

is determined (in whole or in part) under subsection (b) of section 1033 (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.

For the treatment of involuntary conversion as a "sale or exchange" see section 1.121-3(b).

(e) *Property used in part as principal residence.* (1) When a taxpayer can satisfy the ownership and use requirements of section 121(a)(2) only with respect to a portion of the property sold, then section 121 shall apply only with respect to so much of the gain from the sale or exchange of the property as is attributable to such portion. Thus, if the residence was used only partially for residential purposes, only that part of the gain allocable to the residential portion is not to be recognized under section 121(a).

(2) The provisions of this paragraph are illustrated by the following example:

Example. Taxpayer A, an attorney, uses a portion of the property constituting his principal residence as a law office for a period in excess of 2 years out of the 5 years preceding the sale of such residence. Accordingly, section 121 does not apply with respect to so much of the gain on the sale of the property as is allocable to the portion of the property used as a law office.

(f) *Determination of marital status.* Marital status is to be determined as of the date of the sale or exchange of the residence. An individual who on the date of the sale or exchange is legally separated from his spouse under a decree of divorce or of separate maintenance is not considered as married on such date.

(g) *Application of sections 1033 and 1034.* (1) In applying sections 1033 (relating to involuntary conversions) and 1034 (relating to sale or exchange of residence), the amount realized from the sale or exchange of property used as one's principal residence is treated as being the amount determined without regard to section 121, reduced by the amount of gain excluded from gross income pursuant to an election made under section 121(a). Thus, the amount which must be invested in a new resi-

dence in order to fully satisfy the non-recognition provisions of section 1033 or 1034 is reduced by the amount of gain not included in the taxpayer's gross income because of an election made under section 121(a).

(2) The provisions of this paragraph are illustrated by the following examples:

Example (1). Taxpayer A sells his residence for \$180,000, incurring \$2,000 in fixing-up expenses described in section 1034(b)(2). He has a basis of \$65,000 for the residence. Of his total gain of \$115,000 (\$180,000-\$65,000), \$100,000 is excluded from his gross income under this section.

He may still use the provisions of section 1034 to defer all or part of the remaining \$15,000 of gain. To determine the adjusted sales price for purposes of section 1034, the amount realized (consideration received minus selling expenses, described in paragraph (b)(4)(i) of section 1.1034-1) is reduced by the sum of the fixing-up expenses (described in paragraph (b)(6) of section 1.1034-1) plus the amount excluded under section 121. Here, then, for purposes of section 1034, A's adjusted sales price is \$78,000 ((\$180,000-\$2,000)-\$100,000). If his new residence costs at least \$78,000, all \$15,000 of the remaining gain will be deferred. However, if he purchases a new residence for \$72,000, then \$6,000 (\$78,000-\$72,000) of his gain is currently taxable.

Example (2). Taxpayer B's residence has a basis of \$65,000. She sells the residence for \$115,000. If she makes an election under section 121(a), her gain of \$50,000 is all excluded from gross income, and, accordingly, no portion of the realized gain remains to be deferred under section 1034.

(h) *Special rules applicable to certain reacquisitions of real property.* For special rules relating to a case where real property with respect to which an election under this section is in effect is reacquired by the seller in partial or full satisfaction of the indebtedness arising from the sale of such property and resold by him within 1 year after the date of such reacquisition, §1.1038-2.

[T.D. 7614, 44 FR 24841, Apr. 27, 1979]

§ 1.122-1 Applicable rules relating to certain reduced uniformed services retirement pay.

(a) *Rule applicable prior to January 1, 1966.* In the case of a member or former member of the uniformed services of the United States (as defined in 37 U.S.C. 101(3)) who has made an election

under Subchapter I of Chapter 73 of Title 10 of the U.S. Code (also referred to in this section as the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431)) to receive a reduced amount of retired or retainer pay, gross income shall include the amount of any reduction made in his retired or retainer pay before January 1, 1966, by reason of such election, unless such reduction, or portion thereof, is otherwise excluded from gross income under Part III of Subchapter B of Chapter 1 of the Internal Revenue Code of 1954 or any other provision of law.

(b) *Rule applicable after December 31, 1965*—(1) In a case of a member or former member of the uniformed services of the United States (as defined in 37 U.S.C. 101(3)), gross income shall not include the amount of any reduction made in his or her retired or retainer pay after December 31, 1965, by reason of—

(i) An election made under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431), or

(ii) The provisions of Subchapter II of Chapter 73 of Title 10 of the U.S. Code (also referred to in this section as the Survivor Benefit Plan (10 U.S.C. 1447)).

