PERSONAL

Home Sweet ‘Property’? Tax Court Examines Gain Exclusion on the Sale of a Principal Residence

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Very little in the tax law is simple or straightforward, as demonstrated by the three opinions generated by litigation concerning the gain-exclusion provisions relating to the sale of a principal residence. Taxpayers determined to obtain the maximum benefit of a tax-free half-million dollars and an IRS determined to prevent it both apparently failed to make arguments that might have bolstered their respective cases.

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The concept of "home" is evocative for most people. Support for this notion requires little more than paying attention. Indeed, sayings about home abound: There's no place like home; home is where the heart is; a man's home is his castle; home sweet home. In addition to pervading the language, the idea of "home" is found in various parts of the Code, including gain exclusion under Section 121 on the sale or exchange of a principal residence.

This provision, like many others, was designed to promote home ownership. While Congress and the IRS generally allow this tax benefit to individuals for the betterment of society as a whole, there are limits. The boundaries of Section 121 were recently tested in *Gates,* 135 TC No 1, 2010 WL 2640132 , a reviewed opinion. Addressing a novel legal question, the case yielded three strong opinions, and provides an opportunity to explore several theories that potentially could affect future disputes involving similar issues. In short, *Gates* examined whether Congress, in enacting the current version of Section 121, contemplated the sale of home sweet "home" or home sweet "property."

TAX BREAKS UNDER SECTION 121

To appreciate the significance of *Gates,* one must first understand the aspects of the law that the Tax Court addressed in rendering its decision. The starting point in determining a taxpayer's federal income tax liability is "gross income." Generally, "gross income" means all income from any source (including gains from dealings in property), unless specifically excluded by the Code. [1] Among the items that are specifically excluded from gross income is a taxpayer's gain from the sale or exchange of his principal residence. The key provision, Section 121(a), contains the following rule:

"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." [2]

The amount of gain that a taxpayer may exclude from gross income is not unlimited. Indeed, the Code ordinarily allows an exclusion of up to $250,000, which increases to $500,000 for a married couple filing a joint return. [3]

The law in this area has significantly changed over time, with the most recent incarnation being Section 121 as enacted as part of TRA '97. Anyone with experience with the current law or its many predecessors will immediately recognize that Section 121, while straightforward enough on its face, contains plenty of ambiguity and complexities. This reality was recently confirmed by the Tax Court in its decision in *Gates.*

THE *GATES* FACTS

In late 1984, the taxpayer purchased a house in Santa Barbara (the "Original House"), which, logically, was located on a particular lot (the "Land"). Approximately five years later, in 1989, the taxpayer married. Although the record is deficient as to what happened in the interim, it is clear that the couple lived in the Original House for at least two years, from 1996 to 1998.

At the beginning of that period, the couple decided to enlarge and remodel the Original House. The architect they hired to assist with this project advised the couple that more stringent building and permit restrictions had been introduced since the Original House was built. As the Tax Court pointed out, however, the evidence presented by the parties did not demonstrate whether the new restrictions "prevented" the couple from carrying out their initial plans of expanding and updating the Original House. The couple ultimately decided to demolish the Original House and build a new, larger place (the "New House") on the same Land. The New House, completed in 1999, fully complied with the existing building and permit rules.

The Tax Court underscored three pivotal points. First, the New House had different characteristics from the Original House. The court noted the following in this regard: "The footprint of the new house has a very different shape from that of the original house, and it appears to be two to three times larger than the footprint of the original house. Only about one-half of the land area of the original house overlaps with the land area covered by the new house, and no part of the original foundation perimeter corresponds to the foundation perimeter of the new house."

Second, the Tax Court stated that the record did not contain details concerning where the couple resided during the demolition and construction period, which apparently occurred in late 1998 and 1999.

Third, and perhaps most important, the Tax Court indicated that the couple "never resided" in the New House.

Without ever moving into the New House, the couple sold it in 2000 for $1.1 million, resulting in a capital gain of $591,406. The couple did not report any of the gain as income on their federal income tax return for 2000, but they subsequently agreed that $91,406 should have been reported as gain. The couple arrived at the gain figure based on the following formula from which they would not budge: $591,406 in gain, minus the exclusion of $500,000 under Section 121, equals $91,406. The IRS issued a deficiency notice asserting that the couple owed tax on the entire $591,406, plus penalties for filing their 2000 tax return late, and the taxpayers petitioned the court for a redetermination.

