

~~~~~

\* The material contained herein is for educational purposes only and is not intended as a substitute for the professional services an advisor would normally provide to a client, including up to the minute legal research.

## **I. Introduction**

- A. Course Objectives
- B. Course Structure

**II. Global Example.** Jack is 78 years old and incapacitated. Jack owns a house (FMV \$400,000, AB \$150,000), an IRA (\$250,000) and cash (\$125,000). Jack's social security income is \$30,000 per year and his annual expenses (including property taxes, income taxes and an in-house aid) are \$90,000. Jack is widowed and has one child, Jill. Jill is named in Jack's Power of Attorney as his attorney-in-fact. Jill visits you to discuss planning for her father.

## **III. Threshold Issues**

- A. Determine Jack's capacity
- B. Review Jack's documents
  - 1. Power of Attorney (Gifting/Successor Agents)
  - 2. Health Care Directive (HIPAA/Successor Agents)
  - 3. Will
- C. Verify Jack's Assets and Liabilities
- D. Verify Jack's Income and Expenses (look at prior year's Form 1040)
- E. Verify no one is leaving Jack any money.

## **IV. Jack's Principal Residence**

- A. Options
  - 1. Do Nothing
  - 2. Gift Principal Residence (Outright/Trust)
  - 3. Sell Principal Residence
  - 4. Rent Principal Residence

## **V. Section 121: Exclusion of Gain Realized on Sale of Principal Residence**

- A. General Rule-IRC Section 121(a) - Gross Income shall not include gain realized from the sale or exchange of property if, during the five-year period ending on the date of sale or exchange, such property was owned and used by the taxpayer as its principal residence for periods aggregating two or more years. The amount of gain that can be excluded is generally limited to \$250,000 (single individuals) and \$500,000 (married couples and certain surviving spouses).
- B. Principal Residence – a residence includes a houseboat, mobile home, Coop and Condo. Furniture and other personal property will not qualify under IRC Section 121.
- C. Ownership and Use:
  - 1. In General-Reg. Section 1.121-1(c)(7) – The ownership and use requirements may be satisfied during noncurrent periods so long as both the ownership and use requirements are met (24 months or 730 days) during the 5-year period ending on the date of sale or exchange.
  - 2. Use:
    - a. Reg. Section 1.121-1(c)(2) - Occupancy is required for the use test to be met. Short-

term absences such as vacations or other seasonal absences, even if accompanied by rental of the residence, are counted as periods of use.

- b. A special rule applies to any taxpayer who becomes physically or mentally incapable of self-care and who owns property and uses it as the principal residence for periods aggregating at least one year during the 5-year period ending on the date of the sale or exchange (Section 121(d)(7); 1.121-1(c)(2)(ii)). Under this rule, the taxpayer is treated as using the property as the principal residence for any time during that five-year period in which the taxpayer owns the property but resides in any nursing home or other facility that is licensed by a state or political subdivision to care for an individual in the taxpayer's condition.
- 3. **Ownership:** If a residence is owned by a trust, the taxpayer is treated as owning the residence for any period for which the taxpayer is treated under the grantor trust rules (IRC Sections 671-679; See VI. below) as the owner of the trust or the portion of the trust that includes the residence, and the sale or exchange by the trust will be treated as if made by the taxpayer (Reg. Sec. 1.121-1(c)(3)(i)). If a residence is owned by an eligible entity that has a single owner and is disregarded for federal tax purposes as an entity separate from its owner, the owner of the entity is treated as owning the residence, and the sale or exchange by the entity will be treated as if made by the owner (Reg. Sec. 1.121-1(c)(3)(ii)).
  - 4. **Partial Use (1.121-1(e)):** If a portion of any property is used as a principal residence and another portion, separate from the dwelling unit, is used for non-residential purposes, only the gain allocable to the residential portion is eligible for the Section 121 exclusion. No allocation is required if both the residential and non-residential portions of the property are within the same dwelling unit, but Section 121 does not apply to the portion of the gain attributable to depreciation deductions allowed for periods after May 6, 1997. To determine the amount of gain allocable to the residential and non-residential portions of the property, the taxpayer must allocate the basis and the amount realized between the residential and the non-residential portions of the property using the same method of allocation that the taxpayer used to determine depreciation.
  - 5. **Spousal Ownership:**
    - a. **\$500,000 exclusion for certain joint filers (121(b)(2)).** In the case of a taxpayer who files a joint return for the tax year of the sale or exchange of the property, the \$250,000 limitation that applies to the exclusion of gain from the sale or exchange of a principal residence becomes \$500,000 if:
      - i. either spouse meets the ownership requirements with respect to the property;
      - ii. both spouses meet the use requirements with respect to the property;
      - iii. neither spouse is ineligible for the benefits of the exclusion with respect to the property by reason of the one sale every two years rule (Reg. Section 121(b)(3)).
    - b. There is a special rule (121(b)(4)) applicable to certain sales or exchanges after December 31, 2007 by surviving spouses. The \$500,000 exclusion amount for joint returns applies to a sale or exchange by an unmarried individual whose spouse is deceased as of the date of sale provided:
      - i. the sale occurs not later than two years after the date of death of the spouse; and
      - ii. the requirements set forth in V.C.5.a. above were met immediately before the date of death.

- c. An unmarried widower/widow is treated as owning and using the property for any period that the deceased spouse of such individual owned and used the property.

**Example 1:** SS has solely owned the residence that SS and her spouse (DS) have used as their principal residence since January 1, Year 1. On January 1, Year 10, DS dies. SS and DS had not sold another residence within the two years before DS's death. SS sells the residence on January 2, Year 11. SS would be entitled to a maximum gain exclusion of up to \$500,000 because:

- the sale occurred not later than two years after DS's date of death (i.e., before January 1, Year 12);
- SS met the two-year ownership requirements with respect to the residence immediately before DS died;
- both DS and SS met the two-year use requirements with respect to the residence immediately before DS died; and
- neither DS nor SS was ineligible for the benefits of the exclusion with respect to the residence by reason of the one sale every two years rules.

**Example 2:** The facts are the same as in Example 1, except that DS and SS had owned their residence as tenants in common since January 1, Year 1. Under the terms of DS's will, DS's interest in the residence is left to a trust for the benefit of SS and DS's descendants (for example, a qualified terminable interest property trust or QTIP trust). SS and the trustee of the trust sell the residence on January 2, Year 11. Will SS be entitled to a maximum gain exclusion of up to \$500,000?

6. Exclusion allowed on one sale every two (2) years: Assuming the eligibility requirements are met, the exclusion of gain from the sale or exchange of a principal residence does not apply to any sale or exchange by the taxpayer if, during the two-year period ending on the date of the sale or exchange, there was any other sale or exchange by the taxpayer to which the exclusion applied. If a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years before the marriage, the newly married taxpayer is allowed a maximum exclusion of \$250,000. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either of them, the taxpayers may exclude \$500,000 of gain on their joint return.
7. Disposition of Principal Residence Caused by Employment, Health or Unforeseen Circumstances
- a. A Taxpayer who fails to meet the requirements of Section 121 due to a change in place of employment, health or unforeseen circumstances may exclude the fraction of the \$250,000 (\$500,000) amount equal to the shorter of (1) the aggregate periods during which the ownership and use requirements were met during the five year period ending on the date of sale bears to two years or (2) the period after the date of the most recent sale to which Section 121 applied bears to two years.
