Sale of Residence-Land

James R. Hasselback

A. Sale of Residence-Land

1. Married taxpayers purchased a house in 2014 for $400,000, with $100,000 of the price allocated to the purchase of the land, and $300,000 to the home. The taxpayers used the house as their principal residence for all of 2014, 2015 and 2016, before moving out at the beginning of 2017. Starting in 2017 they rented the house to tenants, before a fire decimates the house in 2018. At the time of the fire, the basis in the home – after being reduced for depreciation deductions while the home was rented – was $280,000. Because the value of the home had increased markedly, they received $650,000 of insurance proceeds to compensate them for the fire. Rather than use the proceeds to rebuild the home, they pocketed the cash. In 2019, they exchanged the underlying land for other land that they intend to hold for investment that is valued at $300,000 [Ltr. Rul. 201944066].

2. Sale of Residence Questions

   a. How do you treat:

      1) The disposition of the house in 2018?

      2) The disposition of the land in 2019?

3. Principal Residence Exclusion

   a. Section 121 of the Code allows an individual to exclude up to $250,000 of gain upon the sale of a home that was owned and used as the individual's "principal residence" for two of the five years preceding the sale.

      1) There are a host of rules under Section 121 that may expand or limit the available exclusion.

   b. Sale of Residence

      1) Three 2-Year Rules

         a) Must have owned the residence for two years

         b) Must have lived in the residence for two years

         c) Exclusion available only once every two years

2) The Section 121 exclusion increases to $500,000 for certain married couples.

   a) The exclusion doubles when:

      (1) One spouse or the other has owned the property for the required two-of-five year period prior to the sale,

      (2) Both spouses have used the property for the required two-of-five year period, and

      (3) Neither spouse has sold a principal residence and used Section 121 in the previous two years.

4. Depreciation

   a. Reg. Section 1.121-1(d) provides that the exclusion is not available against any previously claimed depreciation deductions against the residence.

5. Nonqualified Use

   a. A taxpayer has to reduce their available maximum exclusion by the amount of gain attributable to a period of "nonqualified use," i.e., when the property was being rented out.

   b. This rule only applies for periods after 2008.

      1) If the rental use comes before the home was used as a principal residence, the exclusion gets reduced; if the rental period comes after the taxpayer stops using the home as his or her principal residence, no allocation is required and the exclusion is not reduced.

         a) An example of nonqualified use is where the taxpayers purchased a house on January 1, 2001. They rented the house out through 2017. They lived in the house through 2020. The house was sold on December 31, 2020 for a $220,000 gain that does not include the gain on the depreciation. The unrelated use provision did not begin until 2009 and thus they had 9 years of unrelated use. The proportion of $220,000 gain eligible for the Section 121 exclusion is the 11 years of related use divided by the 20 years the house was owned. The nine years of ownership before the unrelated use provision was passed by Congress counts as related use plus the three years of living in the house equals the 12 years of related use. Thus, only $121,000 of the gain qualifies for the Section 121 exclusion.

b) Contrast that to the situation were a single individual purchased a principal residence for $300,000 and had to sell it after only one year of living in it because of an employer transfer to a new location. The principal residence was sold for a $50,000 gain. The $250,000 exclusion is reduced to $125,000 by the one year of ownership and use divided by the required two years. Thus, the entire $50,000 gain is excluded under Section 121.

(a) The first example prorated the gain and the second example prorated the exclusion.

c. If rent for more than three years, will not qualify for Sec. 121 exclusion.

6. Supreme Court

a. According to the Supreme Court (Helverling v. William Flaccus Oak Leather), the receipt of insurance proceeds upon the destruction of a home does not constitute a “sale or exchange” of the home, which is obviously necessary before the Section 121 exclusion can be used.

b. Fortunately, Section 121(d)(5) steps in, and provides that the destruction of a home is treated as a sale or exchange for these purposes.

7. The Sale of the House in 2018

a. In 2018, a house with a basis of $280,000 was destroyed by fire.

b. Insurance proceeds of $650,000 were received that were not used to rebuild the house.

c. As a result, under Section 121(d)(5), there is a sale or exchange of the house for $650,000, resulting in gain of $370,000.

d. The taxpayers had owned and used the house as a principal residence for all of 2014, 2015, and 2016, so they satisfy the two-of-five year requirement as of the date of sale at the end of 2018.