Citing the statutory language in Section 121, the Service argued that the couple was not entitled to the $500,000 exclusion because they never occupied the New House as a "principal residence" before they sold it in 2000. In other words, the IRS contended that the couple failed the two-year "use" test in Section 121(a). A key to the Service's position was that "property" means a "dwelling" that was owned and occupied by the taxpayer as his "principal residence" for a minimum of two of the five years before the sale.

The couple, however, urged the Tax Court not to focus on the terms "principal residence" or "dwelling," but rather on "property." They maintained that a proper reading of Section 121(a) would lead to the conclusion that the exclusion applies to gain on the sale of any "property" that was used as a principal residence during the relevant period. In advancing this position, the couple underscored two facts:

> (1) They used the Original House and the Land as their principal residence for more than two years during the five-year pre-sale period.
> (2) Along with the New House, they sold the Land on which the Original House and, later, the New House had been situated (i.e., the "property").

As the Tax Court summarized it, the couple argued that "the requirements of section 121(a) are satisfied if a taxpayer lived in *any dwelling* on the *property* for the required 2-year period *even if* that dwelling is not the dwelling that is sold." (Emphasis added.) Exhibit 1 provides a visual comparison of the text of Section 121(a) with the parties' varying interpretations of that provision, which may be helpful in fully comprehending the dispute in *Gates.*

Exhibit 1. The Conflicting Interpretations of Section 121

Text of Section 121(a)	IRS Interpretation	Taxpayer's Interpretation

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.	Gross income shall not include gain from the sale or exchange of [a dwelling unit, along with the real property on which the dwelling unit is located] if, during the 5-year period ending on the date of the sale or exchange, [such dwelling unit and the property] has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.	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 [i.e., the land and any dwelling unit located on such land] has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.

THE MAJORITY SPEAKS

The Tax Court was divided in its analysis of the case, generating majority, dissenting, and concurring opinions. The majority began by reviewing the general rules which dictate that all income, including the gain from the sale or exchange of property, is part of "gross income." After clarifying the parties' principal arguments, the majority turned to the text of Section 121(a) and noted that it fails to define the key terms.

The majority was thus obligated to apply the principles of statutory construction to determine congressional intent, one of which provides that an undefined term should be given its ordinary meaning. The majority cited multiple, conflicting dictionary definitions of "property," "principal," and "residence," and concluded that the meaning of Section 121(a) is not clear and unambiguous.

The majority turned, therefore, to the legislative history of Section 121 and its predecessors to determine the proper tax treatment. Specifically, the majority examined the congressional reports and statutory language of various forerunners, including 1939 Code Section 112(n)(1) (enacted in 1951), Section 1034 (introduced in 1954), and the former Section 121 enacted in 1964. It also looked to the reports associated with TRA '97, which contained the current version of Section 121. The majority included the following portion of the TRA '97 House Report in its opinion and highlighted several terms:

"Calculating capital gain from the sale of a principal residence is among the most complex tasks faced by a typical taxpayer. Many taxpayers buy and sell a number of *homes* over the course of a lifetime, and are generally not certain of how much *housing* appreciation they can expect. Thus, even though most *homeowners* never pay any income tax on the capital gain on their principal residences, as a result of the rollover provisions and the $125,000 one-time exclusion, detailed records of transactions and expenditures on *home* improvements must be kept, in most cases, for many decades. To claim the exclusion, many taxpayers must determine the basis of each *home* they have owned, and appropriately adjust the basis of their current *home* to reflect any untaxed gains from previous *housing* transactions. This determination may involve augmenting the original cost basis of each *home* by expenditures on improvements. In addition to the record-keeping burden this creates, taxpayers face the difficult task of drawing a distinction between improvements that add to basis, and repairs that do not. The failure to account accurately for all improvements leads to errors in the calculation of capital gains, and hence to an under- or overpayment of the capital gains on principal residences. By excluding from taxation capital gains on principal residences below a relatively high threshold, few taxpayers would have to refer to records in determining income tax consequences of transactions related to their *house*....