- i. Change in Employment – Safe Harbor: New place of employment is at least 50 miles further from the residence sold than was the former place of employment.
- ii. Change in Health – Move needed to obtain, provide or facilitate the diagnosis, cure, mitigation or treatment of a disease, illness or injury (Safe Harbor:

Physician's recommendation).

- iii. Unforeseen Circumstances – the occurrence of an event that the taxpayer could not reasonably have anticipated (i.e. Natural disaster, divorce, unemployment that results in an inability to pay housing costs and reasonable basic living expenses).

## VI. Grantor Trust Rules

### A. Synopsis of Grantor Trust Rules

1. **Section 673** – Under Section 673, the grantor is the owner of any portion of a trust in which he or she holds a reversionary interest that on the date of the transfer to the trust has a value in excess of 5 percent of the trust fund.
2. **Section 674** – Under Section 674, the grantor is the owner of any portion of a trust over which he or she or any nonadverse party holds a power to control the trust beneficial enjoyment, even if that power cannot be exercised for the grantor's personal benefit, subject, however, to numerous important exceptions. These rules are of critical importance in drafting inter vivos trusts, because they dictate what powers a selected trustee may hold and, when certain powers are essential, who may serve as the trustee without causing the grantor to be taxed as the owner of the trust.
3. **Section 675** – Under Section 675, the grantor is the owner of any portion of a trust as to which the grantor or any other nonadverse party holds certain administrative powers. Section 675 includes important limitations on the ability to avoid grantor trust status while providing the grantor with benefits from the trust in the form of loans, and on the exercise by any person of fiduciary powers (such as the right to vote closely held stock) in a nonfiduciary capacity.
4. **Section 676** – Under Section 676, the grantor is the owner of any portion of a trust as to which he or she holds a power to revoke the trust and reacquire its assets.
5. **Section 677** – Section 677 taxes the grantor as the owner of any portion of a trust the income from which is or may be paid to, accumulated for, or used to pay premiums on policies of insurance on the lives of the grantor or the grantor's spouse. These rules also tax the grantor as the owner of any portion of trust income actually used to discharge the grantor's legal obligation of support, making this set of rules an important consideration in trust administration.
6. **Section 678** – Section 678 taxes a person other than the grantor as the owner of any portion of a trust over which such third person (virtually always a beneficiary) holds a substantially unrestricted power to invade the trust assets. This rule also applies when trust income is used to discharge the support obligation of a third person, and when the holder of a broad power partially releases that power and retains a more limited power resembling a grantor trust power under Sections 673 through 677.
7. **Section 679** – Section 679 contains rules that tax a U.S. grantor as the owner of any portion of a foreign trust that has or may have a U.S. beneficiary.

### B. Right to Substitute Assets – Section 675(4)

1. The retention of the right, exercisable in a nonfiduciary capacity, to reacquire assets by substituting assets of equivalent value, will create a grantor trust.\
2. *Jordahl v. Commissioner* (65 TC 92 (1975)) and PLRs 200606006 and 200603040 – the 674(4) power does not constitute a power to alter, amend or revoke a trust within Section 2038(a)(2). However, in *Jordahl*, the power to substitute was possessed in a

fiduciary capacity. Also Rev. Rul. 2008-22 and PLR 200944002 – retained power by a trust grantor, acting in a non fiduciary capacity, to substitute trust assets with other assets having an equivalent value does not cause the trust to be included in the Grantor's estate under Code Sections 2036 and 2038. This result will apply provided the trustee has a fiduciary obligation, either under local law or pursuant to the terms of the trust document, to ensure that the properties substituted by the grantor are in fact equivalent value and the power of substitution cannot be exercised in a manner that can shift interests among the beneficiaries of the trust.

3. Rev. Rul. 2011-28 – the power to reacquire life insurance policy in a non-fiduciary capacity, so long as trustee can require appropriate value, will not cause inclusion under IRC Sec. 2042.

## **VII. Transfer Tax Ramifications of Gifting Residence**

### **A. Gift**

1. General Rule – When is a gift complete?
  - a. Under IRC Section 2511(a), a gift tax applies whether a transfer is made in trust or not; whether a gift is direct or indirect; and whether property is real, personal, tangible or intangible. When a donor parts with dominion and control of a gift so as to leave him no power to change its disposition, a gift is complete (Treasury Regulation Section 25.2511-2(b)). But, if a donor retains any power over the disposition of property, depending on the facts of the transfer, a gift may be wholly incomplete or may be partially complete and partially incomplete. Thus, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined.
2. Incomplete Gift – Under Treasury Regulation Section 25.2511-2(b) and (c), a transfer is incomplete when a donor transfers property to a trust and retains the power to change the beneficial interests in the trust (Example: Testamentary Limited Power of Appointment makes gift incomplete).
  - a. However, IRS Chief Counsel Office issued Internal Legal Memorandum CCA 201208026 which stated a testamentary limited power of appointment is not sufficient to make entire gift incomplete (only remainder interest).
  - b. As a result, it would be prudent to also insert a provision in the IDIT allowing the Grantor to add charitable beneficiaries to the trust.
3. Basis of Gift
  - a. Completed Gift
  - b. Incomplete Gift (See Estate Rules Below)

### **B. Estate IRC Section 2036 – Retained Income/Right to Designate**

1. 2036(a)(1). If the decedent retained, by express or implied agreement, possession, enjoyment, or the right to income, then the transferred property should be included in the decedent's estate. The decedent is considered as having retained the income from property transferred that is applied towards the discharge of a legal obligation of the decedent. The existence or nonexistence of an express or implied agreement is determined from the facts and circumstances surrounding both the transfer of the property and the subsequent use of the property.
2. 2036(a)(2). If the decedent, either alone or in conjunction with any person, retains the right to designate the persons who shall possess or enjoy the property transferred or the

income therefrom, then the property transferred should be included in the decedent's estate. This subsection **does not** include the retention of a right to exercise managerial powers over the transferred property nor does it apply if such a retained power is held solely by a person other than the decedent.

## **VII. Jack's IRA/Cash**

### **A. Jack's IRA (\$250,000)**

1. Gift IRA: Jack will pay approximately \$60,000 (24%) in income taxes and will be able to gift the balance of \$190,000.
2. Keep IRA: Use for Jack's living expenses for next 5 years.
3. Part Gift/Keep Balance.

### **B. Jack's Cash (\$125,000)**

1. Gift: \$25,000 (see plan below VIII.A.).
2. Keep: \$100,000 (see plan below VIII.A.).

## **VIII. Analysis**

### **A. Plan**

1. Determine Living Expense Deficiency.
  - a. \$60,000: Annual deficiency between Social Security Income (\$30,000) and living expenses (\$90,000).
  - b. Five Year Deficiency: \$300,000 (\$60,000 X 5). Jack will need approximately \$300,000 to "live on" over next 5 years.
