.

DATES: *Effective Date:* These regulations are effective December 24, 2002.

Applicability Date: For dates of applicability, see §§ 1.121-1(f), 1.121-2(c), 1.121-3(l), 1.121-4(l), and 1.1398-3(d).

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

SUPPLEMENTARY INFORMATION:

Background

On October 10, 2000, the IRS and the Treasury Department published in the **Federal Register** a notice of proposed rulemaking (REG-105235-99, 2000-44 I.R.B. 447 [65 FR 60136]) under section 121 of the Internal Revenue Code. Comments were specifically requested regarding what circumstances should qualify as unforeseen for purposes of the reduced maximum exclusion under section 121(c). Written and electronic comments responding to the notice of proposed rulemaking were received. A public hearing was held on January 26, 2001.

After considering all of the comments, the proposed regulations are adopted as amended by this Treasury decision. Proposed and temporary regulations regarding the reduced maximum exclusion are also published in this issue of the **Federal Register**.

On September 9, 2002, the IRS published Notice 2002-60, 2002-36 I.R.B. 482, which provides that certain taxpayers affected by the September 11, 2001, terrorist attacks may claim a reduced maximum exclusion for a sale or exchange of the taxpayer's principal residence by reason of unforeseen circumstances.

Explanation and Summary of Comments

1. Exclusion of Gain from the Sale or Exchange of a Principal Residence

Under section 121 and the proposed regulations, 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.

a. Principal residence

The proposed regulations provide that whether property is used by the taxpayer as the taxpayer's residence, and whether the property is used as the taxpayer's principal residence, depends upon all the facts and circumstances. The proposed regulations further provide that if a taxpayer alternates between two properties, the property that the taxpayer uses a majority of the time during the year will ordinarily be considered the taxpayer's principal residence.

Commentators requested a bright line test or a list of factors to identify a property as the taxpayer's principal residence in the case of a taxpayer with multiple residences. Other commentators questioned whether the property that a taxpayer uses a majority of the time during the year should generally be considered the taxpayer's principal residence, arguing that the determination of the taxpayer's principal residence should be judged on a day-by-day, rather than a year-by-year, basis.

The final regulations continue to provide that the residence that the taxpayer uses a majority of the time during the year will ordinarily be considered the taxpayer's principal residence. However, this test is not dispositive. The final regulations also include a nonexclusive list of factors that are relevant in identifying a property as a taxpayer's principal residence.

b. Vacant land

Commentators requested clarification of the circumstances in which vacant land surrounding a residential structure would be treated as part of the residence for purposes of section 121. Several commentators maintained that a taxpayer who sells vacant land should be entitled to the section 121 exclusion if the taxpayer used the vacant land in conjunction with a dwelling unit as the taxpayer's principal residence for at least two years.

Under section 1034 and former section 121, a sale of vacant land that did not include a dwelling unit did not qualify as a sale of the taxpayer's residence. See Rev. Rul. 56-420, 1956-2 C.B. 519; Rev. Rul. 83-50, 1983-1 C.B. 41; *O'Barr v. Commissioner*, 44 T.C. 501 (1965); *Roy v. Commissioner*, T.C. Memo. 1995-23; *Hale v. Commissioner*, T.C. Memo. 1982-527. However, if the sale of vacant land was one of a series of transactions that included the

sale of the house, and the series of transactions all occurred during the replacement period provided by section 1034 (two years before or after the date of the taxpayer's purchase of a replacement residence), the sale of vacant land and the sale of the house were treated as one sale. See *Bogley v. Commissioner*, 263 F.2d 746 (4th Cir. 1959); Rev. Rul. 76-541, 1976-2 C.B. 246.

Consequently, the final regulations provide that section 121 applies to the sale or exchange of vacant land that the taxpayer has owned and used as part of the taxpayer's principal residence if the sale or exchange of the dwelling unit occurs within two years before or after the sale or exchange of the vacant land. The vacant land must be adjacent to land containing the dwelling unit and the sale or exchange of the vacant land must otherwise satisfy the requirements of section 121.

For purposes of section 121(b)(1) and (2) (regarding the maximum limitation amount of the section 121 exclusion), sales or exchanges of the dwelling unit and vacant land are treated as one sale or exchange. Therefore, only one maximum limitation amount of \$250,000 (\$500,000 for certain joint returns) applies to the combined sales or exchanges of the vacant land and dwelling unit. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, gain from the sale or exchange of the dwelling unit, up to the maximum limitation amount under section 121(b)(1) or (2), is excluded first, and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and § 1.121-2(a)(3)(i) (relating to the limitation for certain joint returns) apply. Sales or exchanges of the dwelling unit and adjacent vacant land in separate transactions are disregarded in applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years) to each other but are taken into account as a sale or exchange of a principal residence on the date of each transaction in applying section 121(b)(3) to that transaction and the sale or exchange of any other principal residence.