"Present law also may discourage some older taxpayers from selling their *homes*. Taxpayers who would realize a capital gain in excess of $125,000 if they sold their *home* and taxpayers who have already used the exclusion may choose to stay in their *homes* even though the *home* no longer suits their needs." [4]

Based on this legislative history, the majority in *Gates* explained that Congress intended "principal residence" to mean the primary dwelling or house that a taxpayer occupied as his principal residence or place of abode. The majority then acknowledged that, while a "principal residence" may include the land surrounding the dwelling, the legislative history indicates that the Section 121 exclusion applies "only if the dwelling the taxpayer sells was actually used as his principal residence for the period required by section 121(a)."

The majority fortified its holding by looking at the Regulations under the predecessors to Section 121. In particular, the majority examined the definition of "principal residence" in the former Section 121, enacted in 1964, which cross-referenced former Section 1034. According to the majority, the "focal point" of the Regulations under Section 1034 was the dwelling unit a taxpayer used as his principal residence.

The majority further bolstered its decision by reviewing four prior cases interpreting former Section 1034 and factually distinguishing the "only case" where a taxpayer was permitted to exclude gain on a sale of land that did not occur simultaneously with the sale of the taxpayer's principal residence, i.e., *Bogley,* 3 AFTR 2d 688, 263 F2d 746 (CA-4, 1959). [5]

The absence of contrary authority also lent support to the majority's ruling. As already noted, Congress enacted the current version of Section 121 in 1997. This relatively new provision amended the previous version of Section 121 and repealed Section 1034. The majority noted that Congress continued to use the same wording throughout, that is, it limited the exclusion to situations where the taxpayer sells "property ... used by the taxpayer as the taxpayer's principal residence." In enacting the modern version of Section 121 in 1997, Congress did not expressly indicate in the legislative history that the phrase should have a different meaning, or state any disagreement with how the courts had construed the former Section 1034 over the years. The majority inferred from this consistency and silence that Congress intended the comparable wording in Section 1034 and Section 121 to be interpreted comparably.

Finally, the majority emphasized that Section 121 is a statutory "exclusion" from gross income and, as such, must be narrowly construed against the taxpayer.

THE DISSENT

The dissenting opinion in *Gates* began with the acknowledgment that there was "adequate ground" for the majority's position that, to qualify for the gain exclusion under Section 121, a taxpayer needs to sell or exchange not only property on which the principal residence is located, but also the principal residence itself. It pointed out, however, that equally adequate ground existed for the conclusion that the sale of the New House and the Land by the taxpayers in *Gates* should qualify for the exclusion. The dissenting opinion raised several arguments in support of this line of reasoning.

First, the dissent challenged the basis on which the majority rooted its opinion. In arriving at its conclusion (i.e., that the couple did not satisfy the two-year use requirement under Section 121(a)), the majority relied not on the text of statute, but rather a congressional report from 1997 that mainly discusses the difficulties a homeowner faces in tracking the basis in his home. According to the dissent, this report, which neither addressed the language of the proposed statutory amendment nor exhausted the situations creating the need for the amendment, provided "insufficient grounds" for the majority's conclusion that Congress intended Section 121 to apply only if the dwelling was actually used as the taxpayer's principal residence during the relevant two-year period.

Next, the dissent explained that the majority's interpretation of the law was contrary to the remedial purposes of Section 121. Specifically, the dissenting judges argued that, while they agreed with the majority that the Supreme Court has stated that exclusions from income should be narrowly construed, the highest tribunal has also ruled that a tax provision liberalizing the law for public policy reasons should *not* be narrowly construed. [6]

Keeping in mind the need to broadly interpret such provisions, the dissenting opinion presented the following scenario. A taxpayer's longtime but uninsured house is destroyed by a hurricane. The owner rebuilds the house on the same land, lives in it for 18 months, and then sells the house at a gain. [7] The dissent pointed out that, under the majority's analysis, the taxpayer would not be entitled to the exclusion under Section 121 because he did not live in the rebuilt house for two years. The dissent also assumed that, if the taxpayer's house merely had been damaged and repaired, as opposed to destroyed and rebuilt, he would have benefited from the exclusion. According to the dissent, "[t]hat seems like an untenable distinction."

