

not expired by filing an amended return.

(i) through (j) [Reserved]. See § 1.121-3(i) through (j).

(k) *Audit protection.* The Internal Revenue Service will not challenge a taxpayer's position that a sale or exchange of a principal residence that occurred before December 24, 2002 but on or after May 7, 1997, qualifies for the reduced maximum exclusion under section 121(c) if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 121(c) and if the sale or exchange otherwise qualifies under section 121.

(l) *Effective date.* For the applicability of this section, see § 1.121-3(l).

[T.D. 9031, 67 FR 78369, Dec. 24, 2002]

§ 1.121-4 Special rules.

(a) *Property of deceased spouse—(1) In general.* For purposes of satisfying the ownership and use requirements of section 121, a taxpayer is treated as owning and using property as the taxpayer's principal residence during any period that the taxpayer's deceased spouse owned and used the property as a principal residence before death if—

(i) The taxpayer's spouse is deceased on the date of the sale or exchange of the property; and

(ii) The taxpayer has not remarried at the time of the sale or exchange of the property.

(2) *Example.* The provisions of this paragraph (a) are illustrated by the following example. The example assumes that § 1.121-3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The example is as follows:

Example. Taxpayer H has owned and used a house as his principal residence since 1987. H and W marry on July 1, 1999 and from that date they use H's house as their principal residence. H dies on August 15, 2000, and W inherits the property. W sells the property on September 1, 2000, at which time she has not remarried. Although W has owned and used the house for less than 2 years, W will be considered to have satisfied the ownership and use requirements of section 121 because W's period of ownership and use includes the period that H owned and used the property before death.

(b) *Property owned by spouse or former spouse—(1) Property transferred to indi-*

vidual from spouse or former spouse. If a taxpayer obtains property from a spouse or former spouse in a transaction described in section 1041(a), the period that the taxpayer owns the property will include the period that the spouse or former spouse owned the property.

(2) *Property used by spouse or former spouse.* A taxpayer is treated as using property as the taxpayer's principal residence for any period that the taxpayer has an ownership interest in the property and the taxpayer's spouse or former spouse is granted use of the property under a divorce or separation instrument (as defined in section 71(b)(2)), provided that the spouse or former spouse uses the property as his or her principal residence.

(c) *Tenant-stockholder in cooperative housing corporation.* A taxpayer who holds stock as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)) may be eligible to exclude gain under section 121 on the sale or exchange of the stock. In determining whether the taxpayer meets the requirements of section 121, the ownership requirements are applied to the holding of the stock and the use requirements are applied to the house or apartment that the taxpayer is entitled to occupy by reason of the taxpayer's stock ownership.

(d) *Involuntary conversions—(1) In general.* For purposes of section 121, the destruction, theft, seizure, requisition, or condemnation of property is treated as a sale of the property.

(2) *Application of section 1033.* In applying section 1033 (relating to involuntary conversions), the amount realized from the sale or exchange of property used as the taxpayer's principal residence is treated as being the amount determined without regard to section 121, reduced by the amount of gain excluded from the taxpayer's gross income under section 121.

(3) *Property acquired after involuntary conversion.* If the basis of the property acquired as a result of an involuntary conversion is determined (in whole or in part) under section 1033(b) (relating to the basis of property acquired through an involuntary conversion),

then for purposes of satisfying the requirements of section 121, the taxpayer will be treated as owning and using the acquired property as the taxpayer's principal residence during any period of time that the taxpayer owned and used the converted property as the taxpayer's principal residence.

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

Example. (i) On February 18, 1999, fire destroys Taxpayer A's house which has an adjusted basis of \$80,000. A had owned and used this property as her principal residence for 20 years prior to its destruction. A's insurance company pays A \$400,000 for the house. A realizes a gain of \$320,000 (\$400,000—\$80,000). On August 27, 1999, A purchases a new house at a cost of \$100,000.

(ii) Because the destruction of the house is treated as a sale for purposes of section 121, A will exclude \$250,000 of the realized gain from A's gross income. For purposes of section 1033, the amount realized is then treated as being \$150,000 (\$400,000—\$250,000) and the gain realized is \$70,000 (\$150,000 amount realized—\$80,000 basis). A elects under section 1033 to recognize only \$50,000 of the gain (\$150,000 amount realized—\$100,000 cost of new house). The remaining \$20,000 of gain is deferred and A's basis in the new house is \$80,000 (\$100,000 cost—\$20,000 gain not recognized).

(iii) A will be treated as owning and using the new house as A's principal residence during the 20-year period that A owned and used the destroyed house.