(2)(i) In a case where a member or former member of the uniformed services has, pursuant to the election described in paragraph (a) of this section, received before January 1, 1966, a reduced amount of retired or retainer pay, he shall, after December 31, 1965, exclude from gross income under section 122(b) and this subdivision all amounts received as uniformed services retired or retainer pay until there has been so excluded an amount of retired or retainer pay equal to the "consideration for the contract" (as described in subdivision (iii) of this subparagraph).

(ii) Upon the death of a member or former member of the uniformed services, where the "consideration for the contract" (as described in subdivision (iii) of this subparagraph) has not been excluded in whole or in part from gross income under section 122(b) and subdivision (i) of this subparagraph, the survivor of such member who is receiving an annuity under Chapter 73 of Title 10 of the U.S. Code shall, after December 31, 1965, exclude from gross

income under section 72(o) and this subdivision such annuity payments received after December 31, 1965, until there has been so excluded annuity payments equalling the portion of the "consideration for the contract" not previously excluded under subdivision (i) of this subparagraph.

(iii) The term "consideration for the contract" as used in this subparagraph means—

(a) The total amount of the reductions, if any, before January 1, 1966, in retired or retainer pay by reason of an election under Subchapter I of Chapter 73 of Title 10 of the United States Code, plus

(b) The total amount, if any, deposited by the serviceman at any time pursuant to the provisions of sections 1438 or 1452(d) of Title 10 of the United States Code, plus

(c) The total amount, if any, excludable from income under section 101(b)(2)(D) and paragraph (a)(2) of § 1.101-2 with respect to a survivor annuity provided by such retired or retainer pay, minus

(d) The total amount, if any, excluded from income before January 1, 1966, pursuant to the provisions of section 72 (b) and (d) with respect to a survivor annuity provided by such retired or retainer pay.

(iv) In determining whether there has been a recovery of the "consideration for the contract" under subdivision (i) of this subparagraph, the exclusion of retired pay from income after December 31, 1965, under sections 104(a)(4) and 105(d) shall not be considered as recovery of all or part of the "consideration for the contract."

(c) *Special rules.* In any of the following situations, the computation of the excludable portion of disability retired pay received by the member or former member of the uniformed services shall be governed by the following rules:

(1) An exclusion under section 122(a) and paragraph (b)(1) of this section is applicable only in the taxable year in which a reduction in retired pay is made under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) or the Survivor Benefit Plan (10 U.S.C. 1447).

(2) Where the member or former member of the uniformed services is entitled to exclude the whole or a portion of his retired pay under the provisions of section 104(a)(4) or section 105(d) and under section 122(a) and paragraph (b)(1) of this section, the exclusion under section 122(a) and paragraph (b)(1) of this section shall be applied prior to the exclusions under sections 104(a)(4) and 105(d).

(3) Where the member or former member of the uniformed services waives a portion of his disability retired pay, or such retired pay reduced under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431), or the Survivor Benefit Plan (10 U.S.C. 1447) in favor of a nontaxable pension or compensation receivable under laws administered by the Veterans Administration (38 U.S.C. 3105), the waived amount of such disability retired pay, or reduced amount thereof, shall first be subtracted from any amounts which are excludable under the provisions of sections 104(a)(4) or 105(d) so as to reduce the amounts otherwise excludable under those sections.

(4) Where the member or former member of the uniformed services receives (before any forfeiture) disability retired pay (whether or not reduced under the Retired Serviceman's Family Protection Plan) or the Survivor Benefit Plan which is partially excludable under section 104(a)(4), and also forfeits a portion of such disability retired pay under the Dual Compensation Act of 1964 (5 U.S.C. 5531 or any former corresponding provision of law), the amount of the forfeiture under such Act shall be applied against disability retired pay (before any forfeiture) in the same proportion that the excludable portion of such pay under section 104(a)(4) bears to the total amount of such pay after subtraction of any reduction under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) or the Survivor Benefit Plan (10 U.S.C. 1447).

(5) The exclusion provided by section 122(b) and paragraph (b)(2)(i) of this section shall be available with respect to repayments made upon removal from the temporary disability retired list even though such repayments were

previously excluded from gross income under section 104(a)(4) or 105(d).

However, the exclusion permitted by the prior sentence will apply only to the extent the repaid amount has not been previously excluded under section 122(b) and paragraph (b)(2)(i) of this section.