2. Use as a Principal Residence

a. Occupancy requirement

Numerous commentators asserted that the two-year use requirement of section 121

should not require actual occupancy. Instead, they argued for a facts and circumstances test similar to the test employed under section 1034. Under that test, a taxpayer's non-occupancy of a residence would count as use if the taxpayer did not intend to abandon the property as the taxpayer's principal residence. The final regulations do not adopt this suggestion because it is inconsistent with the statutory approach under section 121 of aggregating periods of use over a five-year period, and with the legislative history that provides that "a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange." See H.R. Rep. No. 148, 105th Cong., 1st Sess. 348 (1997), 1997-4 (Vol. 1) C.B. 319, 670; S. Rep. No. 33, 105th Cong., 1st Sess. 37 (1997), 1997-4 (Vol. 2) C.B. 1067, 1117; H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 386 (1997), 1997-4 (Vol. 2) C.B. 1457, 1856.

Commentators proposed a special exception to the occupancy requirement for taxpayers who are absent from the home for an extended period of time due to employment but have not purchased a replacement residence. Other commentators suggested that members of the uniformed services and the United States Foreign Service should be accorded a special exception because they are often away from home for extended periods of time. A commentator also requested that the home day-care industry be exempted from the occupancy requirement because calculating the days of actual occupancy presents a particular difficulty for home daycare providers who often use the same space for residential and business purposes.

The final regulations do not adopt these comments because there is no specific authority under section 121 to provide exceptions to the use requirement except in the cases of property of a deceased spouse (section 121(d)(2)), property of a former spouse (section 121(d)(3)(B)), and out-of-residence care (section 121(d)(7)). Moreover, section 1034 contained a special rule for members of the Armed Forces, which Congress did not include in enacting section 121.

b. Short temporary absences

Commentators requested that the regulations specify a maximum period of time

that would constitute a short temporary absence from the residence and be considered use for purposes of satisfying the two-year use requirement. One commentator suggested that periods of up to five years away from home due to international employment assignments should be considered short temporary absences.

Because the determination of whether an absence is short and temporary depends on the facts and circumstances, the final regulations do not adopt these suggestions.

c. Property used in part as a principal residence

The proposed regulations provide that if a taxpayer satisfies the use requirement with respect to only a portion of the property sold or exchanged, section 121 will apply only to the gain allocable to that portion. Thus, if the residence was used partially for residential purposes and partially for business purposes (mixed-use property), only that part of the gain allocable to the residential portion is excludable under section 121.

Under section 121(d)(6), the exclusion does not apply to so much of the gain from the sale of the property as does not exceed depreciation attributable to periods after May 6, 1997. Commentators suggested that the enactment of section 121(d)(6) illustrates legislative intent to eliminate the allocation requirement for mixed-use property that existed under prior law.

The IRS and Treasury Department have reconsidered the allocation rules of the proposed regulations. The final regulations provide that section 121 will not apply to the gain allocable to any portion of property sold or exchanged with respect to which a taxpayer does not satisfy the use requirement if the non-residential portion is separate from the dwelling unit. Additionally, if the depreciation for periods after May 6, 1997, attributable to the non-residential portion of the property exceeds the gain allocable to the non-residential portion of the property, the excess will not reduce the section 121 exclusion applicable to gain allocable to the residential portion of the property. No allocation of gain is required if both the residential and non-residential portions of the property are within the same dwelling unit, however, section 121 will not apply to the gain to the extent of any post-May 6, 1997, depreciation adjustments. The final regulations provide that the term *dwelling-*

ing unit has the same meaning as in section 280A(f)(1), but does not include appurtenant structures or other property.

A commentator asked for clarification regarding how to allocate the basis and the amount realized under the allocation rules between the portions of the property used for business and residential purposes. The commentator suggested that the regulations should require allocation on the same basis used to determine previous depreciation deductions. The regulations adopt this comment and provide that the taxpayer must use the same method to allocate the basis and the amount realized between the business and residential portions of the property as the taxpayer used to allocate the basis for purposes of depreciation, if applicable.

3. Ownership by Trusts

Commentators suggested that the regulations adopt the holdings of Rev. Rul. 66-159, 1966-1 C.B. 162, and Rev. Rul. 85-45, 1985-1 C.B. 183, regarding treatment of sales of property by certain trusts. Rev. Rul. 66-159 holds that, in cases in which the grantor is treated as the owner of the entire trust under sections 676 and 671, gain realized from the sale of trust property used by the grantor as the grantor's principal residence qualifies under section 1034 for the rollover of gain into a replacement residence. Because the grantor is treated as the owner of the entire trust, the sale by the trust will be treated for federal income tax purposes as if made by the grantor.

Rev. Rul. 85-45 holds that, in cases in which the beneficiary of a trust is treated as the owner of the entire trust under sections 678 and 671, gain realized from the sale of trust property used by the beneficiary as the beneficiary's principal residence qualifies for the one-time exclusion of gain from the sale of a residence under former section 121. For the period that the beneficiary is treated as the owner of the entire trust, the beneficiary will be treated as owning the property for section 121 purposes, and the sale by the trust will be treated for federal income tax purposes as if made by the beneficiary.

The final regulations adopt these suggestions and provide that, if a residence is held by a trust, a taxpayer is treated as the owner and the seller of the residence during the period that the taxpayer is treated as the owner of the trust or the portion of

the trust that includes the residence under sections 671 through 679. The regulations provide similar treatment for certain single-owner entities.