The dissent further argued that the majority's interpretation of the property-use requirement in Section 121 suggested that there is a discernible difference between remodeling a house, on one hand, and demolishing and rebuilding a house, on the other. Assuming that the majority's holding in *Gates* does not mean that remodeling a house terminates the use of the house as the taxpayer's principal residence and resets the two-year use clock to zero, the dissent questioned whether this was simply a question of degree: What about a taxpayer who demolishes the old house, leaves the foundation, and constructs a new home on the existing foundation?

If this constitutes remodeling, and if remodeling does not reset the time requirements under Section 121, the dissent posited an alternative resolution in *Gates:* "Might we not conclude that part of the foundation of the old house was incorporated into the new, thus making [*Gates*] a remodeling case and not a rebuilding case?" [8] The dissent also warned that the *Gates* decision will provoke future remodeling-vs.-rebuilding questions.

The final argument raised by the dissent was one not advanced by the taxpayer in *Gates.* Citing *Bogley,* the dissent explained that authority exists for the proposition that if the principal residence consists of land and improvements, then a sale of the improvements and part of the land, followed by the sale of the remaining land, can qualify under Section 121. In light of this judicial authority, the dissenting opinion stated that it would not be an "impossible stretch" to consider the demolition of the Old House in *Gates* as a sale for zero dollars followed by a subsequent sale of the Land. Under that approach, the demolition/sale of the Old House would generate a nondeductible loss with the basis going to the Land under Section 280B; any gain attributable to the Original House would be realized on the sale of the New House and the Land, and Section 121 would apply.

THE CONCURRING OPINION

Courts often acknowledge that a particular result may be severe to the litigant at hand, but that the outcome is mandated by the law. For instance, the Tax Court made the following observation in a decision earlier this year: "We are not unsympathetic to petitioner's position. We also realize that the statutory requirements may seem to work harsh results to taxpayers, such as petitioner.... However, we are bound by the language of the statute as it is written and the accompanying regulations when consistent therewith." [9]

Courts also note with frequency that they must address only the case at hand, not hypothetical future situations, regardless of how probable they might be. These types of struggles arose in *Gates,* where the dissent cautioned that the majority's opinion would trigger future tax disputes involving remodeling-vs.-rebuilding questions and urged the Tax Court to recognize, "as no doubt the Commissioner and taxpayers will, the weight that the analysis in [*Gates*] will carry in similar situations under principles of stare decisis."

The concurring opinion rejected these notions and confirmed its support of the majority's analysis, explaining several times that the Tax Court is limited to the facts before it.: "The dissent argues that the holding of the majority is inconsistent with the remedial purpose of Section 121. This Court's assigned task in the first instance, however, is to apply Section 121 as written to the facts of this case....

"The dissent objects to the result and argues that the majority's analysis in this case will distort the result in other cases in which the taxpayer should qualify for the section 121 exclusion. The response to this argument is straightforward—it is not this Court's job to anticipate and decide cases that are not yet before it.... We have often stated that we 'must decide the case in the light of what was done, not what might have been done.' ... The majority properly limits its analysis to the facts of this case, which were fully stipulated, and to the issues raised by the parties.... We may reach a different conclusion in cases involving different facts if and when the opportunity arises, but we should not distort the result in this case by anticipating those cases."

WHAT MAKES *GATES* NOTEWORTHY?

Thanks largely to the proliferation of electronic tax research services, we are constantly bombarded with new tax cases, administrative rulings, etc. Finding sufficient tax authorities was difficult in the old days; now, the challenge has become filtering the abundance of data to determine what is truly important or relevant. When the court expressly labels a case one of "first impression," the significance is obvious. In other cases, such as *Gates,* one must look a little harder to see why they matter.

Some of the most interesting aspects of a case often are not those specifically addressed in the opinion, but rather those of which there is no mention whatsoever. Courts may raise items on their own, but the responsibility of presenting evidence and broaching legal arguments generally lies with the parties. Accordingly, the scope of a court's opinion is guided by the effectiveness of the litigants.

This is true in *Gates,* where the concurring opinion confirmed that the court's analysis was limited to "the facts of this case, which were fully stipulated, and to the issues raised by the parties." Several arguments, potentially favorable to the taxpayers or the IRS, did not appear in the opinion.

Arguments Potentially Helpful to the Taxpayers

The following issues, if raised, could have potentially benefited the taxpayers.