(d) *Examples with respect to the Retired Serviceman's Family Protection Plan.* The rules discussed in this section relating to the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) may be illustrated by the following examples:

Example (1). A, a member of the uniformed services, retires on January 1, 1963, and receives nondisability retired pay computed to be 60 percent of his active duty pay of \$10,000 per year, or \$6,000 per year, based upon 24 years of service. He elects, under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431), to provide his survivor with an annuity equal to one-fourth of his reduced retired pay. His retired pay of \$6,000 is reduced by \$600, to \$5,400, in order to provide a survivor annuity of \$1,350 per year or \$112.50 per month. For 1963, 1964, and 1965, A must include in gross income the unreduced amount of retired pay, or \$6,000. For 1966 and subsequent years, he may exclude under section 122(a) and paragraph (b)(1) of this section the \$600 total annual reductions to provide the survivor annuity, and may, for 1966, further exclude from gross income under section 122(b) and paragraph (b)(2)(i) of this section the \$1,800 "consideration for the contract" *i.e.*, the total reductions which were made in 1963, 1964, and 1965, to provide the survivor annuity. Accordingly, A will include \$3,600 of retired pay in gross income for 1966 (\$6,000 minus the sum of \$600 and \$1,800).

Example (2). Assume the facts in Example (1) except that A retires on disability resulting from active service and his disability is rated at 40 percent. The entire amount of disability retirement pay, prior to and including 1966, is excludable from gross income under sections 104(a)(4) and 105(d), and in 1966, section 122(a). Assume further that A attains retirement age on December 31, 1966, dies on January 1, 1967, and his widow then begins receiving a survivor annuity under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431). A's widow may exclude from gross income in 1967 and 1968 under section 72(o) and paragraph (b)(2)(ii) of this section, the \$1,800 of "consideration for the contract" *i.e.*, the reductions in 1963, 1964, and 1965 to provide the survivor annuity. Thus, A's widow will exclude all of the survivor annuity she receives in 1967 (\$1,350) and \$450 of the \$1,350 annuity received in 1968. In addition, if A had not attained retirement age at the time of his death, his widow would,

under section 101 and paragraph (a)(2) of §1.101-2, exclude up to \$5,000 subject to the limitations of paragraph (b)(2)(i) of this section.

Example (3). Assume, in the previous example, that A dies on January 1, 1965, and his widow then begins receiving a survivor annuity. Assume further that A's widow is entitled to exclude under section 72(b) \$1,000 of the \$1,350 she received in 1965. Under section 72(o) and paragraph (b)(2)(ii) of this section, A's widow for 1966 will exclude the \$200 remaining consideration for the contract (\$1,200-\$1,000) and will include \$1,150 of the survivor annuity in gross income.

Example (4). B, a member of the uniformed services, retires on January 1, 1966, after 32 years of active military service, and receives disability retirement pay under section 1401 of title 10, limited to 75 percent of his active duty pay of \$15,000 per year, or \$11,250. His disability rating is 30 percent. B has not reached retirement age (as defined in §1.79-2(b)(3)). He elects under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) to provide his survivor with an annuity equal to one-half of his reduced retired pay and, for that purpose, his retired pay of \$11,250 is reduced by \$1,250 to provide an annuity of \$5,000 per year. B also elects to waive retired pay in the amount of \$1,000 in order to receive disability compensation in like amount under laws administered by the Veterans Administration. In addition, B is required to forfeit \$4,088 of his retired pay under the Dual Compensation Act of 1964 (5 U.S.C. 5532) (\$11,250-\$1,000 = \$10,250 less one-half of excess thereof over \$2,074) and by reason of his Federal employment is not entitled to an exclusion of his retired pay under section 105(d). B's taxable retired pay for 1966 is \$3,002, computed as follows:

Gross retired pay	\$11,250
Less: Section 122(a) exclusion	(1,250)
Reduced retired pay	10,000
Less: Retired pay waived to receive V.A. compensation	(1,000)
Adjusted retired pay—	9,000
Less:	
(i) Excludable retired pay computed under section 104(a)(4) as limited by 10 U.S.C. 1403	\$4,500
(ii) Less: Retired pay, not to exceed (i), waived to receive V.A. compensation	(1,000)
(iii) Net disability exclusion	(3,500)
Taxable retired pay before adjustment for Dual Compensation forfeiture	5,500
Less:	
Adjustment for Dual Compensation forfeiture of \$4,088	
5500÷9000×\$4,088 = \$2,498 (rounded)	(2,498)
Net taxable retired pay	3,002

