

Chapter 1

The Personal Residence

- § 1:1 Introduction
- § 1:2 Deductibility of Personal Interest Expense
 - § 1:2.1 “Qualified Residence”
 - § 1:2.2 “Acquisition Indebtedness” and “Home Equity Indebtedness” Concepts
- § 1:3 Deductibility of Points
- § 1:4 Whether Points May Be Deducted on Refinancing
- § 1:5 Tax Issues Relating to the Rental of Vacation Homes
 - § 1:5.1 Deductions Limited by Personal Use of Property
 - ▶ Example 1-1
 - ▶ Example 1-2
 - § 1:5.2 Passive Loss Limitations
- § 1:6 Home Office Deductions
 - § 1:6.1 In General
 - § 1:6.2 *Soliman* Case and “Principal Place of Business” Test:
 - [A] The IRS’s Interpretation of the *Soliman* Rationale
 - § 1:6.3 Law Under the TRA 97 Applicable to Post-1998 Years
 - § 1:6.4 Calculation of the Home Office Deduction
 - ▶ Example 1-3
 - § 1:6.5 Capital Gain Tax Attributable to a Previously Depreciated Home Office
- § 1:7 Taxation of Gain on the Sale of a Principal Residence
 - § 1:7.1 In General: Law Prior to TRA 97
 - § 1:7.2 Requirements Under Pre-TRA 97 Laws for Rollover Treatment
 - ▶ Example 1-4: Under Pre-TRA 97 Law
 - § 1:7.3 One-Time \$125,000 Exclusion Under Pre-TRA 97 Law
 - ▶ Example 1-5: Under Pre-TRA 97 Law
 - § 1:7.4 Taxation of the Sale of a Principal Residence After TRA 97
 - [A] The \$250,000/\$500,000 Exemption
 - [B] Two-Out-of-Five-Year Continuous Ownership and Occupancy Tests

- ▶ **Example 1-6**
 - [B][1] Nonqualified Use Limitation for Periods Subsequent to January 1, 2009**
 - [B][1][a] In General**
 - [B][1][b] Conversion of Vacation Home to Principal Residence**
- ▶ **Example 1-6A**
 - [B][1][c] “After Last Date” Exception**
- ▶ **Example 1-6B**
- ▶ **Example 1-6C**
 - [B][1][d] “Temporary Absence” Exception**
 - [B][1][e] “Gain Attributable to Depreciation” Exception**
- ▶ **Example 1-6D**
 - [C] The Two-Year Anti-Churning Provision**
- ▶ **Example 1-7**
 - [D] Exception to Anti-Churning Rules: Reduced Maximum Exclusion of Gain Under Specified Circumstances**
- ▶ **Example 1-8**
 - [D][1] Temporary Regulations: Pre-August 13, 2004**
 - [D][2] Final Regulations Establishing Safe Harbor Provisions Effective August 13, 2004**
- ▶ **Example 1-9**
- ▶ **Example 1-10**
 - [E] Pre-May 7, 1997 Sales Disregarded in Applying Anti-Churning Rules**
 - [F] Issues Applicable to Married Taxpayers and Unmarried Taxpayers Living Together**
- ▶ **Example 1-11**
- ▶ **Example 1-12**
- ▶ **Example 1-13**
- ▶ **Example 1-14**
- ▶ **Example 1-15**
 - [G] Sale of Partial Interests**
- ▶ **Example 1-16**
 - [H] Depreciation**
- ▶ **Example 1-17**
 - [I] Need to Track Basis**
- ▶ **Example 1-18**
 - [J] The Effect of Section 121 on the Foreclosure of a Personal Residence**
 - [K] Strategy When Expected Gain on the Sale of a Residence Used As a Vacation Property Substantially Exceeds the \$250,000/\$500,000 Ceiling**
 - [L] The Surviving Spouse Penalty**
 - [L][1] Pre-2008 Law**
- ▶ **Historic Example 1-19: Pre-2008 Law**
 - [L][2] Law Effective January 1, 2008**

- [M] **Availability of Section 121 Exclusion to Trustee in Bankruptcy**
- [N] **May the Section 121 Exclusion Apply to a Partnership Owned Directly or Indirectly by Occupants of a Principal Residence?**
- [O] **Availability of Section 121 Exclusion to Heir, Estate, Trust or Single-Owner Entity**
- [P] **Vacant Land**
 - ▶ **Example 1-20**
 - [Q] **Gain Recognition from the Sale of a Principal Residence Acquired in a Section 1031 Like-Kind Exchange Within Five Years Prior to the Sale**
 - [R] **Sale of a Partial Interest in a Principal Residence**
 - ▶ **Example 1-21**
 - [S] **Section 121 Related-Party Restrictions**
 - [T] **Moving from and Renting One's Primary Residence Until Favorable Market Conditions Return**
 - ▶ **Example 1-21A**
- § 1:8 **"First-Time Homebuyer" Tax Credit for Homes Purchased in the District of Columbia**
- § 1:9 **Roth IRA Distributions Used to Purchase a Home**
 - § 1:9.1 **Background**
 - § 1:9.2 **Distributions from a Roth IRA**
- § 1:10 **Transfer of Personal Residence Incident to Divorce**
 - § 1:10.1 **Background**
 - § 1:10.2 **Current Law**
 - § 1:10.3 **Basis to Transferee Spouse of Marital Property**
 - § 1:10.4 **Transfer of Property Subject to a Loan in Excess of Basis**
 - ▶ **Example 1-22**
- § 1:11 **Does a Federal Tax Lien Attributable to One Spouse Attach to Real Property Owned by Both Spouses As Tenants-by-the-Entirety?**
- § 1:12 **Purchaser's Obligation to Withhold Tax on Purchase of Residence from a Foreign Individual or Entity**
 - § 1:12.1 **Withholding Certificate Guidance Under Revenue Procedure 2000-35**
 - [A] **In General**
 - [B] **How to Apply for the Withholding Certificate**
 - [C] **Format for the Withholding Certificate Application**
 - [D] **Residences Held for Investment and Traded in a Section 1031 Tax-Free Exchange**
- § 1:13 **Credit for Residential Energy-Efficient Property**
 - § 1:13.1 **The Credit**
 - § 1:13.2 **Limitations on the Credit**
 - § 1:13.3 **Carry-Forward of Credit**
 - § 1:13.4 **Special Rules**

- [A] **Labor Costs**
- [B] **Solar Panels**
- [C] **Swimming Pools**
- [D] **Dollar Limit on Fuel Cell Expenditures Made to Dwelling Unit Occupied by More Than One Taxpayer**
- [D][1] **Limit**
- [D][2] **Proration**
- [E] **Tenant-Stockholders in Cooperative Housing Corporations**
- [F] **Condominiums**
- § 1:14 **Credit for Nonbusiness Energy Property**
- § 1:15 **Discharge of Indebtedness Relief Under the Mortgage Forgiveness Debt Relief Act of 2007**
- § 1:16 **Tax-Free Exchanges of Dwelling Units Held for Investment**
- § 1:17 **First-Time Homebuyer Credit**
 - § 1:17.1 **Eligibility for Credit**
 - § 1:17.2 **Use of the Credit**
 - § 1:17.3 **Recapture of the Credit**
 - § 1:17.4 **Related-Party and Other Limitations**
 - § 1:17.5 **Modifications to the Credit Under the American Recovery and Reinvestment Act of 2009 Section 1006(a)(2)**

§ 1:1 Introduction

For many clients, the only real estate-related tax issue they will ever confront involves their primary personal residence or their vacation home. Questions such as “If I refinance my home, can I deduct points?” to “Can I deduct any of the cost of my vacation home that I sometimes rent out?” are the likely kinds of questions that a practitioner will be asked. In addition, questions will likely be raised regarding the most appropriate way of titling the home to minimize the tax consequences of selling it. In this chapter, I set forth many of the legal principles that underlie the foregoing issues as well as other issues that are likely to arise in one’s practice. Some issues are deferred to later sections dealing with estate planning using real estate; accordingly, a cursory review of the table of contents is recommended.

§ 1:2 Deductibility of Personal Interest Expense

Prior to the Tax Reform Act of 1986, personal interest, such as the interest one paid on one’s automobile installments, was deductible as an itemized expense, in much the same way as real estate taxes. Today, however, with certain exceptions, personal interest is not deductible as an itemized expense. The principal exception involves payments made on real estate indebtedness involving “qualified residences” owned by a taxpayer.

In *Njenge v. Commissioner*,¹ the Tax Court held that the taxpayers were entitled to take a deduction for interest paid on the mortgage to their home, despite the fact that the mortgage was in the name of their son. In the case, the parents were the sole occupants of the house and paid all of the bills, including mortgage payments. Based on these facts, the court concluded that the parents had equitable and beneficial ownership of the home, and, therefore, were entitled to the deduction.

§ 1:2.1 “Qualified Residence”

To be deductible, interest paid with respect to a personal residence must be expended in connection with a “qualified residence.” A “qualified residence” includes the taxpayer’s principal residence as well as one other secondary residence, such as a vacation home, provided that the other secondary residence meets one of two criteria. First, if the secondary residence was not rented during the year, it automatically qualifies as a “qualified residence.”^{1,1} Second, if the residence was rented during the year, it must also have been used by the taxpayer for personal purposes (the “personal use test”) for a number of days exceeding the greater of (1) fourteen days, or (2) 10% of the number of days it was rented at fair market value.²

§ 1:2.2 “Acquisition Indebtedness” and “Home Equity Indebtedness” Concepts

Interest paid on a “qualified residence” is deductible provided that the interest derives from either “acquisition indebtedness” or “home equity indebtedness.” Acquisition indebtedness is indebtedness incurred in the acquisition, construction, or substantial improvement of a qualifying residence.³ To the foregoing, there must also be added the requirements that (1) on property mortgaged on or after October 13, 1987, the aggregate mortgage cannot exceed \$1 million⁴ and

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1. *Njenge v. Comm’r*, T.C. Summ. Op. 2008-84, 2008 WL 2746329 (July 15, 2008), citing *Uslu v. Comm’r*, T.C. Memo 1997-551.
 - 1.1. I.R.C. § 163(h)(5)(A)(3).
 2. I.R.C. §§ 163(h)(3) and 280A(d).
 3. I.R.C. § 163(h)(3)(B)(i)(I).
 4. I.R.C. § 163(h)(3)(B)(ii). In an IRS legal memorandum released in March 2009, the IRS held that the \$1 million limitation on the size of a mortgage against which deductible interest could be claimed applied to a residence owned by an unmarried couple. Chief Council Advisory 200911007 (Mar. 13, 2009). This position has been criticized by Cain, *Unmarried Couples and the Mortgage Interest Deduction*, TAX NOTES, Apr. 27, 2009.

(2) the debt must be secured by the mortgaged property.⁵ Accordingly, interest on accommodation loans from one's family member, where the loan is not secured by the underlying property, will not be deductible as personal residence interest.

A second situation in which personal residence interest will be deductible is where the taxpayer takes out an equity loan that (1) does not exceed the difference between (a) the fair market value of the property and (b) any acquisition indebtedness with respect to the property, and (2) is secured by the underlying property. Under these circumstances, if the loan does not exceed \$100,000 (\$50,000 in the case of married individuals filing separate returns), the interest is fully deductible even if the borrowed funds are used for personal purposes and even if, under comparable circumstances, the interest on a nonhome equity loan obtained for the same personal purposes, would not have been deductible.⁶

Interest on acquisition indebtedness that is incurred to acquire, construct, or substantially improve a personal residence is deductible under both the home equity indebtedness ceiling of \$100,000^{6.1} as well as the general indebtedness subject ceiling of \$1 million. As a result, if a taxpayer spends \$1,100,000 on the acquisition, construction, or substantial improvement of a personal residence, interest on the entire \$1,100,000 is deductible despite the general \$1 million limitation.^{6.2}

§ 1:3 Deductibility of Points

In the Metropolitan Washington area, as elsewhere, the charging of points for loans has become common practice. Though points can represent a service charge unrelated to interest, in the main, more

5. I.R.C. § 163(h)(3)(B)(i)(II). Specifically, a debt will be considered secured by a qualified residence if:

- it makes the interest of the debtor in the qualified residence specific security for the payment of the debt;
- in the event of default, the residence could be subject to the satisfaction of the debt with the same priority as a mortgage or deed of trust in the jurisdiction in which the property is situated;
- the debt is recorded where permitted, or is otherwise perfected in accordance with applicable state law.

A debt will not be considered to be secured by a qualified residence if it is secured solely by virtue of a lien upon the general assets of the taxpayer or by a security interest, such as a mechanic's lien or judgment lien, that attaches to the property without the consent of the debtor.

6. I.R.C. § 163(h)(3)(C)(ii).

6.1. I.R.C. § 163(h)(3)(C).

6.2. Chief Counsel Advice 200940030.

often than not they are a cost of using funds and, as such, can be regarded as interest that is being prepaid by the taxpayer. In most cases, prepaid interest is not deductible, but, rather, must be capitalized and deducted over the term of the loan, by cash basis taxpayers such as individual taxpayer homeowners.⁷ However, a cash method taxpayer can deduct points in the year paid, subject to specified criteria.⁸ The Service has published such criteria for the deductibility of points in the form of “safe harbor” guidelines.⁹

As set forth in Revenue Procedure 94-27, the criteria are:

- (1) The HUD-1 settlement sheet must clearly specify the amount being paid as points (for example, as “loan origination fees” or as “loan discount fees,” as typically found on lines 801 and 802 of the HUD-1).
- (2) The points must be calculated as a percentage of the amount being borrowed, rather than as a flat fee.
- (3) The payment of points must conform to an established practice (as is generally true in this area), and the points in question must not exceed the amount normally charged for home mortgages.
- (4) The points must relate to a mortgage obtained for the purchase¹⁰ of the taxpayer’s principal residence, and the mortgage must be secured by the underlying property.
- (5) The points must have been paid directly by the purchaser with funds obtained from a source other than the lender (that is, the funds must have come from a source other than the loan money, itself).

For sales taking place after December 31, 1990, points “paid by the seller (including points charged to the seller) in connection with the loan to the taxpayer will be treated as paid directly by the taxpayer from funds that have not been borrowed for such purpose.”¹¹ As with

7. I.R.C. § 461(g).

8. I.R.C. § 461(g)(2).

9. Rev. Proc. 94-27, 1994-1 C.B. 613.

10. Although I.R.C. § 461(g)(2) permits a deduction for prepaid interest (*i.e.*, points) with respect to the “purchase” or “improvement” of a principal residence, the Service’s safe harbor is limited to the “acquisition” of a principal residence. Nevertheless, for one who has paid points on an improvement loan, and has, otherwise, satisfied the applicable criteria of the Revenue Procedure, it would seem reasonable to argue that the deduction is permitted by the statute even if not contemplated by the safe harbor guidelines.

11. Rev. Proc. 94-27, § 3.05.

the safe harbor provisions in general, the provisions relating to seller-paid-for points would appear to apply only to the purchases of principal residences, but not to improvements to same.

§ 1:4 Whether Points May Be Deducted on Refinancing

Generally, points cannot be deducted with respect to a refinancing since such points are not paid for the purpose of “purchasing” or “improving” the home. Instead, refinancing points must normally be deducted ratably over the duration of the loan. However, one court has held that points paid on permanent financing, used to refinance a three-year balloon mortgage, were deductible in the year paid.¹² Where refinancing points have not been deducted at the time of sale and the property is subsequently sold or again refinanced, the unamortized refinancing points can be deducted in the year of sale or refinancing.

