COMMENTS ON PROPOSED REGULATIONS UNDER SECTION 121

These comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association.

These comments were prepared by individual members of three Committees of the ABA Section of Taxation: Domestic Relations; Real Estate; and Sales, Exchanges & Basis. Principal responsibility was exercised by Annette Nellen, Chair of the Sales, Exchanges & Basis Committee. Substantive contributions were made by Kevin Thomason, Donald H. Read, and Jack Ross. The Comments were reviewed by Laurence Reich of the Section’s Committee on Government Submissions and by Stanley Blend, Council Director for the Committee on Sales, Exchanges & Basis.

Although members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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EXECUTIVE SUMMARY

In general, we find the proposed regulations to be very clear and helpful. The use of many examples is helpful. We also appreciate the Service officially stating in regulations that the estate of a bankrupt individual may use the Section 121 exclusion (an administrative position that was previously stated only in an Action on Decision).

Individual members of the ABA Section of Taxation and the Standing Committee on Legal Assistance for Military Personnel have made suggestions for changes to Sections 1034 and 121 in the past several years. Where appropriate to the proposed Section 121 regulations, we restate in this letter, the suggestions made in prior submissions and resolutions, along with our other comments on the proposed regulations.

A summary of our recommendations is as follows:

1. Better guidance is needed on the identification of the property that is the principal residence. The regulations should state that in identifying the property that constitutes a residence for Section 121 purposes, the taxpayer’s intent and actual use should be considered. The size and nature of a property should not be determining factors.

2. Clarification is needed to provide that vacant land resulting from destruction of a principal residence may be a principal residence for Section 121 purposes.

3. The final regulations should reflect that concurrent ownership and use of more than one residence during a calendar year is contemplated by the statute. The proposed regulations assume that a person cannot have more than one principal residence per calendar year unless there has been a sale of an old home and purchase of a new home. In Example 10 in Prop. Reg. §1.121-1(f), where a person uses a home in New York for 7 months during the year and a Florida home for 5 months, nothing in Section 121 prohibits treating each home as a principal residence during the time it is used. During the year, the homeowner would accumulate 7 months of use under Section 121 for the New York home and 5 months of Section 121 use on the Florida home. This treatment puts this taxpayer on par with an individual who, during a 5-year period, uses a New York home as a principal residence from January 1, 1998 to December 31, 1999, and then uses a Florida home from January 1, 2000 to December 31, 2001. Section 121 does not appear intended to limit taxpayers to accumulating months of “use” during a single calendar year on only one home.

4. Medical care should constitute a temporary absence.

5. Absence on military duty should suspend the 5-year period or constitute a temporary absence.

6. A safe harbor should be added to allow minor use of a residence for rental or office in the home to still be treated as use of a residence (with the taxpayer forgoing depreciation on such minor rental or office use).

7. “Unforeseen circumstances,” as used in Section 121(c)(2) should be defined broadly to encompass the many types of personal situations that may cause an individual to unexpectedly sell a home that has been owned and used for less than 2 years.

8. Guidance on the forms of ownership of a residence that qualify for the Section 121 gain exclusion should be provided.

9. Modification to the gain characterization rules of the Section 469 regulations is needed to treat depreciation recapture gain under Section 121 as passive activity gross income if the rental was a passive activity.
10. Prop. Reg. §1.121-4(b)(2) should be modified to state that if a divorce or separation instrument grants use of the residence to one spouse, the other spouse, who maintains an ownership interest in the residence, should continue to be treated as meeting the Section 121(a) use requirements without regard to the manner in which the spouse granted use of the residence actually uses the residence.

11. Prop. Reg. §1.121-4(b)(2), pertaining to Section 121(d)(3)(B), should be expanded to allow for a divorce or separation instrument to give retroactively the right to use the residence to the spouse residing there.

12. The final regulations should provide that Section 121 overrides Section 1041 to the extent it would operate to exclude gain on sale of a residence between spouses.

13. The final regulations should include a reference to Section 1016(a)(7) relating to basis of a home for which gain was previously deferred under old Section 1034. Also, because former Section 1034(e) is not readily available for reference (Section 1034 having been repealed), its text should be included in the Section 121 regulations.

PRIOR SUBMISSIONS ON TAXATION OF THE SALE OF A PRINCIPAL RESIDENCE

In March 1998, individual members of the ABA Section of Taxation submitted comments to Treasury and the Internal Revenue Service on Section 121 as amended by the Taxpayer Relief Act of 1997. In addition to suggestions for technical corrections, the following recommendations were offered in order to have new Section 121 better meet its intended simplification goals. The first 3 suggestions would require legislative action. The last 2 suggestions are restated in these comments on the proposed Section 121 regulations.

