The IRC § 121 Home-Sale Exclusion: Tax Flexibility in Uncertain Housing Markets

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ABSTRACT

Over the past five years, the performance of United States housing market has been sporadic at best. Market related factors such as increased interest rates, fluctuating mortgage rates, housing affordability and low inventory of available homes are potential causes according to a U.S. Bank whitepaper. In addition, the current political climate may impact home sales. For example, an Axios/Ipsos Two America's Index Poll found that over 50% of American adults have thought about moving to a state with a climate that matches their "political beliefs" and "social values." The same poll also shows that 30% of American adults have thought about moving within a six-month window.

Given the above factors, homeowners contemplating entering the market may need to be ready to sell their home on short notice while maximizing the tax benefits granted under Code Section 121. In some circumstances, taxpayers may need to execute home sales that do not fit the general requirements of the home-sale exclusion. This paper will determine relevant methods for homeowners executing atypical home-sales such as vacant lot sales, emergency sales, homes owned by business entities, and instances where taxpayers own multiple homes.

Keywords: taxation, housing, residence, accounting, real estate.

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INTRODUCTION[1]

Over the past five years, the performance of United States housing market has been sporadic at best. Market related factors such as increased interest rates, fluctuating mortgage rates, housing affordability and low inventory of available homes are potential causes according to a U.S. Bank whitepaper.[2] In addition, the current political climate is also impacting home sales. For example, an Axios/Ipsos Two America's Index Poll found that over 50% of American adults have thought about moving to a state with a climate that matches their "political beliefs" and "social values."[3] The same poll also shows that 30% of American adults have thought about moving within a six-month window.[4]

Given the above factors, homeowners contemplating entering the market may need to be ready to sell their home on short notice while maximizing the tax benefits granted under Code Section 121. In some circumstances, taxpayers may need to execute home sales that do not fit the general requirements of the home-sale exclusion.

In addition, most tax practitioners and clients are aware that the home-sale exclusion provides a $250,000 ($500,000 if married) exclusion of gain from the sale of a home.[5] Further, many are aware of the requirements that the homeowner must own and use the home as a principal residence for 2 years out of a 5-year period.[6] Also, taxpayers can take advantage of this provision once every two years. However, many are likely unaware of the flexibility of the exceptions available for the home-sale exclusion's requirements.

This article overviews the Code Section 121 home-sale exclusion and answers five critical questions: 1) Is a homeowner required to simultaneously own and use the home as a principal residence? 2) May an LLC or trust own the home? 3) Are there exceptions to the 2 out of 5 year ownership and use requirements? 4) Will renting the home prevent or limit a home-sale exclusion? and 5) What if the taxpayer owns and lives in multiple residences? The answers to these questions will help tax practitioners provide additional value to clients seeking to sell their personal or rental properties in this uncertain housing market.

Do Ownership and Use of the Home Need to Be Simultaneous?

No. Taxpayers do not need to own and use the home as a residence at the same time.[7] However, the 2-year ownership and use requirements must both be met during the same 5 year period.[8] This rule is a catch-all provision that can be used by taxpayers renting to own a home, taxpayers that move in with relatives, taxpayers renting the home to tenants as they prepare for its sale, or a variety of other situations. For example, a taxpayer may rent the home from a

[1] Note that citations are made using the APA Manual of Style which refers to the Bluebook Uniform System of Citation for legal references of legal authorities. References to Title 26 of the United States Code are referred to as "IRC" for Internal Revenue Code.
[2] The Impact of Today's Higher Interest Rates on The Housing Market, U.S. Bank (Sept. 27, 2023) available at: https://www.usbank.com/investing/financial-perspectives/investing-insights/interest-rates-impact-on-housing-market.html.
[3] Talev, Margaret and Nather, David, Two Americas Index: Red-blue Migration, Axios (Aug. 8, 2022). See also Gabriel, Trip, Two Families Got Fed Up with Their States' Politics. So They Moved Out., New York Times (Oct. 7, 2023).
[4] Id.
[5] IRC § 121(b)(1) and (2)(A).
[6] IRC § 121(a)(2).
[7] Treas. Reg. § 1.121-1(c).
[8] Id.

landlord during the first three years of the measurement period.[9] The taxpayer would still qualify if they purchased the aforementioned home and rented the property to tenants during the last 2 years of the measurement period.[10] A reverse situation would technically qualify the taxpayer for the exclusion as well. Practitioners should also consider the effect of nonqualified use provisions discussed further below.