Role of "facts and circumstances." One of the linchpins in the Service's argument and the Tax Court's decision was that the couple in *Gates* "never resided" in the New House, and thus never "used" it as a principal residence before selling it. Conspicuously absent from the opinion in *Gates* was a lengthy discussion of the particular facts and circumstances that led up to the sale of the New House, which is noteworthy because Reg. 1.121-1(b)(1) provides that "[w]hether property is used by the taxpayer as the taxpayer's residence depends upon all the facts and circumstances." *Gates* was submitted to the court fully stipulated, thus eliminating the introduction of direct testimony. Such oral evidence might have provided the Court with more context and the taxpayers with a stronger foundation on which to argue by analogy to prior cases.

In support of its decision, the majority cited five cases. [10] These cases, while instructive, are not directly on point. They deal with two main scenarios: (1) the sale of the land without the dwelling unit, or (2) the sale of both the land and dwelling unit, but at different times. *Gates,* by contrast, deals with sale of the land and a dwelling unit simultaneously; it is just that the dwelling unit sold was not the same dwelling unit in which the taxpayers previously resided.

The taxpayers in *Gates* might have bolstered their position by referring to a more recent case, *Gummer,* 81 AFTR 2d 98-1740, 40 Fed Cl 812 (Fed. Cl. Ct., 1998), which is arguably as relevant as the cases cited in the opinion. In *Gummer,* the taxpayer owned and resided in a house for approximately 22 years before relocating to a rental apartment in 1990. She tried to sell the house, but the sale was delayed until 1994 because of a sharp decline in the local real estate market. The issue in *Gummer,* as in *Gates,* was whether the taxpayer was entitled to gain exclusion under Section 121. The parties each filed motions for summary judgment.

The government argued that Gummer was ineligible for gain exclusion under Section 121 because she failed the "use" test, that is, she failed to "physically occupy" the house for the requisite period of time before the sale, which is "always" a requirement. The government also suggested that the facts and circumstances surrounding whether the property served as the "principal residence" for that period were irrelevant.

The taxpayer maintained that the statutory phrase about property "used as a principal residence" did not create two separate tests, but rather one term. Thus, the "use" requirement is intertwined with the definition of "principal residence," and whether the property was physically occupied by the owner constitutes only part of the analysis. The other part, the taxpayer contended, is comprised of the facts and circumstances related to any physical absence from the property.

The Court of Federal Claims was persuaded by the taxpayer's characterization of "use" and "principal residence" as interdependent terms, stating: "[The government's] attempt to bifurcate the terms ‘use’ and ‘principal residence,’ presumably to avoid the court's adoption of a facts and circumstances analysis from the definition of ‘principal residence’ in the section 1034 Treasury Regulations, is illogical and unsupported by the plain language of the statute. Therefore, the court will read the terms ‘use’ and ‘principal residence’ together."

In addition, the court ruled in favor of the taxpayer on her second argument, that is, a facts-and-circumstances analysis should be undertaken to ascertain whether the property was used as a principal residence for the requisite duration. In coming to this second taxpayer-favorable conclusion, the Court of Federal Claims pointed out that "[c] ases interpreting whether property is ‘used’ as a ‘principal residence’ under section 1034 do not always require strict physical occupancy, but rather analyze whether the facts and circumstances surrounding any absence still entitle the party to a finding that the old property was used as a principal residence."

The court also underscored that ignoring the facts and circumstances, as the government urged, would be contrary to the Regulations and congressional intent: "[I]t would clearly defy Congress's purpose to apply a strict physical occupancy requirement rather than inquiring about the reasons for a party's physical absence. Depending upon the situation, an individual who does not physically occupy the residence for the requisite period may have extenuating circumstances which prevent physical presence but do not deny the characterization of ‘use’ of the property as a ‘principal residence’ for the requisite time under the statute and its legislative history. After an absence from the residence is explained under a ‘facts and circumstances’ test, the court may or may not find that the party ‘used’ the property as their [sic] ‘principal residence’ for the requisite time."