§ 1:5 Tax Issues Relating to the Rental of Vacation Homes

Where a taxpayer rents a vacation home and at the same time experiences costs in paying for and maintaining the property, there is a reasonable expectation that the costs should be deductible, at least insofar as they apply to the proportionate period of time during which the property is rented. However, two sets of limitations restrict the amounts that can be deducted.

§ 1:5.1 Deductions Limited by Personal Use of Property

In the circumstance where the personal use test is not met (that is, where the taxpayer uses a vacation home for less than the greater of (1) fifteen days a year, or (2) 10% of the number of days that the residence is rented at fair market value), the taxpayer, subject to the “passive loss” limitations,¹³ can deduct costs associated with ownership and maintenance of the residence.

However, where the personal residence test is met (that is, where the residence is used for personal purposes, by the taxpayer, a member of his family, or an unrelated third party who uses the residence and does not pay a fair market rent, for a period of time in excess of the fifteen-day/10% test), then section 280A limits the amount of the

12. *Huntsman v. Comm’r*, 905 F.2d 1182 (8th Cir. 1990) (“[because] the permanent mortgage obtained was sufficiently in connection with the purchase of the home . . . points paid in connection with the permanent financing [could] be deducted in the year in which they were incurred”).

13. Discussed *infra* section 1:5.2.

deduction available to the taxpayer.¹⁴ Specifically, the proposed regulations under section 280A(c)(5) provide that the amount that may be deducted with respect to costs such as maintenance, repairs, and depreciation is “that amount which bears the same relationship to the total amount of the item as the number of days on which the unit is rented at a fair rental during the taxable year bears to the number of days on which the unit is used for any purpose.”¹⁵

► **Example 1-1**

Assume that Taxpayer A uses vacation premises for personal purposes for thirty days out of the year and that she rents the premises at fair market value for ninety days out of the year. Assume further that insurance and utilities on the premises amount to \$7,000. Subject to the limitations set forth in Example 1-2, the amount that can be deducted under the foregoing provision is \$5,250 ($\$7,000 \times 90/120$).

In addition to the foregoing limitation, costs such as maintenance, repairs, utilities, and depreciation can only be deducted to the extent that they do not exceed the difference between (1) gross rental income, less (2) a proportionate share of deductions allocable to the rental use (that is, interest and real estate taxes) that otherwise would have been available to the taxpayer during the period that the property was rented. The exact order of the available deductions is set forth in section 1.280A-3(d)(3) of the proposed regulations, which closely tracks the order of deductions associated with the business use of one’s home.¹⁶ However, how this formulation is applied can produce substantially divergent results.

► **Example 1-2**

Assume, as in Example 1-1, that Taxpayer A uses vacation premises for personal purposes for thirty days out of the year and that she rents the premises at fair market value for ninety days out of the year. Assume further that she receives \$12,000 in income for the three-month rental. Assume further that her interest

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14. Where vacation property is rented for less than fifteen days per year, no deductions (except for those otherwise available, such as interest and real estate taxes) may be taken with respect to the maintenance of the property. I.R.C. § 280A(g)(1). Correspondingly, however, the taxpayer need not recognize any income received during such less than fifteen-day period. I.R.C. § 280A(g)(2).
15. Prop. Treas. Reg. § 1.280A-3(d)(3).
16. See section 1:6.4, *infra*.

and taxes for the year are \$10,000. Under the Service's construction of section 280A(c)(5), the amount of noninterest and nontax expenses that can be deducted is a function of the number of days the property is rented at fair market value (90) as compared to the total number of days the property is used (120). This approach yields a ceiling on those deductions of \$4,500 ($\$12,000 - [90/120 \times \$10,000]$ in interest and taxes). Accordingly, not all of the available \$5,250 in maintenance, repairs, and utility expenses described in Example 1-1 will be deductible.¹⁷ By contrast, on the same facts, a decision of the Ninth Circuit¹⁸ would support a deductibility ceiling based upon the number of days the property is rented at fair market value (90) as compared to the number of days in the year (360). This approach yields a much higher ceiling of approximately \$9,500 ($\$12,000 - [90/360 \times \$10,000]$ in interest and expenses).¹⁹ Further, even if the personal use test is not met, deductions that are not foreclosed by section 280A, nevertheless, can prove to be ephemeral by virtue of the "passive loss" limitations discussed in the next section.

§ 1:5.2 **Passive Loss Limitations**

In addition to the section 280A limitations, lessors of real estate, including lessors of vacation homes, are subject to the "passive loss" limitations of section 469(a).²⁰ Generally, under the rules, individuals who are investors in rental real estate can only deduct losses from those rental activities to the extent of their income from passive sources. However, subject to a scaling-back provision, a special dispensation from these provisions applies to persons who rent properties such as vacation homes and who have adjusted gross incomes of less than \$150,000. Under this special provision, owners of vacation homes who rent them out and who, otherwise, are not limited by the section 280A limitations, can offset against their ordinary, that is, nonpassive, income up to \$25,000 per year in losses incurred from the

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17. See Prop. Treas. Reg. § 1.280A-3(d)(4). Subject to the above-discussed limitations, any nontax or noninterest amount disallowed in a given year can be deducted in the succeeding year. I.R.C. § 280A(c)(5) (flush language). In addition, if the taxpayer itemizes deductions, the portion of real estate taxes and interest not attributed to the rental of the residence may be taken as itemized deductions in the year incurred. Prop. Treas. Reg. § 1.280A-3(d)(4).
 18. *Bolton v. Comm'r*, 694 F.2d 556 (9th Cir. 1982).
 19. For amplified discussion of this issue, see 2000 Stand. Fed. Tax Rep. (CCH) ¶ 14,854.35, and ROBINSON, FEDERAL INCOME TAXATION OF REAL ESTATE (Warren, Gorham & Lamont, Inc. 1989), at ¶ 2.06[2].
 20. The passive loss provisions are discussed more extensively in section 4:1 *infra*.

rental of these homes.²¹ In the case of married taxpayers filing separately, where the spouses live apart during the entire year, the foregoing limit is reduced to \$12,500 per taxpayer.²²

To obtain the deduction, two criteria must be satisfied: First, the taxpayer must have “actively participated” in the rental of the vacation home.²³ For such purposes, the term “actively participated” means that one has made significant and bona fide management decisions, such as approving tenants, rental provisions, and expenditures.²⁴ Second, the taxpayer must have owned at least a 10% interest in the property.²⁵

In addition to the foregoing criteria, to the extent that the taxpayer (filing jointly) and his spouse’s aggregate adjusted gross income exceeds \$100,000, the \$25,000 permissible deduction amount is reduced by 50% of the excess, with the result that the permissible deduction amount is completely phased out at \$150,000 of adjusted gross income.²⁶ For married persons filing separately and living apart during the entire year, the adjustment is based on income in excess of \$50,000 and is applied against the \$12,500 ceiling applicable to these taxpayers.²⁷

§ 1:6 Home Office Deductions

With the advent of “telecommuting,” where more and more individuals are spending time at home working on business matters, the availability of home office deductions has taken on increasing importance. Under what circumstances may a taxpayer take deductions for the proportionate share of home-related costs associated with carrying on a business?

§ 1:6.1 In General

Generally, section 162(a) permits a deduction for “all the ordinary and necessary expenses paid or incurred . . . in carrying on any trade or

21. I.R.C. § 469(i)(2).

22. *Id.*

23. I.R.C. § 469(i)(1).

24. See in this regard S. COMM. ON FINANCE, REPORT ON PUB. L. NO. 99-514, at 737 (Comm. Print 1999), and *Madler v. Comm’r*, T.C. Memo 1998-112 (1998), where the \$25,000 exception was held inapplicable because all of the management activities, *e.g.*, tenant approval, rental terms and maintenance decisions were all handled by a management company hired by the taxpayer owner.

25. I.R.C. § 469(i)(6).

26. I.R.C. § 469(i)(3). See exceptions to the phaseout rule in I.R.C. § 469(i)(3)(B)–(C).

27. I.R.C. § 469(i)(5)(A) and (B).

business.” However, section 162(a), as it applies to home office expenses, is limited by section 280A(a). Except as discussed below, section 280A(a) specifies that deductions “with respect to the use of a dwelling unit that is used by the taxpayer . . . as a residence” are generally not deductible.

As with many sections of the Internal Revenue Code, the exceptions to section 280A(a) are of paramount importance. Specifically, section 280A(c)(1) states that the prohibition of section 280A(a) does not limit the availability of a deduction to the extent that the deduction is allocable to a portion of the dwelling unit that is “exclusively²⁸ used on a regular basis” in one of the following three ways:

- As the “principal place of business” for any trade or business of the taxpayer;
- As a place of business that is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business; or
- In the case of a separate structure that is not attached to the dwelling unit, in connection with the taxpayer’s trade or business.

Of the three forms of permissible use, the one that has precipitated the most questions and has been responsible for the most litigation is the first, that is, whether the portion of a residence used by the taxpayer constitutes his principal place of business for any trade or business the taxpayer conducts.

§ 1:6.2 Soliman Case and “Principal Place of Business” Test: Law Through the End of 1998

In the earlier stages of litigation surrounding the meaning of the term “principal place of business,” the Tax Court employed what had come to be known as the “focal point test.”²⁹ Under the focal point

28. An exception to the “exclusivity” requirement exists with respect to storage units used to store inventory and/or product samples in one’s home. Under this provision, expenses related to a storage unit used to store inventory and/or product samples will be deductible even if such storage unit is used on a “regular” rather than “exclusive” basis, provided that (1) the stored items are used in the taxpayer’s trade or business of selling products at wholesale or retail, and (2) the taxpayer’s home is the sole fixed location of that trade or business. I.R.C. § 280A(c)(2), as amended by § 1113 of the Small Business Job Protection Act of 1996, Pub. L. No. 104-188 (H.R. 3448) [hereinafter SBJPA] (effective for tax years beginning after Dec. 31, 1996, as to deductions for storage units used to store samples).

29. See, e.g., *Jackson v. Comm’r*, 76 T.C. 696 (1981).

test, the Tax Court assessed whether a taxpayer's residence constituted the principal place of business for the work being performed, by determining whether the residence was the "place where goods or services were being provided or where income is produced." However, after criticism from two courts of appeals,³⁰ the Tax Court abandoned the "focal point test" for a more lenient test.

Under the more lenient test, the "principal place of business" criterion could be satisfied where "management or administrative activities are essential to the taxpayer's trade or business and the only available office space is in the taxpayer's home."³¹ In the *Soliman* case, Dr. Soliman was an anesthesiologist who treated patients at three different hospitals, but who also devoted about 25% of his time at home to performing administrative functions, such as preparing patient logs, reading medical literature and attending to billing matters.

Under the revised criteria, the following factors were to be weighed heavily in favor of determining whether the home office was the taxpayer's principal place of business:

- Whether the home office is essential to the taxpayer's business;
- Whether the taxpayer spends a substantial amount of time in the home office; and
- Whether there is no other location available for performance of the office functions of the business.³²

When the *Soliman* case finally reached the Supreme Court, the Court pointedly rejected the Tax Court's test as adopted by the Fourth Circuit and established its own set of criteria for evaluating whether one, such as Dr. Soliman, was entitled to take deductions for home office expenses. Specifically, the Supreme Court adopted a two-part test. As stated by the Court, "there are . . . two primary considerations in deciding whether a home office is a taxpayer's principal place of business: the relative importance of the activities performed at each business location and the time spent at each place."³³

To analyze these two criteria, the Supreme Court determined that the anesthesiology services provided by Dr. Soliman at his hospital

30. *Meiers v. Comm'r*, 782 F.2d 75, 76 (7th Cir. 1986); *Weissman v. Comm'r*, 751 F.2d 512 (2d Cir. 1984); *Drucker v. Comm'r*, 715 F.2d 67 (2d Cir. 1983).

31. *See Soliman v. Comm'r*, 935 F.2d 52, 54 (4th Cir. 1991), *aff'g* 94 T.C. 20 (4th Cir. 1990), where the Fourth Circuit upheld the Tax Court's revised criteria in the case of a physician who used his home for administrative and billing purposes.

32. *Id.* at 54.

33. *Comm'r v. Soliman*, 506 U.S. 168 (1993), *rev'g* 935 F.2d 52 (4th Cir. 1991).

were by far the more important of the activities performed by him in his medical capacity. In addition, the Court noted that three-quarters of Dr. Soliman's time was spent at the hospitals. Accordingly, in the case of each of the two tests established by the Court, Dr. Soliman's home could not be regarded as his principal place of business.³⁴

[A] The IRS's Interpretation of the *Soliman* Rationale

On March 23, 1994, the Service released Revenue Ruling 94-24³⁵ in which it interpreted the conclusions of the *Soliman* case in the context of four different fact patterns. The preamble to the revenue ruling stated:

This home office expense guidance illustrates the principles of last year's Supreme Court decision in *Soliman* for determining a principal place of business. A taxpayer must first compare the relative importance of the work done at each business location, considering the particular characteristics of the business. Great weight must be given to such factors as where the taxpayer delivers goods or services to customers and any special facilities required by the job.

Under this rationale, the Service determined that a taxpayer's home office was not his principal place of business in the case of

- (1) a plumber who spent ten hours a week in his home office talking with customers over the telephone and reviewing books, and
- (2) a teacher who spent twenty-five hours per week at school and thirty to thirty-five hours per week at home preparing for classes.

By contrast, a home office was determined to be the taxpayer's principal place of business in the case of

- (3) an author who spent thirty to thirty-five hours per week writing at home and ten to fifteen hours per week in other locations, and

34. For a post-*Soliman* decision involving a similar fact pattern and arriving at a like decision, see *Chong v. Comm'r*, T.C. Memo 1996-232, 71 T.C.M. 3035 (1996). See also *Popov v. Comm'r*, 246 F.2d 1190 (9th Cir. 2001), a case governed by *Soliman*. In *Popov*, the court of appeals held that a violinist who spent 90% of her work time rehearsing in her home office was entitled to a home office deduction. In so holding, the court concluded that her practice time at home was as essential to her success as her performances away from home.

35. Rev. Rul. 94-24, 1994-15, 1994-1 C.B. 87.

- (4) a costume jewelry maker who spent twenty-five hours per week working at home and fifteen hours per week at craft shows.³⁶

§ 1:6.3 Law Under the TRA 97 Applicable to Post-1998 Years

Effective for tax years beginning after December 31, 1998, TRA 97 essentially overruled the Supreme Court's decision in *Soliman*. Specifically TRA 97 added the following qualification to the definition of "principal business":

For purposes of subparagraph (A), the term "principal place of business" includes a place of business which is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business.³⁷

Thus, under this statutory scheme, the Supreme Court's "relative importance of the activities performed at each business location" test and the Court's "time spent at each business location" test must give way to a simple assessment of whether (1) the taxpayer performs administrative and management activities of a trade or business at his home, and (2) whether, in fact, there is "no other fixed location of such trade or business where the taxpayer conducts 'substantial' administrative or management activities of such trade or business."