(e) *Sales or exchanges of partial interests—(1) Partial interests other than remainder interests—(i) In general.* Except as provided in paragraph (e)(2) of this section (relating to sales or exchanges of remainder interests), a taxpayer may apply the section 121 exclusion to gain from the sale or exchange of an interest in the taxpayer's principal residence that is less than the taxpayer's entire interest if the interest sold or exchanged includes an interest in the dwelling unit. For rules relating to the sale or exchange of vacant land, see § 1.121-1(b)(3).

(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), sales or exchanges of partial interests in the same principal residence 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 the partial interests. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, a taxpayer may exclude gain from the first sale or exchange of a partial interest up to the taxpayer's full maximum limitation amount and may exclude gain from the sale or exchange of any other partial interest in the same principal residence to the extent of any remaining maximum limitation amount, 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.* For purposes of applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years), each sale or exchange of a partial interest is disregarded with respect to other sales or exchanges of partial interests in the same principal residence, but is taken into account as of the date of the sale or exchange in applying section 121(b)(3) to that sale or exchange and the sale or exchange of any other principal residence.

(2) *Sales or exchanges of remainder interests—(i) In general.* A taxpayer may elect to apply the section 121 exclusion to gain from the sale or exchange of a remainder interest in the taxpayer's principal residence.

(ii) *Limitations—(A) Sale or exchange of any other interest.* If a taxpayer elects to exclude gain from the sale or exchange of a remainder interest in the taxpayer's principal residence, the section 121 exclusion will not apply to a sale or exchange of any other interest in the residence that is sold or exchanged separately.

(B) *Sales or exchanges to related parties.* This paragraph (e)(2) will not apply to a sale or exchange to any person that bears a relationship to the taxpayer that is described in section 267(b) or 707(b).

(iii) *Election.* The taxpayer makes the election under this paragraph (e)(2) by filing a return for the taxable year of

the sale or exchange that does not include the gain from the sale or exchange of the remainder interest in the taxpayer's gross income. A taxpayer may make or revoke the election at any time before the expiration of a 3-year period beginning on the last date prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred.

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

Example. In 1991 Taxpayer A buys a house that A uses as his principal residence. In 2004 A's friend B moves into A's house and A sells B a 50% interest in the house realizing a gain of \$136,000. A may exclude the \$136,000 of gain. In 2005 A sells his remaining 50% interest in the home to B realizing a gain of \$138,000. A may exclude \$114,000 (\$250,000—\$136,000 gain previously excluded) of the \$138,000 gain from the sale of the remaining interest.

(f) *No exclusion for expatriates.* The section 121 exclusion will not apply to any sale or exchange by an individual if the provisions of section 877(a) (relating to the treatment of expatriates) applies to the individual.

(g) *Election to have section not apply.* A taxpayer may elect to have the section 121 exclusion not apply to a sale or exchange of property. The taxpayer makes the election by filing a return for the taxable year of the sale or exchange that includes the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. A taxpayer may make an election under this paragraph (g) to have section 121 not apply (or revoke an election to have section 121 not apply) at any time before the expiration of a 3-year period beginning on the last date prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred.

(h) *Residences acquired in rollovers under section 1034.* If a taxpayer acquires property in a transaction that qualifies under section 1034 (section 1034 property) for the nonrecognition of gain realized on the sale or exchange of another property and later sells or exchanges such property, in determining the period of the taxpayer's ownership

and use of the property under section 121 the taxpayer may include the periods that the taxpayer owned and used the section 1034 property as the taxpayer's principal residence (and each prior residence taken into account under section 1223(7) in determining the holding period of the section 1034 property).

(i) [Reserved]

(j) *Election to apply regulations retroactively.* Taxpayers who would otherwise qualify under §§ 1.121-1 through 1.121-4 to exclude gain from a sale or exchange of a principal residence before December 24, 2002 but on or after May 7, 1997, may elect to apply §§ 1.121-1 through 1.121-4 for any years for which the period of limitation under section 6511 has not expired. The taxpayer makes the election under this paragraph (j) by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. Taxpayers who have filed a return for the taxable year of the sale or exchange may elect to apply the provisions of these regulations for any years for which the period of limitation under section 6511 has not expired by filing an amended return.

(k) *Audit protection.* The Internal Revenue Service will not challenge a taxpayer's position that a sale or exchange of a principal residence occurring before December 24, 2002 but on or after May 7, 1997, qualifies for the section 121 exclusion if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 121. Compliance with the provisions of the regulations project under section 121 (REG-105235-99 (2000-2 C.B. 447)) generally will be considered a reasonable, good faith effort to comply with the requirements of section 121.

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

[T.D. 9030, 67 FR 78361, Dec. 24, 2002; 68 FR 6350, Feb. 7, 2003]