In summary, *Gummer* arguably stands for the proposition that (1) former Section 121 did not require physical occupancy by the taxpayer, (2) the terms "use" and "principal residence" are interdependent terms that must be read together, such that the pivotal phrase becomes "such property has been owned and used by the taxpayer as his principal residence," and (3) courts are obligated to consider the facts and circumstances of a particular case. The situation in *Gates* differs from *Gummer* in that the taxpayers in the former never lived in the New House. Nevertheless, the legal principles established in the latter, if raised by the taxpayers, might have strengthened the case and provided the Tax Court a broader basis on which to render an opinion.

Taxpayer-relief provisions construed in favor of taxpayers. One of the pillars on which the majority's opinion rested was that an income-exclusion provision, such as Section 121, must be narrowly interpreted. The dissent countered by noting that where legislation liberalizes the law in favor of the taxpayer as a result of public policy, it should not be subject to a restricted reading. What was not addressed in *Gates,* however, was that Section 121 is a taxpayer-relief provision entitled to special deference.

Under the long-standing rule of statutory construction, remedial or relief provisions demand a broad construction in favor of the class of intended beneficiaries. [11] The Tax Court has recognized that Section 121 and its predecessors constitute part of this protected category. Perhaps there is no better example than *Clapham,* 63 TC 505 (1975), which describes Section 1034 as a "remedial provision" with a "clearly expressed remedial purpose" that provides "relief" to taxpayers and effectuates its "remedial policy" by deliberately making the determination about whether a property is a principal residence dependent on the particular facts and circumstances of each case. This language tends to indicate that the taxpayers' case in *Gates* might have been fortified by the "taxpayer relief" argument, had it been raised.

Ambiguous tax statutes interpreted against the government. The text of Section 121 is ambiguous; the majority in *Gates* acknowledged as much. What the Tax Court did not discuss, though, is the venerable rule of statutory construction providing that, if the words in a *tax* provision are doubtful, then such doubt must be resolved against the government, and the provision must be construed liberally in favor of the taxpayer.

In *Merriam,* 4 AFTR 3673, 263 US 179, 68 L Ed 240, 1923-2 CB 87 (1923), the Supreme Court stated: "[I]n statutes levying taxes the literal meaning of the words employed is most important for such statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the government and in favor of the taxpayer."

This was echoed by the Seventh Circuit in *Maryland Casualty Co.,* 9 AFTR 1354, 49 F2d 556, 1931-2 CB 381 (CA-7, 1931), which said that "[tax] statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the government and in favor of the taxpayer.... Such acts, including provisions of limitation embodied therein, are to be construed liberally in favor of the taxpayer.... There must be certainty as to the meaning and scope of language imposing any tax, and doubt in respect to its meaning is to be resolved in favor of the taxpayer" (citations omitted).

The Ninth Circuit reiterated this position in *Bryson,* 16 AFTR 663, 79 F2d 397 (CA-9, 1935): "It is familiar doctrine that ‘taxing acts, including provisions of limitation embodied therein [are] to be construed liberally in favor of the taxpayer.’"

The taxpayers' principal argument in *Gates* was that Section 121 grants an income exclusion when a taxpayer sells "property" that has been owned and used as a principal residence during the applicable period. The provision does not expressly refer to the sale of a "dwelling unit," as the IRS contended. Moreover, as the taxpayers could have argued, if Congress and the IRS had meant "dwelling unit," as opposed to "property," they certainly knew how to say it.

Take, for instance, Reg. 1.121-1(b)(3), which contains rules relating to the application of the gain exclusion to vacant land. It provides that a sale or exchange does not involve the taxpayer's "principal residence" unless four factors are met, one of which is that "[t]he vacant land is adjacent to land containing the dwelling unit of the taxpayer's principal residence." The taxpayers might have argued that this demonstrates that "principal residence" is broader than just the house, and that the Service understands the difference between a "dwelling unit" and "property."

Another example is found in the gain allocation rules that apply when property is used partially as a principal residence. Reg. 1.121-1(e)(2) states that, for purposes of that Regulation, a "dwelling unit" generally has the same meaning described by Congress in Section 280A(f)(1). Thus, a "dwelling unit" encompasses a house, apartment, condominium, mobile home, boat, or similar property.

The taxpayers in *Gates* might have buttressed their position by advancing the preceding Regulations, statutes, and the "ambiguous tax provisions must be construed against the government" rule.