1. Provide further simplification by eliminating the one-sale-every-two-years limitation, as well as the "forced sale" limitation.

2. Provide further simplification and make Section 121 more neutral in its effect on taxpayer financial decisions by eliminating the dollar limitation (or making the dollar limitation applicable only to residences with a sales price exceeding a specific dollar amount).

3. If the dollar limitation is not removed, provide transitional relief for individuals who have relied on the long-standing gain deferral rule of former Section 1034.

4. Provide further simplification by allowing gain exclusion with respect to de minimis use of a residence as a rental property or home office.

5. Add a definition of principal residence that includes land that was part of a principal residence that was destroyed in an involuntary conversion, if it is sold within a time period such that the ownership and use requirement of Section 121 is satisfied.

Over the past several years, individual members of the ABA also have recommended that changes be made to Sections 1034 and 121 to better address the unique situations faced by some military personnel who must reside outside of their principal residence due to active duty assignments. In January 2001 David C. Hague, Chair of the Standing Committee on Legal Assistance for Military Personnel, submitted comments to the Service recommending that the 5-year period under Section 121 be suspended for time spent away from the home for official extended duty (see the Appendix to this letter). We also offer another related suggestion in our comments below on the proposed Section 121 regulations.

The March 1998 submission also suggested a change to Section 108 to allow an individual to elect to treat acquisition indebtedness on a principal residence as non-recourse debt upon disposition of the residence.
I. Definition of a Principal Residence

Background

Prop. Reg. §1.121-1(b) provides that whether property is used by the taxpayer as the taxpayer’s residence, or as the taxpayer’s principal residence when the taxpayer uses more than one property as a residence, depends upon all of the facts and circumstances. Where a taxpayer uses more than one property as a residence for successive periods of time, the property used a majority of the time during the year will ordinarily be considered the taxpayer’s principal residence (emphasis added). A principal residence may include a houseboat, a house trailer, or stock held by a tenant-stockholder in a cooperative housing corporation in specific situations.

Prop. Reg. §1.121-1(c) provides that the ownership and use requirements for periods aggregating two years or more may be satisfied by establishing ownership and use for 24 full months or 730 days. Occupancy of the residence is required to meet the use requirement. However, short temporary absences, such as for vacation or seasonal absence, are counted as periods of use, even if the residence is rented out during the absence. Example 4 in Prop. Reg. §1.121-1(f) illustrates that a one-year absence from the home while the owner works abroad is not considered a temporary absence. Example 5 in Prop. Reg. §1.121-1(f) illustrates that a 2-month absence in each of 2 years for summer vacation is a temporary absence such that the 4 months are counted as “use” for determining if the 24 months of use requirement under §121 is met. Example 10 at Prop. Reg. §1.121-1(f) involves a taxpayer who, over a 5-year period, owns and uses 2 residences each year, spending 7 months per year in the New York home and 5 months in the Florida home. Since the taxpayer used the New York home a majority of the time each year, that home is considered the taxpayer’s principal residence and would be the only residence eligible for the §121 gain exclusion unless facts and circumstances indicate otherwise.

Prop. Reg. 1.121-1(e) provides that if a taxpayer satisfies the use requirement only for a portion of the property sold or exchanged, Section 121 only applies to such portion. An example of this would be where a portion of the home is used for business purposes.

Comments

1. Better Guidance is Needed on the Identification of the Property that is the Principal Residence

In some situations, it may not be obvious as to how much of a tract of land and its structures constitutes a principal residence. For example, a taxpayer may have a residence located on several acres of land or have additional structures on the land. In some cases, parts of the property may have been used for business purposes in prior years. There have been cases and rulings under former Section 1034 on how much of a taxpayer’s property constituted a principal residence. These same types of situations are likely to exist under present Section 121, and additional guidance in the regulations would be helpful. Some of these prior cases and rulings are explained here to illustrate the type of additional guidance that would be useful.

In a 1997 case, the Service contended that approximately 43 acres of taxpayer's property adjacent to his residence was held for investment because it would be possible to subdivide the property and sell it. However, the Tax Court found that the taxpayer presented credible testimony that he had no intent to use the acreage for other than personal purposes, including "appreciating nature, living in open spaces, hiking,
horseback riding, and enjoying unobstructed views of the countryside. ... Nothing in section 1034 prohibits us from finding that such use constitutes ‘significant use’ for residential purposes.”

