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Neil Harl
Iowa State University, harl@iastate.edu

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WHO CAN CLAIM EXCLUSION ON PRINCIPAL RESIDENCE?

— by Neil E. Harl

The exclusion for gain on the principal residence, which has been $250,000 ($500,000 on a joint return) since May 6, 1997, has been available for individual taxpayers as to “the taxpayer's principal residence….” The 1997 amendment eliminated the age requirement (which had been age 55) and the limitation to a one-time exclusion.

A question being raised with increasing frequency is whether other types of entities can claim the exclusion.

Ownership by partnership

Under the revision of the exclusion in effect after the 1978 amendment which increased the exclusion from $35,000 to $125,000, IRS ruled that ownership of a residence through an interest in a partnership did not preclude eligibility for exclusion of gain when the partnership interest was terminated. However, if the house had been treated as partnership property at all times, the exclusion was not available.

Ownership by trust

Transfer of the residence to a revocable inter vivos trust apparently does not preclude eligibility for the exclusion. At least, that was the case so long as the owners could exercise the power to revoke the trust.

For a residence held by an irrevocable inter vivos trust, the principal residence has been considered eligible for the exclusion to the extent the owner was treated as the owner of the trust under I.R.C. §§ 671-677.

Ownership by bankruptcy estate

The courts are divided on whether the exclusion is available on the sale of a debtor's principal residence by a bankruptcy estate. In two cases decided before the 1997 amendment to the exclusion was enacted, and one case decided after the 1997 amendment became effective, the courts held that the exclusion was not available to the bankruptcy estate. All involved Chapter 7 bankruptcy liquidation proceedings.

However, in a series of cases decided in 1998 and 1999, all involving interpretation of the statute as amended in 1997, a U.S. District Court and three Bankruptcy Courts have held that the exclusion could be claimed by a bankruptcy estate on sale of the debtor's principal residence.

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.
The courts allowing the exclusion on sale of a principal residence by the bankruptcy estate have reasoned that the Bankruptcy Tax Act of 1980 provides that—

"Except as otherwise provided by this section, the taxable income of the [bankruptcy] estate shall be computed in the same manner as for an individual. The tax shall be computed on such taxable income and shall be paid by the trustee."[16]

Moreover, the transfer of property to the bankruptcy estate is not to be treated as a disposition of the property “...and the estate shall be treated as the debtor would be with respect to such asset.”[17]

Two of the recent decisions allowing the exclusion noted that the Bankruptcy Tax Act of 1980 also specifies that the bankruptcy estate takes over from the debtor various tax attributes including the holding period and the “character” of the asset “it had in the hands of the individual.”[20] The court in the case of In re Kerr[21] concluded that to allow the exclusion (which the court did) was consistent with In the Matter of Kochell[22] which stated that once the debtor files bankruptcy, the estate is thereafter treated as the debtor. Thus, in that case, the bankruptcy estate was liable for the penalty for premature withdrawal of funds from the debtor’s IRA.[23]

Ownership by estate

Typically, the new income tax basis received at death or up to six months after death largely eliminates the gain on post-death sale of the principal residence. However, if the decedent's principal residence is sold after death with gain on the transaction, the question is whether that gain is eligible for the exclusion provided the ownership and use requirements are met and the debtor had not used the exclusion within the last two years.[26]

The repeal of the age requirement in 1997 eliminated one barrier to an estate claiming the exclusion to date. No case or ruling has considered the eligibility of an estate for the exclusion but it would appear that an estate should not be prevented from claiming the exclusion if the various requirements are met.

FOOTNOTES


3. I.R.C. § 121(a).

4. See Rev. Rul. 75-62, 1975-1 C.B. 188 (no exclusive rule for determining when partnership is viewed as an entity or an aggregate).


8. Id.


11. Id.


15. I.R.C. § 1398.

16. Id.


19. See note 13 supra.

20. I.R.C. § 1398(g)(6).


22. 804 F.2d 84 (7th Cir. 1986).

23. Id.


26. I.R.C. § 121(b).