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MORE DETAIL ON THE PRINCIPAL RESIDENCE EXCLUSION

— by Neil E. Harl

Temporary¹ and final² regulations issued in late 2002 for the exclusion from income of gain on the principal residence³ provide helpful guidance in claiming the $250,000 exclusion ($500,000 on a joint return).⁴

What is a principal residence?

The final regulations provide useful detail on what is a “principal residence” as required for the exclusion.⁵ Mirroring the regulations issued for the now-repealed provision on sale of the principal residence and reinvestment of the proceeds in a replacement residence,⁶ the final regulations issued for purposes of the exclusion of gain from income state that a residence can include a houseboat, a house trailer or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation.⁷ The term “residence,” not surprisingly, does not include personal property that is not a fixture under state law.⁸

In addition to the taxpayer’s use of the property, relevant factors in determining a taxpayer’s principal residence include, but are not limited to—(1) the taxpayer’s place of employment; (2) the principal place of abode of the taxpayer’s family members; (3) the address listed on federal and state tax returns, driver’s license, automobile registration and voter registration card; (4) the taxpayer’s mailing address for bills and correspondence; (5) the location of the taxpayer’s banks; and (6) the location of religious organizations and recreational clubs with which the taxpayer is affiliated.⁹ This additional specificity is obviously directed at those situations where taxpayers exclude gain on additional residences (such as vacation homes) after meeting the technical occupancy requirements.¹⁰

The final regulations address the eligibility of vacant land for the exclusion.¹¹ The sale or exchange of vacant land is not a sale or exchange of the principal residence unless—(1) the vacant land is adjacent to land containing the dwelling unit of the taxpayer’s principal residence; (2) the taxpayer owned and used the vacant land as part of the taxpayer’s principal residence; (3) the taxpayer sells or exchanges the dwelling in a sale or exchange that meets the requirements for the exclusion within two years before or two years after the date of the sale or exchange of the vacant land; and (4) the requirements have otherwise been met for the exclusion with respect to the vacant land.¹²

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Partial interests and remainder interests

A taxpayer can apply the exclusion to gain from the sale or exchange of partial interests (other than remainder interests) if the interest sold or exchanged includes an interest in the dwelling unit. Only one exclusion amount can be claimed for the combined sales or exchanges of the partial interests, however.

The final regulations did not change significantly the rules governing the eligibility of remainder interests for the exclusion. A remainder interest is eligible for the exclusion if the person acquiring the interest is not a related person and if it is the taxpayer’s principal residence. The election may not be made for sales or exchanges to related parties.

Ownership of residence by trust

Under the regulations issued in late 2002, if a residence is held by a trust, a taxpayer is treated as the owner and the seller of the residence during the period that the taxpayer is treated as the owner of the trust or the portion of the trust that includes the residence under the grantor trust rules applicable to the residence. That passage addresses situations like that discussed in a 2000 private letter ruling where the trust beneficiary (a disabled daughter) was not deemed to be the owner of the trust as the owner of the residence and, therefore, was not eligible for the exclusion.

Other entities

The regulations specify that if a residence is held by an entity with a single owner (such as an LLC) and is disregarded for federal tax purposes as an entity separate from its owner, the owner is treated as owning the residence.

A bankruptcy estate succeeds to the exclusion with respect to property transferred to the bankruptcy estate. This is in accord with the IRS position announced in 1999 after losing several cases on the issue.

Claiming a partial exclusion

A taxpayer who fails to meet the ownership and use requirements by reason of a change of place of employment, health or unforeseen circumstances is able to exclude the fraction of the $500,000 ($250,000 on a separate return) equal to the fraction of the exclusion for the years the requirement is met.

Temporary regulations address in detail what is meant by “change of employment,” “health” and “other unforeseen circumstances.”

• As for change of employment, a safe harbor is provided if the change in place of employment occurs during the period of the taxpayer’s ownership and use of the property and the new place of employment is at least 50 miles farther from the former place of employment or, if there was no former place of employment, the distance between the new place of employment and the residence sold or exchanged is at least 50 miles.

• A sale or exchange is for reasons 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 of a “qualified individual” or to obtain or provide medical or personal care for a “qualified individual” suffering from a disease, illness or injury. A safe harbor is provided if the primary reason for the sale or exchange is for health reasons based upon a physician’s recommendation.