Thus, taxpayer intent and actual use swayed the court to conclude that acreage surrounding a home was held for residential, rather than for investment or business use.

In Revenue Ruling 56-420, where a taxpayer sold a portion of the land on which his principal residence was located, there was held to be no sale of a principal residence. In Revenue Ruling 76-541, a taxpayer sold his principal residence along with 3 of the 10 acres of land surrounding it. The taxpayer planned to build a new home on the retained acreage. However, within 2 years of the sale of the home, taxpayer sold another 2 acres of the remainder of the 7-acre parcel. The ruling concluded that the sale of the 2 acres fell under former Section 1034 because it was sold within the Section 1034 replacement period and was "proximately related to the sale of the dwelling unit."

**Recommendation:** Prop. Reg. §1.121-1(b) should be expanded to address the above rulings. The regulations should state that, in identifying the property that constitutes a residence for Section 121 purposes, the taxpayer’s intent and actual use should be considered. The size and nature of a property should not be the sole determining factors. Where property which includes a dwelling and its surrounding property has been used for residential purposes, rather than for business or investment purposes, it should be considered a residence for Section 121 purposes. Additional factors that may be relevant in determining the taxpayer’s intent as to the use of the property should include real estate records, such as property tax assessments. For example, where a jurisdiction allows for a homeowner’s exemption to reduce property taxes on property that is the owner’s principal residence, such an exemption covering an entire property (structure and land) would be a factor indicating that the entire property is a principal residence for Section 121 purposes.

2. Clarify that Vacant Land Resulting From Destruction of a Principal Residence May Be a Principal Residence

When a principal residence is destroyed, leaving vacant land, an issue arises as to whether that vacant land is still a principal residence to which the tax benefits of Section 121 could apply if the land is sold at a gain. Revenue Ruling 96-32, 1996-1 C.B. 177, provides that any gain from sale of such remaining land can be treated as an involuntary conversion under Section 1033 if the sale occurs within the period described in Section 1033(a)(2)(B). However, if the owner does not plan to reinvest the sales proceeds, to obtain relief, the owner must apply the facts and circumstances approach of the proposed Section 121 regulations to support a position that the land was a principal residence for 2 of the 5 years preceding the sale date. It would be helpful to state that land remaining after destruction of a principal residence is still a principal residence for Section 121 purposes if the specified time requirements are satisfied.

**Recommendation:** Prop. Reg. §1.121-1(b) should be expanded to clarify that where an individual’s residence is destroyed in an involuntary conversion, the land that remains continues to be eligible for the Section 121 gain exclusion provided it is sold within a time period such that the 2-out-of-5-year ownership and use requirements of Section 121 are satisfied.

Example: Taxpayer K has owned and used a home as a principal residence since 1990. On February 1, 2001, a fire destroyed the home. On February 1, 2002, K receives insurance proceeds greater than K’s basis in the home and excludes the realized gain under Section 121(d)(5)(A). On February 1, 2003, K sells the land where K’s home once stood, realizing a gain. Because K used

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5 In such a situation, new Section 121(d)(5)(A), which treats destruction of a residence as a sale, provides no relief because the land has not been destroyed.
the property as a principal residence for 2 of the 5 years prior to February 1, 2003, the gain is excluded under Section 121.

3. Concurrent Ownership and Use of More Than One Residence During a Calendar Year is Contemplated by the Statute and Should be Reflected in the Regulations

For various personal and work-related reasons, individuals may own and use more than one residence at a time. While the proposed regulations provide guidance on how to determine which home is the principal residence (generally, the one used the majority of time each year), they are not clear as to when use of both homes during the year can each count towards the required 24 months of use for Section 121 purposes. Since the general rule of Section 121 is that ownership and use for only 24 months of a 60-month period is required, it appears that Congress did not intend that the homeowner must reside in the home during the entire ownership period in order to obtain the benefits of Section 121. Also, because Section 121 allows for a sale or exchange every 2 years to qualify for gain exclusion, it again appears that Congress intended Section 121 to apply to individuals who concurrently own and use more than one residence. In short, it would seem that a taxpayer could have the “24-month” clock ticking at more than one residence at a time. Also, this result would treat a taxpayer owning and using 2 homes at the same time, similarly to a taxpayer who owns only one home at a time, but owned and used 2 different homes over a 5-year period.

