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SALE OF RESIDENCE IN TRUST: IS THE EXCLUSION AVAILABLE?

— by Neil E. Harl

With more use of trusts, particularly revocable inter vivos trusts, the question is being raised with increasing frequency as to whether sale of the residence by the trust is eligible for the $250,000 exclusion from income ($500,000 for married taxpayers) on a joint return. The stakes are high and may influence whether a residence is placed in trust.

What's necessary for eligibility

The authority on this issue began to emerge shortly after the enactment in 1964 of Section 121 of the Internal Revenue Code which currently allows the exclusion. In 1966, the Internal Revenue Service ruled that gain realized from the sale by a trust of property used by the grantor as the grantor’s principal residence qualified for non-recognition on rollover of the gain into a replacement residence. Although that ruling appeared shortly after enactment of I.R.C. § 121 the ruling did not address the effect of trust ownership on the residence exclusion.

Rev. Rul. 85-45, issued in 1985, provided detailed guidance on eligibility of trust-owned residences for the exclusion. That ruling involved a marital deduction trust for the wife at the husband’s death. Their principal residence was made part of the corpus of the trust. Four years later, the residence was sold. The wife treated the gain from the sale as excludible under I.R.C. § 121.

The ruling points out that the wife, under the husband’s will, had the power to vest the trust corpus or income therefrom in any person including herself. Therefore, the wife was treated as the owner of the entire trust for federal income tax purposes. Since she was treated as the owner of the entire trust, the sale of the residence was treated for federal income tax purposes as if made by the wife. Therefore, the wife could exclude from gross income the gain from the sale of the residence.

The 1985 ruling was consistent with three earlier private letter rulings. In a 1980 private letter ruling, the residence was owned by a revocable inter vivos trust. Since the grantor was treated as the owner of the trust, the transfer of residence title to the revocable inter vivos trust did not disqualify the grantor from claiming the exclusion for the gain on the residence. A mid-1982 private letter ruling involved a residence owned by an irrevocable inter vivos trust. Because a non-adverse party was serving as trustee, the grantor’s son, and the son was the holder of a 25 percent remainder interest in principal and accumulated income, the grantor was treated as the owner of...

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75 percent of the trust. A late 1982 private letter ruling involved a revocable inter vivos trust. The grantor requested a ruling as to whether transfer of the title to the residence (which was community property) to the trust would disqualify the grantor from the exclusion for the gain. Because the grantors had reserved the power to revoke the trust, the grantors were treated as the owners of the entire trust. Thus, the grantors were not disqualified from claiming the exclusion on sale of the residence. The ruling specified, however, that the ruling was “strictly limited to the period of time in which both...are alive, neither...becomes subject to a judicial determination of incompetence, and [the grantor] may fully exercise the power to revoke [their] respective interests in the trust.”

More recent authority

A 1998 private letter ruling, involving a revocable inter vivos trust, allowed the exclusion on the sale of the residence owned by the trust.

In an early 2000 private letter ruling, the only asset held by a trust was the taxpayer’s residence. The taxpayer was the income beneficiary of the trust, established by the taxpayer’s parent. The taxpayer was currently living in an assisted care facility and the trustee was planning to either lease or sell the residence. The taxpayer had no power over trust corpus or discretionary authority to distribute trust corpus. The ruling holds that the taxpayer was not deemed to be the owner of the trust. Therefore, the trustee could not exclude any gain from the sale of the residence from trust income.

In conclusion

It is clear from the rulings to date, that, to the extent the grantor or beneficiary has sufficient authority over the trust or trust property to require that the grantor or beneficiary be considered the owner of the trust, such portion of the gain on the residence is excludible from income.

That suggests careful planning attention on whether the residence should be placed in trust and the powers exercisable over the trust and over trust property by the grantor or beneficiary. Indeed, it suggests that it may be wise to place the residence in the marital trust for that reason.

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FOOTNOTES

2. Pub. L. No. 88-272, Sec. 206(a); Pub. L. No. 97-34, Sec. 123, 95 Stat. 197 (1981), amending I.R.C. § 121 (excluded amount increased to $125,000 ($62,500 on separate return)).
5. See note 2 supra.
15. See Treas. Reg. § 1-672(a)-1(a).
16. See note 13 supra.
17. Id.
21. Id.
24. Id.
25. I.R.C. § 121.

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CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

FEDERAL TAX-ALM § 13.03[7].

POST-PETITION INTEREST. The IRS filed a claim for nondischargeable taxes in the debtor’s Chapter 11 case. The plan provided for full payment of the claim, but as required by Section 502(b)(2), no provision was made for payment of post-petition and pre-confirmation interest (so-called gap interest). The court held that the debtor was personally liable for the gap interest because (1) Section 502(b)(2) prevented the bankruptcy estate from paying that interest; (2) because the interest was not a liability of the estate, the plan did not estop the IRS from collecting the interest from the debtor; and (3) the underlying tax was nondischargeable so the gap interest was nondischargeable. In re Stacy, 2000-1 U.S. Tax Cas. (CCH) ¶ 50,481 (Bankr. W.D. Va. 2000).

TAX LIEN. The debtor was married but filed for Chapter 13 separately. The debtor and spouse filed a joint income tax return for 1994 and the IRS filed a claim for taxes owed for that year. The IRS filed a notice of tax lien for the 1994 taxes and the issue was whether the lien included the value of the debtor’s entire residence or only the debtor’s interest.