4. Dollar Limitations Applicable to Jointly Owned Property

Commentators requested further clarification of the application of the dollar limitations of section 121(b) to non-married taxpayers who are joint owners of a residence. In response, the final regulations provide that each unmarried taxpayer who jointly owns a principal residence may be eligible to exclude from gross income up to \$250,000 of gain that is attributable to each taxpayer's interest in the property.

5. Reduced Maximum Exclusion

Section 121(c) provides an exclusion of gain in a reduced maximum amount for taxpayers who have owned or used a principal residence for less than two of the five years preceding the sale or exchange or who have excluded gain from another sale or exchange during the last two years. Taxpayers who fail to meet any of these conditions may qualify for the reduced maximum exclusion if the sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances.

The proposed regulations explain the general rule and the computation of the reduced maximum exclusion but do not provide rules clarifying what is a sale or exchange by reason of a change in place of employment, health, or unforeseen circumstances. Comments were requested regarding what circumstances should qualify as unforeseen. Because the rules formulated in response to the comments are extensive, the IRS and Treasury Department have concluded that it is appropriate to publish proposed and temporary regulations to provide the public with adequate notice and opportunity to comment. These proposed and temporary regulations are published elsewhere in this issue of the Bulletin. The final regulations provide guidance regarding the computation of the reduced maximum exclusion.

6. Property of Deceased Spouse

Commentators suggested that the regulations allow a surviving spouse to exclude up to \$500,000 of gain if the sale or exchange of the marital home occurs within one year of the death of the decedent spouse

and the requirements of section 121 are otherwise met. Under section 121(b)(2), the \$500,000 exclusion is only available to spouses who file a joint return. A surviving spouse is eligible to file a joint return with the decedent spouse only for the year of the decedent spouse's death. Therefore, the final regulations do not adopt this suggestion.

Commentators also requested clarification regarding the computation of basis and gain for surviving spouses. They asked for guidance regarding the advantages of titling the marital home in the names of both spouses so that a surviving spouse can obtain a step-up in basis and, consequently, realize less gain from the disposition of the marital home. Because the rules regarding the computation of basis and gain are outside the scope of these regulations, the final regulations do not address these issues.

7. Partial Interests

Commentators suggested that the regulations clarify that a taxpayer who sells a partial interest in the taxpayer's principal residence and more than two years later sells the remaining interest in the same property is entitled to use up to the full exclusion for each sale.

The final regulations provide that a taxpayer may exclude gain from the sale or exchange of partial interests (other than interests remaining after the sale or exchange of a remainder interest) in the taxpayer's principal residence if the interest sold or exchanged includes an interest in the dwelling unit.

However, the IRS and Treasury Department believe that allowing more than the maximum limitation amount with respect to the same principal residence is contrary to the language and intent of section 121. Therefore, only one maximum limitation amount of \$250,000 (\$500,000 for certain joint returns) applies to the combined sales or exchanges of partial interests.

In this regard, for purposes of determining the maximum limitation amount under section 121(b)(1) and (2), the sales or exchanges of partial interests in the same principal residence are treated as one sale or exchange. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, a taxpayer may exclude gain from the first sale or ex-

change of a partial interest up to the taxpayer's full maximum limitation amount and may exclude gain from the sale or exchange of any other partial interest in the same principal residence to the extent of any remaining maximum limitation amount, and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and § 1.121-2(a)(3)(i) (relating to the limitation for certain joint returns) apply.

For purposes of applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years), each sale or exchange of a partial interest is disregarded with respect to other sales or exchanges of partial interests in the same principal residence, but is taken into account as of the date of the sale or exchange in applying section 121(b)(3) to that sale or exchange and the sale or exchange of any other principal residence.

8. Elections Under Sections 121(d)(8) and (f)

Commentators asked for clarification regarding when a taxpayer may make or revoke an election under section 121(d)(8) (election to have the section 121 exclusion apply to a sale or exchange of a remainder interest in the taxpayer's principal residence) or section 121(f) (election to have the section 121 exclusion not apply to a sale or exchange of the taxpayer's principal residence). The final regulations adopt and clarify the provisions of the proposed regulations and provide that a taxpayer may make or revoke either election at any time before the expiration of a three-year period beginning on the last date prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred.

9. Reporting Sales or Exchanges

Commentators recommended the creation of a form for taxpayers to use to report the sale or exchange of a principal residence even if the gain is entirely excludable under section 121. The final regulations do not adopt this suggestion because, unlike sales or exchanges under section 1034, no tax attributes of the sold residence carry over to a new residence. Therefore the reporting of excluded gain is unnecessary and would be unduly burdensome for taxpayers.

10. Election to Apply Regulations Retroactively

The regulations provide that taxpayers who would otherwise qualify under the provisions of §§ 1.121-1 through 1.121-4 of the final regulations to exclude gain from a sale or exchange before the effective date of the regulations but on or after May 7, 1997, may elect to apply the provisions of the final regulations for any years for which the period of limitation under section 6511 has not expired. A taxpayer may make 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 taxpayer's principal residence in the taxpayer's gross income. Taxpayers who have filed a return for the taxable year of the sale or exchange may elect to apply the provisions of the final regulations for any years for which the period of limitation under section 6511 has not expired by filing an amended return.