The Conference Report on H.R. 2014, which describes the House bill that gave rise to the amendment, offers some insights as to how the provision should be construed. Specifically, the Conferees state:

A home office deduction is allowed . . . if a portion of a taxpayer's home is exclusively and regularly used to conduct administrative or management activities for a trade or business of the taxpayer, who does not conduct substantial administrative or management activities at any other fixed location of the trade or business, regardless of whether administrative or management activities connected with his trade or business (*e.g.*, billing activities) are performed by others at other locations.

36. With respect to home office deductions taken prior to 1992, the Service had announced in a prior publication that it would not challenge such deductions where the taxpayer reasonably came within the scope of the principal place of business examples set forth in the proposed regulations in effect prior to the *Soliman* case or as described in I.R.S. Publication No. 587, "Business Use of Your Home (Including Use by Day-Care Providers)." I.R.S. Notice 92-12, 1993-1 C.B. 298.

37. I.R.C. § 280A(c)(1).

The fact that a taxpayer also carries out administrative or management activities at sites that are not fixed locations of the business, such as a car or hotel room, will not affect the taxpayer's ability to claim a home office deduction under the bill.

If a taxpayer conducts some administrative or management activities at a fixed location of the business outside the home, the taxpayer still is eligible to claim a deduction so long as the administrative or management activities conducted at any fixed location of the business outside the home are not substantial (*e.g.*, the taxpayer occasionally does minimal paperwork at another fixed location of the business).

A taxpayer's eligibility to claim a home office deduction will not be affected by the fact that the taxpayer conducts substantial non-administrative or non-management business activities at a fixed location of the business outside the home (*e.g.*, meeting with, or providing services to, customers, clients, or patients at a fixed location of the business away from home).

If a taxpayer in fact does not perform substantial administrative or management activities at any fixed location of the business away from home, then the second part of the test will be satisfied, regardless of whether or not the taxpayer opted not to use an office away from home that was available for the conduct of such activities.³⁸

§ 1:6.4 Calculation of the Home Office Deduction

Apart from determining whether the taxpayer's home constitutes the "principal place of business" for his business activity, the statute also provides an auxiliary set of hurdles related to the deductibility of expenses such as insurance and utilities, on the one hand, and depreciation, on the other.³⁹

In general, the limitations are tiered as follows:

- (1) The taxpayer must determine the gross income derived from the business.

38. H.R. CONE REP. NO. 105-220, at 744-45 [hereinafter Statement of the Managers] (describing the House bill that was adopted by the Committee). The deduction is still predicated on the taxpayer using his home office exclusively on a regular basis as a place of business.

For an additional discussion of the impact of the TRA 97 home office deduction provisions on the *Soliman* case, see *Focus: Home Office Deduction*, 16 Tax Mgmt. (BNA) 1880 (Dec. 22, 1997).

39. Examples of the deduction limitations can be found in proposed regulations beginning at Treas. Reg. § 1.280A-2(i), and in I.R.S. Publication No. 587.

- (2) The taxpayer must then deduct the share of mortgage interest and real estate taxes that apply, on a proportionate basis, to the home office.
- (3) The taxpayer must deduct non-home-related costs of running the business, such as the cost of secretarial services, business telephone, office supplies, and books and consulting services.
- (4) To the extent that the foregoing subtotal is a positive income figure, the taxpayer is entitled to deduct a proportionate share of the residential maintenance costs, such as utilities, that are attributable to the space occupied by the home office, and, then, a proportionate share of the depreciation. To the extent that the deduction limitations preclude a deduction in any given year, section 280A(c)(5) permits the excess deduction to be carried forward to subsequent years, subject, however, to those deductions running the limitation gauntlet described above.

► **Example 1-3**

Assume that Taxpayer A's home office occupies 10% of the square footage of her home, and that insurance and utility costs for the year amount to \$15,000. Assume also that Taxpayer A has consulting income derived from her home office of \$15,000, secretarial and business supplies expense of \$10,000, and that mortgage interest and real estate taxes for the year are \$25,000. Assume further that total annual depreciation on the residence is \$15,000. Under such circumstances, Taxpayer A's income after business-related expenses is \$5,000 (\$15,000 income less \$10,000). In addition, Taxpayer A has allocable interest and real estate taxes of \$2,500 ($\$25,000 \times 10\%$) (with the remaining interest and real estate taxes deductible as itemized deductions), allocable utility costs of \$1,500 ($\$15,000 \times 10\%$), and allocable depreciation of \$1,500 ($\$15,000 \times 10\%$). Both the allocable interest and real estate taxes and allocable utilities will be deductible. However, under the tiering system described above, only \$1,000 of the allocable \$1,500 of depreciation will be deductible (with the excess being available as a carry-over into subsequent years).⁴⁰

§ 1:6.5 Capital Gain Tax Attributable to a Previously Depreciated Home Office

The circumstance has often occurred where a taxpayer, who has used part of his principal residence as a home office, converts the office

40. Prop. Treas. Reg. § 1.280A-2(i)(7) (ex.).

space back to residential space. Assuming that depreciation was taken during the period of time that the residence was used as a home office, the amount of depreciation would have lowered the taxpayer's basis in the residence and, concomitantly, increased his potential for capital gain. However, under pre-TRA 97 law, if the reconverted space were used for a sufficiently long enough period of time to "cleanse" it of the home office taint, any depreciation induced gain could be sheltered through the medium of a residential rollover into a more expensive house.⁴¹ The same circumstance might also have arisen where a taxpayer took depreciation on a vacation home and then used the vacation home as his primary residence for a sufficiently long enough period of time to "cleanse" the residence of its vacation home taint.

Under TRA 97, the residential rollover has been eliminated⁴² and with that elimination there now exists the potential for taxation of depreciation-generated gain on principal residences that had been used as depreciable vacation homes or offices. The rules are:

- For depreciation taken up to and including May 7, 1997, depreciation-generated gain on a principal residence will not be subject to capital gains tax provided that the gain does not exceed the \$500,000 or \$250,000 exemption threshold.⁴³
- For depreciation taken after May 7, 1997, depreciation-generated gain on a principal residence will be subject to capital gains tax at a maximum rate of 25%.

§ 1:7 Taxation of Gain on the Sale of a Principal Residence

§ 1:7.1 In General: Law Prior to TRA 97

Prior to TRA 97, most clients in the Metropolitan Washington, D.C., area were probably well familiar with the then-extant tax concept that allowed gain on the sale of a personal residence to be deferred in the circumstance where the proceeds were "rolled over" into another personal residence. The specific requirements of this statutory relief mechanism were as follows.

41. See discussion of pre-TRA 97 rollover provisions *infra* sections 1:7.1 and 1:7.2.

42. See section 1:7, *infra*.

43. See section 1:7.4, *infra*.

§ 1:7.2 Requirements Under Pre-TRA 97 Laws for Rollover Treatment

Section 1034(a) provided for nonrecognition of gain in a rollover circumstance: If property used by the taxpayer as his principal residence (the old residence) was sold by him and, within a period beginning two years before the date of sale and ending two years after that date (the two-year requirement), property (the new residence) was purchased and used by the taxpayer as his principal residence, gain (if any) from the sale would have been recognized only to the extent that the taxpayer's adjusted sales price (as defined in the statute) of the old residence exceeded the taxpayer's cost of purchasing the new residence.

► Example 1-4: Under Pre-TRA 97 Law

The foregoing provision can be illustrated as follows: Assume the taxpayer sold his principal residence on July 15, 1994, for an "adjusted sales price" (that is, the price paid for the residence less certain permissible costs of sale) of \$400,000. Assume further that the taxpayer had a basis in the residence of \$200,000. Under such circumstances, the entire \$200,000 gain on the sale of the old residence would have been sheltered, to the extent that the taxpayer purchased (or had purchased) a new principal residence for at least \$400,000 during the period commencing on July 16, 1994, and ending on July 15, 1996.

Under regulations section 1.1034-1(c)(4)(i), the taxpayer's cost of purchasing the new residence included not only cash but also any indebtedness to which the property purchased was subject at the time of purchase whether or not assumed by the taxpayer (for example, purchase-money mortgages) and the face amount of any liabilities of the taxpayer that were part of the consideration for the purchase. In addition, commissions and other purchasing expenses paid or incurred by the taxpayer on the purchase of the new residence were to be included in determining that cost. For purposes of the foregoing, indebtedness on the replacement residence incurred by the taxpayer more than two years prior to the acquisition of the replacement residence could not be included as part of the purchase price of the replacement residence.⁴⁴

44. See *Dunnegan v. Comm'r*, 82 F.2d 404 (3d Cir. 1996) (replacement cost did not include purported assumption of mortgage on which taxpayer had been liable for a preexisting period longer than the two-year replacement period).

§ 1:7.3 **One-Time \$125,000 Exclusion Under Pre-TRA 97 Law**

As was true of the pre-TRA 97 rollover provisions, most clients were also generally aware of the proposition that, if he was age fifty-five or older, he could have sold his personal residence and excluded up to \$125,000 of the gain realized on the sale. The \$125,000 exclusion could have been used by anyone who

- (1) had reached the designated age,
- (2) had not previously utilized the exclusion, and
- (3) sold his principal residence.

Where a husband and wife filed a joint return, the exclusion applied if either had reached age fifty-five on or before the date of sale.⁴⁵

For purposes of the exclusion, a residence was regarded as a “principal residence” if the taxpayer (1) owned the residence in question and (2) had used the residence as his principal residence, for periods totaling at least three years during the five-year period ending on the date of sale.⁴⁶ For persons who chose to retain a residence in a cooler climate such as the Metropolitan Washington, D.C., area, but who also purchased a second residence in a warmer climate, such as Florida, the three-out-of-five-year requirement could have been a substantial problem, particularly where, for tax⁴⁷ or other reasons, the taxpayer treated Florida as his domicile and/or lived in his Florida residence for a substantial enough number of months during the year to cause that residence to become his principal residence.

► **Example 1-5: Under Pre-TRA 97 Law**

Assume that a taxpayer in the Metropolitan Washington, D.C., area had owned a home there for thirty years, but on July 15, 1991, he purchased a home in Florida, and thereafter spent eight months out of the year in that home. If the taxpayer chose to sell his Washington residence on July 15, 1994, the Washington residence would no longer have qualified as his personal residence. Even though he had owned it during the intervening time,

45. I.R.C. § 121(d)(1); Treas. Reg. § 1.121-5(a)(1)(iii).

46. I.R.C. § 121(a)(2); Treas. Reg. § 1.121-1(a)(2).

47. Because Florida does not have a personal income tax, it is an attractive tax haven. Florida does, however, have an “intangible personal property tax,” which is annually levied against the gross value of intangible assets, such as stock, at the rate of one mill per dollar of valuation (subject to legislatively established declines in the rate).

he would not have used it as his principal residence for three years out of the preceding five-year period ending on the date of sale of the Washington, D.C., residence.

§ 1:7.4 Taxation of the Sale of a Principal Residence After TRA 97

[A] The \$250,000/\$500,000 Exemption

Effective for transactions on or after May 7, 1997,⁴⁸ the rollover provisions and the over-fifty-five, one-time \$125,000 exclusion no longer apply. Rather, a taxpayer generally is now able to exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence.⁴⁹

[B] Two-Out-of-Five-Year Continuous Ownership and Occupancy Tests

To be eligible for the exclusion, a taxpayer must have owned the residence and occupied it as a principal residence for periods “aggregating two years or more” out of the five years prior to the sale or exchange. Short temporary absences, such as for vacation or other seasonal absence, are counted as periods of use.

If a taxpayer alternates between two 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 will ordinarily be considered the taxpayer’s principal residence.⁵⁰ Further, a property used by the taxpayer as the taxpayer’s principal residence may include a houseboat, a house trailer, or stock held by a tenant-stockholder in a cooperative housing corporation.⁵¹

► Example 1-6

Taxpayer *K* owns two residences, one in New York and one in Florida. From 1999 through 2003, he lives in the New York

48. Taxpayers who sold houses with a gain in excess of the \$250,000/\$500,000 ceiling, but who would have been able to shelter the excess gain under the former rollover provisions, could still have elected to utilize such former provisions under the following circumstances: (i) sales that occurred after May 6, 1997, and before August 5, 1997; (ii) sales that occurred after August 5, 1997, subject to a binding contract in effect on August 5, 1997; and (iii) sales that occurred after August 5, 1997, where a replacement residence was acquired before August 6, 1997, outright or under a binding contract, and the rollover provision would have applied under prior law. TRA 97 § 312(d).

49. I.R.C. § 121(b); Treas. Reg. § 1.121-2(a)(3).

50. Treas. Reg. § 1.121-1(b)(2).

51. Prop. Treas. Reg. § 1.121-1(b).

residence for seven months and in the Florida residence for five months. Thus, *K* used the New York residence a majority of the time in each year from 1999 through 2003. Therefore, in the absence of facts and circumstances indicating otherwise, the New York residence will be his principal residence, and only the New York residence will be eligible for the section 121 exclusion if it is sold at the end of 2003.⁵²

In *Guinan v. United States*,⁵³ the taxpayer owned three residences—one located in Georgia, one in Arizona and one in Wisconsin. The taxpayer sold the Wisconsin residence in 1998 and attempted to qualify for the section 121 exemption. The IRS acknowledged that the taxpayer had occupied the residence during the preceding five years more days in total than was true of either of the other two residences, but denied the exemption. Citing section 1.121-1(b)(2) of the Treasury regulations,⁵⁴ the court agreed with the IRS and observed that the test was not whether the taxpayer had occupied the Wisconsin residence for more days during the total five-year period. Rather, stated the court, the regulations require that the assessment be made on a year-by-year basis. Under this test, while the taxpayer occupied the Wisconsin residence for the majority of time during the first year of the five-year period, the taxpayer spent the majority of each succeeding year in either the Georgia or Arizona residences.⁵⁵

If a taxpayer acquired his or her current residence in a rollover transaction, periods of ownership and use of the prior residence are

52. Treas. Reg. § 1.121-1(b)(4) (ex. 1).

53. *Guinan v. United States*, 2003 WL 21224797 (D. Ariz. Apr. 10, 2003).

54. Under Treas. Reg. § 1.121-1(b)(2), the determination of which residence constitutes the taxpayer's principal residence will be based on all of the facts and circumstances. If a taxpayer alternates between two properties, using each as a residence, the determination will be made on a year-by-year basis, with the residence occupied for the greatest period of time during any given year ordinarily constituting the principal residence for that year. Also, the IRS may consider the taxpayer's place of employment, the principal abode of family members, the address listed on the taxpayer's tax returns, automobile license, automobile registration and voter registration, the address used by the taxpayer for bills, and the location of the taxpayer's banks, religious organizations and recreational clubs.