2. Keep Enough Assets for Jack to live on.
  - a. IRA: \$250,000 (Approximately \$210,000 after income taxes)
  - b. Cash: \$100,000
3. Jack makes an incomplete gift of the Remaining Assets (House: \$400,000 and cash \$50,000) to an IDIT.

### **B. Result**

1. No need to file Gift Tax Return (Form 709) as gift is incomplete.
2. Step-up in basis of assets in IDIT at Jack's demise as IDIT will be includable in Jack's estate (IRC §2036 and 2038).
3. Get §121 Exclusion if sell house while Jack's alive as IDIT is a Grantor Trust.
4. Start 5 year clock running for Medicaid.

## **IX. Conclusion**

LII > U.S. Code > Title 26 > Subtitle A > CHAPTER 1 > Subchapter B  
> PART III > **§ 121**

Quick search by citation:

**Title**

**Section**

Go!

# 26 U.S. Code § 121 - Exclusion of gain from sale of principal residence

U.S. Code   Notes   Authorities (CFR)

## **(a) EXCLUSION**

Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.

## **(b) LIMITATIONS**

### **(1) IN GENERAL**

The amount of gain excluded from gross income under subsection (a) with respect to any sale or exchange shall not exceed \$250,000.

## **(2) SPECIAL RULES FOR JOINT RETURNS**

In the case of a husband and wife who make a joint return for the taxable year of the sale or exchange of the property—

### **(A) \$500,000 Limitation for certain joint returns**

Paragraph (1) shall be applied by substituting “\$500,000” for “\$250,000” if—

- (i)** either spouse meets the ownership requirements of subsection (a) with respect to such property;
- (ii)** both spouses meet the use requirements of subsection (a) with respect to such property; and
- (iii)** neither spouse is ineligible for the benefits of subsection (a) with respect to such property by reason of paragraph (3).

### **(B) Other joint returns**

If such spouses do not meet the requirements of subparagraph (A), the limitation under paragraph (1) shall be the sum of the limitations under paragraph (1) to which each spouse would be entitled if such spouses had not been married. For purposes of the preceding sentence, each spouse shall be treated as owning the property during the period that either spouse owned the property.

## **(3) APPLICATION TO ONLY 1 SALE OR EXCHANGE EVERY 2 YEARS**

Subsection (a) shall not apply to any sale or exchange by the taxpayer if, during the 2-year period ending on the date of such sale or exchange, there was any other sale or exchange by the taxpayer to which subsection (a) applied.

## **(4) SPECIAL RULE FOR CERTAIN SALES BY SURVIVING SPOUSES**

In the case of a sale or exchange of property by an unmarried individual whose spouse is deceased on the date of such sale, paragraph (1) shall be applied by substituting “\$500,000” for “\$250,000” if such sale occurs not later than 2 years after the date of death of such spouse and the requirements of paragraph (2) (A) were met immediately before such date of death.

## **(5) EXCLUSION OF GAIN ALLOCATED TO NONQUALIFIED USE**

**(A) In general**

Subsection (a) shall not apply to so much of the gain from the sale or exchange of property as is allocated to periods of nonqualified use.

**(B) Gain allocated to periods of nonqualified use**

For purposes of subparagraph (A), gain shall be allocated to periods of nonqualified use based on the ratio which—

(i) the aggregate periods of nonqualified use during the period such property was owned by the taxpayer, bears to

(ii) the period such property was owned by the taxpayer.

**(C) Period of nonqualified use**

For purposes of this paragraph—

**(i) In general**

The term “period of nonqualified use” means any period (other than the portion of any period preceding January 1, 2009) during which the property is not used as the principal residence of the taxpayer or the taxpayer’s spouse or former spouse.

**(ii) Exceptions**

The term “period of nonqualified use” does not include—

(I) any portion of the 5-year period described in subsection (a) which is after the last date that such property is used as the principal residence of the taxpayer or the taxpayer’s spouse,

(II) any period (not to exceed an aggregate period of 10 years) during which the taxpayer or the taxpayer’s spouse is serving on qualified official extended duty (as defined in subsection (d)(9)(C)) described in clause (i), (ii), or (iii) of subsection (d)(9)(A), and

(III) any other period of temporary absence (not to exceed an aggregate period of 2 years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the Secretary.

**(D) Coordination with recognition of gain attributable to depreciation**

For purposes of this paragraph—

**(i)** subparagraph (A) shall be applied after the application of subsection (d)(6), and

**(ii)** subparagraph (B) shall be applied without regard to any gain to which subsection (d)(6) applies.

**(c) EXCLUSION FOR TAXPAYERS FAILING TO MEET CERTAIN REQUIREMENTS**

**(1) IN GENERAL**

In the case of a sale or exchange to which this subsection applies, the ownership and use requirements of subsection (a), and subsection (b)(3), shall not apply; but the dollar limitation under paragraph (1) or (2) of subsection (b), whichever is applicable, shall be equal to—

**(A)** the amount which bears the same ratio to such limitation (determined without regard to this paragraph) as

**(B)**

**(i)** the shorter of—

**(I)** the aggregate periods, during the 5-year period ending on the date of such sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence; or

**(II)** the period after the date of the most recent prior sale or exchange by the taxpayer to which subsection (a) applied and before the date of such sale or exchange, bears to

**(ii)** 2 years.

**(2) SALES AND EXCHANGES TO WHICH SUBSECTION APPLIES**

This subsection shall apply to any sale or exchange if—

**(A)** subsection (a) would not (but for this subsection) apply to such sale or exchange by reason of—

**(i)** a failure to meet the ownership and use requirements of subsection (a), or

**(ii)** subsection (b)(3), and

**(B)** such sale or exchange is by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances.

**(d) SPECIAL RULES**

**(1) JOINT RETURNS**

If a husband and wife make a joint return for the taxable year of the sale or exchange of the property, subsections (a) and (c) shall apply if either spouse meets the ownership and use requirements of subsection (a) with respect to such property.

**(2) PROPERTY OF DECEASED SPOUSE**

For purposes of this section, in the case of an unmarried individual whose spouse is deceased on the date of the sale or exchange of property, the period such unmarried individual owned and used such property shall include the period such deceased spouse owned and used such property before death.

**(3) PROPERTY OWNED BY SPOUSE OR FORMER SPOUSE**

For purposes of this section—

**(A) Property transferred to individual from spouse or former spouse**

In the case of an individual holding property transferred to such individual in a transaction described in section 1041(a), the period such individual owns such property shall include the period the transferor owned the property.

**(B) Property used by former spouse pursuant to divorce decree, etc.**

Solely for purposes of this section, an individual shall be treated as using property as such individual's principal residence during any period of ownership while such individual's spouse or former spouse is granted use of the property under a divorce or separation instrument.

**(C) Divorce or separation instrument**

For purposes of this paragraph, the term "divorce or separation instrument" means—

**(i)** a decree of divorce or separate maintenance or a written instrument incident to such a decree,

**(ii)** a written separation agreement, or

(iii) a decree (not described in clause (i)) requiring a spouse to make payments for the support or maintenance of the other spouse.

#### **(4) TENANT-STOCKHOLDER IN COOPERATIVE HOUSING CORPORATION**

For purposes of this section, if the taxpayer holds stock as a tenant-stockholder (as defined in section 216) in a cooperative housing corporation (as defined in such section), then—

(A) the holding requirements of subsection (a) shall be applied to the holding of such stock, and

(B) the use requirements of subsection (a) shall be applied to the house or apartment which the taxpayer was entitled to occupy as such stockholder.

