**INCOME TAX RULES RELATING TO SALE OF PRINCIPAL RESIDENCE**

**The Taxpayer Relief Act of 1997 established new rules for the treatment of gain on the sale of a principal residence. Under the prior law, IRC  1034, this gain could be deferred if a home of equal or greater value was purchased within two (2) years before or after the sale of the taxpayers principal residence. In addition, taxpayers over 55 could claim a one-time $125,000 exclusion.**

**The Taxpayer Relief Act of 1997 repealed IRC  1034 for sales of principal residences after May 6, 1997. The provision was replaced by an expanded and revised IRC   121, which generally provides complete nonrecognition of up to $500,000 of gain recognized by all individual taxpayers. To qualify for exclusion under IRC  121(a), the taxpayer must have owned and used the home as his principal residence for at least two of the five years preceding the date of the sale of the home. As long as the sale of the residence is not more than three years after one of the former spouses abandons the use of the residence to the other, IRC  121 should be available, assuming that the other qualifying conditions have been met. The exclusion may be claimed as often as once every two years.**

**If the parties file a joint income tax return for the taxable year of the sale they may claim a $500,000 exclusion, provided the following requirements are met:**

**(i) Either spouse has owned the property during two of the 5 years preceding the date of the sale;**

**(ii) Both spouses used the property during the 5 year period ending on the date of the sale as his/her principal residence, for periods aggregating 2 years or more;**

**(iii) Neither spouse used the exclusion for a sale within the preceding two years.**

**Taxpayers who sold their homes before August 5, 1997, or pursuant to a binding contract entered into before August 5, 1997 may elect to use the old rules.**

**It's usual in matrimonial matters for one spouse to move out while the other remains in the jointly owned family home. Under prior law, if the home was later sold, the spouse who had moved out would lose the ability to elect non-recognition treatment because the home no longer qualified as his or her principal residence. The Taxpayers Relief Act of 1997 alleviates this problem. If the departing spouse has lived in the home for at least two years when he or she moves out, up to three years can pass before the home is sold without loss of the exclusion.**

**IRC  21 (d)(3) provides that an individual is treated as having used a home as a principal residence during any period of ownership while the individual's spouse or former spouse is granted use of the home under a divorce or separation instrument. For example, if H and W divorce in 1998 and W is awarded use of their jointly owned home for ten years, when they sell the home in 2008, each may claim an exclusion of up to $250,000.**

**IRC  21(d)(3) permits tacking of spouses ownership periods. For example, assume W owns the family home and transfers it to H pursuant to a divorce judgment. The transfer is tax-free to W as a transfer incident to divorce. Ordinarily, H would have to wait two years to meet the ownership requirements and qualify for the exclusion. A special rule, however, provides that the amount of time H owns the home includes the period the transferor owned the property.**

**Under the normal two-out-five-years ownership and use test that must be met to qualify for the exclusion if H owned the family residence but it was awarded to W in a divorce proceeding, W would not be eligible for nonrecognition on a sale in the two years following the transfer. Under the special rule of IRC  121(d)(3)(A), however, if property is acquired in a transfer to which ' 1041 applies - as in the case of transfers incident to a divorce - the transferee spouse gets to tack the transferor spouse's ownership period. For example, if H purchased a family residence into which H and W moved on July 1, 1998, and on December 31, 1999 H and W were divorced and the family residence was transferred to W, W would satisfy the ownership requirement as of July 2, 2000. Because IRC  121(d)(3)(A) applies whenever a transfer is subject to IRC  1041, which applies to all transfers between spouses, IRC  121(d)(3)(A) also assures that the ownership test is met whenever for any purpose there is a transfer of interests in the family's principal residence between spouses within two years preceding the sale of the residence, provided, however, that one or the other of the spouses owned the residence for at least two years prior to sale.**

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