• With respect to unforeseen circumstances, a sale or exchange meets the test if the primary purpose is the occurrence of an event the taxpayer does not anticipate before purchasing and occupying the residence. Safe harbors are provided in the event of an involuntary conversion of the residence, natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence; and, in the case of a “qualified individual,” death, cessation of employment, change in employment or employment status that results in the taxpayer’s inability to pay housing costs and reasonable basic living expenses of the taxpayer’s household (but not for an affluent or luxurious standard of living); divorce or legal separation under a decree of divorce or separate maintenance; multiple births resulting from the same pregnancy; or an event determined by the commissioner in published guidance.

A “qualified individual,” which is important in determining the scope of the provisions, means the taxpayer, taxpayer’s spouse, co-owner of the residence or a person whose principal place of abode is in the same household as the taxpayer or, for purposes of health reasons, a related individual within the meaning of I.R.C. § 152(a)(1) through (8).

FOOTNOTES

4. I.R.C. § 121(a), (b).
5. I.R.C. § 121(b)(1), (2).
8. Id.
10. See I.R.C. § 121(a).
12. Id.
15. See I.R.C. § 121(d)(8).
16. Id.

* Agricultural Manual (ALM).
CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

FENCE. The disputed land was located on the defendant’s side of a fence which ran between the parties’ properties. The fence was constructed over 50 years ago and was continuous except for periods in the winter when the property was used for winter sports by the nearby town. The parties had treated the fence as the boundary line until the plaintiff had the properties surveyed. The defendant claimed title to the property by adverse possession and the plaintiff argued that no adverse possession occurred because the fence was one of convenience. The defendant denied this and supported its claim by years of use for grazing of cattle and horses. The court noted that the fence was constructed in a straight line and did not deviate for natural obstacles; therefore, the fence was not constructed for convenience but was intended to mark the boundary line. Davis v. Chadwick, 55 P.3d 1267 (Wyo. 2002).

BANKRUPTCY

GENERAL-ALM § 13.03.*

SETOFF. The farm debtor originally filed for Chapter 7 and that case was closed and the debtor personally discharged of debts, including secured debts owed to the FSA. The creditor sought foreclosure of those secured debts but the foreclosure was delayed by the debtor’s filing for Chapter 12. The debtor was allowed to enroll in federal farm programs post-petition and became entitled to payments under those programs. The USDA sought a setoff of the farm program payments against the secured debts. The court held that, because the debtor was relieved of personal liability for the secured debts in the prior Chapter 7 case, there existed no mutual personal debts between the USDA and the debtor to support a setoff under Section 553(a). In re Myers, 284 B.R. Bankr. D. N.M. 2002.

FEDERAL TAX-ALM § 13.03[7].

TAX LIENS. The debtors filed for Chapter 7 and the estate consisted of various exempt and non-exempt properties. The IRS had filed a pre-petition tax lien against the property of the debtors. The debtors sought a ruling that the tax lien did not attach to property claimed as exempt in the bankruptcy case. The debtors argued that I.R.C. § 6331 excluded exempt property from a tax lien. The court noted, however, that Section 6331 speaks only to exemption from levy and does not affect tax liens; therefore, the court held that the tax lien attached to the exempt and non-exempt assets of the debtors. In re Goodykoontz, 284 B.R. 235 (Bankr. N.D. W. Va. 2002).

FEDERAL AGRICULTURAL PROGRAMS

EGGS. The AMS has issued proposed regulations amending the voluntary shell egg grading program by clarifying the requirements for using the “Produced From” grademark for shell eggs. As currently written, the regulations state that the “Produced From” grademark may be used to identify products for which there are no official U.S. grade standards (e.g., pasteurized shell eggs), provided that these products are approved by the Agency and are prepared from U.S. Consumer Grade AA or A shell eggs under the continuous supervision of a grader.” The proposed regulations remove the words “under the continuous supervision of a grader.” 68 Fed. Reg. 1169 (Jan. 9, 2003).

FARM LOANS. The FSA has issued proposed regulations which eliminate the 30-day past-due period prior to a determination that the borrower is delinquent and clarify the use of the terms “delinquent” and “past due”