Thus, they are entitled to a maximum exclusion of $500,000.

e. The house was rented in 2017 and 2018.

1) This is not a period of nonqualified use, because it came after the period the house was used as a principal residence.

2) There is no required allocation to this period. The exclusion is not

reduced.

3) Depreciation expense of $20,000 was taken while the house was rented in 2017 and 2018, and this depreciation can never be excluded under Section 121.

4) As a result, the taxpayers can exclude $350,000 of the $370,000 of gain under Section 121.

a) The $20,000 attributable to prior depreciation must be recognized and realized.

8. Sec. 121 on Land

a. The Regs. allow for gain from the sale of land – and just land – to be excluded under Section 121 provided that:

1) The land is adjacent to the land on which the residence sits,

2) The land was part of the principal residence,

3) The taxpayer also sells the residence within two years before or two years after the sale of the land, and

4) The two-of-five years test is met with regard to the land as well as the house.

b. Treated as One Sale

1) The sale of the land and sale of the house are treated as one sale, subject to one maximum exclusion.

2) Thus, if you sell the home first and land next, the gain from both combined would be subject to your available maximum exclusion.

3) Any gain from the home sale always reduces the exclusion first, even if the land sale happens earlier in time.

9. Exchange Real Property

a. A taxpayer can "exchange" real property for other real property of a like kind and defer any gain inherent in the relinquished property as long as both the relinquished and replacement property were:

Held for investment or

1) Used in a trade or business

10. The Disposition of the Land

    a. When allowing for the Section 121 exclusion to be applied separately against the sale of vacant land, the regulations contemplate the sale of land that is separate from the land the residence was situated on.

    b. In this Ltr. Rul., however, because the "sale" of the home was in the form of insurance reimbursements, the subsequent disposition of the land represents the sale of all the land, including the land on which the home was built.

11. Sec. 121 Exclusion Applies to Land

    a. Nevertheless, the IRS concluded in the Ltr. Rul. that it is "reasonable to apply those same requirements (for exclusion) to a sale of vacant land on which the dwelling unit was actually located."

    b. Thus, because the taxpayers owned and used the land as part of their principal residence for two of the five years preceding the land sale in 2019, (2015 and 2016), the gain from the sale of the land can be excluded under Section 121.

12. Land Either Excluded or Deferred

    a. The land was not sold; rather, it was exchanged for other land held for investment.

    b. Thus, the gain could either be excluded under Section 121 or deferred under Section 1031, because in the latter case, both the relinquished land and replacement land were held for investment.

13. Exclusion Preferred Over Deferral

    a. The Section 121 exclusion would be preferred, because an exclusion is forever.

    b. To the contrary, a Section 1031 exchange results in a mere deferral, with the gain subsequently recognized when the replacement property is disposed of.

14. Exclusion Limited to Remaining Exclusion

    a. There is a limit to the amount that can be excluded under Section 121 upon the sale of the land.

b. The maximum limit was $500,000, and $350,000 of gain was previously excluded upon the sale of the house.

c. That leaves $150,000 of exclusion on a gain of $200,000 ($300,000 value less $100,000 basis), meaning only $150,000 of the $200,000 gain may be excluded under Section 121.

d. In Revenue Ruling 2015-14, Sections 121 and 1031 can apply to the same transaction.

15. Also Using Sec. 1031

a. The land was exchanged for other land. Because the land was held for investment at the time of the fire (a rental property), and the land received in the exchange is also held for rental, the remaining $50,000 of gain can be deferred under Section 103

b. The basis in the replacement land would be $250,000; the $100,000 basis in the relinquished land plus the $150,000 of gain that was excluded under Section 121.

16. Acreage as Part of Residence

Bennett, 8 AFTR2d 5593All 65 acres considered
(DC Ga 1961)part of personal residence

Richards, TCM 1993-42228 of 158 acres considered
part of personal residence

OZ Roy, TCM 195-23All 100 acres considered
part of personal residence

Schlicher, TCM 1997-3743 of 51 acres considered
part of personal residence