#### **(5) INVOLUNTARY CONVERSIONS**

##### **(A) In general**

For purposes of this section, the destruction, theft, seizure, requisition, or condemnation of property shall be treated as the sale of such property.

##### **(B) Application of section 1033**

In applying section 1033 (relating to involuntary conversions), the amount realized from the sale or exchange of property shall be treated as being the amount determined without regard to this section, reduced by the amount of gain not included in gross income pursuant to this section.

##### **(C) Property acquired after involuntary conversion**

If the basis of the property sold or exchanged is determined (in whole or in part) under section 1033(b) (relating to basis of property acquired through involuntary conversion), then the holding and use by the taxpayer of the converted property shall be treated as holding and use by the taxpayer of the property sold or exchanged.

#### **(6) RECOGNITION OF GAIN ATTRIBUTABLE TO DEPRECIATION**

Subsection (a) shall not apply to so much of the gain from the sale of any property as does not exceed the portion of the depreciation adjustments (as defined in section 1250(b)(3)) attributable to periods after May 6, 1997, in respect of such property.

#### **(7) DETERMINATION OF USE DURING PERIODS OF OUT-OF-RESIDENCE CARE**

In the case of a taxpayer who—

**(A)** becomes physically or mentally incapable of self-care, and

**(B)** owns property and uses such property as the taxpayer's principal residence during the 5-year period described in subsection (a) for periods aggregating at least 1 year,

then the taxpayer shall be treated as using such property as the taxpayer's principal residence during any time during such 5-year period in which the taxpayer owns the property and resides in any facility (including a nursing home) licensed by a State or political subdivision to care for an individual in the taxpayer's condition.

## **(8) SALES OF REMAINDER INTERESTS**

For purposes of this section—

### **(A) In general**

At the election of the taxpayer, this section shall not fail to apply to the sale or exchange of an interest in a principal residence by reason of such interest being a remainder interest in such residence, but this section shall not apply to any other interest in such residence which is sold or exchanged separately.

### **(B) Exception for sales to related parties**

Subparagraph (A) shall not apply to any sale to, or exchange with, any person who bears a relationship to the taxpayer which is described in section 267(b) or 707(b).

## **(9) UNIFORMED SERVICES, FOREIGN SERVICE, AND INTELLIGENCE COMMUNITY**

### **(A) In general**

At the election of an individual with respect to a property, the running of the 5-year period described in subsections (a) and (c)(1)(B) and paragraph (7) of this subsection with respect to such property shall be suspended during any period that such individual or such individual's spouse is serving on qualified official extended duty—

**(i)** as a member of the uniformed services,

**(ii)** as a member of the Foreign Service of the United States, or

**(iii)** as an employee of the intelligence community.

**(B) Maximum period of suspension**

The 5-year period described in subsection (a) shall not be extended more than 10 years by reason of subparagraph (A).

**(C) Qualified official extended duty**

For purposes of this paragraph—

**(i) In general**

The term “qualified official extended duty” means any extended duty while serving at a duty station which is at least 50 miles from such property or while residing under Government orders in Government quarters.

**(ii) Uniformed services**

The term “uniformed services” has the meaning given such term by section 101(a)(5) of title 10, United States Code, as in effect on the date of the enactment of this paragraph.

**(iii) Foreign Service of the United States**

The term “member of the Foreign Service of the United States” has the meaning given the term “member of the Service” by paragraph (1), (2), (3), (4), or (5) of section 103 of the Foreign Service Act of 1980, as in effect on the date of the enactment of this paragraph.

**(iv) Employee of intelligence community**

The term “employee of the intelligence community” means an employee (as defined by section 2105 of title 5, United States Code) of—

**(I)** the Office of the Director of National Intelligence,

**(II)** the Central Intelligence Agency,

**(III)** the National Security Agency,

**(IV)** the Defense Intelligence Agency,

**(V)** the National Geospatial-Intelligence Agency,

**(VI)** the National Reconnaissance Office,

**(VII)** any other office within the Department of Defense for the collection of specialized national intelligence through reconnaissance programs,

**(VIII)** any of the intelligence elements of the Army, the Navy, the Air Force, the Marine Corps, the Federal Bureau of Investigation, the Department of Treasury, the Department of Energy, and the Coast Guard,

**(IX)** the Bureau of Intelligence and Research of the Department of State, or

**(X)** any of the elements of the Department of Homeland Security concerned with the analyses of foreign intelligence information.

**(v) Extended duty**

The term "extended duty" means any period of active duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period.

**(D) Special rules relating to election**

**(i) Election limited to 1 property at a time**

An election under subparagraph (A) with respect to any property may not be made if such an election is in effect with respect to any other property.

**(ii) Revocation of election**

An election under subparagraph (A) may be revoked at any time.

**(10) PROPERTY ACQUIRED IN LIKE-KIND EXCHANGE**

If a taxpayer acquires property in an exchange with respect to which gain is not recognized (in whole or in part) to the taxpayer under subsection (a) or (b) of section 1031, subsection (a) shall not apply to the sale or exchange of such property by such taxpayer (or by any person whose basis in such property is determined, in whole or in part, by reference to the basis in the hands of such taxpayer) during the 5-year period beginning with the date of such acquisition.

**[(11) REPEALED. PUB. L. 111-312, TITLE III, §301(A), DEC. 17, 2010, 124 STAT. 3300]**

**(12) PEACE CORPS**

**(A) In general**

At the election of an individual with respect to a property, the running of the 5-year period described in subsections (a) and (c)(1)(B) and paragraph (7) of this subsection with respect to such property shall be suspended during any period that such individual or such individual's spouse is serving outside the United States—

**(i)** on qualified official extended duty (as defined in paragraph (9)(C)) as an employee of the Peace Corps, or

**(ii)** as an enrolled volunteer or volunteer leader under section 5 or 6 (as the case may be) of the Peace Corps Act (22 U.S.C. 2504, 2505).

**(B) Applicable rules**

For purposes of subparagraph (A), rules similar to the rules of subparagraphs (B) and (D) of paragraph (9) shall apply.

**(e) DENIAL OF EXCLUSION FOR EXPATRIATES**

This section shall not apply to any sale or exchange by an individual if the treatment provided by section 877(a)(1) applies to such individual.

**(f) ELECTION TO HAVE SECTION NOT APPLY**

This section shall not apply to any sale or exchange with respect to which the taxpayer elects not to have this section apply.

**(g) RESIDENCES ACQUIRED IN ROLLOVERS UNDER SECTION 1034**

For purposes of this section, in the case of property the acquisition of which by the taxpayer resulted under section 1034 <sup>[1]</sup> (as in effect on the day before the date of the enactment of this section) in the nonrecognition of any part of the gain realized on the sale or exchange of another residence, in determining the period for which the taxpayer has owned and used such property as the taxpayer's principal residence, there shall be included the aggregate periods for which such other residence (and each prior residence taken into account under section 1223(6) <sup>[1]</sup> in determining the holding period of such property) had been so owned and used.

