The Home Sale Gain Exclusion

A Historical Perspective

By Robert Clovey and Richard L. Russell

On June 30, 2008, Congress passed the Housing and Economic Recovery Act (HERA; H.R. 3221). The act continues Congress' tradition of providing homeowner preferences and incentives that began over 50 years ago (e.g., IRC section 121). While HERA placed minor restrictions on taxpayers selling homes and excluding gains, its net effect was to continue the established policy of providing preferences to homeowners.

A cursory review of the tax code reveals that there is an unmistakable bias toward homeowners. As an example, before the implementation of IRC section 121 with its $250,000/$500,000 exclusion of home sale gains, homeowners generally avoided paying taxes on home sale gains altogether by rolling over the proceeds from the sale of their homes to a new home within two years of the sale. (See Christine A. Klein, "A Requiem for the Rollover Rule: Capital Gains, Farmland Loss, and the Law of Unintended Consequences," *Washington and Lee Law Review,* vol. 403, 1998.)

Codification of homeowner preferences began with the Revenue Act of 1951. The act implemented a gain rollover provision that, with few exceptions, remained in the code until 1997. Because the preferences were born out of a reverence for home ownership, some will find it surprising that these preferences are also related to involuntary conversions of ships lost by their owners during World War I.

A close examination of the history of realized gains from home sales as a tax preference can provide a context to the current state of affairs.

Gross Income

The concept of gross income was first codified in 1939, when IRC section 22 defined gross income as "gains, profits, and income derived from salaries, wages, or compensation for personal service … or transactions of any business carried on for gain or profit, or gains or profits and income derived from whatever source." Even though the clause "gains or profits derived from any source" implies that the list is not intended to be exhaustive, taxpayers frequently challenged the IRS's ability to tax items that were not specifically included on the list. (See *James v. United States,* 366 U.S. 213 and *Comm'r v. Glenshaw Glass Co.,* 348 U.S. 426.)

In 1954, the definition of gross income was moved from IRC section 22 to section 61, and the language was changed to: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived." The phrase "except as otherwise provided" clearly communicates to taxpayers that unless the taxpayer can specifically find authority to deduct or exclude items from income in the text of the code, the income in question is taxable and must be reported on the taxpayer's tax return. The only receipts outside the scope of IRC section 61 are return of capital and loan proceeds that are protected by the U.S. Constitution. The preferential treatment of gains from the sale of homes does not stem from any taxpayer right but is granted through legislative action.

Tax Exemption Versus Tax Deferral

Under the U.S. tax system, income from property is not taxed (recognized) until there is a realization event. That is, gain from property is not recognized until the owner sells or exchanges the property with an unrelated party. In determining whether any income or gain is recognized on the sale or exchange, taxpayers first reduce the amount realized by the unrecovered basis in the asset. This reduction produces a realized gain or loss on the asset. When taxpayers can find a provision in the tax code that allows them to defer or permanently exclude the gain from taxable income, realized gain or loss on an asset is still not recognized.

Deferrals and exclusions are similar in that they both provide tax advantages to certain owners of properties. There is, however, a significant difference between the two: deferrals are a postponement of taxes while exclusions are tax-free transactions.

Taxpayers eligible for a tax deferral exclude realized gain from taxation until some later period of time as is permitted in the code. Deferrals are advantageous to taxpayers due to the time value of money; that is, a dollar paid in taxes today is worth more than a dollar paid tomorrow. To demonstrate, assume that under the code, Bob, a 25% marginal rate taxpayer, can defer paying taxes on a $20,000 taxable gain until five years in the future. Further assume a 5% market rate of interest compounded annually. If Bob pays the taxes today, his income tax expense is $5,000 ($20,000 × .25). If, however, Bob is eligible for a deferral, he can invest approximately $3,918 at the 5% market rate of interest and accumulate $5,000 in five years—a $1,082 savings.