For example, assume that Individual B works in New York and Florida and owns residences in both states. During a 5-year period, B used both homes for over 24 months as a personal residence. Upon sale of either home, B should be entitled to use Section 121. In contrast, assume that Individual C works in New York and owns and uses a home there. After 2 years of such use, C moves to Florida and buys a home and uses it as a personal residence for 2 years. Both of C’s homes are eligible for gain exclusion under Section 121 (although C (as well as B) would generally only be able to use the exclusion once in a 2-year period). In these examples, both B and C should be treated similarly in measuring their use of a residence for Section 121 purposes. It should not matter that B used both residences each year over 4 years while C only used one residence in each 2-year period.

Recommendation: Prop. Reg. §1.121-1(c) should be clarified to address the above example. The proposed regulations assume that a person cannot have more than one principal residence per calendar year unless there has been a sale of an old home and purchase of a new home. In Example 10 in Prop. Reg. §1.121-1(f), where a person uses a home in New York for 7 months during the year and a Florida home for 5 months, nothing in Section 121 prohibits considering each home as a principal residence during the time it is used. During the year, the homeowner would accumulate 7 months of use under Section 121 of the New York home and 5 months of Section 121 use of the Florida home. This treatment puts this taxpayer on a par with an individual who, during a 5-year period uses a New York home as a principal residence from January 1, 1998 to December 31, 1999 and then uses a Florida home from January 1, 2000 to December 31, 2001. Section 121 does not appear intended to limit taxpayers to only accumulating months of “use” during a single calendar year on just one home.

Example 10 in Prop. Reg. §1.121-1(f) should be clarified to state that both the 7 months spent in the New York home and the 5 months spent in the Florida home each year count towards use of a residence for each home separately if the facts and circumstances indicate that each is used as a principal residence while it is used during the year. The key point of the example then would be that the 5 months in Florida do not constitute a temporary absence from the New York home, and, therefore, the 5 months do not count as use of the New York home for Section 121 purposes.

4. Medical Care Should Constitute a Temporary Absence

In addition to vacation or other seasonal absence, another common reason for a temporary absence from a home is for medical care.
**Recommendation:** The last sentence of Prop. Reg. §1.121-1(c) should be modified to read: “However, short temporary absences, such as for vacation, seasonal absence, or medical care (although accompanied with rental of the residence), are counted as periods of use.”

5. Military Duty Should Suspend the 5-Year Period or Constitute a Temporary Absence

Members of the military may have difficulty meeting the 24-months-of-use requirement of Section 121 due to time spent away from the residence for official active duty. Many service members on extended overseas assignments, or who are required to live in government housing while stationed in the U.S., may end up not qualifying for the gain exclusion of Section 121.

**Recommendation:** The ABA Standing Committee on Legal Assistance for Military Personnel has submitted comments on the Section 121 proposed regulations on this issue. We agree with that committee’s suggestion to incorporate into the proposed Treasury Regulation a modification that would suspend, for time spent away from home due to official extended duty, the 5-year period during which the ownership and use requirements of Section 121 must be met for service members. The proposed modification follows.

Section 1.121-4(d). Special Rule For Members Of Uniformed Services In Determining Exclusion Of Gain From Sale Of Principal Residence.

(1) In general. The running of the 5-year period described in I.R.C. section 121 shall be suspended with respect to an individual during any time that such individual or such individual's spouse is serving on qualified official extended duty as a member of the uniformed services.

(i) Qualified official extended duty. The term “qualified official extended duty” means any period of extended duty as a member of the uniformed services during which the member serves at a duty station that is at least 50 miles from such property or is under official orders to reside in government quarters.

(ii) Uniformed services. The term “uniformed services” has the meaning given such term by section 101(a)(5) of title 10, United States Code, as in effect on the date of the enactment of these regulations.

(iii) Extended duty. The term “extended duty” means any period of active duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period.

The full text of the Standing Committee’s submission is attached to this comment letter as an appendix.

As an alternative, if the Service believes that the preceding recommendation cannot be accomplished without legislative action, we recommend that the Section 121 regulations address this issue through the definition of a temporary absence. The definition of temporary absence in Prop. Reg. §1.121-1(c) could be expanded to provide that, for members of the military, time spent away from a residence on government orders will count as use of the residence. A minimum actual use requirement could be added to ensure that the owner’s intent was to use the residence as a personal residence. For example, the member of the military could be required to have a minimum of 3 months of actual use as a residence in order to treat time spent away on assignment as use of the residence.

6. Treatment of De Minimis Rental or Office in the Home as Use of a Residence

As described by the legislative history of the Taxpayer Relief Act of 1997, the primary reason for changing the treatment of gain from sale or exchange of a principal residence was to simplify tax
compliance by eliminating the need to maintain records to substantiate the basis of a principal residence.\(^6\) Under prior law, "detailed records of transactions and expenditures on home improvements must be kept, in most cases, for many decades."