(Added Pub. L. 88-272, title II, § 206(a), Feb. 26, 1964, 78 Stat. 38; amended Pub. L. 94-455, title XIV, § 1404(a), title XIX, § 1906(b)(13)(A), Oct. 4, 1976, 90 Stat. 1733, 1834; Pub. L. 95-600, title IV, § 404(a)-(c)(2), Nov. 6, 1978, 92 Stat. 2869, 2870; Pub. L. 97-34, title I, § 123(a), Aug. 13, 1981, 95 Stat. 197; Pub. L. 100-647, title VI, § 6011(a), Nov. 10, 1988,

LII > Electronic Code of Federal Regulations (e-CFR)

> Title 26—Internal Revenue

> CHAPTER I—INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY

> SUBCHAPTER A—INCOME TAX > PART 1—INCOME TAXES

> Credits Against Tax

> **§ 1.121-1 Exclusion of gain from sale or exchange of a principal residence.**

# 26 CFR § 1.121-1 - Exclusion of gain from sale or exchange of a principal residence.

CFR

---

## **§ 1.121-1 Exclusion of gain from sale or exchange of a principal residence.**

**(a) *In general.*** Section 121 provides that, under certain circumstances, gross income does not include gain realized on the sale or exchange of property that was owned and used by a taxpayer as the taxpayer's principal residence. Subject to the other provisions of section 121, a taxpayer may exclude gain only if, during the 5-year period ending on the date of the sale or exchange, the taxpayer owned and used the property as the taxpayer's principal residence for periods aggregating 2 years or more.

**(b) Residence**—(1) *In general.* Whether property is used by the taxpayer as the taxpayer's residence depends upon all the facts and circumstances. A property used by the taxpayer as the taxpayer's residence may include a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)). Property used by the taxpayer as the taxpayer's residence does not include personal property that is not a fixture under local law.

**(2) Principal residence.** In the case of a taxpayer using more than one property as a residence, whether property is used by the taxpayer as the taxpayer's principal residence depends upon all the facts and circumstances. If a taxpayer alternates between 2 properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. In addition to the taxpayer's use of the property, relevant factors in determining a taxpayer's principal residence, include, but are not limited to—

- (i) The taxpayer's place of employment;
- (ii) The principal place of abode of the taxpayer's family members;
- (iii) The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;
- (iv) The taxpayer's mailing address for bills and correspondence;
- (v) The location of the taxpayer's banks; and
- (vi) The location of religious organizations and recreational clubs with which the taxpayer is affiliated.

**(3) Vacant land**—(i) *In general.* The sale or exchange of vacant land is not a sale or exchange of the taxpayer's principal residence unless—

- (A) The vacant land is adjacent to land containing the dwelling unit of the taxpayer's principal residence;
- (B) The taxpayer owned and used the vacant land as part of the taxpayer's principal residence;
- (C) The taxpayer sells or exchanges the dwelling unit in a sale or exchange that meets the requirements of section 121 within 2 years before or 2 years after the date of the sale or exchange of the vacant land; and
- (D) The requirements of section 121 have otherwise been met with respect to the vacant land.

**(ii) *Limitations***—(A) *Maximum limitation amount.* For purposes of section 121(b)(1) and (2) (relating to the maximum limitation amount of the section 121 exclusion), the sale or exchange of the dwelling unit and the vacant land are treated as one sale or exchange. Therefore, only one maximum limitation amount of \$250,000 (\$500,000 for certain joint returns) applies to the combined sales or exchanges of vacant land and the dwelling unit. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, gain from the sale or exchange of the dwelling unit, up to the maximum limitation amount under section 121(b)(1) or (2), is excluded first and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and § 1.121-2(a)(3)(i) (relating to the limitation for certain joint returns) apply.

**(B) *Sale or exchange of more than one principal residence in 2-year period.*** If a dwelling unit and vacant land are sold or exchanged in separate transactions that qualify for the section 121 exclusion under this paragraph (b)(3), each of the transactions is disregarded in applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years) to the other transactions but is taken into account as a sale or exchange of a principal residence on the date of the transaction in applying section 121(b)(3) to that transaction and the sale or exchange of any other principal residence.

**(C) *Sale or exchange of vacant land before dwelling unit.*** If the sale or exchange of the dwelling unit occurs in a later taxable year than the sale or exchange of the vacant land and after the date prescribed by law (including extensions) for the filing of the return for the taxable year of the sale or exchange of the vacant land, any gain from the sale or exchange of the vacant land must be treated as taxable on the taxpayer's return for the taxable year of the sale or exchange of the vacant land. If the taxpayer has reported gain from the sale or exchange of the vacant land as taxable, after satisfying the requirements of this paragraph (b)(3) the taxpayer may claim the section 121 exclusion with regard to the sale or exchange of the vacant land (for any period for which the period of limitation under section 6511 has not expired) by filing an amended return.

**(4) *Examples.*** The provisions of this paragraph (b) are illustrated by the following examples:

**EXAMPLE 1.**

Taxpayer A owns 2 residences, one in New York and one in Florida. From 1999 through 2004, he lives in the New York residence for 7 months and the Florida

residence for 5 months of each year. In the absence of facts and circumstances indicating otherwise, the New York residence is A's principal residence. A would be eligible for the section 121 exclusion of gain from the sale or exchange of the New York residence, but not the Florida residence.

**EXAMPLE 2.**

Taxpayer B owns 2 residences, one in Virginia and one in Maine. During 1999 and 2000, she lives in the Virginia residence. During 2001 and 2002, she lives in the Maine residence. During 2003, she lives in the Virginia residence. B's principal residence during 1999, 2000, and 2003 is the Virginia residence. B's principal residence during 2001 and 2002 is the Maine residence. B would be eligible for the 121 exclusion of gain from the sale or exchange of either residence (but not both) during 2003.

**EXAMPLE 3.**

In 1991 Taxpayer C buys property consisting of a house and 10 acres that she uses as her principal residence. In May 2005 C sells 8 acres of the land and realizes a gain of \$110,000. C does not sell the dwelling unit before the due date for filing C's 2005 return, therefore C is not eligible to exclude the \$110,000 of gain. In March 2007 C sells the house and remaining 2 acres realizing a gain of \$180,000 from the sale of the house. C may exclude the \$180,000 of gain. Because the sale of the 8 acres occurred within 2 years from the date of the sale of the dwelling unit, the sale of the 8 acres is treated as a sale of the taxpayer's principal residence under paragraph (b)(3) of this section. C may file an amended return for 2005 to claim an exclusion for \$70,000 (\$250,000-\$180,000 gain previously excluded) of the \$110,000 gain from the sale of the 8 acres.

**EXAMPLE 4.**

In 1998 Taxpayer D buys a house and 1 acre that he uses as his principal residence. In 1999 D buys 29 acres adjacent to his house and uses the vacant land as part of his principal residence. In 2003 D sells the house and 1 acre and the 29 acres in 2 separate transactions. D sells the house and 1 acre at a loss of \$25,000. D realizes \$270,000 of gain from the sale of the 29 acres. D may exclude the \$245,000 gain from the 2 sales.

**(c) *Ownership and use requirements***—(1) *In general.* The requirements of ownership and use for periods aggregating 2 years or more may be satisfied by establishing ownership and use for 24 full months or for 730 days (365 × 2). The

requirements of ownership and use may be satisfied during nonconcurrent periods if both the ownership and use tests are met during the 5-year period ending on the date of the sale or exchange.