Exclusions are even more advantageous to taxpayers with recognized gains, because they are permanently excluded from taxation. If, in the example above, Bob had a $20,000 gain that was excluded from income, he would never pay income taxes on the transaction.

Involuntary Conversions

During World War I, the U.S. government requisitioned or condemned privately owned ships in support of the war effort. Other ship owners contracted their ships out for war-related efforts. Ship owners with condemned ships—or those with ships sunk by torpedoes in war-related activities—were compensated for their loss and were often forced to recognize gains on these transactions. After paying income taxes on these unintentional gains, they were not able to purchase a comparable ship with the net proceeds. The U.S. secretary of the Treasury was sympathetic to their plight and, in a letter to the House Ways and Means Committee, he urged Congress to provide them with tax relief in the Revenue Act of 1918. The secretary argued that to tax gains realized from involuntary conversions in cases where the owner reinvested the proceeds was unfair. (See *American Natural Gas Company v. United States,* F.2d 220, 225-26, citing the secretary of the Treasury's letter to the Ways and Means Committee.) Ultimately, relief was provided to the ship owners and other owners of capital assets under then–IRC section 1033, "Involuntary Conversions."

Example. John's ship, with a fair market value (FMV) of $150,000 and adjusted basis of $80,000, was condemned by the government during World War I. Assuming the government pays John $150,000, he has a realized gain of $70,000 on the condemnation. If John's $70,000 realized gain were taxable, the net proceeds would not be sufficient to replace the ship at an FMV of $150,000.

Codification of the involuntary conversions rules gave taxpayers in situations similar to John's the option of deferring recognition of unintentional realized gains until there was a taxable disposition of the property. John could elect to defer recognition of the gain on the ship or pay income taxes in the year of compensation. To qualify for gain deferral, he would be required to reinvest the net proceeds received in a property similar or related in service or use to the converted property. In addition, the property must be replaced within two years after the close of the tax year in which the gain was realized (IRC section 1033). John must adjust his basis in the acquired property (i.e., reduce his basis) by the amount of the unrealized gain.

Rollover Rule

The tax preference for home sale gains—also known as the rollover rule—first appeared in section 318(a) of the Revenue Act of 1951, codified as IRC section 1034 in 1954. Congress' goal was to "eliminate a hardship" on homeowners who sold property as necessitated by change in family size or change in employment. [See H.R. Rep. No. 82-586 at 27 (1951).] The rollover rule allowed taxpayers to defer taxes on home sale gains if the taxpayer purchased a new home within one year of the sale.

Specifically, the text of IRC section 1034 (repealed) of the 1954 code provided that "where the sale of a taxpayer's principal residence is followed within a period of one year by the purchase of another residence, or where another residence is purchased within 1 year prior to the sale of the taxpayer's principal residence, no gain is to be recognized except to the extent that the selling price exceeds the price of the new residence." Homeowners taking advantage of this provision were required to adjust the cost of the new home by the amount of any gain not recognized on the sale. The home sale provision also applied to taxpayers building new residences where construction started within one year after the sale of the residence.

By the late 1990s, Congress had made so many changes that the once limited exclusion had become almost unlimited.

Example. James purchased his principal residence in 1929 for $20,000 and, in 1954, sold the home for $25,000. Under section 318(a) of the Revenue Act of 1951, James had one year to reinvest by purchasing a new home or starting construction of a new home. Assuming the new home was purchased for $35,000, James' adjusted basis in the new home is $30,000 ($35,000 cost – $5,000 deferred gains).

From its beginnings in 1951 through its repeal in 1997, there were several notable changes or expansions to the rollover rule. Many of these were minor, such as IRC section 1034(i) adding the condemnation of properties to the definition of a section 1034 sale. The Tax Reform Act of 1976 allowed home sellers to add expenses incurred for certain work performed to the adjusted basis of the home. Other changes were more substantial, such as P.L. 94-12 and P.L. 97-34, which extended the deferral periods from one year to 18 months and from 18 months to two years, respectively.