11. Audit Protection

The regulations provide that the IRS will not challenge a taxpayer's position that a sale or exchange before the effective date of these regulations but on or after May 7, 1997, qualifies for the section 121 exclusion if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 121. Compliance with the provisions of the proposed regulations that preceded these final regulations generally will be considered a reasonable, good faith effort.

12. Section 121 Exclusion in Individuals' Title 11 Cases

The regulations provide 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 the individual's section 121 exclusion if the individual satisfies the requirements of section 121. Although the effective date for this provision is on or after publication of 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)*, 222 B.R. 313 (M.D. Tenn. 1998), AOD CC-1999-009 (August 30, 1999), and Chief Counsel Notice (35)000-162 (August 10, 1999), the IRS will not challenge a position taken prior to the ef-

fective date of these regulations that a bankruptcy estate may use the section 121 exclusion if the debtor would otherwise satisfy the section 121 requirements.

13. Effective Date

These regulations apply to sales or exchanges on or after December 24, 2002.

Special Analyses

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 Internal Revenue 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 business.

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 the Treasury Department participated in the development of the regulations.

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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 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 taxpayer's principal residence. Subject to the other provisions of section 121, a taxpayer may 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) *Residence*—(1) *In general.* Whether property is used by the taxpayer as the taxpayer's residence depends upon all the facts and circumstances. A property used by the taxpayer as the taxpayer's residence may include a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)). Property used by the taxpayer as the taxpayer's residence does not include personal property that is not a fixture under local law.

(2) *Principal residence.* In the case of a taxpayer using more than one property as a residence, whether property is used by the taxpayer as the taxpayer's principal residence depends upon all the facts and circumstances. If a taxpayer alternates between 2 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 ordinarily will be considered the taxpayer's principal residence. In addition to the taxpayer's use of the property, relevant factors in determining a taxpayer's principal residence, include, but are not limited to—

- (i) The taxpayer's place of employment;
- (ii) The principal place of abode of the taxpayer's family members;
- (iii) The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;
- (iv) The taxpayer's mailing address for bills and correspondence;
- (v) The location of the taxpayer's banks; and
- (vi) The location of religious organizations and recreational clubs with which the taxpayer is affiliated.

(3) *Vacant land*—(i) *In general.* The sale or exchange of vacant land is not a sale or exchange of the taxpayer's principal residence unless—

(A) The vacant land is adjacent to land containing the dwelling unit of the taxpayer's principal residence;

(B) The taxpayer owned and used the vacant land as part of the taxpayer's principal residence;

(C) The taxpayer sells or exchanges the dwelling unit in a sale or exchange that meets the requirements of section 121 within 2 years before or 2 years after the date of the sale or exchange of the vacant land; and

(D) The requirements of section 121 have otherwise been met with respect to the vacant land.

(ii) *Limitations*—(A) *Maximum limitation amount.* For purposes of section 121(b)(1) and (2) (relating to the maximum limitation amount of the section 121 exclusion), the sale or exchange of the dwelling unit and the vacant land are treated as one sale or exchange. Therefore, only one maximum limitation amount of \$250,000 (\$500,000 for certain joint returns) applies to the combined sales or exchanges of vacant land and the dwelling unit. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, gain from the sale or exchange of the dwelling unit, up to the maximum limitation amount under section 121(b)(1) or (2), is excluded first and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and § 1.121-2(a)(3)(i) (relating to the limitation for certain joint returns) apply.

(B) *Sale or exchange of more than one principal residence in 2-year period.* If a dwelling unit and vacant land are sold or exchanged in separate transactions that qualify for the section 121 exclusion under this paragraph (b)(3), each of the transactions is disregarded in applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years) to the other transactions but is taken into account as a sale or exchange of a principal residence on the date of the transaction in applying section 121(b)(3) to that transaction and the sale or exchange of any other principal residence.

(C) *Sale or exchange of vacant land before dwelling unit.* If the sale or exchange

of the dwelling unit occurs in a later taxable year than the sale or exchange of the vacant land and after the date prescribed by law (including extensions) for the filing of the return for the taxable year of the sale or exchange of the vacant land, any gain from the sale or exchange of the vacant land must be treated as taxable on the taxpayer's return for the taxable year of the sale or exchange of the vacant land. If the taxpayer has reported gain from the sale or exchange of the vacant land as taxable, after satisfying the requirements of this paragraph (b)(3) the taxpayer may claim the section 121 exclusion with regard to the sale or exchange of the vacant land (for any period for which the period of limitation under section 6511 has not expired) by filing an amended return.

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

Example 1. Taxpayer A owns 2 residences, one in New York and one in Florida. From 1999 through 2004, he lives in the New York residence for 7 months and the Florida residence for 5 months of each year. In the absence of facts and circumstances indicating otherwise, the New York residence is A's principal residence. A would be eligible for the section 121 exclusion of gain from the sale or exchange of the New York residence, but not the Florida residence.