However, even minimal use of a residence for rental or home office purposes necessitates the maintenance of records on basis and improvements. The complications such recordkeeping involves can be an accounting nightmare, particularly where only a relatively small percentage of the property is not used as a principal residence. For example, a home office might be a 12’ x 12’ room in a 2,400-square foot house, which is only 6 percent of the total area.

**Recommendation:** A safe harbor should be added to Prop. Reg. §1.121-1(e) to allow for exclusion of gain for a portion of a principal residence that was used as an office or rental provided such portion is minor. This exception could be structured as an election under which the individual would forgo depreciation deductions on the office or rental portion of the home. This change would provide further simplification by eliminating the need to compute and track depreciation on the property.

**II Reduced Exclusion and Unforeseen Circumstances**

**Background**

If the 2-out-of-5-year ownership and use requirements are not satisfied, generally any realized gain upon sale or exchange must be recognized. Also, if, during the 2-year period ending on the sale or exchange date, there was any other sale or exchange to which the exclusion applied, no exclusion is allowed. However, an exception applies if the owner is forced to move, for example, because of a "change in place of employment, health, or, to the extent provided in regulations, other unforeseen circumstances" (Section 121(c)(2)). When a "forced" sale occurs, the maximum exclusion amount is adjusted to reflect the fraction of the 2-year ownership and use requirement that was satisfied. If there is more than one sale or exchange during a 2-year period, and the later sale is not a "forced" sale, the gain cannot be excluded under Section 121. Similarly, if the 2-out-of-5-year ownership and use requirements are not met and the sale is not a "forced" sale, any gain must be recognized.

The proposed regulations do not describe “other unforeseen circumstances.” Instead, the preamble to the proposed regulations states that comments are requested regarding what should qualify as an “unforeseen circumstance for purposes of determining whether a taxpayer is eligible to claim the reduced exclusion” of Section 121(c).

**Comments**

“Unforeseen circumstances” should be broadly defined with a realistic view of the many reasons why an individual may have to sell a home prior to meeting the 2-year ownership and use requirement of Section 121. An investment in a home that serves as a principal residence is a significant investment of funds, time, and energy for most individuals. Such an investment usually involves a decision to remain at the home for a significant period of time. Where the home is sold after less than 2 years of ownership, there is usually an unexpected reason for doing so. In such situations, the owner is often unlikely to generate a gain from the sale due to the short ownership period and the costs of selling the home. However, in certain real estate markets, a gain may result. In light of the otherwise generous nature of Section 121, requiring an individual to pay capital gain taxes on top of the other costs of selling and moving and dealing with the personal issues that resulted in the need to sell the home, seems out of line with congressional intent. Thus, in drafting guidance on “unforeseen circumstances,” a broad view should

be taken of the personal circumstances that may unexpectedly require an individual to sell a home owned for less than 2 years.

**Recommendation:** “Unforeseen circumstances” should be defined broadly to encompass the many types of personal situations that may cause an individual to sell a home unexpectedly. These circumstances should include divorce; breakup of a permanent relationship among co-owners of the home; health problems of any member of the household, broadly defined; care-giving responsibilities that require someone to move to be near, for example, an ill parent or child; safety or nuisance reasons; and relocation of a military employee.

**III. Form of Ownership of a Principal Residence**

**Background**

Section 121 applies to a taxpayer who has owned and used a home. In most instances, this provision does not raise any issues because an individual directly owns and uses the home. However, some individuals have placed their residences into trusts or other entities and rulings have been issued in the past as to how former Sections 121 and 1034 applied to such ownership.\(^7\)

The Section 121 proposed regulations were issued along with Prop. Reg. §1.1398-3 to state officially the Service’s position as to the application of Section 121 for residences held by a bankruptcy estate in response to differing court opinions. It states that the bankruptcy estate of an individual succeeds to and takes into account the individual Section 121 exclusion if the individual satisfies the requirements of Section 121(a). The proposed regulations do not address other forms of ownership.

**Comments**

For years, individuals, for varying reasons, have sometimes opted to hold their principal residence in some type of trust. Court cases and private letter rulings have been issued to address the application of former Section 121 and both former and present Section 121 to these forms of ownership. However, guidance is incomplete.

**Recommendation:** The Section 121 regulations should be expanded to provide guidance on the types of ownership of a residence that will and will not qualify the owner for the Section 121 exclusion. Given the variety of forms of ownership that may be used (revocable trusts, irrevocable trusts, partnerships, etc.), it would be most useful for the Service to provide a list of factors that must exist in order for the beneficial owner to be able to use the Section 121 gain exclusion.