Rollover/Partial Exclusion

Home sale preferences reached a high point with the passage of the Revenue Act of 1964 (P.L. 88-272), giving taxpayers with home sale gains the option to roll over, exclude, recognize home sale gains as capital gains, or some combination of all three. This exclusion was codified under IRC section 121. At the time, the IRC section 121 exclusion could be used in combination with the section 1034 rollover. Initially, this exclusion was extremely restricted in that it provided eligible taxpayers a once-in-a-lifetime election to exclude a portion of home sale gain from taxable income. Only taxpayers 65 years or older who had owned and used their homes as their principal residence in any five of the past eight years were eligible to utilize the exclusion. Furthermore, the exclusion amount was limited whenever the adjusted sales price (sales price minus expenses) exceeded $20,000 (later increased to $35,000). Homeowners could elect to exclude a portion of the gain in the ratio of total gain to adjusted sales price. Any excess gains not eligible for exclusion could be rolled over under IRC section 1034. In effect, qualified taxpayers selling homes with an adjusted sales price of $20,000 or less could elect to exclude the total gain.

Example. Assume all of the facts in the example above, except that James sold his home in 1965 at the age of 65. James could make a onetime election to exclude $4,000 ($20,000 ÷ $25,000 × $5,000) of the gains from taxable income. James could take advantage of both IRC sections 121 and 1034 by rolling the additional $1,000 of gain over. Another alternative would be to have the $1,000 taxed as a capital gain.

1978 Expansion of the Exclusion

In 1978, Congress made a second round of major changes to homes sale preferences. Concluding that the taxes imposed on homeowners who sold their homes and did not use the IRC section 1034 rollover provisions, or who sold their homes and moved into less expensive homes, "may be unduly high," Congress passed P.L. 95-600, which lowered the eligible age from 65 years and older to 55 and over. A second significant adjustment of P.L. 95-600 increased the gain exclusion amount to a maximum of $100,000 (increased to $125,000 in 1981). Finally, P.L. 95-600 reduced the ownership and principal residence use requirement from five out of eight years to three out of five years immediately preceding the date of sale.

Example. Assume that Sam, age 55, sold his home in August 1978 for $250,000. Sam had purchased the home in 1972 for $120,000 and used it as rental property from 1972 to 1974 and as his principal residence from 1975 until the sale. Because Sam had owned and occupied the home for at least three of the past five years as his primary residence, he has the following options under P.L. 95-600: Sam could make a onetime election to exclude up to $100,000 gain from taxable income or he could defer taxation on the gain by purchasing a home *at equal or greater cost* and rolling the gain over under IRC section 1034. (Other alternatives might include paying the capital gains tax and considering a combination of rollover and exclusion.)

1997 Changes: Exclusion Only

The Taxpayer Relief Act of 1997 ended the rollover as a preference by repealing IRC section 1034. But the act provided the following significant changes to IRC section 121:

- The age requirement was completely eliminated from the code.
- The exclusion amount was increased from $125,000 per individual or married couple to $250,000 per individual and $500,000 per married couple.
- The once-in-a-lifetime requirement was changed to once every two years. This change allowed the exclusion to be used multiple times.
- The ownership and use requirement was reduced from three of the past five years to two of the past five years.

Example. Jane, a single taxpayer, sold her personal residence on January 1, 2008. She had purchased it on January 1, 2003, and used it as a rental property for the first three years until January 1, 2006. On January 1, 2006, Jane moved into the property and used it as her personal residence for two years. Under this application of IRC section 121, Jane can exclude realized gains of up to $250,000 on the property. During the five-year period ending on the date of sale (January 2, 2003 to January 1, 2008), Jane owned and used the property as her principal residence for an aggregate of at least two years, thus qualifying for the exclusion (as long as Jane has not used the IRC section 121 exclusion in the past two years).