Example 2. Taxpayer B owns 2 residences, one in Virginia and one in Maine. During 1999 and 2000, she lives in the Virginia residence. During 2001 and 2002, she lives in the Maine residence. During 2003, she lives in the Virginia residence. B's principal residence during 1999, 2000, and 2003 is the Virginia residence. B's principal residence during 2001 and 2002 is the Maine residence. B would be eligible for the 121 exclusion of gain from the sale or exchange of either residence (but not both) during 2003.

Example 3. In 1991, Taxpayer C buys property consisting of a house and 10 acres that she uses as her principal residence. In May 2005, C sells 8 acres of the land and realizes a gain of \$110,000. C does not sell the dwelling unit before the due date for filing C's 2005 return, therefore C is not eligible to exclude the \$110,000 of gain. In March 2007, C sells the house and remaining 2 acres realizing a gain of \$180,000 from the sale of the house. C may exclude the \$180,000 of gain. Because the sale of the 8 acres occurred within 2 years from the date of the sale of the dwelling unit, the sale of the 8 acres is treated as a sale of the taxpayer's principal residence under paragraph (b)(3) of this section. C may file an amended return for 2005 to claim an exclusion for \$70,000 (\$250,000 - \$180,000 gain previously excluded) of the \$110,000 gain from the sale of the 8 acres.

Example 4. In 1998, Taxpayer D buys a house and 1 acre that he uses as his principal residence. In 1999, D buys 29 acres adjacent to his house and uses the vacant land as part of his principal residence. In 2003, D sells the house and 1 acre and the 29 acres in 2 separate transactions. D sells the house and 1 acre at

a loss of \$25,000. D realizes \$270,000 of gain from the sale of the 29 acres. D may exclude the \$245,000 gain from the 2 sales.

(c) *Ownership and use requirements*—

(1) *In general.* 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.

(2) *Use.* (i) 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.

(ii) *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 periods 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.

(3) *Ownership*—(i) *Trusts.* If a residence is owned by a trust, for the period that a taxpayer is treated under sections 671 through 679 (relating to the treatment of grantors and others as substantial owners) as the owner of the trust or the portion of the trust that includes the residence, the taxpayer will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement of section 121, and the sale or exchange by the trust will be treated as if made by the taxpayer.

(ii) *Certain single owner entities.* If a residence is owned by an eligible entity (within the meaning of § 301.7701-3(a) of this chapter) that has a single owner and is disregarded for federal tax purposes as an entity separate from its owner under § 301.7701-3 of this chapter, the owner will be treated as owning the residence for pur-

poses of satisfying the 2-year ownership requirement of section 121, and the sale or exchange by the entity will be treated as if made by the owner.

(4) *Examples.* The provisions of this paragraph (c) are illustrated by the following examples. The examples assume that § 1.121-3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The examples are as follows:

Example 1. Taxpayer A has owned and used his house as his principal residence since 1986. On January 31, 1998, A moves to another state. A rents his house to tenants 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 of the 5 years preceding the sale.

Example 2. Taxpayer B owns and uses a house as her principal residence from 1986 to the end of 1997. On January 4, 1998, B moves to another state and ceases to use the house. B's son moves into the house in March 1999 and uses the residence until it is sold on July 1, 2001. 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 lives in a townhouse that he rents from 1993 through 1996. On January 18, 1997, he purchases the townhouse. On February 1, 1998, C moves into his daughter's home. On May 25, 2000, while still living in his daughter's home, C sells 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 19, 1997, until May 25, 2000) and he used the townhouse as his principal residence for at least 2 years during the 5-year period preceding the sale (from May 25, 1995, until February 1, 1998).

Example 4. Taxpayer D, a college professor, purchases and moves into a house on May 1, 1997. He uses the house as his principal residence continuously until September 1, 1998, when he goes abroad for a 1-year sabbatical leave. On October 1, 1999, 1 month after returning from the leave, D sells the house. Because his leave is not considered to be a short temporary absence under paragraph (c)(2) of this section, the period of the sabbatical 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 purchases a house on February 1, 1998, that he uses as his principal residence. During 1998 and 1999, E leaves his residence for a 2-month summer vacation. E sells 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, under paragraph (c)(2) of this section, 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.

(d) *Depreciation taken after May 6, 1997*—(1) *In general.* 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 the property for periods after May 6, 1997. Depreciation adjustments allocable to any portion of the property to which the section 121 exclusion does not apply under paragraph (e) of this section are not taken into account for this purpose.

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

Example. On July 1, 1999, Taxpayer A moves into a house that he owns and had rented to tenants since July 1, 1997. A 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, A sells the property on August 1, 2001. A's gain realized from the sale is \$40,000. A has no other section 1231 or capital gains or losses for 2001. Only \$26,000 (\$40,000 gain realized - \$14,000 depreciation deductions) may be excluded under section 121. Under section 121(d)(6) and paragraph (d)(1) of this section, A must recognize \$14,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h).