55. It is also noteworthy that the court observed that the taxpayer filed Georgia and Arizona tax returns, as compared to Wisconsin tax returns, that the taxpayer was registered to vote in Georgia and in Arizona but not in Wisconsin, and that the taxpayer had a Georgia driver's license and subsequently an Arizona driver's license, but not a Wisconsin driver's license. These factors were deemed to be relevant under the facts and circumstances component of Treas. Reg. § 1.121-1(b)(2).

taken into account in determining ownership and use of the current residence.⁵⁶

During periods of absences due to service, certain categories of persons serving within the military or with specified U.S. agencies may elect to suspend (for a maximum of ten years) the otherwise applicable five-year measuring period for determining ownership of a primary residence. The categories encompassed by this exemption are the uniformed services (the Army, Navy, Air Force, Marine Corps, and Coast Guard), the Commissioned Corps of the National Oceanic and Atmospheric Administration, and the Commissioned Corps of the Public Health Service. Under the Tax Relief and Health Care Act of 2006,⁵⁷ the exemption is extended to employees of the intelligence community, which includes the Treasury Department, the Energy Department, and the Department of Homeland Security, during any period in which they are serving extended duty.⁵⁸

**[B][1] Nonqualified Use Limitation for Periods
Subsequent to January 1, 2009**

[B][1][a] In General

Under the 2008 Housing and Economic Recovery Act (HERA),⁵⁹ the \$250,000/\$500,000 exemption will not be applied to that portion of the gain on the sale of a principal residence attributable to the period of time the residence was owned by the taxpayer and subject to a “nonqualified use” (described below). Thus, even if the taxpayer satisfies all of the other eligibility requirements for the \$250,000/\$500,000 exemption, such as the two-out-of-five-year-occupancy requirement but there is a “nonqualified use” period accounting for 50% of the period of ownership, then 50% of the gain will have to be recognized.

**[B][1][b] Conversion of Vacation Home to Principal
Residence**

A “nonqualified use” is any period (after January 1, 2009) that the property is not used by the taxpayer or the taxpayer’s spouse (or former spouse) as a principal residence. For example, if, after January 1, 2009, the taxpayer converted a vacation home into his or her principal residence and the property is later sold at a gain, a portion of the gain will have to be recognized even if less than the \$250,000/\$500,000 exemption otherwise applicable to the transaction. The

56. I.R.C. § 121(g).

57. Tax Relief and Health Care Act of 2006, H.R. 6111, 109th Cong. (2006).

58. Technical Explanation of H.R. 6111, “Tax Relief and Health Care Act of 2006,” at 104–05.

59. H.R. 3221.

amount of taxable gain will be determined by a fraction the numerator of which will that part of the post-January 1, 2009 period during which the vacation home was not used as the taxpayer's principal residence and the denominator of which will be the total years the residence was owned by the taxpayer starting with the original purchase date. By contrast, if the vacation property had been converted to a principal residence prior to January 1, 2009, then no part of the holding period would be a disqualified use, irrespective of how many years the property previously served as a vacation home.

► **Example 1-6A**

Assume that *H* and *W* purchase a vacation home on January 1, 2007 for \$400,000. Assume that *H* and *W* sell their principal residence on January 1, 2011, invest \$100,000 of the proceeds on capital expenditures for their vacation home, and immediately move into their vacation home and treat it as their principal residence. Assume that *H* and *W* sell this property on December 31, 2016 for \$750,000, resulting in a gain of \$250,000. Under the foregoing circumstances, the two-year period between January 1, 2009, and December 31, 2010 represents a nonqualified use period, and when compared with the overall ten-year ownership of the property, will cause 2/10 of the \$250,000 gain to be taxed. The remaining \$200,000 of gain will be sheltered by *H* and *W*'s \$500,000 exemption.

[B][1][c] “After Last Date” Exception

Nonqualified use does not include any period after the last date the property is used as the principal residence of the taxpayer or spouse (regardless of how the property is used during that period).

► **Example 1-6B**

Assume *A* dies on December 31, 2010. If, prior to *A*'s death, the property had been used by *A* as her principal residence, then the period subsequent to her death will not be treated as a nonqualified use period, even if the property is merely held by her estate for sale.

► **Example 1-6C**

Assume that an individual buys a principal residence on January 1, 2009, for \$400,000, moves out on January 1, 2019, and on December 1, 2021 sells the property for \$600,000. The entire \$200,000 gain is excluded from gross income, as under present law, because periods after the last qualified use do not constitute nonqualified use.

[B][1][d] “Temporary Absence” Exception

Nonqualified use does not include any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances.

[B][1][e] “Gain Attributable to Depreciation” Exception

As under previous law, if any gain is attributable to post-May 6, 1997, depreciation, the \$250,000/\$500,000 exclusion does not apply to that amount of gain, but the gain is not taken into account in determining the amount of gain allocated to nonqualified use.

► Example 1-6D

Assume that A buys a property on January 1, 2009, for \$400,000, and uses it as rental property for two years, claiming \$20,000 of depreciation deductions. On January 1, 2011, A converts the property to his principal residence. On January 1, 2013, A moves out and sells the property for \$700,000 on January 1, 2014. As under present law, the \$20,000 of recaptured gain attributable to the depreciation deductions is included in income. Of the remaining \$300,000 gain, 40% of the gain (2 years divided by 5 years), or \$120,000, is allocated to nonqualified use and is not eligible for the exclusion. Since the remaining gain of \$180,000 is less than the maximum gain of \$250,000 that may be excluded, gain of \$180,000 is excluded from gross income.

[C] The Two-Year Anti-Churning Provision

The exclusion is allowed each time a taxpayer selling or exchanging a principal residence meets the eligibility requirements, but, except as discussed below, no more frequently than once every two years.⁶⁰

► Example 1-7

Taxpayer has a basis of \$200,000 in her principal residence. Taxpayer sells her principal residence for \$300,000, realizing a gain of \$100,000. Taxpayer does not roll over her gain into a new house. Rather, she moves into what had been her vacation house and lives there continuously for two years, treating it as her principal residence. After two years, taxpayer sells her new principal residence at a gain of \$50,000. Taxpayer does not have to pay capital gains tax on the sale of either residence.

60. I.R.C. § 121(b)(3)(A); Prop. Treas. Reg. § 1.121-2(c).

[D] Exception to Anti-Churning Rules: Reduced Maximum Exclusion of Gain Under Specified Circumstances

As illustrated in the following example, a taxpayer who fails to meet the occupancy and/or ownership requirements by reason of a change of place of employment, health, or other unforeseen circumstances is able to benefit from a fraction of the \$250,000/\$500,000 exemption.

► **Example 1-8**

Taxpayer sells her principal residence at a gain of less than \$250,000. She pays no tax. Taxpayer buys a replacement residence for \$400,000. Eighteen months later, taxpayer's employer moves her to another state. Taxpayer sells her principal residence for \$460,000. As originally enacted, of the \$60,000 gain, \$45,000 (\$60,000 gain × 18/24 months) was sheltered from capital gains tax. Original I.R.C. section 121(c) as enacted by the TRA. However, under the IRS Restructuring and Reform Act of 1998 (H.R. 2676), the pro rata reduction was made to apply to the exemption amount rather than the gain realized. Thus, in the example, any amount of gain less than \$187,500 (18/24 of taxpayer's \$250,000 exemption) would be exempt. Since the \$60,000 of gain realized is obviously less than pro-rated \$187,500 exemption, all of the gain would be exempt from tax. The clarification enacted by the 1998 legislation is effective for sales after May 6, 1997.⁶¹

[D][1] Temporary Regulations: Pre-August 13, 2004

Under temporary regulations published by the IRS, a sale or exchange was considered to be for reasons of health if the taxpayer's primary reason for the sale or exchange was (1) to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual, or (2) to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. A sale or exchange that was merely beneficial to the general health or well-being of the individual was not a sale or exchange by reason of health.⁶² For purposes of the foregoing, the temporary regulations so establish a safe harbor where a physician recommends a change of residence for reasons of health.⁶³

With respect to a sale or exchange by reason of a change in place of employment, the temporary regulations also established a distance safe harbor. For such purposes, the safe harbor provided that the

61. See Treas. Reg. § 1.121-3(g)(2) (ex. 1).

62. Treas. Reg. § 1.121-3T(d)(1).

63. *Id.* § 1.121-3T(d)(2).

primary reason for the sale or exchange was deemed to be a change in place of employment if the new place of employment of a qualified individual was at least fifty miles farther from the residence sold or exchanged than was the former place of employment. If the individual was unemployed, the distance between the new place of employment and the residence sold or exchanged must have been at least fifty miles.⁶⁴

[D][2] Final Regulations Establishing Safe Harbor Provisions Effective August 13, 2004

The final regulations, effective August 13, 2004, do not depart significantly from the temporary regulations effective prior to that date. Under the final regulations, for a taxpayer to claim a reduced maximum exclusion under I.R.C. section 121(c), the sale or exchange must still be by reason of a change of a place of employment, health, or unforeseen circumstances.⁶⁵ However, if a safe harbor described in the final regulations applies, a sale or exchange will be deemed to be by reason of one of the foregoing (for example, a change in place of employment, health or unforeseen circumstances). By contrast, if a safe harbor described in the final regulations does not apply, a sale or exchange will be treated as being by reason of a change in place of employment, health or unforeseen circumstances only if the “primary reason” for the sale or exchange is such a change in place of employment,⁶⁶ health⁶⁷ or unforeseen circumstances.⁶⁸

- *Distance Safe Harbor: Sale or Exchange by Reason of a Change of Employment.* Under the “distance safe harbor,”⁶⁹ a sale or exchange is deemed to be by reason of a change of employment if:
 - The change in place of employment occurs during the period of the taxpayer’s ownership and use of the property as the taxpayer’s principal residence; and
 - The qualified individual’s new place of employment is at least fifty miles farther from the residence sold or exchanged than was the former place of employment, or, if there was no former place of employment, the distance between the qualified individual’s new place of employment and the residence sold or exchanged is at least fifty miles.

64. Treas. Reg. § 1.121-3T(c)(1)–(2).

65. Treas. Reg. § 1.121-3(b). For examples of unforeseen circumstances relating to violence, schooling, and divorce, see respectively Priv. Ltr. Ruls. 200601009, 200601022, and 200601023.

66. Within the meaning of Treas. Reg. § 1.121-3(c).

67. Within the meaning of Treas. Reg. § 1.121-3(d).

68. Within the meaning of Treas. Reg. § 1.121-3(e).

69. Treas. Reg. § 1.121-3(c)(2).

- *Physician's Recommendation Safe Harbor: Sale or Exchange by Reason of Health.* A sale or exchange will be deemed to be by reason of health if a physician⁷⁰ recommends a change of residence for reasons of health.⁷¹ A sale or exchange is by reason of health if "the primary reason for the sale or exchange is to obtain, provide or facilitate the diagnosis, cure, mitigation or treatment of disease, illness or injury, or to obtain or provide medical or personal care for a 'qualified individual'⁷² suffering from a disease, illness or injury."⁷³ A sale or exchange that is "merely beneficial to the general health or well being of an individual is not a sale or exchange by reason of health."⁷⁴

► **Example 1-9**

A, who has chronic asthma, purchases a house in Minnesota in 2004 that he uses as his principal residence. A's doctor tells A that moving to a warm, dry climate will mitigate A's asthma symptoms. In 2005, A sells his house and moves to Arizona to relieve his asthma symptoms. Under the regulations, the sale is within the physician's recommendation safe harbor and A is entitled to claim a reduced maximum exclusion under I.R.C. section 121(c)(2).⁷⁵

► **Example 1-10**

In 2004, A and B purchase a house in Michigan that they use as their principal residence. A's doctor tells A that he should get more outside exercise but A is not suffering from any disease that can be treated or mitigated by outside exercise. In 2005, A and B sell their house and move to Florida so that A can increase his general level of exercise by playing golf year round. Under the regulations, because the sale of the house is merely beneficial to A's health, the sale of the house is not by reason of A's health and does not fit within the physician's recommendation safe harbor. A and B will not be entitled to claim a reduced maximum exclusion under I.R.C. section 121(c)(2).⁷⁶

70. As defined in I.R.C. § 213(d)(4).

71. As defined in Treas. Reg. § 1.121-3(d).

72. Under Treas. Reg. § 1.121-3(f), a "qualified individual" includes the taxpayer, the taxpayer's spouse, a co-owner of the residence, or a person whose principal place of abode is in the same house as the taxpayer.

73. *Id.*

74. *Id.*

75. Treas. Reg. § 1.121-3(b)(2) (ex. 4).

76. Treas. Reg. § 1.121-3(b)(2) (ex. 5).

- *Specific Event Safe Harbors: Sale or Exchange by Reason of Unforeseen Circumstances.* “In general, a sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer would not reasonably have anticipated before purchasing or occupying the residence.”⁷⁷ A sale or exchange will be deemed to be by reason of unforeseen circumstances if any of the following events occur during the period of the taxpayer’s ownership and use of the residence as the taxpayer’s principal residence:
 - The involuntary conversion of the residence;
 - Natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence;
 - In the case of a “qualified individual,”⁷⁸ one of the following:
 - Death;
 - The cessation of employment as a result of which the qualified individual is eligible for unemployment compensation;
 - A change in employment or self-employment status that results in the taxpayer’s inability to pay housing costs and reasonable basic living expenses for the taxpayer’s household;
 - Divorce or legal separation under a decree of divorce or separation maintenance;
 - Multiple births resulting from the same pregnancy;⁷⁹
 - Any other definition of unforeseen circumstances promulgated by regulation.

[E] Pre-May 7, 1997 Sales Disregarded in Applying Anti-Churning Rules

The requirement that a sale or exchange take place no more frequently than every two years is applied without regard to any sale or exchange that took place before May 7, 1997.⁸⁰

77. Treas. Reg. § 1.121-3(e).

78. Treas. Reg. § 1.121-3(f), described *supra*.

79. Treas. Reg. § 1.121-3(e)(2)(iii)(A)–(E).

80. I.R.C. § 121(b)(3)(B).

[F] Issues Applicable to Married Taxpayers and Unmarried Taxpayers Living Together

Married persons who each owned a qualified personal residence prior to being married may each qualify for the \$250,000 exemption after they are married.

► Example 1-11

Married taxpayers *H* and *W* file a joint return for the taxable year in which they sell their house which is owned solely by *H*. Both spouses have used the house as their principal residence continuously for a period of two years and neither spouse has sold a principal residence during the two years prior to sale in question. Under such circumstances, *H* and *W* may shelter up to \$500,000 of gain on the sale of their residence.

► Example 1-12

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 eligible to exclude up to \$250,000 of gain from the sale of each of their residences. However, *W* may not use *H*'s unused exclusion to exclude gain in excess of her exclusion amount. Therefore, *H* and *W* must recognize \$50,000 of the gain realized on the sale of *W*'s residence.⁸¹

In the case of taxpayers filing a joint return, but not sharing a principal residence, the \$250,000 exclusion is available on a qualifying sale or exchange of each spouse's principal residence, provided that each spouse would have qualified for the \$250,000 if they had filed separate returns.⁸²

If a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the marriage, the newly married taxpayer is eligible for an exclusion of \$250,000. Once both spouses satisfy the eligibility rules

81. Treas. Reg. § 1.121-2(a)(4) (ex. 3).

82. Statement of the Managers at 297.

and two years have passed since the last exclusion was allowed to either of them, the married taxpayers may exclude up to \$500,000 of gain on a subsequent sale.⁸³

An executor may stand in the shoes of a decedent with respect to a principal residence sold by the surviving spouse in the year of the decedent's death.