May an LLC or Trust Own the Home?

Yes, under certain circumstances. The home may be owned by certain single-owner entities and trusts.[11] However, partnerships, corporations, and other entities will not qualify for the home-sale exclusion.[12] The determining factor is whether the taxpayer is the sole owner of the entity and whether the entity's income is reported on the taxpayer's return.[13]

Certain single-owner entities may own the home if the entity is considered disregarded on the taxpayer's return. For example, this means that the taxpayer must be the only member of the entity.[14] Also, the entity must be treated as a flow-through entity.[15] An LLC will not qualify for the home-sale exclusion if the taxpayer has elected to treat the single member LLC as a corporate entity on Form 8832 Entity Classification Election.[16]

Trusts may also own the home under the appropriate circumstances. The taxpayer must be considered the owner of the trust under IRC §§ 671 through 679.[17] Thus, the taxpayer will generally be considered the owner of the trust if the entity's income flows through to the taxpayer's return.[18]

Which One of the Taxpayer's Homes Is Their Principal Residence?

Taxpayers may only have one principal residence at a given time. Therefore, taxpayers with multiple homes and/or vacation homes must first determine whether the residence being sold is their principal residence. This rule is generally simple, the home where the taxpayer spends the majority of their time during the year will typically be considered the taxpayer's principal residence.[19]

Determining the principal residence for owners splitting time evenly between multiple homes can be more complicated (retired and/or wealthy taxpayers, etc.). The determination of residency depends on the taxpayers specific facts and circumstances in these instances. The regulations provide the following factors for this determination: 1) the taxpayer 's place of employment, 2) the location of the taxpayer's relatives, 3) addresses listed on tax returns, 4)

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[9] Treas. Reg. § 1.121-1(c)(4)(Example 3).
[10] Id.
[11] Treas. Reg. § 1.121-1(c)(3).
[12] Treas. Regs. §§ 1.121-1(c)(3)(ii) and 303.7701-3(a).
[13] Id. (Note that the entity must be disregarded for federal tax purposes).
[14] Id.
[15] Id.
[16] See generally Treas. Regs. §§ 1.121-1(c)(3)(ii) and 303.7701-3(a). See also Form 8832 Entity Classification Election and Instructions.
[17] See Treas. Reg. § 1.121-1(c)(3)(i). See generally IRC §§ 671 and 679.
[18] Id.
[19] Treas. Reg. § 1.121-1(b)(2)

mailing addresses for bills and correspondence, and 5) the location of the taxpayer's religious organizations and social clubs.[20]

However, the taxpayer is not limited to the factors listed in the regulations. Furthermore, courts have placed more weight on some factors than others when determining residency. For example, in Wickersham v. Commissioner,[21] a married couple, the Wickershams, sold a residence in Iowa and also owned a residence in Nebraska.[22] The IRS denied the home-sale exclusion and asserted that the Wickershams' Nebraska home was their principal residence since they owned several businesses there.[23] However, the Tax Court found that the Iowa home was the Wickershams' true residence.[24] The court noted that the Wickershams' 28 children and grandchildren lived in Iowa and that they held 15 to 20 family gatherings in Iowa per year.[25] The court also noted that Mr. Wickersham was diagnosed and treated for throat cancer in Iowa.[26] Thus, the court went beyond the Treasury Regulation § 1.121-1(b)(2) factors and considered all of the Wickershams' relevant circumstances.

