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A Hole in the New 'Exclusion of Exclusion of Gain' Statute

By John Incorvaia

John Incorvaia is an attorney in solo practice in Palm Coast, Fla.

Section 121 of the Internal Revenue Code is titled "Exclusion of Gain From Sale of Principal Residence."[1] Because of this code section, taxpayers are permitted to exclude all or a portion of gain realized on the sale of a principal residence under certain conditions, most notably that the claimants have owned and used the property as their principal residence for an aggregate of two of the preceding five years.[2] The taxpayers must have sold the property within a five-year period in which they met the ownership and use conditions. If taxpayers met the conditions of ownership, use, and time, they were permitted to exclude gain in the amount of $250,000 or, if married and filing a joint return, $500,000.[3]

Section 121 expressly allows taxpayers to aggregate the amount of time that a person uses a property as a principal residence. It does not require that a taxpayer own and use the property for a consecutive period of time. If the aggregate time equals or exceeds two years (presumably meaning 731 days) within the prior five years (presumably 1,826 days), then before the new amendment to this law, the taxpayers would have been able to exclude either $250,000 or $500,000, depending on their filing status.

"Principal residence" is not statutorily defined for these purposes. Rather, it is a facts-and-circumstances inquiry.[4] Although the IRS states in its regulations that it deems the residence where the taxpayer spends more time to be the primary residence,[5] there is no codification of this principle, and the Service does not end its inquiry there. There is no one determining factor, and the inquiry as to whether any property constitutes a principal residence is intensely factual. A review of the regulations, cases, and treatises shows that time is a factor and is not conclusive.[6] Many factors can and should be considered. Any factor can be given consideration, such as those in the regulations, but perhaps equally important is the good faith of the taxpayers,[7] as well as their acts and

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[1]26 U.S.C. section 121.

[2]26 U.S.C. section 121(a). Exclusion.

Gross income shall not include gain from the sale or exchange of property if, during the five-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more.

[3]26 U.S.C. section 121(b). Limitations.

(1) In general. The amount of gain excluded from gross income under subsection (a) with respect to any sale or exchange shall not exceed $250,000.

(2) Special rules for joint returns. In the case of a husband and wife who make a joint return for the taxable year of the sale or exchange of the property —

(A) $500,000 limitation for certain joint returns. Paragraph (1) shall be applied by substituting "$500,000" for "$250,000" if —

(i) either spouse meets the ownership requirements of subsection (a) with respect to such property;

(ii) both spouses meet the use requirements of subsection (a) with respect to such property; and

(iii) neither spouse is ineligible for the benefits of subsection (a) with respect to such property by reason of paragraph (3).

(B) Other joint returns. If such spouses do not meet the requirements of subparagraph (A), the limitation under paragraph (1) shall be the sum of the limitations under paragraph (1) to which each spouse would be entitled if such spouses had not been married. For purposes of the preceding sentence, each spouse shall be treated as owning the property during the period that either spouse owned the property.

(Footnote continued in next column.)

[4]*See, e.g.*, 26 C.F.R. section 1.121(1)(b)(2) titled "Principal residence," which states in pertinent part that 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."

[5]*Id.*

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.

[6]*Guinan v. United States* (D. Ariz., Apr. 9, 2003), *Doc 2003-12254*, *2003 TNT 98-12*. "The Court also concurs with the United States that while time spent in a residence is a major factor, if not the most important factor, in determining whether it is the principal residence, other factors are also relevant."

[7]*United States v. Sheahan*, 323 F.2d 383 (1963).

intent.[8] Other factors that have been considered in determining a principal residence are: the location of the plaintiffs' recreational and other activities; the location of the principal abodes of the children; the location of vehicle registrations; the filing of state income tax returns; the location of voter registration; and the size of a residence in comparison with other properties owned.[9]

The Housing and Economic Recovery Act of 2008[10] amended section 121[11] to limit the exclusion on sale of principal residence, thereby creating an exclusion to the exclusion of gain. The act added new subsection (b)(4)[12] to section 121, which states:

(4) EXCLUSION OF GAIN ALLOCATED TO NONQUALIFIED USE —

> (A) IN GENERAL — Subsection (a) shall not apply to so much of the gain from the sale or exchange of property as is allocated to periods of nonqualified use.
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> (B) GAIN ALLOCATED TO PERIODS OF NONQUALIFIED USE — For purposes of subparagraph (A), gain shall be allocated to periods of nonqualified use based on the ratio which —
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> (i) the aggregate periods of nonqualified use during the period such property was owned by the taxpayer, bears to
>
> (ii) the period such property was owned by the taxpayer.
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> (C) PERIOD OF NONQUALIFIED USE — For purposes of this paragraph —
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> (i) IN GENERAL — The term 'period of nonqualified use' means any period (other than the portion of any period preceding January 1, 2009) during which the property is not used as the principal residence of the taxpayer or the taxpayer's spouse or former spouse.
>
> (ii) EXCEPTIONS — The term 'period of nonqualified use' does not include —
>
> (I) any portion of the 5-year period described in subsection (a) which is after the last date that such property is used as the principal residence of the taxpayer or the taxpayer's spouse,
>
> (II) any period (not to exceed an aggregate period of 10 years) during which the taxpayer or the taxpayer's spouse is serving on qualified official extended duty (as defined in subsection (d)(9)(C)) described in clause (i), (ii), or (iii) of subsection (d)(9)(A), and
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> (III) any other period of temporary absence (not to exceed an aggregate period of 2 years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the Secretary.
>
> (D) COORDINATION WITH RECOGNITION OF GAIN ATTRIBUTABLE TO DEPRECIATION — For purposes of this paragraph —
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> (i) subparagraph (A) shall be applied after the application of subsection (d)(6), and
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> (ii) subparagraph (B) shall be applied without regard to any gain to which subsection (d)(6) applies.

The amendment made by this section applies to sales and exchanges after December 31, 2008.[13]

The new subsection (b)(4) creates an exclusion to the "exclusion of gain upon sale of principal residence" as originally set forth within section 121. Under the new subsection, gain is not excluded for any period after December 31, 2008, during which the property is not used as the principal residence. With some limited exceptions, any such period that the property is not used as a principal residence is termed "nonqualified use." The gain realized on sale of the property is then allocated between the periods when the property is used as the principal residence and the period of nonqualified use. The new subsection requires the creation of a ratio, the numerator of which is the period that the property was not used as a principal residence before the time the taxpayer made it his principal residence, and the denominator of which is the *entire period of ownership* of the property.[14] That ratio is then applied to the gain. The portion of the gain from the period during which the property was used as a principal residence is excluded from income to the extent of either $250,000 or $500,000, depending on the taxpayer's circumstances. But to the extent that the gain is apportioned to a period of nonqualified use, the taxpayer is taxed on that portion of the gain. More simply stated, to the extent of nonqualified use, the taxpayer must include some or all of the gain that would otherwise have been excluded by statute before this amendment.

The following examples show how this works:

Example 1: Alan and Betty are married and file a joint tax return. On January 1, 2009, they buy a second home. On January 1, 2013, they move into that home and make it their principal residence. On January 1, 2019, they sell the home, realizing a gain of $500,000. Because during 4 of the 10 years of ownership Alan and Betty did not use the property as their principal residence, they will not be able to exclude four-tenths of the gain, or $200,000, on which they will be taxed. They will exclude $300,000 of gain.

Example 2: Carol is single. On January 1, 2009, she buys a second home. On January 1, 2013, she moves into that home and makes it her principal residence. On January 1, 2019, she sells the home, realizing a gain of $150,000. Because during 4 of the 10 years of ownership Carol did not use the property as the principal residence,

[8] *Beall v. Commissioner*, 229 F.3d 1156 (2000), *Doc 2000-19304, 2000 TNT 138-19*. Both "act and intent, neither of which taken alone, makes a house a principal residence."

[9] *Guinan v. United States*, *supra* note 6.

[10] P.L. 110-289, signed into law by President Bush on July 30, 2008.

[11] *Id*. at section 3092.

[12] *Id*. at section 3092 (1)(a).

[13] *Id*. at section 3092 (1)(b).

[14] 26 U.S.C. section 121(b)(4)(B).

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she will not be able to exclude four-tenths of the gain, or $60,000. Carol will exclude $90,000 of gain and will be taxed on $60,000.