**IV. Interaction of Sections 121 and 469**

**Background**

Section 469 was added to the Internal Revenue Code by the Tax Reform Act of 1986 to require certain taxpayers (including individuals) to use losses from passive activities only against income from passive activities. A passive activity includes a rental activity. Regulations issued under Section 469 provide guidance to determine how much of a gain from the sale of property used or previously used in a passive activity is considered passive activity gross income to which passive activity losses (including

losses carried forward from prior years) may be used. Section 469(g) provides that if an interest in a passive activity (or former passive activity) is disposed of in a fully taxable transaction, the passive activity loss is “triggered” to be used against any type of income in the year of disposition. However, if the disposition is one where realized gain is not recognized (such as a sale to which the gain exclusion of Section 121 applies), the passive activity loss is not triggered, but remains to be used against future passive activity income.

Reg. §1.469-2T(c)(2) provides that, generally, gain from disposition of property used in a passive activity is treated as passive activity gross income if the property was used in a passive activity in the year the gain is recognized. If the property is not used in a passive activity in the tax year of disposition, the gain is treated as not from a passive activity. Reg. §1.469-2T(c)(2)(ii) provides a “12-month lookback rule” to determine how much of the gain from the sale of property used in a passive activity some time in the prior 12 months is passive activity gross income. Under this rule, the amount realized and the adjusted basis “must be allocated among such activities on a basis that reasonably reflects the use of such interest in property during such 12-month period.”

Section 121(d)(6) provides that gain attributable to depreciation claimed on a residence after May 6, 1997 may not be excluded under Section 121.

Example: Mary rents her home out for one year, then lives in it for two years and finally rents it for two months before selling it at a gain of $100,000. Mary claimed $9,000 of depreciation on the home after May 6, 1997. Mary satisfies the ownership and use requirements of Section 121 and so, may exclude $91,000 of her realized gain ($9,000 must be recognized under Section 121(d)(6)).

While Mary’s home was rental property, it generated a passive activity loss (PAL) of $30,000, which remains at the disposition date. Under the 12-month lookback rule of Reg. §1.469-2T(c)(2)(ii), 2/12 of Mary’s recognized gain (from the depreciation recapture) would be passive activity gross income. Under Section 469(g), Mary’s PAL is not triggered. Under Reg. §1.469-2T(c)(2)(ii), only 2/12 of Mary’s gain is passive activity gross income ($1,500) so only $1,500 of her suspended $30,000 PAL is usable in the year of disposition of the property. If there had instead been no rental in the 12 months preceding the disposition, none of the recognized depreciation recapture gain would be passive activity gross income and the entire $30,000 PAL would remain. If Mary has no passive activities to generate passive activity gross income, the PAL will remain.

Comments

The Section 469 regulations characterizing gain from sale of property used (or formerly used) in a passive activity were written prior to the revision to Section 121 in 1997. New rules are needed to better coordinate the interplay of Sections 469 and 121.

Recommendation: The Section 469 regulations should be amended to provide that recognized gain from depreciation recapture under Section 121(d)(6) is treated entirely as passive activity gross income regardless of the use of the residence in the year of sale, provided the depreciation was a passive activity deduction.
V. Interaction of Section 121 and Divorce or Separation

Background

Prop. Reg. §1.121-4(b)(1) restates Section 121(d)(3)(A), providing that if an individual holds a residence transferred to that individual incident to divorce, the period that individual owns the property shall include the period the spouse or former spouse owned it.

Prop. Reg. §1.121-4(b)(2) pertains to Section 121(d)(3)(B) providing a special rule for a divorced spouse who moves out of his or her principal residence, but continues to own it (the “out-spouse”). Under this provision, an individual is treated as using property as his or her principal residence during any period of ownership while his or her spouse or former spouse (the “in-spouse”) is granted use of the residence under a divorce or separation instrument (as defined in Section 71(b)(2)). Prop. Reg. §1.121-4(b)(2) expands the language of the statute by also stating that the in-spouse must use the property as a principal residence.

Section 1041 provides that no gain or loss shall be recognized on a transfer of property from an individual to a spouse or former spouse if it is incident to divorce. There is no guidance in the statute or in regulations as to how Sections 121 and 1041 are to interact in situations where both provisions appear to apply.