General Limitations of the Home-Sale Exclusion

Practitioners should also note the general limitations for the home-sale exclusion. There are three limitations on the home-sale exclusion. The first limitation is that the exclusion is not allowed if the taxpayer has claimed the exclusion within the last two years.[27] The second limitation is that the exclusion is not allowed for a home that was obtained with an IRC § 1031 like-kind exchange within the last five years.[28] Lastly, an individual may not claim the exclusion if they are subject to the U.S. expatriate tax.[29]

Exceptions to the Home-Sale Requirements

Taxpayers may have an available exception in special situations that require the sale of the home before reaching the 2 out of 5 year ownership and use requirements. These exceptions may be based on changes in the taxpayer's circumstances such as: 1) a change in employment, 2) health issues, or 3) other unforeseen circumstances.[30] Further, an applicable exception will qualify a taxpayer for a reduced home-sale exclusion based on the amount of time that the taxpayer owned and used the home as a principal residence.[31]

The availability of these exceptions are based on the suitability of the property, the taxpayer's financial ability to maintain the home, whether the change in circumstance occurred during the use or ownership periods, and whether the circumstances necessitating the move were

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[20] Id.
[21] T.C. Memo. 2011-178.
[22] Id at 1.
[23] Id at 7 and 8.
[24] Id at 10.
[25] Id at 8 and 9.
[26] T.C. Memo. 2011-178 at 8.
[27] IRC § 121(b)(3)
[28] IRC § 121(d)(10)
[29] IRC § 121(e).
[30] Treas. Reg. § 1.121-3(b)
[31] Treas. Reg. § 1.121-3(g)(1)(Calculation of the reduced exclusion based on time).

foreseeable.[32] Practitioners should note that the taxpayer qualifies only if the changes affect a qualified individual. Qualified individuals include: the taxpayer, the taxpayer's spouse, a co-owner of the residence, or an individual whose principal residence is the same as the taxpayers.[33] For the purposes of the health related safe-harbor, a qualified individual also includes someone meeting the relational definition of a qualifying relative (regardless of whether this person would qualify as a dependent).[34] This would include: siblings, nieces/nephews, aunts/uncles, and parents. Also, a 1st cousin of the taxpayer may qualify for the health related safe-harbor as well.[35]

Changes in Employment

A change in employment may qualify a taxpayer for a partial home-sale exclusion. A distance related safe-harbor exists to assure taxpayers of their qualification. To qualify, the taxpayer's commute must be increased by more than 50 miles. Specifically, the taxpayer's new place of employment must be at least 50 miles farther from the old residence than the taxpayer's old employer.[36] There may be some situations where the taxpayer has obtained new employment and does not have a previous employer. In these situations, the distance between the principal residence and the new employer must be more than 50 miles to qualify for the safe-harbor.[37]

Health Related Safe-Harbor

Taxpayers have a health related exception if the primary reason for the home sale is to obtain healthcare for a disease, injury, or ailment for a qualified individual as defined above.[38] This can include obtaining, providing, or facilitating a "diagnosis, cure, mitigation, or treatment of disease, illness, or injury."[39] Practitioners should note that a safe-harbor exists if a physician (defined by IRC § 213(d)(4)) recommends the change in primary residence.[40] Thus, a taxpayer moving to a warmer and drier location due to a chronic asthma condition could qualify for the safe-harbor if a physician recommended the change in residence.[41]

Unforeseen Circumstances

Taxpayers have a catch-all exception for various changes to the taxpayer's living circumstances or the circumstances of qualified individuals. The situations applicable to the unforeseen circumstances safe-harbor can include: involuntary conversion of the residence, acts

[32] Treas. Reg. § 1.121-3(b)(1-6).
[33] Treas. Reg. § 1.121-3(f).
[34] Treas. Reg. § 1.121-3(f)(5) and IRC 152(a)(1 - 8).
[35] Treas. Reg. § 1.121-3(f)(5)(noting that a descendent of the taxpayer's grandparents would qualify for the purposes of the health related safe-harbor).
[36] Treas. Reg. § 1.121-3(c)(2).
[37] Id.
[38] Treas. Reg. § 1.121-3(d).
[39] Id.
[40] Id.
[41] See Treas. Reg. § 1.121-3(d)(3)(Example 4).

of war/terrorism, natural disasters, death, divorce, cessation of employment (with unemployment eligibility), inability to pay housing cost, and multiple childbirths from the same pregnancy.[42]