Example 3: Dan is single. On January 1, 2009, he buys a second home. On January 1, 2013, Dan moves into that home and makes it his principal residence. On January 1, 2019, he sells the home, realizing a gain of $500,000. Because during 4 of the 10 years of ownership Dan did not use the property as the principal residence, he will not be able to exclude four-tenths of the gain, or $200,000. Dan will exclude $250,000 of the remaining $300,000 gain under section 121(a). The result is that he will exclude $250,000 of gain and will have to include gain of $250,000 ($200,000 plus $50,000).

New section 121(b)(4)(C)(ii)(I) states that nonqualified use does not include ''any portion of the five-year period described in subsection (a) which is after the last date that such property is used as the principal residence of the taxpayer or the taxpayer's spouse.'' In other words, within the scope of the five-year period when the taxpayer must aggregate two years of use of the property as a principal residence, once the taxpayer uses the property as his principal residence, no subsequent period within that five-year time frame is counted as a period of nonqualified use. Because time is not the definitive factor in determining whether a property is a principal residence, there is no condition about the amount of time that the taxpayer must use the property as his principal residence so as to toll the period of nonqualified use. Therefore, as long as the taxpayer owns the property, immediately makes it his principal residence, and then, during the next five years, aggregates two years with that property as principal residence, then there is no ''exclusion of exclusion of gain.'' Simply put, the full exclusion of gain under section 121(a) would apply under those circumstances.

The following examples show how this works:

Example 4: Ellen is single. On January 1, 2009, she buys a second home, but does not immediately move into it. Instead, she retains her old home and has her new home renovated for a period of six months. After this time, Ellen moves into the new home and makes it her principal residence. On July 1, 2012, she sells the property at a gain of $250,000. Ellen could not exclude one-~~fifth~~ sixth of her gain. She will exclude $200,000 of gain and be taxed on $50,000 of gain.

Example 5: Assume the same facts as in example 4 except that Ellen gives up her old home and makes the new home her principal residence, residing there while the renovations are accomplished. In these circumstances, Ellen could exclude all of the gain.

Example 6: Frank and Grace are married. On January 1, 2009, they buy a home and make it their principal residence. On July 1, 2009, they move out of the home and rent it out for three years. On July 1, 2012, they again use the home as their principal residence and continue to do so until they sell the home on January 1, 2014, realizing a gain of $500,000. Because they made the home their principal residence on purchase, and aggregated two years of use as a principal residence during the five-year period, they would be able to exclude all of the gain.

The new section 121(b)(4) was passed as part of the Housing and Economic Recovery Act of 2008, but the results of new section 121(b)(4) would overall seem to be counterproductive to a recovery of either the housing market or the economy. The new law results in tax on sale of a home if a homeowner chooses to make renovations before making the residence their principal residence. Similarly, the acquisition and subsequent sale of a second home for vacation or retirement is also likely to result in tax. Because new section 121(b)(4) taxes the gain realized by individuals who take time to renovate properties before taking them up as their principal residence, as well as retirees who buy second homes with the intention of one day making them their principal residence and later sell them, the overall effect of this law would seem more likely to further stifle both the housing market and the economy, rather than foster any recovery.

The new law lends itself to some odd results. Most tax laws are written in a convoluted manner that makes understanding them difficult and this exclusion of exclusion of gain certainly does not disappoint on that count. More importantly, it is difficult to understand a clear policy behind the law because of the awkward and uneven results achieved by the application of this new law. It would seem that Congress intended to catch taxable income resulting from the sale of mixed-use (qualified and nonqualified use) properties, vacation properties, second homes, or just from the properties of taxpayers who own multiple properties. But if that is the case, there seems to be a hole in the law in that as long as a taxpayer makes the property his principal residence first, the taxpayer can then make any use of the property for up to three years and still reap the full benefit of section 121(a), assuming the taxpayer can aggregate two years of ownership and use during the five-year period preceding sale.

With the new law taking effect on January 1, 2009, it becomes imperative for new property owners to take steps to establish immediately that the property is their principal residence (and just as important, to safeguard the proof thereof) to qualify for the full exclusion from gain under section 121. Further, even when the property is first used for a nonqualified use, the amount of time of nonqualified use can be stemmed, thereby mitigating negative tax consequences, by the taxpayers' clear establishment of the property as their principal residence. Because these are facts-and-circumstances types of inquiries, taxpayers are well advised to collect and keep safe as much proof as can be documented of how and when the property first becomes their principal residence.

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