Multiple Taxpayers Can Exclude Capital Gains Upon the Sale of Their Primary Residence

Section 121 of the Internal Revenue Code and Section 1.121 of the Treasury Regulations

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Parties that can elect to exclude their capital gain income tax liability on the sale of their primary residence under Section 1.121 of the Department of the Treasury Regulations is a topic not directly addressed under Section 121 of the Internal Revenue Code ("121 Exclusion"), and therefore is subject to some debate.

Upon close examination of Congressional intent in enacting the provision and the subsequent administrative and legal interpretations of its applicability, it is clear that the 121 Exclusion provides a $250,000 exclusion for *each* qualified taxpayer that owns title to the property, and a $500,000 exclusion for married couples that file jointly, and NOT a single 250,000 or 500,000 election per property, upon the sale of the principal residence as many advisors have incorrectly represented.

The legislative history behind Section 112 of the 1939 Internal Revenue Code, the predecessor of Section 121 of the Internal Revenue Code and of Section 1034 of the Internal Revenue Code (since repealed in 1997) in the 1954 Code, indicates that Congress was trying to relieve the tax burden of taxpayers who were forced to sell and replace their residences because of an increase in the sizes of their families or because of a change in the place of the taxpayers' employment.[1]

Although Congress was primarily concerned with providing relief for this forced type of sale, Congress recognized that it would be too administratively burdensome to confine the provision's application, and extended relief to all residential sales that meet the requirements.[2]

There is nothing in the legislative history that supports the contention that Congress intended to restrict this benefit solely to one individual taxpayer, where title to the property is held in a joint tenancy or a tenancy-in-common. Rather, if the original intent of the enactment was to provide relief for taxpayers upon the forced sales of their primary residence, it is reasonable to believe that the U.S. Congress intended

[1] S.Rep. No. 781, 82d Cong., 1st Sess. 34 (1951), 1951-2 C.B. 458, 482.
[2] *Rev. Rul. 83-50, 1983-1 C.B. 41.*

that relief to be available to all parties adversely effected by the sale of their primary residence and eligible under the Treasury Regulations[3] so that where title to the relinquished property is held by two completely separate and individual taxpayers, both taxpayers are eligible to elect to exclude the maximum amount based on their ownership interest in their primary residence.

The materials issued by the Internal Revenue Service and the Department of the Treasury to clarify the applicability of the 121 Exclusion under different factual scenarios also supports the contention that multiple taxpayers may elect to take a 121 Exclusion upon the sale of a primary residence held as tenants-in-common.

In General Counsel Memorandum 38188 issued in 1979[4] the Internal Revenue Service explicitly stated that because the Treasury Regulations do not explicitly cover unmarried co-owners as a separate category, each individual is to be treated as a separate taxpayer for the purposes of Section 121.

This interpretation was based on several earlier Revenue Rulings: Revenue Ruling 67-234 establishes that where an unmarried individual holds title to the residence as a joint tenant or tenant-in-common, and meets all the age, use, and holding requirements of Section 121 of the Internal Revenue Code of 1954, that taxpayer is entitled to exclude from gross income that portion of the gain which is attributable to his undivided interest in the residence at the time of the sale, subject to the limitations of Section 121.[5]

This interpretation was again upheld by the Internal Revenue Service in Revenue Ruling 67-235, 67-2 C.B. 79, where it was held that property jointly owned by a brother and sister can be apportioned accordingly, so that each sibling may elect to take a 121 Exclusion for the portion of the jointly owned residence attributable to their interest.[6]

Early Private Letter Rulings ("PLRs") also support the contention that each individual taxpayer that jointly owns property may validly elect to exclude up to the statutory dollar limitation upon the sale of their primary residence in accordance with Section 121.

PLR 8942008 addressed the situation where a husband and wife (by the entireties) owned a property jointly with their mother. There were two houses on the property, one in which the husband and wife lived as their primary residence from 1983-1989, with the other house serving as the mother's primary residence from 1940-1987. In May of 1987, the mother voluntarily entered a state licensed home for the elderly, a facility for those physically or mentally unable to care for themselves, and husband, wife and mother requested clarification on whether they could sell the Property, including the

[3] Section 1.121 of the Department of the Treasury Regulations.
[4] GCM 38188 IRS GCM
[5] Rev. Rul. 67-234, 67-2 C.B. 78, 79.
[6] Rev. Rul. 67-235, 67-2 C.B. 79

houses, and exclude any gain under Section 121 of the Internal Revenue Code of 1986.