Gain allocation argument. If a portion of a taxpayer's property was used for residential purposes and another portion (separate from the dwelling unit) was used for nonresidential purposes, only the gain allocable to the residential portion may be excluded. [12] Outside of this rule, neither Section 121 nor the Regulations thereunder address the possibility of gain allocation between a house and the land. It is not altogether surprising, then, that the taxpayers in *Gates* failed to advance a gain allocation argument.

As explained above, the Tax Court was sharply divided in *Gates.* Despite this division, the majority, dissenting, and concurring opinions were unified in pointing out the omission of a potentially helpful argument to the taxpayers. They stated that "[p]etitioners do not contend or provide any authority for the proposition that we should allocate the gain between gain on the land and gain on the residence, or offer any evidence to support such an allocation" (majority), "[t]hat approach requires the allocation of the proceeds between the new house and the land, which apparently petitioners did not think to address" (dissent), and "[p]etitioners did not argue for a partial exclusion of gain attributable to the sale of the land, nor did petitioners introduce any evidence that would have permitted the Court to allocate between the new house and the land" (concurring opinion).

Together, these comments could be construed as an indication of the Tax Court's potential receptiveness to a gain allocation argument. Had the taxpayers made such a contention in *Gates,* it might have helped avoid the harsh, all-or-nothing result.

Arguments Potentially Helpful to the IRS

The Service, like the taxpayer in *Gates,* seemed to omit certain arguments in its favor.

Earlier legislative history. The majority identified four main reasons for ruling in the Service's favor, including legislative history, Regulations promulgated under predecessors to the current Section 121, five prior cases interpreting former Section 1034, and the need to narrowly construe statutory exclusions from gross income.

In developing the first point about legislative history, the majority cited at great length a TRA '97 committee report, accompanying the current version of Section 121. As quoted above, the majority pointed to the repeated use of "home," "house," "housing," and "homeowners" as evidence that Congress intended the term "principal residence" in Section 121 to refer to the primary dwelling that a taxpayer occupied as his principal residence or place of abode.

The majority opinion in *Gates* did not mention previous legislative history that arguably fortified the Service's position that Section 121 is aimed solely at the sale of a particular dwelling. The House Report for the Revenue Act of 1978 contains the following explanation:

"In addition, the exclusion applies only with respect to gain realized on the sale or exchange of a principal residence which the taxpayer has owned and occupied as his or her principal residence for periods aggregating two years out of the three-year period which immediately precedes the sale. For purposes of determining the length of time that a principal residence was owned and occupied by a taxpayer making this election, *only that period of time which the particular principal residence that is being sold or exchanged was owned and occupied will be taken into account.* There would be no "tacking" of the holding period for replacement property. For example, the holding period for an old residence would not be taken into account even if gain had been rolled over into a new residence." [13]

The Senate Report states as follows: "The bill's exclusion applies only with respect to gain realized on the sale or exchange of a principal residence which the taxpayer has owned and occupied as his or her principal residence for a period aggregating two years out of the three-year period which immediately precedes the sale. As under present law, the ownership and occupancy rules may be satisfied only by the taxpayer, or by the taxpayer's spouse in the case of married individuals. However, the bill provides two exceptions to the generally applicable ownership and occupancy rule.... In all other instances the actual use and occupancy requirements must be satisfied. *Thus, only that period of time which the particular principal residence which is being sold or exchanged was owned and occupied by the taxpayer will be taken into account.* The holding period for an old residence will not be taken into consideration even if gain on that residence's sale had been rolled into the new principal residence which is being sold." [14]

Based on these committee reports, the IRS might have argued that Section 121 was designed to shield taxpayers only from gain on the sale of "the particular principal residence" that was owned and occupied by the taxpayers during the relevant period. In *Gates,* that would limit the applicability of Section 121 to the Original House, not the New House.

Preamble to the Regulations. Inherent in the taxpayers' argument in *Gates* is that, although the couple voluntarily demolished the Original House and built the New House, the Land on which both buildings were located was identical, and the couple never intended to change principal residences until they ultimately decided to sell the New House. In other words, perhaps in their minds (and hearts), the couple never "abandoned" their principal residence during the demolition-and-rebuilding period.