Comments

1. Clarify the Meaning of Use by the In-Spouse

The Section 121 Proposed Regulations restrict the out-spouse’s right to claim use of a residence as his principal residence to the period that the in-spouse uses the property as a principal residence – language that does not appear in Section 121(d)(3)(B) (or in the legislative history to the Taxpayer Relief Act of 1997). This limitation, if strictly applied, may create problems for the out-spouse which most likely were not intended by Congress in drafting the relief provision of Section 121(d)(3)(B). An out-spouse may have no control over the activities of the former spouse and may also be prevented from selling the property if the former spouse moves out.

Recommendation: Prop. Reg. §1.121-4(b)(2) should be modified to state that if a divorce or separation instrument grants use of the residence to the in-spouse, the out-spouse should continue to be treated as meeting the Section 121(a) use requirements without regard to the manner in which the in-spouse uses the residence.

2. Allow for Application of Section 121(d)(3)(B) Prior to Existence of a Written Instrument

Often in the case of divorce, one spouse may move out of the residence for an extended period while the parties try to work things out. In such situations, there is often a clear understanding between the parties that one of the spouses and any children will continue to stay in the house, but there is no written instrument.

Recommendation: Reg. §1.121-4(b)(2) should be expanded to allow for a divorce or separation instrument to give the right to use the residence to the “in-spouse” retroactively.

3. Provide that Section 121 Overrides Section 1041

In some divorce situations where both spouses continue to co-own the residence, the in-spouse would like to purchase the out-spouse’s interest in the home. If Section 1041 applies in this situation though, while the out-spouse has no taxable gain, the in-spouse does not receive an increased basis for the money paid to purchase the out-spouse’s interest.
Recommendation: A provision should be added to Prop. Reg. §1.121-4(b) to state that the Section 121 gain exclusion overrides the Section 1041 gain exclusion to the extent it would operate to exclude gain on sale of a residence between spouses.

VI. Old Section 1034 and Basis

Background

Many individuals will continue to own and use a residence with a basis adjusted under former Section 1034. Section 1016(a)(7) was modified by the Taxpayer Relief Act of 1997 to provide that the basis still is determined under former Section 1034(e). However, Section 1016 is not cross-referenced in Section 121 and some people may thus not be aware of this basis provision.

Comment

Recommendation: The Section 121 regulations should include a reference to Section 1016(a)(7) as relating to the basis of a residence for which gain was previously deferred under former Section 1034. Also, because Section 1034(e) is not readily available for reference due to repeal of Section 1034, its text should be provided in the Section 121 regulations.

In addition to making these clarifications, we also encourage the Treasury Department to recommend technical corrections legislation to add as subsection 121(h) a cross-reference to Section 1016(a)(7) and to amend Section 1016(a)(7) to set forth the text of Section 1034(e) as in existence prior to the Taxpayer Relief Act of 1997, instead of merely referring to it.
APPENDIX

COMMENTS SUBMITTED BY STANDING COMMITTEE ON LEGAL ASSISTANCE FOR MILITARY PERSONNEL

January 8, 2001

CC:M&SP:RU (REG-105235-99)
Room 5226
Internal Revenue Service
POB 7604
Ben Franklin Station
Washington, D.C. 20044

Dear Sir/Madam:

The American Bar Association respectfully requests that you modify the proposed regulations to I.R.C. § 121 to suspend the five-year period during which the ownership and use requirements of I.R.C. § 121 must be met for time spent by members of the uniformed services away from the home due to qualified official extended duty. We believe this modification to the proposed regulation would be consistent with the intent of Congress in enacting I.R.C. § 121, the proposed regulation's facts and circumstances test for determining what is a principal residence and what constitutes use as a principal residence, and with other Federal law applicable to members of the uniformed services.

The Taxpayer Relief Act of 1997 significantly modified I.R.C. § 121. Under the modified provision, a single taxpayer may exclude up to $250,000 of gain from the sale of a home concluded after May 6, 1997. Married couples who file jointly may exclude up to $500,000 of gain. To qualify for the exclusion, the taxpayer must have both owned and used the property as a principal residence for two years or more during the five-year period preceding the date of sale.

The significant changes made to I.R.C. § 121 included the repeal of former I.R.C. § 1034, the "roll-over" rules. Given the proper facts, case law applying the "roll over" rules allowed a homeowner to be absent from his or her principal residence for an extended period without it losing its status as principal residence. This section had permitted military members up to four years (to a maximum of eight years for military members serving abroad) to roll over a gain on a sale of a principal residence into a new residence, typically at a new duty station.