► **Example 1-13**

Married taxpayers *H* and *W* have owned and used their principal residence since 1998. On February 16, 2001, *H* dies. On September 21, 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.⁸⁴

In the case of an unmarried taxpayer whose spouse is deceased on the date of the sale or exchange of property, the period such unmarried taxpayer owned and used such property shall include the period such deceased spouse owned and used such property before death.⁸⁵

► **Example 1-14**

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 is not remarried. Although *W* has owned and used the house for less than two 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 his death.

In the case of a taxpayer who receives a residence from a former spouse incident to a divorce (as described in section 1041(a) of the Internal Revenue Code), the period such taxpayer owns such residence includes the period the former spouse owned the property.⁸⁶

A taxpayer will be treated as using property as such taxpayer's principal residence during any period of ownership while such individual's spouse

83. *Id.* at 292.

84. Prop. Treas. Reg. § 1.121-1(b)(3) (ex. 4).

85. I.R.C. § 121(d)(2); Treas. Reg. § 1.121-4(a)(2).

86. I.R.C. § 121(d)(3)(A); Treas. Reg. § 1.121-4(b)(1).

or former spouse is granted use of the property (and uses it as his or her personal residence) under a divorce or separation instrument (as defined in section 71(b)(2) of the Internal Revenue Code).⁸⁷

In the case of unmarried taxpayers who jointly own their principal residence, the regulations provide that each will be eligible to exclude from gross income up to \$250,000 of gain that is attributable to each such taxpayer's interest in the property.⁸⁸

► **Example 1-15**

Unmarried taxpayers *A* and *B* own a house as joint owners, with each owning a 50% interest in the house. They sell the house after owning and using it as their principal residence for two 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 \$250,000.⁸⁹

[G] Sale of Partial Interests

Gain from the sale or exchange of the remainder interest in the taxpayer's principal residence can qualify for the otherwise allowable exclusion, provided that the sale or exchange does not involve a related person, as described in section 267(b) or 707(b) of the Internal Revenue Code.⁹⁰

A taxpayer may also take advantage of the section 121 exclusion with respect to the sale or exchange of an interest in the taxpayer's principal residence that is not a remainder interest and is less than the taxpayer's entire interest if the interest sold or exchanged includes an interest in the dwelling unit.⁹¹ For purposes of the foregoing, sales or exchanges of partial interests in the same principal residence are treated as one sale or exchange.⁹² Therefore, only one maximum limitation amount of \$250,000 (or \$500,000 where applicable) applies to the combined sales or exchanges of the partial interests.⁹³

87. I.R.C. § 121(d)(3)(B); Treas. Reg. § 1.121-4(b)(2).

88. Treas. Reg. § 1.121-2(a)(2).

89. Treas. Reg. § 1.121-2(a)(4) (ex. 1). Had *A* and *B* in the example been married, then the entire \$256,000 would have been excluded because the amount in question did not exceed the \$500,000 available to *A* and *B* as married taxpayers filing a joint return. *Id.* at ex. 2.

90. I.R.C. § 121(d)(8); Treas. Reg. § 1.121-4(e)(2).

91. Treas. Reg. § 1.121-4(e)(1)(i).

92. Treas. Reg. § 1.121-4(e)(1)(ii).

93. *Id.*

► **Example 1-16**

In 1991, taxpayer *A* buys a house that *A* uses as his principal residence. In 2004, *A*'s friend moves into *A*'s house and *A* sells *B* a 50% interest in the house, with *A* 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* and realizes a gain of \$138,000. *A* may exclude \$114,000 (\$250,000 minus \$136,000 of gain previously excluded) of the \$138,000 gained from the sale of the remaining interest.⁹⁴

[H] Depreciation

The section 121 exclusion does not apply to so much of the gain from the sale or exchange of property attributable to depreciation adjustments (as defined in section 1250(b)(3)) for periods after May 6, 1997.⁹⁵

► **Example 1-17**

On July 1, 1999, Taxpayer *F* moves into a house that he owns and had rented to tenants since July 1, 1997. *F* took depreciation deductions totaling \$14,000 for the period that he rented the property. After using the residence as his principal residence for two full years, *F* sells the property on August 1, 2001. *F*'s gain realized from the sale is \$40,000. *F* had no capital losses for 2001. Only \$26,000 (\$40,000 gain realized minus \$14,000 depreciation deductions) may be excluded under section 121. The \$14,000 of gain recognized by *F* is unrecaptured section 1250 gain within the meaning of section 1(h).

[I] Need to Track Basis

While generous, new section 121 may pose some bookkeeping problems for some. The problem arises from the fact that the \$250,000/\$500,000 gain provisions hinge upon the taxpayer's basis in his or her home—a determination that, for some, may have been lost in antiquity.

► **Example 1-18**

Assume that Taxpayer *A* purchased his first home in 1970 for \$50,000. Assume that, thereafter, Taxpayer *A* sold his home for \$150,000—generating a \$100,000 gain, but that none of the gain was recognized because he rolled all of the proceeds into the purchase of a new residence for which he paid \$225,000. At this

94. Treas. Reg. § 1.121-4(c)(4) (ex.).

95. Treas. Reg. § 1.121-1(d).

point, Taxpayer A has a basis of \$125,000 and unrecognized gain of \$100,000. Assume further that, in 1976, Taxpayer A places an addition on the home at a cost of \$75,000, thereby increasing his basis to \$200,000 (and preserving his potential gain at \$100,000). Assume further that Taxpayer A marries in 1978 and that, in 1980, the couple sell their home for \$450,000, and, once again escape, gain recognition, by virtue of rolling over the entire proceeds into a new home for which they pay \$525,000. At this point, Taxpayer A and his wife have a \$275,000 basis in their home and potential gain of \$250,000. With two growing children, Taxpayer A and his wife again choose to place their house on the market. As a result of the prolific increase in the price of residential real estate in the late 1980s, Taxpayer A and his wife are able to sell their home in 1988 for \$775,000—a gain of \$250,000. Once again, Taxpayer A and his wife avoid gain recognition by rolling over the entire proceeds into a new home, thereby bringing their potential gain up to \$500,000 and preserving their basis at \$275,000. Since the acquisition of their home, real estate values have remained constant in Taxpayer A's neighborhood, so that, by the late 1990s, Taxpayer A's home will sell for a net of \$775,000 after expenses. In 1999, the second of Taxpayer A's children is preparing to go to college and Taxpayer A and his wife desire to sell their home. If Taxpayer A and his wife have retained careful records (through Form 2119 and other means) and if they sell their home for a net of \$775,000, none of their built-in gain of \$500,000 will have to be recognized. If they have not kept careful records, the gain exemption may still be salvageable; however, they will have to do some skillful reconstruction of events to satisfy the revenueurs.⁹⁶

[J] The Effect of Section 121 on the Foreclosure of a Personal Residence

The circumstance could arise where a taxpayer with an appreciated personal residence has borrowed against the fair market value of the personal residence such that the mortgage exceeds the taxpayer's basis in the residence. If the mortgage is nonrecourse to the taxpayer (that is, secured only by the property itself), and, if, after May 6, 1997, the taxpayer defaults under the mortgage and a foreclosure occurs, the foreclosure will be treated as the equivalent of a sale and the difference between the amount of the mortgage and the taxpayer's basis will be capital gain subject to the \$250,000/

96. For an interesting article, on which this example is based, see Kass, *Intricate Rules Govern Home Sales Tax Exclusion*, WASH. POST, Jan. 16, 1999, at G6.

\$500,000 exemption limits of section 121 of the Internal Revenue Code.⁹⁷

[K] Strategy When Expected Gain on the Sale of a Residence Used As a Vacation Property Substantially Exceeds the \$250,000/\$500,000 Ceiling

For those who are fortunate enough, the circumstance could arise where vacation property purchased many years ago has increased in value exponentially, such that the sale of the property would substantially exceed the applicable \$250,000/\$500,000 limit. Where such a situation arises, one knowledgeable attorney (Stephan Tucker of Washington, D.C.) has suggested that the vacation property be converted into rental property and held for a sufficiently reasonable period of time such that it will qualify for investment property under section 1031 of the Internal Revenue Code. Thereafter, the vacation property may be exchanged for other investment property which may be more attractive to the taxpayer. Though the basis on the property received in the exchange will reflect the low basis on the relinquished vacation property, the gain will be deferred until such time as the new property is sold. Moreover, should the taxpayer retain the property until his or her death, the resulting basis will be stepped up to fair market value at the time of death, thereby alleviating capital gains tax on the property if it is thereafter sold.

[L] The Surviving Spouse Penalty

[L][1] Pre-2008 Law

As reported in the local Washington, D.C., press, one aspect of the 1997 law had come under fire as being inequitable.⁹⁸ Simply put, in the year following the death of a spouse, the surviving spouse's exemption dropped from the previous joint exemption of \$500,000 to a new individual exemption of \$250,000. In the case of a previously, jointly owned residence, the lower exemption will likely have been offset to a substantial degree by the step up in basis available to the surviving spouse. However, where the residence was owned exclusively by the survivor, the "tax trap" would come into play.

97. See section 6:2, *infra*, and Bercik, *The Impact of New Section 121 on Planning for Foreclosure*, 17 ABA SEC. OF TAX'N NEWSL., No. 2 (Winter 1998), at 5.

98. See Kenneth Harney, *Drive Is Underway to Disarm "Surviving Spouse" Tax Trap*, WASH. POST, May 8, 1999, at G1 (upon which this discussion is based).

► **Historic Example 1-19: Pre-2008 Law**

Husband and wife purchase their home in 1975 at a cost of \$250,000. Due to appreciation in the Washington market over the intervening twenty-plus years, the house is now worth \$750,000. If husband and wife sell the house while both are alive, no income tax will be due irrespective of how the house is titled.

Assume, however, that husband dies and that the residence was jointly owned. If wife sells the house in the year of death and a joint return is filed, the \$500,000 exemption will remain in effect. If, by contrast, wife sells the house in the year following husband's death (or thereafter), an exemption of only \$250,000 will be available to wife. However, since the property was jointly owned, wife will also benefit from the step up in basis attributable to husband's half interest in the residence. Accordingly, wife's new basis will equal \$500,000 (\$375,000 of fair market value step up in basis attributable to husband's half interest in the property) and \$125,000 attributable to wife's original half interest in the property). As a result, if the property is sold for \$750,000, no tax will be due since all of the proceeds are sheltered by the \$500,000 basis and the \$250,000 exemption.

Suppose, however, that wife owned the house in her own name. Under such circumstances, she would retain her original \$250,000 basis and would recognize \$250,000 of taxable capital gain income on the sale of the house for \$750,000 (\$750,000 proceeds less \$250,000 basis and \$250,000 exemption).

[L][2] Law Effective January 1, 2008

Effective January 1, 2008, in the case of a sale or exchange of a principal residence by a surviving spouse, the \$250,000 exemption from gain is increased to \$500,000,⁹⁹ provided that (i) the sale occurs not later than two years after the date of death of the deceased spouse, and (ii) the husband and wife would have qualified for the \$500,000 exemption had the sale taken place in the year of death.¹⁰⁰

[M] Availability of Section 121 Exclusion to Trustee in Bankruptcy

Assume that a personal residence becomes part of the debtor's estate in bankruptcy. May the trustee of the estate sell the debtor's

99. I.R.C. § 121(b)(4), as amended by the Mortgage Forgiveness Debt Relief Act of 2007 (§ 7(a)).

100. See I.R.C. § 121(b)(2)(A) (permitting a maximum exclusion of \$500,000 for certain married taxpayers filing a joint return).

residence and benefit from the \$250,000 section 121 exclusion? Following the majority on this issue, the Bankruptcy Court for the Northern District of Georgia ruled that the Trustee may stand in the shoes of the debtor and utilize the section 121 exclusion.¹⁰¹ The IRS has since agreed.¹⁰²

[N] May the Section 121 Exclusion Apply to a Partnership Owned Directly or Indirectly by Occupants of a Principal Residence?

In Private Letter Ruling 200004022, the taxpayers transferred title in their residence to a partnership. The transfer occurred in two steps. First, the taxpayers deeded 98% of the residence to a grantor trust subject to the provisions of sections 671 through 678 of the Internal Revenue Code.¹⁰³ Next, the trust transferred its 98% ownership in the residence to a state law limited partnership in return for which it received 98% of the limited partnership units in the partnership. The individual occupants of the residence then transferred their respective 1% ownership interests in the residence to the partnership in exchange for 1% general partnership interests in the partnership. The partnership was not used to conduct any kind of business enterprise nor did it generate any income.

Under the foregoing circumstances, the IRS initially concluded that the individual taxpayers would be treated as the owners of the residence during the period that the partnership held title to the residence. In arriving at its conclusion, the IRS first analyzed whether the partnership—a good partnership under state law—would be recognized as a partnership under federal tax law.¹⁰⁴ For such purpose, the IRS noted that a partnership will be recognized for tax law purposes where the parties, in good faith and for a business purpose, join together with a view toward sharing profits and losses of the enterprise. Because, in the circumstances of the private letter ruling, there was no carrying on of an enterprise and no intent to generate

101. Gordon v. United States, 83 A.F.T.R.2d ¶ 99-771, No. 97-60313 (Bankr. N.D. Ga. 1999); see also *In re Godwin*, 230 B.R. 341 (Bankr. S.D. Ohio 1999), relying upon *In re Popa*, 218 B.R. 420 (Bankr. N.D. Ill. 1998), and *In re Bradley*, 222 B.R. 313 (Bankr. M.D. Tenn. 1998). In Prop. Treas. Reg. § 1.121-1 *et seq.* (background at ¶ 12), the Service agrees as follows:

Under the authority provided in section 1398(g)(8), the regulations add the section 121 exclusion to the list of tax attributes of the debtor that the bankruptcy estate of an individual in a Chapter 7 or 11 bankruptcy case until title 11 of the United States Code succeeds to and takes into account in computing the taxable income of the estate.

102. Treas. Reg. § 1.1398-3(c).

103. See section 13:8, *infra*.

104. See *Comm'r v. Tower*, 327 U.S. 280 (1946).

any income from the partnership, the IRS initially concluded that the partnership could be disregarded for tax purposes. Further, the IRS was persuaded by the fact that the partnership was owned either directly or indirectly by the individual taxpayers, either in their individual capacity or as grantors of the grantor trust.

The taxpayer success in Private Letter Ruling 200004022 did not last long. For, in Private Letter Ruling 200119014, the IRS revoked Private Letter Ruling 200004022 as “not being in accord with the current views of the Service.”

[O] Availability of Section 121 Exclusion to Heir, Estate, Trust or Single-Owner Entity

With respect to decedents who die after December 31, 2009, the \$250,000 section 121 exclusion will be available to the heir or estate of such decedent or to a qualified revocable trust left by such decedent.¹⁰⁵ For purposes of the foregoing provision, an heir must have acquired the personal residence in the manner prescribed by the Code.¹⁰⁶ Also, for purposes of the foregoing provision, a trust is a “qualified revocable trust” if it may be treated as having been owned by the decedent by virtue of a power to revoke.¹⁰⁷

If a residence is owned by a trust and if, under Code sections 671–679, an individual is treated as an owner of the trust or of that portion of the trust that includes the residence, then the owner will be treated as owning the residence for purposes of satisfying the two-year ownership requirement of Code section 121, and a sale or exchange of the residence by the trust will be treated as if it had been made by the individual.¹⁰⁸

If the residence in question is owned by a single-owner entity that is disregarded for federal tax purposes as an entity separate from

105. See I.R.C. § 121(d)(11).

106. See I.R.C. § 1022(e), which defines the term “Property Acquired From the Decedent” as follows:

(e) Property acquired from the decedent. For purposes of this section, the following property shall be considered to have been acquired from the decedent: (1) Property acquired by bequest, devise, or inheritance, or by the decedent’s estate from the decedent. (2) Property transferred by the decedent during his lifetime—(A) to a qualified revocable trust (as defined in section 645(b)(1)), or (B) to any other trust with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust. (3) Any other property passing from the decedent by reason of death to the extent that such property passed without consideration.