(e) *Property used in part as a principal residence*—(1) *Allocation required.* Section 121 will not apply to the gain allocable to any portion (separate from the dwelling unit) of property sold or exchanged with respect to which a taxpayer does not satisfy the use requirement. Thus, if a portion of the property was used for residential purposes and a portion of the property (separate from the dwelling unit) was used for non-residential purposes, only the gain allocable to the residential portion is excludable under section 121. No allocation is required if both the residential and non-residential portions of the property are within the same dwelling unit. However, section 121 does not apply to the gain allocable to the residential portion of the property to the extent provided by paragraph (d) of this section.

(2) *Dwelling unit.* For purposes of this paragraph (e), the term *dwelling unit* has the same meaning as in section 280A(f)(1), but does not include appurtenant structures or other property.

(3) *Method of allocation.* For purposes of determining the amount of gain allocable to the residential and non-residential

portions of the property, the taxpayer must allocate the basis and the amount realized between the residential and the non-residential portions of the property using the same method of allocation that the taxpayer used to determine depreciation adjustments (as defined in section 1250(b)(3)), if applicable.

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

Example 1. Non-residential use of property not within the dwelling unit. (i) Taxpayer A owns a property that consists of a house, a stable and 35 acres. A uses the stable and 28 acres for non-residential purposes for more than 3 years during the 5-year period preceding the sale. A uses the entire house and the remaining 7 acres as his principal residence for at least 2 years during the 5-year period preceding the sale. For periods after May 6, 1997, A claims depreciation deductions of \$9,000 for the non-residential use of the stable. A sells the entire property in 2004, realizing a gain of \$24,000. A has no other section 1231 or capital gains or losses for 2004.

(ii) Because the stable and the 28 acres used in the business are separate from the dwelling unit, the allocation rules under this paragraph (e) apply and A must allocate the basis and amount realized between the portion of the property that he used as his principal residence and the portion of the property that he used for non-residential purposes. A determines that \$14,000 of the gain is allocable to the non-residential-use portion of the property and that \$10,000 of the gain is allocable to the portion of the property used as his residence. A must recognize the \$14,000 of gain allocable to the non-residential-use portion of the property (\$9,000 of which is unrecaptured section 1250 gain within the meaning of section 1(h), and \$5,000 of which is adjusted net capital gain). A may exclude \$10,000 of the gain from the sale of the property.

Example 2. Non-residential use of property not within the dwelling unit and rental of the entire property. (i) In 1998, Taxpayer B buys a property that includes a house, a barn, and 2 acres. B uses the house and 2 acres as her principal residence and the barn for an antiques business. In 2002, B moves out of the house and rents it to tenants. B sells the property in 2004, realizing a gain of \$21,000. Between 1998 and 2004, B claims depreciation deductions of \$4,800 attributable to the antiques business. Between 2002 and 2004, B claims depreciation deductions of \$3,000 attributable to the house. B has no other section 1231 or capital gains or losses for 2004.

(ii) Because the portion of the property used in the antiques business is separate from the dwelling unit, the allocation rules under this paragraph (e) apply. B must allocate basis and amount realized between the portion of the property that she used as her principal residence and the portion of the property that she used for non-residential purposes. B determines that \$4,000 of the gain is allocable to the non-residential portion of the property and that \$17,000 of the gain is allocable to the portion of the property that she used as her principal residence.

(iii) B must recognize the \$4,000 of gain allocable to the non-residential portion of the property (all of which is unrecaptured section 1250 gain within the meaning of section 1(h)). In addition, the section 121

exclusion does not apply to the gain allocable to the residential portion of the property to the extent of the depreciation adjustments attributable to the residential portion of the property for periods after May 6, 1997 (\$3,000). Therefore, B may exclude \$14,000 of the gain from the sale of the property.

Example 3. Non-residential use of a separate dwelling unit. (i) In 2002, Taxpayer C buys a 3-story townhouse and converts the basement level, which has a separate entrance, into a separate apartment by installing a kitchen and bathroom and removing the interior stairway that leads from the basement to the upper floors. After the conversion, the property constitutes 2 dwelling units within the meaning of paragraph (e)(2) of this section. C uses the first and second floors of the townhouse as his principal residence and rents the basement level to tenants from 2003 to 2007. C claims depreciation deductions of \$2,000 for that period with respect to the basement apartment. C sells the entire property in 2007, realizing gain of \$18,000. C has no other section 1231 or capital gains or losses for 2007.

(ii) Because the basement apartment and the upper floors of the townhouse are separate dwelling units, C must allocate the gain between the portion of the property that he used as his principal residence and the portion of the property that he used for non-residential purposes under paragraph (e) of this section. After allocating the basis and the amount realized between the residential and non-residential portions of the property, C determines that \$6,000 of the gain is allocable to the non-residential portion of the property and that \$12,000 of the gain is allocable to the portion of the property used as his residence. C must recognize the \$6,000 of gain allocable to the non-residential portion of the property (\$2,000 of which is unrecaptured section 1250 gain within the meaning of section 1(h), and \$4,000 of which is adjusted net capital gain). C may exclude \$12,000 of the gain from the sale of the property.