The Preamble to TD 9030, 12/23/02, the most recent Regulations under Section 121, which was not discussed in the *Gates* opinion, states the following:

"Numerous commentators asserted that the two-year use requirement of section 121 should not require actual occupancy. Instead, they argued for a facts and circumstances test similar to the test employed under section 1034. Under that test, a taxpayer's non-occupancy of a residence would count as use if the taxpayer did not intend to abandon the property as the taxpayer's principal residence. The final regulations do not adopt this suggestion because it is inconsistent with the statutory approach under section 121 of aggregating periods of use over a five-year period, and with the legislative history that provides that 'a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange.'"

Had the IRS introduced this portion of the Preamble in *Gates,* it might have deflected the taxpayers' non-abandonment, good-intentions theme.

CONCLUSION

Regardless of whether one sides with the majority, dissenting, or concurring opinion, *Gates* is undisputedly a case of interest. It addressed a novel legal issue, triggered the exploration of other theories that might have affected the outcome, and identified certain unresolved questions. As optimistic homeowners keep building "McMansions" and the economy continues to flounder, another *Gates*-like case is bound to erupt sooner or later. When it does, many taxpayers and practitioners will be watching to see how the interpretation of Section 121 evolves.

Practice Notes

It is very likely that cases with fact patterns similar to that in *Gates* will arise. The different opinions from a fractured Tax Court, along with the potential arguments that were apparently overlooked by both sides, bear close study. Practitioners with clients who have not yet sold such properties may wish to suggest that occupancy may be worthwhile, even at the cost of delaying or losing a sure sale.

PEEBLES IS NEW CO-EDITOR

With this issue, The Journal is pleased to announce that Laura H. Peebles, CPA, PFS, has joined our editorial board as co-editor of the Personal department, taking over from the retiring Steven L. Severin. Ms. Peebles is Tax Director, Washington National Tax office of Deloitte Tax LLP. She has been with Deloitte for 22 years, and has extensive experience serving the charitable, financial, tax, and estate planning needs of high-net-worth individuals. She is a member of the AICPA and the Society of Louisiana CPAs, and has spoken to many professional groups including the ABA Tax Section, the Georgetown Advanced Estate Planning Institute, and the USC Tax Institute. We are delighted to welcome her to our board.

1

Section 61(a); Reg. 1.61-1(a); Section 61(a)(3); Reg. 1.61-6(a).

2

See also Reg. 1.121-1(a).

3

Section 121(b); Reg. 1.121-2(a).

4

Citing H. Rep't No. 105-148, 105th Cong., 1st Sess. 346-349 (1997) (emphasis by the Tax Court). See also S. Rep't No. 105-33, 105th Cong., 1st Sess. 35-37 (1997); H. Rep't No. 105-220, 105th Cong., 1st Sess. 386-387 (1997); Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97, 12/17/97), pages 54-56.

5

This situation also arose in Rev. Rul. 76-541, 1976-2 CB 246, which was not cited in the opinion.

6

Citing Helvering v. Bliss, 14 AFTR 668, 293 US 144, 79 L Ed 246, 1934-2 CB 191 (1934).

7

The dissent clarified that this scenario does not involve an "involuntary conversion" under Section 1033.

8

The dissent noted that the parties stipulated an exhibit, a blueprint, showing that the footprints of the Original House and the New House overlapped.

9

Thomas, TC Memo 2010-11, RIA TC Memo ¶2010-011 .

10

Hughes, 54 TC 1049 (1970); O'Barr, 44 TC 501 (1965); Boesel, 65 TC 378 (1975); Hale, TC Memo 1982-527, PH TCM ¶82527 ; Bogley, 3 AFTR 2d 688, 263 F2d 746 (CA-4, 1959), *rev'g* 30 TC 452 (1958).

11

See, e.g., Robillard, 35 TC 896 (1961), *aff'd* 10 AFTR 2d 5664, 308 F2d 518 (CA-5, 1962) ("The statute [at issue] is remedial in nature and should be liberally construed to give effect to its intention"); John Richard Corp., 46 TC 41 (1966) ("As a relief provision, [Section 1033] is to be construed liberally to achieve its purpose").
12

Reg. 1.121-1(e).
13

H. Rep't No. 95-1445, 95th Cong., 2d Sess. 135 (1978) (emphasis added).
14

S. Rep't No. 95-1263, 95th Cong., 2d Sess. 196-197 (1978) (emphasis added).