Recent Changes, HERA

HERA made significant changes to IRC section 121 that are effective for transactions (sales or exchanges) occurring after December 31, 2008. The legislation did not expand homeowner preferences as did the Taxpayer Relief Act of 1997; rather, it closed a loophole for taxpayers taking advantage of those preferences. In general, HERA restricts IRC section 121 exclusions to gains incurred when the property was used as a primary residence.

The criteria used to determine whether taxpayers are eligible to use the IRC section 121 exclusion remain the same—the ownership and use test and the once-in-two-years requirement. The amount of gain eligible for exclusion is significantly impacted, however. HERA added IRC section 121(b)(4)(5), the effect of which is to include a portion of the previously excluded gain in gross income whenever there are periods of "unqualified use." Unqualified use is any period or portion thereof after January 1, 2009, where the taxpayer, the taxpayer's spouse, or the taxpayer's former spouse do not use the property as their primary residence. The effect is that taxpayers selling their residence at a gain with periods of unqualified use are no longer allowed the full exclusion amounts of $250,000/$500,000.

IRC section 121(b)(4)(5) allows a taxpayer to sell property at a gain, but the gain must be allocated if there are periods of "qualified" and "unqualified" use. The portion allocated to unqualified use is not eligible for exclusion under IRC section 121 and must be included in gross income. The allocation to unqualified use is based on a ratio whereby the period of ownership is the denominator and the period of unqualified ownership is the numerator.

Example. Assume the same facts from the example above, except that the transaction takes place after the effective date of the new provision. Jane, a single taxpayer, will sell her personal residence on January 1, 2014. She had purchased it on January 1, 2009, and used it as a rental property for the first three years until January 1, 2012. On January 1, 2012, Jane moved into the property and used it as her personal residence for two years. This transaction will be covered under the new provisions, and Jane's section 121 exclusions is now limited. In the five-year period ending on the date of sale (January 2, 2009 to January 1, 2014), Jane owned and occupied the property as her primary residence for at least two years. For three of the five years of ownership (60%), the property was not used by Jane, but was rented. This rental use will be considered unqualified use, and 60% of the realized gain will not be eligible for exclusion and will be included in income. If the realized gain after depreciation was $200,000, then $120,000 (60%) of this gain is disqualified and must be included in gross income.

A Historical Bias

The $250,000/$500,000 home sale gain exclusion under IRC section 121 continues a long line of tax preferences for homeowners. This began with the rollover provision under IRC section 318(a), where taxpayers were given the opportunity to postpone paying taxes on gains from the sale of a primary residence. The rollover was justified on the grounds that taxing home sale gains created a hardship on taxpayers in the defense industry selling their primary residences because of job transfers. Congress decided that the realization of these unintended gains should be deferred in a manner similar to involuntary gains under IRC section 1034—implemented to provide tax relief to owners of ships lost during WWI.

Later, homeowner preferences were expanded from a tax postponement provision under IRC section 1033 to a tax postponement and limited, once-in-a-lifetime exclusion under IRC section 121. The initial intent of the rollover and the limited exclusion was to provide some tax relief to home sellers over 65 years of age. By the late 1990s, Congress had made so many changes that the once limited exclusion had become almost unlimited. Individuals were able to exclude gains not only on primary residences but also on homes purchased and used as vacation homes and rental properties. The Housing and Economic Recovery Act of 2008 put some limitations on section 121 gain exclusions as an attempt to curb this abuse. While recent limitations reverse the trend of ever-expanding home sale preferences somewhat, given the current state of the housing market, CPAs should not be surprised if these preferences are expanded in the near future. ❑

Robert Clovey, MS, CPA, *is an assistant professor of accounting and finance at York College/CUNY, Jamaica, N.Y.* ***Richard L. Russell, MBA, JD, CPA,*** *is an assistant professor of accounting in the department of accounting at Jackson State University, Jackson, Miss.*