Additionally, a rather extensive body of case law as well as the Treasury Regulations enacted under I.R.C. § 1034 permitted a military member qualifying under a "facts and circumstances" test to maintain real property as a "principal residence" under the meaning of the section despite living away from the home due to military orders. This permitted a military member to maintain parity with other taxpayers and defer capital gains under the rollover provisions of I.R.C. § 1034. In other words, under the rules applicable to I.R.C. § 1034, a military member's military service did not prevent the member from claiming his or her home as a principal residence under I.R.C. § 1034. These members would defer recognition of any profits from that home's sale by decreasing the basis of a subsequently purchased home. And, once the member reached age 55, the member could sell that home and use the former version of I.R.C. § 121 to exclude up to the $125,000 of gain.

The repeal of I.R.C. § 1034 can be interpreted to also repeal the "facts and circumstances" test that enabled military members to qualify the former home as a "principal residence" even when they were away from the home solely due to military service. However, we believe that the proposed regulations do not achieve the same result as the former law.

to compliance with official orders. Under the new law, for houses sold after May 6, 1997, a military member must actually "own and use" the property for two years of the five-year period immediately preceding the sale to qualify the property for the complete exclusion. This test is strictly applied. Military homeowners who do not occupy their principal residence for at least two of the five years immediately preceding the date of sale must pay taxes on part or all of the capital gain on the home. This is a particular problem for military members on extended overseas assignments or who are required to live in government housing while stationed in the United States. Because military members and their families are often subject to extended tours of duty away from their principal residence, the "own and use" requirements can result in unfair tax penalties when the principal residence is sold.

Previously, Congress recognized this unintended inequity to military homeowners, and passed a Sense of Congress (H.R. 3616, Section 1074), titled, "Sense Of Congress Concerning Tax Treatment Of Principal Residence Of Members Of Armed Forces While Away From Home On Active Duty." Section 1074 states:

"It is the sense of Congress that a member of the Armed Forces should be treated, for purposes of section 121 of the Internal Revenue Code of 1986, as using property as a principal residence during any continuous period that the member is serving on active duty for 180 days or more with the Armed Forces, but only if the member used the property as a principal residence for any period during or immediately before that period of active duty."

The current version of I.R.C. § 121 has a bright line test based on home ownership duration and use during the five-year period immediately before sale. If, during this period, the military member fails to use his or her house as a principal residence for two years the military member will recognize gain, either partially or fully, on the sale of the house, regardless of the intent that it is a principal residence. If the military member has not lived in the house at all during this five-year period he or she will fully recognize all gain on the sale. If the military member has used the house for a period of less than two years during the five-year period, the excludible amount will be reduced. This is so even where the military member was transferred before occupying the house for two years, has been assigned overseas, has occupied government quarters, or has rented another house due to the logistical requirements of the assigned duties.

The inability of the military member to qualify this residence as a "principal residence" under I.R.C. §121 eliminates the parity with other taxpayers enjoyed under the former I.R.C. § 1034 rollover provisions and imposes a tax disadvantage on the highly transient military members.

Our proposed modification removes this harsh result by suspending the running of the five-year period whenever a military member serves at a duty station that is at least 50 miles from such property or is under official orders to reside in government quarters.

We recommend incorporating into the proposed Treasury Regulation a modification that would suspend, for time spent away from home due to official extended duty, the five-year period during which the ownership and use requirements of I.R.C. § 121 must be met for service members. The proposed modification follows.

Section 1.121-4(d). Special Rule For Members Of Uniformed Services In Determining Exclusion Of Gain From Sale Of Principal Residence.

(1) In general. The running of the 5-year period described in I.R.C. section 121 shall be suspended with respect to an individual during any time that such individual or such individual's spouse is serving on qualified official extended duty as a member of the uniformed services.

(ii) Qualified official extended duty. The term 'qualified official extended duty' means any period of extended duty as a member of the uniformed services during which the member serves at a duty station that is at least 50 miles from such property or is under official orders to reside in government quarters.

(iii) Uniformed services. The term 'uniformed services' has the meaning given such term by section 101(a)(5) of title 10, United States Code, as in effect on the date of the enactment of these regulations.

(iii) Extended duty. The term 'extended duty' means any period of active duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period.
The incorporation of this proposed modification to treat periods of absence due to military service as “use” would allow military members to leave their home, serve their country, and not face the possibility of a large capital gain upon selling their home. It reestablishes the parity that existed between military members and other taxpayers under the former I.R.C. § 1034.

Very Respectfully,

[Signature]

David C. Hague
Brigadier General
U. S. Marine Corps, Retired
Chair, Standing Committee on Legal Assistance for Military Personnel
American Bar Association