The qualifications of other situations are based on the taxpayers specific facts and circumstances.[43] However, there are regulatory examples of situations that would qualify that include: canceled marital engagements, unanticipated condominium fees, and certain job requirements which renders the home unsuitable for the taxpayers employment.[44] The regulations also list examples that do not qualify including commute times and personal preferences such as increases in home value or wanting a bigger home.[45]

Calculating the Partial Exclusion

Taxpayers are entitled to a partial home-sale exclusion if they meet the aforementioned exceptions. The partial exclusion must be prorated based on the amount of the 2 year (730 days) ownership and use requirement that was actually fulfilled by the taxpayer.[46] The taxpayer must prorate based on a numerator that is the shorter of the taxpayers 1) ownership period, 2) use period, or 3) the time length between the current and last home-sale exclusion.[47] Thus, a qualifying, single taxpayer would presumably be entitled to a $125,000 exclusion amount if they owned and used the home as a principal residence for exactly 1 out of the last 5 years with no prior home-sale exclusion.

Rental of the Home & Nonqualified Use Limitations

Taxpayers must also limit the amount of a potential home-sale exclusion for certain periods in which the home is not used as the taxpayer's principal residence after December 31, 2008.[48] However, there is an exception for U.S. military, intelligence, and foreign service personnel on qualified official extended duty.[49] Practitioners should also note that depreciation taken on the home after May 1997 may be taxable as an IRC § 1250 gain regardless of whether the home-sale exclusion applies.[50]

Nonqualified use can include the rental of the property depending on when the rental occurs in relation to the taxpayer's use of the home as a principal residence. A rental that occurs before the taxpayer's last use of the home as a principal residence is considered nonqualified use.[51] However, a rental that occurs after the taxpayers last use of the home as a principal residence is considered qualified use.[52] Thus, this rule provides flexibility for taxpayers renting out the home before its final sale.

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[42] Treas. Reg. § 1.121-3(e)(2).
[43] Treas. Reg. § 1.121-3(e)(3).
[44] Treas. Reg. § 1.121-3(e)(3)(Examples 1 - 10).
[45] Id.
[46] Treas. Reg. § 1.121-3(g)
[47] Id.
[48] IRC § 121(b)(5)(A) and (C)(i).
[49] IRC § 121(b)(5)(C)(ii)(II) and (d)(9)(A and C).
[50] Treas. Reg. § 1.121-1(d).
[51] IRC § 121(b)(5)(C)(i).
[52] IRC § 121(b)(5)(C)(ii)(I).

Nonqualified use will limit the amount of the home-sale gain that may be excluded. Practitioners must prorate the gain by the ratio of nonqualified use periods to the total period of time that the home was owned by the taxpayer.[53] Practitioners should be sure not to count any periods before January 1, 2009 as nonqualified use.[54] Thus, a taxpayer would presumably have a nonqualified use gain percentage of 10% if the home was owned for 10 years with 1 year of nonqualified use. A single taxpayer in this circumstance with a $100,000 home-sale gain would only be able to exclude $90,000 of gain. The remaining $10,000 (10%) would be ineligible for the exclusion as a nonqualified use gain.

Special Rules for U.S. Military, Intelligence & Foreign Service Personnel

U.S. military, intelligence, and foreign service personnel receive a grace period for nonqualified use when on qualified official extended duty. Qualified official extended duty includes extended duty which requires the taxpayer to serve at a duty station more than 50 miles from the taxpayers home.[55] In these situations, the taxpayer may elect to suspend the 5 year measurement period for ownership and use of the home.[56] Further, qualifying taxpayers may extend this period up to 10 years.[57] Note that this exception also negates any nonqualified use during the time period. Thus, qualifying taxpayers may rent the home during the suspension period without triggering the nonqualified use provisions.

