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Installment Sale with Section 121 Exclusion Followed by Repossession

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Installment Sale with Section 121 Exclusion Followed by Repossession

-by Neil E. Harl*

A 2014 Tax Court case, *DeBough v. Commissioner*,[1] has clarified the handling of an installment sale transaction involving the sale of a principal residence where the buyer defaulted with the property repossessed by the original seller.[2] The decision places a premium on acting promptly to resell after repossession if the Section 121 exclusion has been applied in the original transaction.[3] The income tax consequences of the repossession can be significant if resale is delayed for more than a year.[4]

The facts of the case

In *DeBough v. Commissioner*,[5] the taxpayer sold the principal residence in 2006 for $1,400,000 with payments stretched over eight-years under an installment contract with the balance due in 2014. The seller had received $505,000 in payments at the time of the default and repossession of the property. The income tax basis, which was not contested, was $742,204. The seller had excluded the maximum of $500,000 of gain on the sale under the § 121 exclusion.[6] The seller treated the reacquisition in 2009 as a reacquisition of the property under I.R.C. § 1038 but assumed the § 121 exclusion still applied.

Relationship of § 121 exclusion to § 1038

Section 121 allows electing taxpayers to exclude gain resulting from the sale or exchange of property constituting the principal residence up to $500,000 for those married who file a joint return, $250,000 for a separate return.[7] That is the case if the property in question had been owned and used as their principal residence for periods aggregating two or more years over the five-year period before sale.[8] If reported as an installment sale, the gain is reported over the term of the installment contract.[9]

The general rule for repossessions. In the event of repossession on default by the purchaser under an installment sale, the original seller is restored to their position before the sale of the property with gain or loss ignored on repossession.[10] However, if the seller has received ". . . money and . . . other property" as payments before the repossession, the seller is taxed on the gain attributable to those payments ". . . to the extent that those amounts have not been previously reported as income."[11] The resale is essentially disregarded and the resale is considered to constitute a sale of the property as of the original sale. The subsequent resale is treated as part of the original sale of the property. In general, the resale is treated as having occurred on the date of the original sale. An adjustment is made to the sales price of the "old" residence and the basis of the "new" residence. Thus, on repossession, the

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amount of gain recognized is the lesser of - (1) the amount of cash and the fair market value of other property received prior to the reacquisition (but only to the extent such money or other property exceeds the amount of gain reported prior to the reacquisition); or (2) the amount of gain realized on the original sale (adjusted sales price less adjusted income tax basis) in excess of the gain previously recognized before the reacquisition and the money or other property transferred by the seller in connection with the reacquisition.[12]

But what if § 121 has been elected? In the event a Section 121 exclusion has been used in the transaction to reduce the reportable gain, if the original seller resells the property within one year from the date of reacquisition of the property by the original seller, the repossession is effectively ignored.[13] If the one-year rule is *not* met, and the sale of the real property gives rise to indebtedness to the seller which is secured by the property which has been sold, and the seller reacquires the property in full satisfaction of the indebtedness, the seller does not recognize gain or loss on the reacquisition.[14]

What about the § 121 exclusion? There is nothing in either § 121 or § 1038 that restores the § 121 exclusion. Therefore, sellers who reacquire a principal residence *but do not resell within the one-year period* must recognize any gain under I.R.C. § 1038(b) which apparently overrides § 121.[15] The taxpayer is taxed on the income received ". . . ..absent any applicable exclusion or deduction."[16] An adjustment is made to the income tax basis of the reacquired residence. By going beyond the one-year statutory limit, the taxpayer has effectively sacrificed the § 121 exclusion.

The Tax Court in *DeBough v. Commissioner*[17] gave short shrift to the argument that such a result was surely not intended by the Congress. However, until amended (if it ever is) or the case is reversed on appeal, the outcome is clear and represents a literal reading of the statute.

It should be noted that no bad debt deduction is permitted for a worthless or partially worthless debt secured by a reacquired personal residence and the income tax basis of any debt not discharged by the repossession is zero. Losses are not deductible on the sale or repossession of the reacquired residence.

Character of the gain from reacquisition under § 1038

The character of the gain from reacquisition under § 1038 is determined by the character of the gain from the original sale. For an original sale reported on the installment method, the character of the reacquisition gain is determined as though there had been a disposition of the installment obligation.[18] In general, that would be capital gain. If the sale had been reported on the deferred payment method, and there was voluntary repossession of the property, the seller would report the gain as ordinary income.

The adjusted income tax basis for the property is the sum of three amounts – (1) the adjusted income tax basis to the seller of the indebtedness, determined as of the date of repossession; (2) the taxable gain resulting from the reacquisition; and (3) the money and other property (at fair market value) paid by the seller as reacquisition costs.

The holding period for the reacquired property, for purposes of subsequent disposition, includes the period during which the seller held the property prior to the original sale plus the period after the reacquisition.[19] However, the holding period *does not include the time between the original sale and the date of reacquisition*.

ENDNOTES

[1] 142 T.C. No. 17 (2014).

[2] See generally 6 Harl, *Agricultural Law* §§ 48.02[5], 48.03[10] (2014); Harl, *Agricultural Law Manual* § 6.03[2] (2013); 1 Harl, *Farm Income Tax Manual* § 2.12[3][a] (2014 ed.).

[3] See I.R.C. §§ 121, 1038(e).

[4] I.R.C. § 1038(e).

[5] 142 T.C. No. 17 (2014).

[6] I.R.C. § 121(b)(1), (2).

[7] I.R.C. § 121(b)(1), (2).

[8] I.R.C. § 121(a).

[9] I.R.C. § 453.

[10] I.R.C. § 1038.

[11] I.R.C. § 1038(b)(1).

[12] I.R.C. § 1038(b)(2).

[13] I.R.C. § 1038(e).

[14] I.R.C. § 1038.

[15] DeBough v. Comm'r, 142 T.C. No. 17 (2014).

[16] *Id*.

[17] 142 T.C. No. 17 (2014).

[18] See Treas. Reg. §§ 1.1038-1(d), 1.453-9(a).

[19] Treas. Reg. § 1. 1038-1(g)(3).