107. See I.R.C. §§ 645(b) and 676.

108. Treas. Reg. § 1.121-1(c)(3)(i).

its owner,¹⁰⁹ the individual will be treated as owning the residence for purposes of satisfying the two-year ownership requirement of section 121, and the sale or exchange of the residence by the disregarded entity will be treated as if made by the individual.

[P] Vacant Land

Section 121 of the Internal Revenue Code 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 the land containing the dwelling unit, and the sale or exchange of the vacant land must otherwise satisfy the requirements of section 121.¹¹⁰ For purposes of the foregoing, 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 (or \$500,000 where applicable) applies to the combined sales or exchanges of the vacant land in the dwelling unit.

► Example 1-20

In 1991, taxpayer A purchased property consisting of a house and ten acres that she uses as her principal residence. In May 2005, taxpayer A sells eight acres of the land and realizes a gain of \$110,000. A does not thereafter sell the dwelling unit before the due date for filing her 2005 income tax return. Therefore, A is not eligible to exclude the \$110,000 of gain associated with the sale of the eight acres. Thereafter, in March 2007, A sells the house and remaining two acres, realizing a gain of \$180,000 from the sale of the house and two acres. A may exclude the \$180,000 of gain. In addition, because the sale of the eight acres occurred within two years from the date of the sale of the dwelling unit, the sale of the eight acres is now treated as a sale of taxpayer's principal residence. Accordingly, A may file an amended return for 2005 and claim an exclusion of \$70,000 (\$250,000 minus \$180,000 gain excluded by virtue of the sale of the residence) off the \$110,000 of gain realized from the sale of the eight acres in 2005.¹¹¹

109. Treas. Reg. § 301.7701-3.

110. Treas. Reg. § 1.121-1(b)(3)(i)(A)-(D).

111. Treas. Reg. § 1.121-1(b)(4) (ex. 3).

[Q] Gain Recognition from the Sale of a Principal Residence Acquired in a Section 1031 Like-Kind Exchange Within Five Years Prior to the Sale

One of the requirements of an I.R.C. section 1031 tax-free exchange is that the acquired property be used as investment property. If the property is a residence, over time the residence may be converted to one's principal residence and used as non-investment property. Under the American Jobs Creation Act of 2004, if investment property has been acquired in a tax-free exchange, and if the property is subsequently converted to a principal residence, then, if the property is subsequently sold within five years of its acquisition in the section 1031 tax-free exchange, the otherwise applicable I.R.C. section 121 gain exclusions will not apply to such sale, even if the property had been used as the seller's principal residence for two years out of such five-year period. The obvious response to this new piece of legislation is to ensure that clients retain any section 1031 property that has subsequently been converted to a principal residence for a period of time that exceeds the five-year limitation of the statute.

[R] Sale of a Partial Interest in a Principal Residence

Except as provided in Code section 123(e)(3) (relating to sales or exchanges of remainder interests), the section 121 exclusion of gain from the sale or exchange of an interest in the taxpayer's principal residence includes the sale of an interest that is less than the taxpayer's entire interest in the dwelling unit.¹¹²

Under the regulations, 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 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.¹¹³

► **Example 1-21**

A buys a house that A uses as his principal residence. In 2008 A's friend B moves into A's house, and A sells B a 50% interest in the

112. Treas. Reg. § 1.121-4(e)(1)(i).

113. Treas. Reg. § 1.121-4(e)(1)(ii)(a).

house, realizing a gain of \$136,000. A may exclude the \$136,000 of gain. In 2009, 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.¹¹⁴

For purposes of applying Code section 121(b)(3) (restricting the application of section 121 to only one sale or exchange every two 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 Code section 121(b)(3) to that sale or exchange and the sale or exchange of any other principal residence.¹¹⁵

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.¹¹⁶ If the 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.¹¹⁷ Further, the exclusion for the sale of a remainder interest will not apply to a sale of a remainder interest to a related person, that is, to any person that bears a relationship to the taxpayer that is described in Code section 123, 267(b), or 707(b).¹¹⁸

[S] Section 121 Related-Party Restrictions

Under I.R.C. section 121(d)(8)(A), the \$250,000/\$500,000 exemption is available with regard to the sale of a remainder interest in a principal residence (although the section specifies that the exemption will not apply to any other interest in the principal residence which is sold separately). However, under I.R.C. section 121(d)(8)(B), the remainder interest exemption will not apply in the case of a sale to a related party, as defined in I.R.C. sections 267(b) and 707(b).

As a result of the limited nature of the related-party restriction, one might reasonably infer that other related-party sales would be exempt

114. Treas. Reg. § 1.121-4(e)(3) (ex.).

115. Treas. Reg. § 1.121-4(e)(1)(ii)(b).

116. The election is made 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 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.

117. Treas. Reg. § 1.121-4(c)(2)(ii)(A).

118. Treas. Reg. § 1.121-4(c)(2)(ii)(B).

under I.R.C. section 121. However, any such analysis would have to take into account the potentially sweeping nature of I.R.C. section 1239, which is discussed in section 9:8.1[A].

[T] Moving from and Renting One's Primary Residence Until Favorable Market Conditions Return

► Example 1-21A

Assume that *H* and *W* purchased their home on January 1, 2001, for \$400,000 and live in it continuously until January 1, 2010. On that date, assume that *H* and *W* move to a retirement community, but are unable to sell their house at a reasonable price due to the downturn in the market. Accordingly, assume that the house is rented for one year and that on January 1, 2011, it is sold for \$900,000. Under the foregoing circumstances, the one-year period between January 1, 2010, and December 31, 2010, represents a nonqualified use period and, when compared with the overall ten-year ownership of the property, will cause 1/10 of the \$500,000 gain (or \$50,000) to be taxed. The remaining \$450,000 of gain will be sheltered by *H* and *W*'s \$500,000 exemption.

Caution: Were the property rented for more than three years prior to the date of sale, all of *H* and *W*'s exemption would be lost because they would not have used the residence as their principal residence for two of the five years prior to sale.

§ 1:8 "First-Time Homebuyer" Tax Credit for Homes Purchased in the District of Columbia

Subject to the limitations that follow, section 1400C of the Taxpayer Relief Act of 1997 provides that first-time District of Columbia homebuyers of a principal residence in the District of Columbia are entitled to a tax credit of up to \$5,000 of the amount of the purchase price. A "first-time homebuyer" is someone who has had "no present ownership in the District during the one-year period ending on the date of purchase."¹¹⁹ Thus, non-first-time homebuyers, including former District residents, would appear to qualify for the credit, provided that, in the latter case, more than a year has elapsed since the person last owned a principal residence in the District of Columbia.

119. I.R.C. § 1400C(c)(1).

The credit phases out for individual taxpayers with adjusted gross income between \$70,000 and \$90,000 (\$110,000 and \$130,000 for joint filers).¹²⁰ The conference agreement clarifies that the credit is available with respect to purchases of existing property as well as new construction. A taxpayer's basis in a property is reduced by the amount of any homebuyer tax credit claimed with respect to such property.¹²¹ As amended by the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, I.R.C. section 1400C(i) was amended so that the credit extended to purchases made through December 31, 2011.

§ 1:9 Roth IRA Distributions Used to Purchase a Home

§ 1:9.1 Background

Under TRA 97, a 10% penalty will not be assessed for distributions from an IRA¹²³ made prior to the time an individual reaches age 59½ if the distributions (which cannot exceed \$10,000 over the lifetime of the IRA holder) are used for a "qualified first-time homebuyer distribution," that is, for the purchase of a principal residence of a "first-time homebuyer" who may be the IRA holder, his spouse, his children, grandchildren, or ancestors. Generally, a first-time homebuyer is an individual (and, if married, his spouse) who has had no present ownership in a principal residence for two years prior to the acquisition of the principal residence for which the IRA distributions were intended.¹²⁴ The foregoing notwithstanding, regular income tax will have to be paid on the distribution. By contrast, as explained below, no tax will have to be paid under the following circumstances if the distribution is from a Roth IRA.

§ 1:9.2 Distributions from a Roth IRA

The TRA 97 created a new type of IRA called a "Roth IRA," a name given to it in honor of Senator Roth, who chaired the Senate Finance Committee and who is given credit for the new form of IRA. In the case of a Roth IRA, contributions are not deductible. However, "qualified

120. I.R.C. § 1400C(b)(1).

121. I.R.C. § 1400C(h).

122. [Reserved.]

123. Under the IRS Restructuring and Reform Act of 1998 (H.R. 2676), the penalty provision does not apply to certain "hardship distributions." I.R.C. § 401(k)(2)(B)(i)(IV), as added by TRA 97 § 303.

124. See I.R.C. §§ 72(t)(2)(F) and 72(t)(8), as added by TRA 97 § 303.

distributions" (including earnings) made from a Roth IRA for tax years beginning after December 31, 1997, are tax free. Included among these qualified distributions are distributions used for first-time homebuyer expenses incurred by the individual Roth IRA holder, the individual's spouse and his children, grandchildren, and ancestors. Such distributions are subject to a \$10,000 lifetime cap.¹²⁵ Further, the distribution will not qualify for tax-free treatment if made within the five-taxable-year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA established for such individual.¹²⁶

§ 1:10 Transfer of Personal Residence Incident to Divorce

§ 1:10.1 Background

In *United States v. Davis*,¹²⁷ the Supreme Court held that the transfer of appreciated property from one spouse to another, in exchange for the release of marital claims, resulted in gain to the transferor. Correspondingly, under the Court's ruling, the spouse receiving the property received a basis in the asset equal to its fair market value. Congress changed this rule in 1984, with the provisions described below becoming effective with regard to transfers made after July 18, 1984, and arising out of divorce instruments executed after that date.

§ 1:10.2 Current Law

Unlike many of the tax provisions applicable to real estate, the rules regarding the transfer of a residence (or any other property) between divorcing spouses are relatively straightforward. Under section 1041(a), no gain will be recognized on the transfer of property from a taxpayer to his spouse, if the transfer is "incident to a divorce." Under section 1041(c), a transfer of property will be considered to have been made "incident to a divorce" if either of the following two requirements is satisfied: (1) The transfer occurs within one year after the date on which the marriage ceases; or (2) the transfer is related to the cessation of the marriage.

Section 1.1041-1T (Q-7) of the regulations specifies when a transfer will be "related to the cessation of the marriage." Under this section, a transfer of property is related to the cessation of the marriage if

125. I.R.C. §§ 72(t)(2)(F), and 408A(d)(2)(A)(iv) and 408(d)(5).

126. I.R.C. § 408A(d)(2)(B).

127. *United States v. Davis*, 370 U.S. 65 (1962).

the transfer is pursuant to a divorce or separation instrument¹²⁸ and the transfer occurs not more than six years after the date on which the marriage ceases. Pursuant to the regulations, a divorce or separation instrument may include a modification or amendment to that decree or instrument.

Significantly, the regulations go on to specify that any transfer not made within the foregoing six-year period is not necessarily “unrelated” to the cessation of the marriage. The failure to meet the six-year requirement will merely establish a presumption that the transfer is not related to the cessation of the marriage. As regards the foregoing, the regulations specify that the presumption may be rebutted by “showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage.” The regulations provide the following as an example of the circumstances in which the presumption will be rebutted: (1) The transfer was not made within the six-year period because “factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage,” and (2) the “transfer is effected promptly after the impediment to transfer is removed.”¹²⁹

§ 1:10.3 Basis to Transferee Spouse of Marital Property

In most circumstances, section 1015 determines the basis of a gift in the hands of the donee. Under this section, the donee’s basis is determined by reference to the donor’s basis, except if the donee subsequently disposes of the property at a loss. Under the latter circumstances, the donee’s basis is established by reference to the fair market value of the property at the time that the gift took place.¹³⁰ This latter provision does not apply in the case of a transfer of property incident to a divorce. Instead, the donee’s basis in property received as a result of a divorce is established exclusively by reference to the basis of the donor, even in the circumstance where the donee ultimately sells the property in question at a loss.¹³¹

§ 1:10.4 Transfer of Property Subject to a Loan in Excess of Basis

Generally, where a taxpayer makes a gift of property subject to a loan that exceeds the donor’s basis and is assumed by the donee, the

128. As defined in I.R.C. § 71(b)(2).

129. Treas. Reg. § 1.1041-1T (Q-7).

130. I.R.C. § 1015(a).

131. I.R.C. §§ 1015(e) and 1041(b)(2).

gift will subject the donor to a gain (unless the loan remains recourse to the donor).¹³² However, the regulations make clear that this result does not apply in the circumstance where property is transferred incident to a divorce and the recipient assumes the loan.¹³³

► **Example 1-22**

Assume that husband owns a residence with a basis of \$200,000 and a fair market value of \$400,000. Assume further that, prior to divorce discussions, there was no mortgage on the property, but that, in contemplation of the divorce, husband borrows against the property and executes a mortgage in the amount of \$250,000. If husband transfers the residence to wife incident to the divorce, and wife assumes the full \$250,000 mortgage on the property, husband will not realize a gain and wife will take husband's \$200,000 basis in the property.

§ 1:11 Does a Federal Tax Lien Attributable to One Spouse Attach to Real Property Owned by Both Spouses As Tenants-by-the-Entirety?

In the circumstance where a deficiency is assessed and becomes final, the Service (after appropriate notice) can impose a lien on the taxpayer's property.¹³⁴ In *Craft v. United States*,¹³⁵ the question that arose was whether a federal tax lien attributable to the husband's failure to file tax returns could be assessed against property owned by husband and wife as tenants-by-the-entirety.

In the case, the husband-taxpayer and his wife had owned the real property in question as tenants-by-the-entirety. The husband had failed to file tax returns, and the Service filed a notice of federal tax lien against the husband's interest in the property. Soon thereafter, husband and wife executed a quitclaim deed transferring the property to the wife for a nominal sum. The wife then attempted to sell the property; however, the sale was not realized as a result of the Service's lien on the property. To resolve matters, the wife filed an action to quiet title.

In an appeal to the Sixth Circuit, the court looked at two issues. First, did the Service's lien attach to the husband's interest in the

132. Treas. Reg. § 1.1001-2(a).

133. Treas. Reg. § 1.1041-1T(d) (Q-12).

134. I.R.C. § 6321.

135. *Craft v. United States*, 140 F.3d 638 (6th Cir. 1998), *rev'd and remanded*, 535 U.S. 274 (2002). See additional discussion of this topic at section 11:2, *infra*.

property at the time that it was held by the husband and wife as tenants-by-the-entirety? Second, when the husband and wife conveyed the property to the wife via the quitclaim deed, was there a moment in time when the property interest possessed by husband and wife became a tenancy-in-common interest, vulnerable to the Service's lien?