Example 4. Separate dwelling unit converted to residential use. The facts are the same as in *Example 3* except that in 2007 C incorporates the basement of the townhouse into his principal residence by eliminating the kitchen and building a new interior stairway to the upper floors. C uses all 3 floors of the townhouse as his principal residence for 2 full years and sells the townhouse in 2010, realizing a gain of \$20,000. Under section 121(d)(6) and paragraph (d) of this section, C must recognize \$2,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h). Because C used the entire 3 floors of the townhouse as his principal residence for 2 of the 5 years preceding the sale of the property, C may exclude the remaining \$18,000 of the gain from the sale of the house.

Example 5. Non-residential use within the dwelling unit, property depreciated. Taxpayer D, an attorney, buys a house in 2003. The house constitutes a single dwelling unit but D uses a portion of the house as a law office. D claims depreciation deductions of \$2,000 during the period that she owns the house. D sells the house in 2006, realizing a gain of \$13,000. D has no other section 1231 or capital gains or losses for 2006. Under section 121(d)(6) and paragraph (d) of this section, D must recognize \$2,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h). D may exclude the remaining \$11,000 of the gain from the sale of her house be-

cause, under paragraph (e)(1) of this section, she is not required to allocate gain to the business use within the dwelling unit.

Example 6. Non-residential use within the dwelling unit, property not depreciated. The facts are the same as in *Example 5*, except that D is not entitled to claim any depreciation deductions with respect to her business use of the house. D may exclude \$13,000 of the gain from the sale of her house because, under paragraph (e)(1) of this section, she is not required to allocate gain to the business use within the dwelling unit.

(f) *Effective date.* This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions of this section retroactively, see § 1.121-4(j).

§ 1.121-2 Limitations.

(a) *Dollar limitations—(1) In general.* A taxpayer may exclude from gross income up to \$250,000 of gain from the sale or exchange of the taxpayer's principal residence. A taxpayer is eligible for only one maximum exclusion per principal residence.

(2) *Joint owners.* If taxpayers jointly own a principal residence but file separate returns, each taxpayer may 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.

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

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

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

(C) Neither spouse excluded gain from a prior sale or exchange of property under section 121 within the last 2 years (as determined under paragraph (b) of this section).

(ii) *Other joint returns.* For taxpayers filing jointly, if either spouse fails to meet the requirements of paragraph (a)(3)(i) of this section, the maximum limitation amount to be claimed by the couple is 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 is treated as owning the property during the period that either spouse owned the property.

(4) *Examples.* The provisions of this paragraph (a) are illustrated by the following examples. The examples assume that

§ 1.121-3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The examples are as follows:

Example 1. Unmarried Taxpayers A and B own a house as joint owners, each owning a 50 percent interest in the house. They sell the house after owning and using it as their principal residence for 2 full years. The gain realized from the sale is \$256,000. A and B are each eligible to exclude \$128,000 of gain because the amount of realized gain allocable to each of them from the sale does not exceed each taxpayer's available limitation amount of \$250,000.

Example 2. The facts are the same as in *Example 1*, except that A and B are married taxpayers who file a joint return for the taxable year of the sale. A and B are eligible to exclude the entire amount of realized gain (\$256,000) from gross income because the gain realized from the sale does not exceed the limitation amount of \$500,000 available to A and B as taxpayers filing a joint return.

Example 3. 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 each eligible to exclude up to \$250,000 of gain from the sale of their individual residences. However, W may not use H's unused exclusion to exclude gain in excess of her limitation amount. Therefore, H and W must recognize \$50,000 of the gain realized on the sale of W's residence.

Example 4. Married Taxpayers H and W sell their residence and file a joint return for the year of the sale. 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 5. Married Taxpayers H and W have owned and used their principal residence since 1998. On February 16, 2001, H dies. On September 24, 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 6. Assume the same facts as *Example 5*, except that W does not sell the residence until January 31, 2002. Because W's filing status for the taxable year of the sale is single, the special rules for joint returns under paragraph (a)(3) of this section do not apply and W may exclude only \$250,000 of the gain.

(b) *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 maximum exclusion), a taxpayer may not exclude from gross income gain from the sale or exchange of a principal residence if, dur-

ing 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 (b)(1), any sale or exchange before May 7, 1997, is disregarded.

(2) *Example.* The following example illustrates the rules of this paragraph (b). The example assumes that § 1.121-3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The example is as follows:

Example. Taxpayer A owns a townhouse that he uses as his principal residence for 2 full years, 1998 and 1999. A buys a house in 2000 that he owns and uses 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 2003. 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.

(c) *Effective date.* This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions of this section retroactively, see § 1.121-4(j).

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

(a) *In general.* In lieu of the limitation under section 121(b) and § 1.121-2, a reduced maximum exclusion limitation may be 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) and (c) or the 2-year limitation described in § 1.121-2(b).

(b) through (f) **[Reserved]**. For further guidance, see § 1.121-3T(b) through (f).

(g) *Computation of reduced maximum exclusion.* (1) The reduced maximum 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 during the 5-year period ending on the date of the sale or exchange; the period of time that the taxpayer used the property as the taxpayer's principal residence 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).