## **(2) Use.**

**(i)** In establishing whether a taxpayer has satisfied the 2-year use requirement, occupancy of the residence is required. However, short temporary absences, such as for vacation or other seasonal absence (although accompanied with rental of the residence), are counted as periods of use.

**(ii) *Determination of use during periods of out-of-residence care.*** If a taxpayer has become physically or mentally incapable of self-care and the taxpayer sells or exchanges property that the taxpayer owned and used as the taxpayer's principal residence for periods aggregating at least 1 year during the 5-year period preceding the sale or exchange, the taxpayer is treated as using the property as the taxpayer's principal residence for any period of time during the 5-year period in which the taxpayer owns the property and resides in any facility (including a nursing home) licensed by a State or political subdivision to care for an individual in the taxpayer's condition.

**(3) *Ownership***—**(i) *Trusts.*** If a residence is owned by a trust, for the period that a taxpayer is treated under sections 671 through 679 (relating to the treatment of grantors and others as substantial owners) as the owner of the trust or the portion of the trust that includes the residence, the taxpayer will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement of section 121, and the sale or exchange by the trust will be treated as if made by the taxpayer.

**(ii) *Certain single owner entities.*** If a residence is owned by an eligible entity (within the meaning of § 301.7701-3(a) of this chapter) that has a single owner and is disregarded for federal tax purposes as an entity separate from its owner under § 301.7701-3 of this chapter, the owner will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement of section 121, and the sale or exchange by the entity will be treated as if made by the owner.

**(4) *Examples.*** The provisions of this paragraph (c) are illustrated by the following examples. The examples assume that § 1.121-3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The examples are as follows:

### **EXAMPLE 1.**

Taxpayer A has owned and used his house as his principal residence since 1986. On January 31, 1998, A moves to another state. A rents his house to tenants from that date until April 18, 2000, when he sells it. A is eligible for the section

121 exclusion because he has owned and used the house as his principal residence for at least 2 of the 5 years preceding the sale.

**EXAMPLE 2.**

Taxpayer B owns and uses a house as her principal residence from 1986 to the end of 1997. On January 4, 1998, B moves to another state and ceases to use the house. B's son moves into the house in March 1999 and uses the residence until it is sold on July 1, 2001. B may not exclude gain from the sale under section 121 because she did not use the property as her principal residence for at least 2 years out of the 5 years preceding the sale.

**EXAMPLE 3.**

Taxpayer C lives in a townhouse that he rents from 1993 through 1996. On January 18, 1997, he purchases the townhouse. On February 1, 1998, C moves into his daughter's home. On May 25, 2000, while still living in his daughter's home, C sells his townhouse. The section 121 exclusion will apply to gain from the sale because C owned the townhouse for at least 2 years out of the 5 years preceding the sale (from January 19, 1997 until May 25, 2000) and he used the townhouse as his principal residence for at least 2 years during the 5-year period preceding the sale (from May 25, 1995 until February 1, 1998).

**EXAMPLE 4.**

Taxpayer D, a college professor, purchases and moves into a house on May 1, 1997. He uses the house as his principal residence continuously until September 1, 1998, when he goes abroad for a 1-year sabbatical leave. On October 1, 1999, 1 month after returning from the leave, D sells the house. Because his leave is not considered to be a short temporary absence under paragraph (c)(2) of this section, the period of the sabbatical leave may not be included in determining whether D used the house for periods aggregating 2 years during the 5-year period ending on the date of the sale. Consequently, D is not entitled to exclude gain under section 121 because he did not use the residence for the requisite period.

**EXAMPLE 5.**

Taxpayer E purchases a house on February 1, 1998, that he uses as his principal residence. During 1998 and 1999, E leaves his residence for a 2-month summer vacation. E sells the house on March 1, 2000. Although, in the 5-year period preceding the date of sale, the total time E used his residence is less than 2 years (21 months), the section 121 exclusion will apply to gain from the sale of

the residence because, under paragraph (c)(2) of this section, the 2-month vacations are short temporary absences and are counted as periods of use in determining whether E used the residence for the requisite period.

**(d) Depreciation taken after May 6, 1997**—(1) *In general.* The section 121 exclusion does not apply to so much of the gain from the sale or exchange of property as does not exceed the portion of the depreciation adjustments (as defined in section 1250(b)(3)) attributable to the property for periods after May 6, 1997. Depreciation adjustments allocable to any portion of the property to which the section 121 exclusion does not apply under paragraph (e) of this section are not taken into account for this purpose.

**(2) Example.** The provisions of this paragraph (d) are illustrated by the following example:

**EXAMPLE.**

On July 1, 1999, Taxpayer A moves into a house that he owns and had rented to tenants since July 1, 1997. A took depreciation deductions totaling \$14,000 for the period that he rented the property. After using the residence as his principal residence for 2 full years, A sells the property on August 1, 2001. A's gain realized from the sale is \$40,000. A has no other section 1231 or capital gains or losses for 2001. Only \$26,000 (\$40,000 gain realized—\$14,000 depreciation deductions) may be excluded under section 121. Under section 121(d)(6) and paragraph (d)(1) of this section, A must recognize \$14,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h).

**(e) Property used in part as a principal residence**—(1) *Allocation required.* Section 121 will not apply to the gain allocable to any portion (separate from the dwelling unit) of property sold or exchanged with respect to which a taxpayer does not satisfy the use requirement. Thus, if a portion of the property was used for residential purposes and a portion of the property (separate from the dwelling unit) was used for non-residential purposes, only the gain allocable to the residential portion is excludable under section 121. No allocation is required if both the residential and non-residential portions of the property are within the same dwelling unit. However, section 121 does not apply to the gain allocable to the residential portion of the property to the extent provided by paragraph (d) of this section.

**(2) Dwelling unit.** For purposes of this paragraph (e), the term *dwelling unit* has the same meaning as in section 280A(f)(1), but does not include appurtenant structures or other property.

**(3) Method of allocation.** For purposes of determining the amount of gain allocable to the residential and non-residential portions of the property, the taxpayer must allocate the basis and the amount realized between the residential and the non-residential portions of the property using the same method of allocation that the taxpayer used to determine depreciation adjustments (as defined in section 1250(b)(3)), if applicable.

**(4) Examples.** The provisions of this paragraph (e) are illustrated by the following examples:

**EXAMPLE 1 NON-RESIDENTIAL USE OF PROPERTY NOT WITHIN THE DWELLING UNIT.**

**(i)** Taxpayer A owns a property that consists of a house, a stable and 35 acres. A uses the stable and 28 acres for non-residential purposes for more than 3 years during the 5-year period preceding the sale. A uses the entire house and the remaining 7 acres as his principal residence for at least 2 years during the 5-year period preceding the sale. For periods after May 6, 1997, A claims depreciation deductions of \$9,000 for the non-residential use of the stable. A sells the entire property in 2004, realizing a gain of \$24,000. A has no other section 1231 or capital gains or losses for 2004.