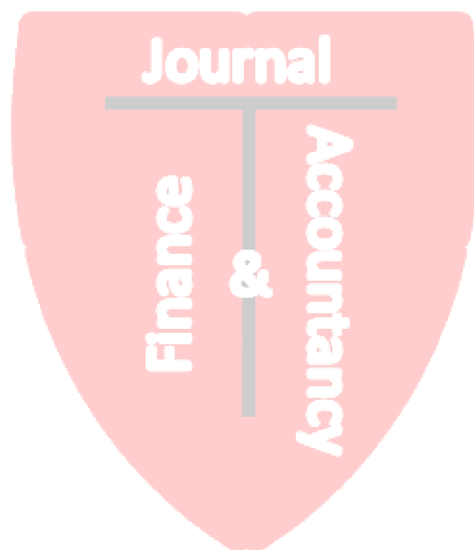
Reporting, Documentation Requirements & Waiver of the Exclusion

An individual must report their home-sale on Form 8949, Sales and Other Disposition of Capital Assets, if the gain exceeds the exclusion amount.[58] Thus, only, individuals with home-sale gains greater than their $250,000/$500,000 threshold, or that are issued a form 1099-S, are required to report home-sale proceeds to the IRS.[59] Practitioners should note that certain high income individuals with proceeds in excess of the home-sale exclusion amount may be subject to the Net Investment Income Tax (NIIT).[60] The NIIT is a 3.8% surcharge to the taxpayer's net investment income (or Modified Adjusted Gross Income over a threshold amount, if less).[61] Practitioners may also inform taxpayers that the home-sale exclusion may be waived by including the income on the tax return for the year of the sale.[62]

[53] IRC § 121(b)(5)(B)
[54] IRC § 121(b)(5)(A) and (C)(i).
[55] IRC § 121(b)(5)(C)(ii)(II) and (d)(9)(A) and (C)(i).
[56] Id.
[57] Id.
[58] See IRS 2022 Instructions to Form 1040, Schedule D Capital Gains and Losses, (2022), page D-2 through 3. See also Revenue Ruling 87-113, IRB 1987-50 and Treas. Reg. § 1.6045-4(a) through (h).
[59] Id.
[60] See Treas. Reg. § 1.411-4(a)(1)(iii) and (d)(3)(Example 3).
[61] See IRC § 1411(a).
[62] See IRC § 121(f) and Treas. Reg. 1.121-4(g).

CONCLUSION

The home-sale exclusion is generally a simple tax benefit for taxpayers. However, there are certain situations that can complicate the home-sale exclusion or provide greater financial flexibility for taxpayers. This is especially true in unique situations involving death, family changes, illness, military obligations, employment changes, or business ventures. Moreover, the current housing market, combined with taxpayer willingness to consider relocating to escape certain political climates, increases the likelihood that practitioners may need to advise clients on these matters. Thus, becoming familiar with IRC § 121 home-sale exclusion and its regulations may allow tax practitioners to demonstrate significant client value with a substantial tax benefit.



References:

1) IRC 121.

2) IRC 1411.

3) Treasury Regulation § 1.121-1.

4) Treasury Regulation § 1.121-3.

5) Treasury Regulation § 1.6045-4.

6) Treasury Regulation § 1.411-4.

7) The Impact of Today's Higher Interest Rates on The Housing Market, U.S. Bank (Sept. 27, 2023) available at: https://www.usbank.com/investing/financial-perspectives/investing-insights/interest-rates-impact-on-housing-market.html.

8) Talev, Margaret and Nather, David, Two Americas Index: Red-blue Migration, Axios (Aug. 8, 2022). See also Gabriel, Trip, Two Families Got Fed Up with Their States' Politics. So They Moved Out., New York Times (Oct. 7, 2023).

9) Treasury Regulation § 303.7701-3(a).

10) Internal Revenue Service, Form 8832 Entity Classification Election and Instructions (2013).

11) IRC § 671.

12) IRC § 679.

13) T.C. Memo. 2011-178.

14) Internal Revenue Service, Instructions to Form 1040, Schedule D Capital Gains and Losses (2022).

15) Internal Revenue Service Form 8949, Sales and Other Disposition of Capital Assets

16) Revenue Ruling 87-113, Internal Revenue Bulletin 1987-50 and Treas. Reg. § 1.6045-4(a) through (h).

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