(2) *Examples.* The following examples illustrate the rules of this paragraph (g):

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 owns a house that he has 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 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 each 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(a)(3)(ii).)

(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, because the sale of the house is due to a change in place of employment, W is eligible to claim a reduced maximum exclusion of 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.

(h) **[Reserved]**. For further guidance, see § 1.121-3T(h).

(i) through (k) **[Reserved]**.

(l) *Effective date.* This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions of this section retroactively, see § 1.121-4(j).

§ 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. The example assumes that § 1.121-3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The example is as follows:

Example. Taxpayer H has owned and used a house as his principal residence since 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. 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 his or her 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 is 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 an 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 which has 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 pays A \$400,000 for the house. A realizes 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) *Sales or exchanges of partial interests—(1) Partial interests other than remainder interests—(i) In general.* Except as provided in paragraph (e)(2) of this section (relating to sales or exchanges of remainder interests), a taxpayer may apply the section 121 exclusion to gain from the sale or exchange of an interest in the taxpayer's principal residence that is less than the taxpayer's entire interest if the interest sold or exchanged includes an inter-

est in the dwelling unit. For rules relating to the sale or exchange of vacant land, see § 1.121-1(b)(3).

(ii) *Limitations—(A) Maximum limitation amount.* For purposes of section 121(b)(1) and (2) (relating to the maximum limitation amount of the section 121 exclusion), sales or exchanges of partial interests in the same principal residence are treated as one sale or exchange. Therefore, only one maximum limitation amount of \$250,000 (\$500,000 for certain joint returns) applies to the combined sales or exchanges of the partial interests. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, a taxpayer may exclude gain from the first sale or exchange of a partial interest up to the taxpayer's full maximum limitation amount and may exclude gain from the sale or exchange of any other partial interest in the same principal residence to the extent of any remaining maximum limitation amount, and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and § 1.121-2(a)(3)(i) (relating to the limitation for certain joint returns) apply.

(B) *Sale or exchange of more than one principal residence in 2-year period.* For purposes of applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years), each sale or exchange of a partial interest is disregarded with respect to other sales or exchanges of partial interests in the same principal residence, but is taken into account as of the date of the sale or exchange in applying section 121(b)(3) to that sale or exchange and the sale or exchange of any other principal residence.

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

(ii) *Limitations—(A) 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.

(B) *Sales or exchanges to related parties.* This paragraph (e)(2) will not apply to a sale or exchange to any person that bears

a relationship to the taxpayer that is described in section 267(b) or 707(b).

(iii) *Election.* The taxpayer makes the election under this paragraph (e)(2) 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. A taxpayer may make or revoke the election at any time before the expiration of a 3-year period beginning on the last date prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred.

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

Example. In 1991, Taxpayer A buys a house that A uses as his principal residence. In 2004, A's friend B moves into A's house and A sells B a 50% interest in the house realizing a gain of \$136,000. A may exclude the \$136,000 of gain. In 2005, A sells his remaining 50% interest in the home to B realizing a gain of \$138,000. A may exclude \$114,000 (\$250,000 - \$136,000 gain previously excluded) of the \$138,000 gain from the sale of the remaining interest.

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

(g) *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. A taxpayer may make an election under this paragraph (g) to have section 121 not apply (or revoke an election to have section 121 not apply) at any time before the expiration of a 3-year period beginning on the last date prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred.

(h) *Residences acquired in rollovers under section 1034.* If a taxpayer acquires property in a transaction that qualifies under section 1034 (section 1034 property) for the nonrecognition of gain realized on the sale or exchange of another property and later sells or exchanges such property, in determining the period of the taxpayer's ownership and use of the property under section

121 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 determining the holding period of the section 1034 property).

(i) **[Reserved].**

(j) *Election to apply regulations retroactively.* Taxpayers who would otherwise qualify under §§ 1.121-1 through 1.121-4 to exclude gain from a sale or exchange of a principal residence before December 24, 2002, but on or after May 7, 1997, may elect to apply §§ 1.121-1 through 1.121-4 for any years for which the period of limitation under section 6511 has not expired. The taxpayer makes the election under this paragraph (j) 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 taxpayer's principal residence in the taxpayer's gross income. Taxpayers who have filed a return for the taxable year of the sale or exchange may elect to apply the provisions of these regulations for any years for which the period of limitation under section 6511 has not expired by filing an amended return.

(k) *Audit protection.* The Internal Revenue Service will not challenge a taxpayer's position that a sale or exchange of a principal residence occurring before December 24, 2002, but on or after May 7, 1997, qualifies for the section 121 exclusion if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 121. Compliance with the provisions of the regulations project under section 121 (REG-105235-99, 2000-2 C.B. 447) generally will be considered a reasonable, good faith effort to comply with the requirements of section 121.

(l) *Effective date.* This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions retroactively, see paragraph (j) of this section.

§ 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 on or after December 24, 2002.

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

Approved December 11, 2002.

Pamela F. Olson,
Assistant Secretary of the Treasury.

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