**(ii)** Because the stable and the 28 acres used in the business are separate from the dwelling unit, the allocation rules under this paragraph (e) apply and A must allocate the basis and amount realized between the portion of the property that he used as his principal residence and the portion of the property that he used for non-residential purposes. A determines that \$14,000 of the gain is allocable to the non-residential-use portion of the property and that \$10,000 of the gain is allocable to the portion of the property used as his residence. A must recognize the \$14,000 of gain allocable to the non-residential-use portion of the property (\$9,000 of which is unrecaptured section 1250 gain within the meaning of section 1(h), and \$5,000 of which is adjusted net capital gain). A may exclude \$10,000 of the gain from the sale of the property.

**EXAMPLE 2 NON-RESIDENTIAL USE OF PROPERTY NOT WITHIN THE DWELLING UNIT AND RENTAL OF THE ENTIRE PROPERTY.**

**(i)** In 1998 Taxpayer B buys a property that includes a house, a barn, and 2 acres. B uses the house and 2 acres as her principal residence and the barn for an antiques business. In 2002, B moves out of the house and rents it to tenants. B sells the property in 2004, realizing a gain of \$21,000. Between 1998 and 2004 B claims depreciation deductions of \$4,800 attributable to the antiques business. Between 2002 and 2004 B claims depreciation deductions of \$3,000

attributable to the house. B has no other section 1231 or capital gains or losses for 2004.

**(ii)** Because the portion of the property used in the antiques business is separate from the dwelling unit, the allocation rules under this paragraph (e) apply. B must allocate basis and amount realized between the portion of the property that she used as her principal residence and the portion of the property that she used for non-residential purposes. B determines that \$4,000 of the gain is allocable to the non-residential portion of the property and that \$17,000 of the gain is allocable to the portion of the property that she used as her principal residence.

**(iii)** B must recognize the \$4,000 of gain allocable to the non-residential portion of the property (all of which is unrecaptured section 1250 gain within the meaning of section 1(h)). In addition, the section 121 exclusion does not apply to the gain allocable to the residential portion of the property to the extent of the depreciation adjustments attributable to the residential portion of the property for periods after May 6, 1997 (\$3,000). Therefore, B may exclude \$14,000 of the gain from the sale of the property.

### **EXAMPLE 3 NON-RESIDENTIAL USE OF A SEPARATE DWELLING UNIT.**

**(i)** In 2002 Taxpayer C buys a 3-story townhouse and converts the basement level, which has a separate entrance, into a separate apartment by installing a kitchen and bathroom and removing the interior stairway that leads from the basement to the upper floors. After the conversion, the property constitutes 2 dwelling units within the meaning of paragraph (e)(2) of this section. C uses the first and second floors of the townhouse as his principal residence and rents the basement level to tenants from 2003 to 2007. C claims depreciation deductions of \$2,000 for that period with respect to the basement apartment. C sells the entire property in 2007, realizing gain of \$18,000. C has no other section 1231 or capital gains or losses for 2007.

**(ii)** Because the basement apartment and the upper floors of the townhouse are separate dwelling units, C must allocate the gain between the portion of the property that he used as his principal residence and the portion of the property that he used for non-residential purposes under paragraph (e) of this section. After allocating the basis and the amount realized between the residential and non-residential portions of the property, C determines that \$6,000 of the gain is allocable to the non-residential portion of the property and that \$12,000 of the gain is allocable to the portion of the property used as his residence. C must recognize the \$6,000 of gain allocable to the non-residential portion of the property

(\$2,000 of which is unrecaptured section 1250 gain within the meaning of section 1(h), and \$4,000 of which is adjusted net capital gain). C may exclude \$12,000 of the gain from the sale of the property.

**EXAMPLE 4 SEPARATE DWELLING UNIT CONVERTED TO RESIDENTIAL USE.**

The facts are the same as in *Example 3* except that in 2007 C incorporates the basement of the townhouse into his principal residence by eliminating the kitchen and building a new interior stairway to the upper floors. C uses all 3 floors of the townhouse as his principal residence for 2 full years and sells the townhouse in 2010, realizing a gain of \$20,000. Under section 121(d)(6) and paragraph (d) of this section, C must recognize \$2,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h). Because C used the entire 3 floors of the townhouse as his principal residence for 2 of the 5 years preceding the sale of the property, C may exclude the remaining \$18,000 of the gain from the sale of the house.

**EXAMPLE 5 NON-RESIDENTIAL USE WITHIN THE DWELLING UNIT, PROPERTY DEPRECIATED.**

Taxpayer D, an attorney, buys a house in 2003. The house constitutes a single dwelling unit but D uses a portion of the house as a law office. D claims depreciation deductions of \$2,000 during the period that she owns the house. D sells the house in 2006, realizing a gain of \$13,000. D has no other section 1231 or capital gains or losses for 2006. Under section 121(d)(6) and paragraph (d) of this section, D must recognize \$2,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h). D may exclude the remaining \$11,000 of the gain from the sale of her house because, under paragraph (e)(1) of this section, she is not required to allocate gain to the business use within the dwelling unit.

**EXAMPLE 6 NON-RESIDENTIAL USE WITHIN THE DWELLING UNIT, PROPERTY NOT DEPRECIATED.**

The facts are the same as in Example 5, except that D is not entitled to claim any depreciation deductions with respect to her business use of the house. D may exclude \$13,000 of the gain from the sale of her house because, under paragraph (e)(1) of this section, she is not required to allocate gain to the business use within the dwelling unit.

**(f) Effective date.** This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions of this section retroactively, see § 1.121-4(j).

[T.D. 9030, 67 FR 78361, Dec. 24, 2002]

# 26 U.S. Code Subtitle A Chapter 1 Subchapter J Part I Subpart E - Grantors and Others Treated as Substantial Owners

U.S. Code      Notes

---

§ 671. Trust income, deductions, and credits attributable to grantors and others as substantial owners

§ 672. Definitions and rules

§ 673. Reversionary interests

§ 674. Power to control beneficial enjoyment

§ 675. Administrative powers

§ 676. Power to revoke

§ 677. Income for benefit of grantor

§ 678. Person other than grantor treated as substantial owner

§ 679. Foreign trusts having one or more United States beneficiaries

# 26 U.S. Code § 675 - Administrative powers

U.S. Code      Notes

---

The grantor shall be treated as the owner of any portion of a trust in respect of which—

**(1) POWER TO DEAL FOR LESS THAN ADEQUATE AND FULL CONSIDERATION**

A power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth.

**(2) POWER TO BORROW WITHOUT ADEQUATE INTEREST OR SECURITY**

A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

**(3) BORROWING OF THE TRUST FUNDS**

The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor. For periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this paragraph to the grantor shall be treated as including a reference to such individual.

**(4) GENERAL POWERS OF ADMINISTRATION**

A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term "power of administration" means any one or more of the following powers: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

# 26 U.S. Code § 2511 - Transfers in general

U.S. Code      Notes

---

## **(a) SCOPE**

Subject to the limitations contained in this chapter, the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible; but in the case of a nonresident not a citizen of the United States, shall apply to a transfer only if the property is situated within the United States.