In addressing these questions, the court of appeals applied Michigan law, which was the law of the situs of the property. In so doing, the court summarized its conclusions as follows:

In Michigan, it is well established that one spouse does not possess a separate interest in an entireties property. . . . This principle in Michigan law has not been overturned by Michigan courts nor trumped by federal law, despite the United States' arguments to the contrary. Because Michigan law does not recognize one spouse's separate interest in an entireties estate, a federal tax lien against one spouse cannot attach to property held by that spouse as an entireties estate.

As to the argument that a momentary tenancy-in-common was created at the moment prior to the time that the husband and wife transferred the property to the wife alone, the court also was unmoved. Specifically, the court stated: "To the contrary it is clear that at the time the entireties estate terminated, [wife] was vested 'with full and complete title.'"¹³⁶

The Supreme Court subsequently overturned the Court of Appeals for the Sixth Circuit.¹³⁷ First, the Supreme Court observed that the broad statutory language contained in I.R.C. section 6321, which authorizes the imposition of tax liens, reveals that Congress meant to reach every property interest that a taxpayer might have. Then, analyzing Michigan law, the Supreme Court held that the rights conferred on the husband under state law qualified as "property" or "rights to property" under I.R.C. section 6321. In particular, stated the Supreme Court, Michigan law gave the husband:

136. Whether the result reached by the Sixth Circuit in *Craft* will apply in a given jurisdiction depends upon the law of the state where the real property is located and whether, as in Michigan, the law of the situs state treats each spouse as possessing an indivisible interest in the property. In this regard, at least one commentator has stated that the majority of states that recognize tenancies by the entirety do not recognize individual interests in such property that can be reached by creditors. See Starczewski, *Federal Tax Collection Procedure*, 638 Tax Mgmt. Portfolio (BNA), at III(B)(3)(b).

137. *United States v. Craft*, 535 U.S. 274 (2002).

[T]he right to use the entireties property, the right to exclude others from it . . . the right of survivorship, the right to become a tenant in common with equal shares upon divorce, the right to sell the property with respondent's consent and to receive half the proceeds from such a sale, the right to place an encumbrance on the property with respondent's consent, and the right to block respondent from selling or encumbering the property unilaterally.

Thus, concluded the Supreme Court, the husband's rights constituted property to which a federal tax lien under section 6321 of the Internal Revenue Code could attach. As to the logic of the result it reached, the Supreme Court stated the following:

Were this Court to reach a contrary conclusion, the entireties property would belong to no one for § 6321 purposes. . . . Such a result seems absurd and would allow spouses to shield their property from federal taxation by classifying it as entireties property, facilitating abuse of the federal tax system.¹³⁸

In *Brickley v. United States*,^{138.1} the Ohio district court extended the foregoing principle. There, a husband and wife held property in a survivorship tenancy. A federal tax lien attached to the husband's one half interest.^{138.2} Husband executed a quitclaim deed pursuant to which his half interest was transferred to his wife. Under the foregoing circumstances, the court held that the transferred interest continued to be burdened by the federal tax lien. Similarly, in *Paternoster v. United States*,^{138.3} also an Ohio district court case, a federal tax lien that had attached to husband's share of a survivorship tenancy five days before his death survived the husband's demise.

§ 1:12 Purchaser's Obligation to Withhold Tax on Purchase of Residence from a Foreign Individual or Entity

Under section 1445, the purchaser of a "United States real property interest"¹³⁹ must deduct and withhold tax from the purchase price

138. See also *Hatchett v. United States*, 330 F.3d 875 (6th Cir. 2003), in which the Sixth Circuit applied *Craft*, retroactively, to a case that was on appeal at the time that the Supreme Court reached its decision in *Craft*.

138.1. *Brickley v. United States*, No. 1:03 CV 112, 2003 WL 22272298 (N.D. Ohio July 30, 2003).

138.2. I.R.C. § 6321.

138.3. *Paternoster v. United States*, 640 F. Supp. 2d 983 (July 22, 2009).

139. Defined in I.R.C. § 897(c) to include a personal residence. The withholding requirement also applied to the sale of options to acquire U.S. real property. CCA 200522020; Treas. Reg. § 1.1445-1(b)(3)(iii).

of the property where the seller is a foreign person. For purposes of determining whether an individual is a foreign person, section 1445(f)(3) states, "the term 'foreign person' means any person other than a United States person." Section 7701(a)(30) defines a "United States person" to include a citizen or resident of the United States, a domestic partnership, a domestic corporation, a domestic estate and various trusts over which U.S. courts may exercise primary supervision. Accordingly, a "foreign person" is a nonresident alien or foreign entity.

To assure oneself that the transferor of a residence is not a foreign person and that, as a result, withholding is not required, one would be wise to request an affidavit-like "certification" of non-foreign-person status.¹⁴⁰ For individuals, the certification must state that the transferor is not a foreign person, set forth the transferor's name, identification number and home address or office address, and must be signed under penalty of perjury.¹⁴¹ Similar requirements exist where the transferor is an entity.¹⁴²

Generally, the amount withheld is equal to 10% of the amount realized on the disposition. The amount withheld is filed under cover of a Form 8288 (U.S. Withholding Tax Return for Disposition by Foreign Persons of U.S. Real Property Interests). However, certain exceptions apply to the 10% withholding requirement.

First, if the U.S. real property interest being disposed of is a residence and is being acquired by the transferee to be used as a residence, no withholding will be required where the amount realized for the property does not exceed \$300,000.¹⁴³ For these purposes, a U.S. real property interest is deemed to have been acquired for use as a residence if on the date of the transfer the transferee has "definite plans to reside in the property for at least 50% of the number of days that the property is used by any person during each of the first

140. The requirements for a certification are set forth in Treas. Reg. § 1.1445-2(b)(2)(i).

141. A foreign corporation that has made a valid election under I.R.C. § 897(i) to be treated as a domestic corporation for purposes of I.R.C. § 897 can also provide a certification of nonforeign status pursuant to Treas. Reg. § 1.1445-2(b)(2). However, an electing foreign corporation must attach to such certification a copy of the acknowledgment of the election provided to the corporation by the Service pursuant to Treas. Reg. § 1.897-3(d)(4).

142. Treas. Reg. § 1.1445-2(b)(2)(iii)(B).

143. I.R.C. § 1445(b)(5).

two twelve-month periods following the date of transfer.”¹⁴⁴ The exception applies only in the case where the transferee is an individual.¹⁴⁵

The second exception applies in the circumstance where the 10% withholding requirement would exceed the transferor’s maximum tax liability, the transferor has requested a “withholding certificate” from the Internal Revenue Service supporting that conclusion, the transferor has notified the transferee¹⁴⁶ of the request, and the Service later issues the certificate. The ruling request is submitted using a Form 8288-B, Application for Withholding Certificate.

Normally, the withheld amount must be submitted to the Service within twenty days following the sale of the property.¹⁴⁷ However, if an application for a withholding certificate has been filed with the Service prior to or on the date of the sale, the filing requirement is extended.

Either the transferor or the transferee can apply for a withholding certificate. If the application for a withholding certificate has been submitted by the transferee, the amount due (whether the amount withheld or such lesser amount as is ultimately determined to be due by the Service) need not be reported and paid over to the Service until the twentieth day following the Service’s final determination with respect to the application for the withholding certificate.¹⁴⁸ Similarly, if the transferor has requested an application for a withholding certificate and the transferee is so notified, the payment of the amount due may be deferred in the manner described in the preceding sentence.¹⁴⁹

144. Treas. Reg. § 1.1445-2(d)(1).

145. *Id.* At least one commentator has cautioned against relying upon the \$300,000 exemption without additional compensation. The caution derives from the fact that, absent a change in circumstances that could not reasonably have been foreseen at the time of purchase, the buyer will remain responsible for the 10% withholding requirement if, after the sale, the buyer does not meet the residence requirement. *See Warner, FIRPTA: Basic Compliance for the Non-Specialist*, paper submitted to 21st Annual Meeting & Educational Institute of Tax Section Florida Bar, Practical Real Estate Taxation Program (Apr. 16–17, 1999).

146. Treas. Reg. § 1.1445-2(d)(3).

147. Treas. Reg. § 1.1445-1(c).

148. Treas. Reg. § 1.1445-1(c)(2)(i)(A).

149. Treas. Reg. § 1.1445-1(c)(2)(i)(B).

§ 1:12.1 Withholding Certificate Guidance Under Revenue Procedure 2000-35

The rules applicable to withholding certificates were recently incorporated in Revenue Procedure 2000-35, which updates prior guidance contained in Revenue Procedure 88-23. The guidance is very lengthy. The following is a general synopsis of the revenue procedure, in particular, as it applies to the sale of residential real property.

[A] In General

The Revenue Procedure notes that withholding under section 1445 of the Code may be reduced or eliminated pursuant to a withholding certificate issued by the IRS. However, according to the Service, a withholding certificate serves only to adjust withholding obligations to correspond as closely as possible to the probable tax liability arising out of the transfer.¹⁵⁰ Therefore, all determinations that are made by the IRS in connection with the issuance of a withholding certificate apply solely for the limited purpose of determining withholding obligations under section 1445 of the Code and do not necessarily represent the Service's final view with respect to any substantive issue that may arise in connection with the transfer.¹⁵¹

The Service notes that a withholding certificate may be issued under one of three circumstances:

- (1) A determination by the Service that reduced withholding is appropriate because either
 - (a) the amount otherwise required to be withheld would exceed the transferor's maximum tax liability; or
 - (b) withholding of a reduced amount would not jeopardize the collection of tax.
- (2) All gain realized by the transferor would be exempt from U.S. tax.
- (3) An agreement has been entered into by the transferee or transferor for the payment of tax and for the provision of security for the tax liability.¹⁵²

150. Rev. Proc. 2000-35, § 3.01.

151. *Id.* § 3.02.

152. *Id.* § 3.03.

[B] How to Apply for the Withholding Certificate

An application for a withholding certificate must be submitted to

Internal Revenue Service Center
P.O. Box 21036
Drop Point 8731
FIRPTA Unit
Philadelphia, PA
19114-0586

As mentioned in section 1:12 above, either transferee or transferor may apply for a withholding certificate. The Service states that it will ordinarily act upon an application no later than the ninetieth day after all information necessary for the Service to make a determination is received.¹⁵³ If an application for a withholding certificate is submitted before or on the date of the transfer, and on the date of the transfer the application remains pending with the Service, the amount required to be withheld by the transferee is not required to be reported and paid over immediately. Instead, that amount or such other amount as is appropriate must be reported and paid over by the twentieth day following the day on which a copy of the withholding certificate or notice of denial is mailed by the Service.¹⁵⁴ If the application is not submitted before or on the date of the transfer, then the transferee must report the transfer and pay any tax withheld by the twentieth day after the date of the transfer.¹⁵⁵

To facilitate the process of applying for withholding certificates, the Revenue Procedure 2000-35 divides all applications into six basic categories:

- (1) Applications for a withholding certificates based on a claim that the transferor is entitled to nonrecognition treatment or is exempt from tax;
- (2) Applications for withholding certificates based solely on a calculation of the transferor's maximum tax liability;
- (3) Applications for withholding certificates under certain special installment sales rules set forth in the Revenue Procedure;
- (4) Applications for withholding certificates based on an agreement for the payment of tax with conforming security;

153. *Id.* § 4.01.

154. *Id.*

155. *Id.*

- (5) Applications for blanket withholding certificates under special rules set forth in the Revenue Procedure;
- (6) Applications for withholding certificates on any other basis.¹⁵⁶

[C] Format for the Withholding Certificate Application

All applications for withholding certificates must provide information in paragraphs labeled to correspond with the number and lettering scheme in the Revenue Procedure. Broadly stated, the information falls within the following categories:

- (1) A statement of the category of the application based upon the six categories of eligibility set forth in section 1:12.1[B] above;
- (2) The name, taxpayer identification number, home address, and business address of the person applying for the withholding certificate, as well a statement as to whether the applicant is the transferor or transferee;
- (3) A recitation of the following required information pertaining to the U.S. real property interest for which the withholding certificate is sought:
 - (a) the type of interest;
 - (b) the contract price;
 - (c) the date of transfer;
 - (d) the location and general description of the property;
 - (e) in the case of certain U.S. real property holding corporations, the class or type and amount of the interest being transferred;
 - (f) whether in the three preceding taxable years,
 - (i) U.S. income tax returns were filed relating to the U.S. real property interest (and, if so, where and when those returns were filed, and if not, why returns were not filed); and
 - (ii) U.S. income taxes were paid relating to the U.S. real property interest, and if so, the amount of the tax paid;

156. *Id.* § 4.03.

- (4) A full statement of information concerning the basis for the issuance of the withholding certificate in accordance with sections 4.05 through 4.11 of the Revenue Procedure;
- (5) The submission of Form 8288-B where the application falls within one of the first three categorizations set forth in section 1:12.1[B] above;¹⁵⁷
- (6) The taxpayer identification number of the seller.¹⁵⁸

[D] Residences Held for Investment and Traded in a Section 1031 Tax-Free Exchange

A seller who is a foreign person may choose to exchange such residence as part of a tax-free exchange under I.R.C. section 1031. Under such circumstances, if no boot is realized on the transaction, it will be exempt from withholding provided that certain procedural requirements are satisfied. The underpinnings of the exemption and the procedural rules are discussed in section 7:1.9, below.

§ 1:13 Credit for Residential Energy-Efficient Property

§ 1:13.1 The Credit

Effective January 1, 2006 and ending December 31, 2009,¹⁵⁹ individual taxpayers are entitled to a credit against tax equal to the sum of:¹⁶⁰

- 30% of the “qualified solar electric property expenditures” made during the taxable year;¹⁶¹
- 30% of the “qualified solar water heating property expenditures” made during the taxable year;¹⁶²

157. *Id.* § 4.04.

158. Treas. Reg. § 1.1445-3(a) (published on Aug. 5, 2003, at 68 Fed. Reg. 46,081).

159. As extended by the Tax Relief and Health Care Act of 2006.

160. I.R.C. § 25D(a)(1)–(3). *See* I.R.S. Announcement 2006-88, 2006-46 I.R.B. 910 (standards for calculating energy savings).

161. The term “qualified solar electric property expenditure” means an expenditure for property that uses solar energy to generate electricity for use in a dwelling unit located in the United States and used as a residence by the taxpayer. I.R.C. § 25D(d)(2).

162. The term “qualified solar water heating property expenditure” means an expenditure for property to heat water for use in a dwelling unit located in the United States and used as a residence by the taxpayer if at least half of the energy used by such property for such purpose is derived from the sun. I.R.C. § 25D(d)(1).

- 30% of the “qualified fuel cell property expenditures” made by the taxpayer during such year;¹⁶³
- 30% of the “qualified small wind energy property expenditures” made by the taxpayer during such year;¹⁶⁴ and
- 30% of the “qualified geothermal heat pump property expenditures” made by the taxpayer during such year.¹⁶⁵

§ 1:13.2 **Limitations on the Credit**

The maximum credit allowed in any taxable year can not exceed the excess of (i) the regular tax or alternative minimum tax due for the year, over (ii) the credits otherwise allowed as set forth in section 1:13.1 above.¹⁶⁶ In addition, the following maximum credit limitations apply for the years indicated:

- 2006–2008 maximum credit:
 - \$2,000 with respect to any qualified solar electric property expenditures.
 - \$2,000 with respect to any qualified solar water heating property expenditures.
 - \$500 with respect to each half kilowatt of capacity of qualified fuel cell property (as defined in I.R.C. section 48(c)(1)) for which qualified fuel cell property expenditures are made.
 - \$500 with respect to each half kilowatt of capacity (not to exceed \$4,000) of wind turbines for which qualified small wind energy property expenditures are made.
 - \$2,000 with respect to any qualified geothermal heat pump property expenditures.