In their response, the Internal Revenue Service determined that Section 121 is available to joint owners of property otherwise qualifying for the benefits of Section 121. This premise was based in part on Revenue Ruling 67-234, 1967-2 C.B. 78, where the Internal Revenue Service ruled that an unmarried individual who held title to his primary residence as a joint tenant or tenant-in-common could exclude from his gross income under Section 121 that portion of the gain which was attributable to his undivided interest in the residence at the time of the sale. The Service also relied on Revenue Ruling 67-235, 1967-2 C.B. 79, in which it was held that a brother and sister who jointly owned their principal residence could utilize Section 121 to exclude from gross income the portion of the gain on the sale of the residence attributable to their undivided interests.

In light of these two Revenue Rulings, it is clear that Section 121 is available to joint owners of property who are not married, and further, that each joint owner may exclude gain limited to that portion attributable to their undivided interest in the residence from income taxation.

Based on the facts as represented, the Internal Revenue Service in PLR 8942008 ruled that Husband and Wife, as one joint owner, and Mother, as the other joint owner, may each exclude their share of the gain on the sale of Property, up to the statutory limits under Section 121 of the Internal Revenue Code of 1986, attributable to their undivided interest in the Property to the extent used by each joint owner as their primary residence.

In response to the frequency with which the issue required clarification by the Internal Revenue Service, final regulations regarding the permissibility of multiple elections under Section 121 for jointly owned property were issued in December of 2002, and codified in 2003-8 I.R.B 495.[7]

In 8-2003 I.R.B. 495, the Internal Revenue Service responded to the comments during the proposed ruling-making relating to the exclusion of gain from the sale or exchange of a taxpayer's primary residence under the Taxpayer Relief Act of 1997[8]:

> "Commentators requested further clarification of the application of the dollar limitations of Section 121(b) of the Internal Revenue Code to non-married taxpayers who are joint owners of a residence. In response, the final regulations provide that each unmarried taxpayer who jointly owns a principal residence may be eligible to exclude from gross income up to $250,000 of gain that is attributable to each taxpayer's interest in the property.

[7] *2003-8 I.R.B. 495, T.D. 9030, 67 FR 78358-01, 2003-1 C.B. 495*
[8] As amended by the Internal Revenue Service Restructuring and Reform Act of 1998

This eligibility is expressly illustrated by the provided hypothetical in the text of the regulation:

> "Example 1. Unmarried Taxpayers A and B own a house as joint owners, each owning a 50 percent interest in the house. They sell the house after owning and using it as their principal residence for 2 full years. The gain realized from the sale is $256,000. A and B are each eligible to exclude $128,000 of gain because the amount of realized gain allocable to each of them from the sale does not exceed each taxpayer's available limitation amount of $250,000.[9]"

Since the adoption and subsequent administrative/judicial interpretation of the 121 Exclusion, and particularly after the express endorsement under 8-2003 I.R.B. 495, individual taxpayers that jointly own the primary residence have both been deemed eligible to take an exclusion under Section 121 and encouraged to do so by the administrative material issued by the Internal Revenue Service.

In Internal Revenue Service Publication 523 (2004), the advisory material issued by the Internal Revenue Service annually to aid taxpayers in preparing their Federal Income Tax returns, the section entitled "Selling Your Home" provides the following guidance for taxpayers:

> "JOINTLY OWNED HOME. If you and your spouse sell your jointly owned home and file a joint return, you figure your gain or loss as one taxpayer.
>
> SEPARATE RETURNS. If you file separate returns, each of you must figure your own gain or loss according to your ownership interest in the home. Ownership interest is determined by state law.
>
> JOINT OWNERS NOT MARRIED. If you and a joint owner other than your spouse sell your jointly owned home, each of you must figure your own gain or loss according to your ownership interest in the home. Each of you applies the rules discussed in this publication on an individual basis."

The length and weight of precedent and legislation supporting the position that each individual non-married taxpayer with an interest in the primary residence is eligible to exclude the portion of gain attributable to their interest in the property is inconvertible, and accordingly, it is a position that practitioners may comfortably take when issuing advice to their clients.

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[9] (*2003-8 I.R.B. 495, T.D. 9030, 67 FR 78358-01, 2003-1 C.B. 495; pp. 78364-78365)*