## **(b) INTANGIBLE PROPERTY**

For purposes of this chapter, in the case of a nonresident not a citizen of the United States who is excepted from the application of section 2501(a)(2)—

**(1)** shares of stock issued by a domestic corporation, and

**(2)** debt obligations of—

**(A)** a United States person, or

**(B)** the United States, a State or any political subdivision thereof, or the District of Columbia,

which are owned and held by such nonresident shall be deemed to be property situated within the United States.

(Aug. 16, 1954, ch. 736, 68A Stat. 406; Pub. L. 89-809, title I, § 109(b), Nov. 13, 1966, 80 Stat. 1575; Pub. L. 107-16, title V, § 511(e), June 7, 2001, 115 Stat. 71; Pub. L. 107-147, title IV, § 411(g)(1), Mar. 9, 2002, 116 Stat. 46; Pub. L. 111-312, title III, § 302(e), Dec. 17, 2010, 124 Stat. 3302.)

LII > Electronic Code of Federal Regulations (e-CFR)

> Title 26—Internal Revenue

> CHAPTER I—INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY

> SUBCHAPTER B—ESTATE AND GIFT TAXES

> PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954 > Transfers

> **§ 25.2511-2 Cessation of donor's dominion and control.**

## 26 CFR § 25.2511-2 - Cessation of donor's dominion and control.

CFR

---

### **§ 25.2511-2 Cessation of donor's dominion and control.**

**(a)** The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable. For gift tax rules related to an ABLE account established under section 529A, see § 1.529A-4 of this chapter.

**(b)** As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor

reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined. For example, if a donor transfers property to another in trust to pay the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among his descendants, no portion of the transfer is a completed gift. On the other hand, if the donor had not retained the testamentary power of appointment, but instead provided that the remainder should go to X or his heirs, the entire transfer would be a completed gift. However, if the exercise of the trustee's power in favor of the grantor is limited by a fixed or ascertainable standard (see paragraph (g)(2) of § 25.2511-1), enforceable by or on behalf of the grantor, then the gift is incomplete to the extent of the ascertainable value of any rights thus retained by the grantor.

**(c)** A gift is incomplete in every instance in which a donor reserves the power to divest the beneficial title to the property in himself. A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard. Thus, if an estate for life is transferred but, by an exercise of a power, the estate may be terminated or cut down by the donor to one of less value, and without restriction upon the extent to which the estate may be so cut down, the transfer constitutes an incomplete gift. If in this example the power was confined to the right to cut down the estate for life to one for a term of five years, the certainty of an estate for not less than that term results in a gift to that extent complete.

**(d)** A gift is not considered incomplete, however, merely because the donor reserves the power to change the manner or time of enjoyment. Thus, the creation of a trust the income of which is to be paid annually to the donee for a period of years, the corpus being distributable to him at the end of the period, and the power reserved by the donor being limited to a right to require that, instead of the income being so payable, it should be accumulated and distributed with the corpus to the donee at the termination of the period, constitutes a completed gift.

**(e)** A donor is considered as himself having a power if it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. A trustee, as such, is not a person having an adverse interest in the disposition of the trust property or its income.

**(f)** The relinquishment or termination of a power to change the beneficiaries of transferred property, occurring otherwise than by the death of the donor (the statute being confined to transfers by living donors), is regarded as the event that completes the gift and causes the tax to apply. For example, if A transfers property in trust for the benefit of B and C but reserves the power as trustee to change the proportionate interests of B and C, and if A thereafter has another person appointed trustee in place of himself, such later relinquishment of the power by A to the new trustee completes the gift of the transferred property, whether or not the new trustee has a substantial adverse interest. The receipt of income or of other enjoyment of the transferred property by the transferee or by the beneficiary (other than by the donor himself) during the interim between the making of the initial transfer and the relinquishment or termination of the power operates to free such income or other enjoyment from the power, and constitutes a gift of such income or of such other enjoyment taxable as of the "calendar period" (as defined in § 25.2502-1(c)(1)) of its receipt. If property is transferred in trust to pay the income to A for life with remainder to B, powers to distribute corpus to A, and to withhold income from A for future distribution to B, are powers to change the beneficiaries of the transferred property.

**(g)** If a donor transfers property to himself as trustee (or to himself and some other person, not possessing a substantial adverse interest, as trustees), and retains no beneficial interest in the trust property and no power over it except fiduciary powers, the exercise or nonexercise of which is limited by a fixed or ascertainable standard, to change the beneficiaries of the transferred property, the donor has made a completed gift and the entire value of the transferred property is subject to the gift tax.

**(h)** If a donor delivers a properly indorsed stock certificate to the donee or the donee's agent, the gift is completed for gift tax purposes on the date of delivery. If the donor delivers the certificate to his bank or broker as his agent, or to the issuing corporation or its transfer agent, for transfer into the name of the donee, the gift is completed on the date the stock is transferred on the books of the corporation.

**(i)** [Reserved]

**(j)** If the donor contends that a power is of such nature as to render the gift incomplete, and hence not subject to the tax as of the calendar period (as defined in § 25.2502-1(c)(1)) of the initial transfer, see § 301.6501(c)-1(f)(5) of this chapter.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7238, 37 FR 28728, Dec. 29, 1972; T.D. 7910, 48 FR 40374, Sept. 7, 1983; T.D. 8845, 64 FR 67771, Dec. 3, 1999; T.D. 9923, 85 FR 74047, Nov. 19, 2020]

# IOWA STATE UNIVERSITY

Center for Agricultural Law and Taxation

## Chief Counsel Memo. 201208026 (Sept. 28, 2011)

(transfers to irrevocable trust under terms of which trustee had full discretion to administer trust for beneficiaries of charity constituted completed gifts of beneficial term interests because donors' retained testamentary limited powers of appointment relate only to trust remainder; gift tax incurred on transfer and transfer not incomplete gift covered by Treas. Reg. Sec. 25.2522-2(b); IRS analyzed income and remainder interests separately and concluded that POA impacted only remainder interest and did not impact what beneficiaries would receive during term interest - donors had no retained interest in term interest; gifts not of minority interests equal in value to donors' respective withdrawal rights (*Crummey* Powers) which would reduce the taxable gifts to zero because withdrawal rights not legally enforceable; beneficiary could not enforce withdrawal right in state court; no annual exclusion allowable for any of the withdrawal rights).

The Center for Agricultural Law and Taxation does not provide legal advice. Any information provided on this website is not intended to be a substitute for legal services from a competent professional. The Center's work is supported by fee-based seminars and generous private gifts. Any opinions, findings, conclusions or recommendations expressed in the material contained on this website do not necessarily reflect the views of Iowa State University.

# 26 U.S. Code § 2036 - Transfers with retained life estate

U.S. Code      Notes

---

## **(a) GENERAL RULE**

The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

**(1)** the possession or enjoyment of, or the right to the income from, the property, or

**(2)** the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

## **(b) VOTING RIGHTS**

### **(1) IN GENERAL**

For purposes of subsection (a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property.

### **(2) CONTROLLED CORPORATION**

For purposes of paragraph (1), a corporation shall be treated as a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death, the decedent owned (with the application of section 318), or had the right (either alone or in conjunction with any person) to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock.

### **(3) COORDINATION WITH SECTION 2035**

For purposes of applying section 2035 with respect to paragraph (1), the relinquishment or cessation of voting rights shall be treated as a transfer of property made by the decedent.