163. The term “qualified fuel cell property expenditure” means an expenditure for qualified fuel cell property (as defined in I.R.C. § 48(c)(1)) installed on or in connection with a dwelling unit located in the United States and used as a principal residence (within the meaning of section 121) by the taxpayer. I.R.C. § 25D(d)(3).

164. The term “qualified small wind expenditure” means an expenditure for or property that uses a wind turbine to generate electricity in connection with a dwelling unit located in the United States and used as a residence by the taxpayer. I.R.C. § 25D(d)(4).

165. The term “qualified geothermal heat pump property” means an expenditure for qualified geothermal heat pump property installed on or in connection with a dwelling unit located in the United States and used as a residence by the taxpayer. I.R.C. § 25D(d)(4).

166. I.R.C. § 25D(c).

- 2009–2017¹⁶⁷ maximum credit:
 - No cap with respect to any qualified solar electric property expenditures.
 - \$2,000 with respect to any qualified solar water heating property expenditures.
 - \$500 with respect to each half kilowatt of capacity of qualified fuel cell property (as defined in I.R.C. section 48(c)(1)) for which qualified fuel cell property expenditures are made.
 - \$500 with respect to each half kilowatt of capacity (not to exceed \$4,000) of wind turbines for which qualified small wind energy property expenditures are made.
 - \$2,000 with respect to any qualified geothermal heat pump property expenditures.

§ 1:13.3 Carry-Forward of Credit

If the percentage credit, as set forth above, exceeds the applicable limitation for a given year, the excess is carried to the succeeding taxable year and added to the credit allowable for the succeeding taxable year.¹⁶⁸

§ 1:13.4 Special Rules

[A] Labor Costs

Expenditures for labor costs properly allocable to on-site preparation, assembly, or original installation of the qualified property expenditures described above and for piping or wiring to interconnect such property to the dwelling unit are taken into account in computing the extent of such expenditures.¹⁶⁹

[B] Solar Panels

Solar panels or other property installed as a roof will not fail to be treated as qualifying property solely because they constitute a structural component of the structure on which they are installed.¹⁷⁰

167. I.R.C. § 25D(g) as extended by H.R. 1424 (Including the Emergency Economic Stabilization, Energy Improvement and Extension Act of 2008).

168. I.R.C. § 25D(e)(4).

169. I.R.C. § 25D(e)(1).

170. I.R.C. § 25D(e)(2).

[C] Swimming Pools

Expenditures that are properly allocable to a swimming pool, hot tub, or any other energy storage medium that has a function other than the function of energy storage can not be taken into account.¹⁷¹

[D] Dollar Limit on Fuel Cell Expenditures Made to Dwelling Unit Occupied by More Than One Taxpayer

In the case of any dwelling unit that is commonly occupied and used during any calendar year as a residence by two or more individuals, the following rules apply to fuel cell expenditures.

[D][1] Limit

The maximum amount of credit-eligible fuel cell expenditures which may be taken into account by all persons is \$1,667 for each half kilowatt of capacity of qualified fuel cell property (defined in I.R.C. section 25D(d)(4)(A)).¹⁷²

[D][2] Proration

Each occupant will receive a prorated credit for any taxable year in an amount that bears the same ratio to the qualifying fuel cell expenditures as the amount that the expenditures made by the occupant during the year bears to the aggregate of such expenditures made by all of occupants for the year.¹⁷³

[E] Tenant-Stockholders in Cooperative Housing Corporations

In the case of a taxpayer who is a tenant-stockholder (as defined in I.R.C. section 216) in a cooperative housing corporation (as defined in I.R.C. section 216), the taxpayer is treated as having made his or her proportionate share (as defined in I.R.C. section 216(b)(3)) of any qualifying expenditures of the co-op.¹⁷⁴

[F] Condominiums

In the case of a taxpayer who is a member of a condominium management association with respect to a condominium that the

171. I.R.C. § 25D(e)(3).
172. I.R.C. § 25D(e)(4)(A).
173. I.R.C. § 25D(e)(4)(B).
174. I.R.C. § 25D(e)(5).

taxpayer owns, the taxpayer is treated as having made his or her proportionate share of any expenditures made by the condo association.¹⁷⁵

§ 1:14 Credit for Nonbusiness Energy Property

In the case of an individual taxpayer, a credit was available under the law prior to the American Recovery and Reinvestment Act of 2009 for energy-efficient improvements made to a primary residence. The credit was available in an amount equal to (i) 10% of all “qualified energy efficient improvements,” as defined in I.R.C. section 25C(c)(1),¹⁷⁶ and (ii) certain “residential energy property expenditures” made during the year, as defined in I.R.C. section 25C(d)(1),¹⁷⁷ with limits applied to specific categories of such expenditures. Further, under I.R.C. section 25C(b)(1) and (2), the foregoing expenditures were subject to a lifetime cap of \$500, no more than \$200 of which was attributable to expenditures made on windows.

Under the American Recovery and Reinvestment Act of 2009, the 10% “qualified energy efficient improvements” limit was increased to 30%,¹⁷⁸ the specific limits on “residential energy property expenditures” was also subject to a 30% cap,¹⁷⁹ and the overall lifetime \$500 cap was increased to an annual \$1,500 cap for 2009 and 2010.¹⁸⁰ The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the “Tax Relief Act of 2010”) extended the time frame for utilizing the credit to improvements made during 2011.¹⁸¹

175. I.R.C. § 25D(e)(6).

176. The term “qualified energy efficiency improvements” is defined in I.R.C. § 25C(c)(1) to mean any energy-efficient building envelope component that meets the criteria for such component established by the 2000 International Energy Conservation Code.

177. The term “residential energy property expenditures” is defined in I.R.C. § 25C(d)(1) to mean expenditures made by a taxpayer for “qualified energy property” that is originally placed in service by the taxpayer in his or her principal residence located in the United States. As defined by I.R.C. § 25C(d)(2)(A), the term “qualified energy property” means (i) energy-efficient building property, (ii) any qualified natural gas furnace, qualified propane furnace, qualified oil furnace, qualified natural gas hot water boiler, qualified propane hot water boiler, or qualified oil hot water boiler, or (iii) an advanced main air circulating fan.

178. I.R.C. § 25C(a)(1), as amended by the American Recovery and Reinvestment Act of 2009 § 1121(a).

179. I.R.C. § 25C(a)(2), as amended by the American Recovery and Reinvestment Act of 2009 § 1121(a).

180. I.R.C. § 25C(b), as amended by the American Recovery and Reinvestment Act of 2009 § 1121(a).

181. See amended I.R.C. §§ 25C(a), 25C(b), and 25C(g)(2).

§ 1:15 Discharge of Indebtedness Relief Under the Mortgage Forgiveness Debt Relief Act of 2007

In response to the subprime mortgage debacle, H.R. 3648, the Mortgage Forgiveness Debt Relief Act of 2007 (MFDBA), was enacted on December 20, 2007,¹⁸² and is effective for returns required to be filed after the enactment date. Under Code section 108(a)(1)(E), as enacted by the MFDBA, a taxpayer's gross income will not include any discharge of indebtedness that

- (i) qualifies as "qualified principal residence indebtedness,"
- (ii) is on account of a decline in the value of the principal residence or a decline in the financial condition of the taxpayer,¹⁸³ and
- (iii) occurs before January 1, 2013.¹⁸⁴

The exclusion applies to both taxpayers who restructure their mortgages as well as to taxpayers who would otherwise realize discharge of indebtedness income by virtue of losing their principal residence in a foreclosure. The taxpayer's basis in the principal residence will be reduced by the amount of the income excluded under the relief provisions.¹⁸⁵

For purposes of the foregoing:

- A "qualified principal residence" only applies in the case of the taxpayer's primary residence and does not include second homes, vacation homes, business property, or investment property.
- "Qualified principal residence indebtedness" is defined by reference to "acquisition indebtedness" rules that generally govern the deductibility of mortgage interest, as limited by the principal residence requirement.¹⁸⁶
- Generally, qualified principal residence indebtedness only arises in the case of debt incurred to either acquire, construct, or substantially improve a principal residence.¹⁸⁷ As a result, most second mortgages and home equity mortgages will not qualify under the relief provisions.

182. Pub. L. No. 110-142 (Dec. 20, 2007).

183. See I.R.C. § 108(h)(3), as enacted by the MFDBA.

184. Originally, the expiration date had been set at January 1, 2010. However, in light of the subprime mortgage crisis, Congress, as part of the Emergency Economic Stabilization Act of 2008 (H.R. 1424), extended the relief period for an additional three years, to January 1, 2013.

185. See I.R.C. § 108(h)(1), as enacted by the MFDBA.

186. As defined in I.R.C. § 163(h)(3)(B).

187. *Id.*

- For married persons who file jointly, the legislation provides for a debt cap of \$2 million on the aggregate amount of debt that may be treated as qualified principal residence indebtedness (with the debt cap being reduced to \$1 million in the case of married persons filing separately).¹⁸⁸

§ 1:16 Tax-Free Exchanges of Dwelling Units Held for Investment

Effective March 10, 2008, Revenue Procedure 2008-16 establishes safe harbor requirements for section 1031 exchanges involving residential dwelling units held for investment.¹⁸⁹

§ 1:17 First-Time Homebuyer Credit

§ 1:17.1 Eligibility for Credit

On July 30, 2008, President George W. Bush signed into law H.R. 3221, the American Housing Rescue and Foreclosure Prevention Act of 2008 (HRFPA). The HRFPA, as modified by subsequent legislation, provides a first-time homebuyer credit with respect to the purchase of a residence between April 8, 2008 and September 30, 2010.¹⁹⁰ The credit is \$8,000.¹⁹¹ The term “principal residence” derives its meaning from I.R.C. section 121, which pertains to the \$250,000/\$500,000 exemption from gain on the sale of a principal residence.¹⁹² However, the term “first-time homebuyer” is broadly defined to include anyone, even a prior homeowner, who has not owned a principal residence (and, if married, whose spouse has not owned a principal residence) during the three-year period ending on the date of the residence purchase for which the credit is sought.¹⁹³

The credit is only available to individual filers with adjusted gross income of less than \$95,000. Even at that, the credit is phased out ratably between \$75,000 and \$95,000. For joint filers, the credit is

188. See I.R.C. § 108(h)(2), as enacted by the MFDDBA.

189. This topic is discussed in section 7:1.12, *infra*.

190. See I.R.C. § 36(h)(3)(B), as amended by the 2010 Homebuyer Assistance Act § 2(b). The 2010 Homebuyer Assistance Act extended the closing deadline from June 30, 2010, to September 30, 2010 for first-time homebuyers who entered into a binding purchase contract on or before April 30, 2010.

191. I.R.C. § 36(h).

192. See Treas. Reg. § 1.121-1(b)(2) and the footnotes accompanying section 1:7.4[B], *supra*.

193. I.R.C. § 36(c)(1).

available to taxpayers with combined adjusted gross income of less than \$170,000. Here, too, the credit is phased out ratably between \$150,000 and \$170,000.¹⁹⁴ The provision does not apply to a purchase from a related party.¹⁹⁵ Nor does it apply if the purchase price of the residence exceeds \$800,000.¹⁹⁶

§ 1:17.2 Use of the Credit

The credit is available to offset tax liability for the year of purchase. However, if the credit exceeds tax liability for that year, the taxpayer will receive a refund or the difference. A special provision permits taxpayers who purchase their principal residence during the period January 1, 2009, to June 30, 2009, to treat the purchase as if it had been made on December 31, 2008, thereby enabling the taxpayer to accelerate the credit.¹⁹⁷ For such purpose, a taxpayer who has already filed his or her 2008 return may file an amended return.

§ 1:17.3 Recapture of the Credit

The credit is subject to recapture, without interest, over a fifteen-year period. Further, if the principal residence to which the credit applies, is sold¹⁹⁸ (or no longer serves as the taxpayer's principal residence)¹⁹⁹ within the fifteen-year recapture period, the un-recaptured credit is recaptured in the year of sale. If the sale is to an "unrelated party" (see the following paragraph), the recapture is limited to the amount of gain realized on the sale.²⁰⁰

§ 1:17.4 Related-Party and Other Limitations

To qualify for the credit, the taxpayer must not have (i) obtained the principal residence in a transaction in which the taxpayer's basis is derived from the basis of the transferor (that is, a gift); or (ii) purchased the principal residence from a related party. The term "related party" takes its meaning from I.R.C. section 267 (disallowance of losses in transactions between related parties) and I.R.C. section 707(b) (disallowance of losses between a partner and a partnership), with certain modifications, in particular, that a person's family only includes his spouse, ancestors or lineal descendants. Thus, a purchase from the

194. I.R.C. § 36(b)(2)(A).
 195. I.R.C. § 36(c)(3)(A)(i).
 196. I.R.C. § 36(b)(3).
 197. I.R.C. § 36(g).
 198. I.R.C. § 36(f)(2).
 199. *Id.*
 200. I.R.C. § 36(f)(3).

taxpayer's sibling would be an eligible purchase. Neither regular nor accelerated recapture takes place if the taxpayer dies during the fifteen-year period.²⁰¹

§ 1:17.5 *Modifications to the Credit Under the American Recovery and Reinvestment Act of 2009*
Section 1006(a)(2)

Under the American Recovery and Reinvestment Act of 2009, the amount of the first-time homebuyer credit was increased from \$7,500 to \$8,000, and the period for purchase was extended from June 30, 2009, to November 30, 2009.²⁰² In addition, for purposes of treating a 2009 purchase as having been made in 2008 so as to permit the homebuyer to take the credit in 2008, the purchase deadline was also extended from June 30, 2009, to November 30, 2009.²⁰³ Under the Homebuyer Assistance and Improvement Act of 2010,²⁰⁴ the purchase deadline was extended to September 30, 2010.

In addition, the recapture rules were significantly relaxed for purchases made after December 31, 2008. For such purchases, the fifteen-year recapture of the credit will no longer apply, thereby converting the first-time homebuyer credit into a real tax credit, as compared to what essentially had been a tax-free loan.²⁰⁵ However, the credit will be recaptured if the purchased residence either ceases to be a principal residence or is sold within three years of the date of purchase.²⁰⁶

201. I.R.C. § 36(f)(4)(A).

202. I.R.C. § 36(g), as amended by American Recovery and Reinvestment Act of 2009 § 1006(a)(1).

203. I.R.C. § 36(g), as amended by American Recovery and Reinvestment Act of 2009 § 1006(a)(2).

204. H.R. 5623, Pub. L. No. 111-198.

205. I.R.C. § 36(f)(4)(D)(i), as amended by American Recovery and Reinvestment Act of 2009 § 1006(c)(1).

206. I.R.C. § 36(f)(4)(D)(ii), as amended by the American Recovery and Reinvestment Act of 2009.