Example (5). C, a member of the uniformed services retires on January 1, 1966, and receives disability retirement pay of \$11,250 per

year, which is reduced by \$1,250 to provide a survivor annuity, and \$1,000 of which is waived in order to receive disability compensation in like amount under laws administered by the Veterans Administration. C has not reached retirement age for purposes of section 105(d) and is not employed by the Federal Government. C's taxable disability retirement pay for 1966 is \$300 computed as follows:

Adjusted retired pay	\$9,000
Less:	
(i) Excludable retired pay under section (a)(4) as limited by 10 U.S.C. 1403	\$4,500
(ii) Excludable retired pay under section 105(d)	5,200
(iii) Total	9,700
(iv) Less: Retired pay, not to exceed (iii), waived to receive V.A. compensation "sick pay" exclusion	(1,000)
(v) Net disability and "sick pay" exclusion	(8,700)
Net taxable retired pay	800

Example (6). D, a member of the uniformed services, retires for physical disability resulting from active service on January 1, 1966, after 35 years of service and with a disability rated at 20 percent. His active duty pay is \$4,000 per year and he attained retirement age prior to retirement. He had an election in effect under the Retired Serviceman's Family Protection Plan to provide his survivor with an annuity and his retired pay is reduced therefor by \$500 per year. He waives \$1,300 of his retired pay in order to receive compensation from the Veterans Administration in like amount. His taxable retired pay for 1966 is \$1,200 computed as follows:

Gross retired pay (75%×\$4,000)	\$3,000
Less: Section 122(a) exclusion	(500)
Reduced retired pay	2,500
Less: V.A. waiver	(1,300)
Adjusted retired pay	1,200
Less:	
(i) Section 104(a)(4) exclusion	\$800
(ii) Less: Retired pay, not to exceed (i), waived to receive V.A. compensation	(800)
(iii) Net disability exclusion	0
Net taxable retired pay	1,200

(e) *Principles applicable to the Survivor Benefit Plan.* The principles illustrated by the examples set forth in paragraph (d) of this section apply to an annuity

under the Survivor Benefit Plan (10 U.S.C. 1447).

[T.D. 7043, 35 FR 8478, June 2, 1970, as amended by T.D. 7562, 43 FR 38819, Aug. 31, 1978]

§ 1.123-1 Exclusion of insurance proceeds for reimbursement of certain living expenses.

(a) *In general.* (1) Gross income does not include insurance proceeds received by an individual on or after January 1, 1969, pursuant to the terms of an insurance contract for indemnification of the temporary increase in living expenses resulting from the loss of use or occupancy of his principal residence, or a part thereof, due to damage or destruction by fire, storm, or other casualty. The term "other casualty" has the same meaning assigned to such term under section 165(c)(3). The exclusion also applies in the case of an individual who is denied access to his principal residence by governmental authorities because of the occurrence (or threat of occurrence) of such a casualty. The amount excludable under this section is subject to the limitation set forth in paragraph (b) of this section.

(2) This exclusion applies to amounts received as reimbursement or compensation for the reasonable and necessary increase in living expenses incurred by the insured and members of his household to maintain their customary standard of living during the loss period.

(3) This exclusion does not apply to an insurance recovery for the loss of rental income. Nor does the exclusion apply to any insurance recovery which compensates for the loss of, or damage to, real or personal property. See section 165(c)(3) relating to casualty losses; section 1231 relating to gain on an involuntary conversion of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977); and section 1033 relating to recognition of gain on an involuntary conversion. In the case of property used by an insured partially as a principal residence and partially for other purposes, the exclusion does not apply to the amount of insurance proceeds which compensates for the portion of increased expenses attrib-

utable to the nonresidential use of temporary replacement property during the loss period. In the case of denial of access to a principal residence by governmental authority, the exclusion provided by this section does not apply to an insurance recovery received by an individual as reimbursement for living expenses incurred by reason of a governmental condemnation or order not related to a casualty or the threat of a casualty.

(4)(i) Subject to the limitation set forth in paragraph (b), the amount excludable is the amount which is identified by the insurer as being paid exclusively for increased living expenses resulting from the loss of use or occupancy of the principal residence and pursuant to the terms of the insurance contract.

(ii) When a lump-sum insurance settlement includes, but does not specifically identify, compensation for property damage, loss of rental income, and increased living expenses, the amount of such settlement allocable to living expenses shall, in the case of uncontested claims, be that portion of the settlement which bears the same ratio to the total recovery as the amount of claimed increased living expense bears to the total amount of claimed losses and expenses, to the extent not in excess of the coverage limitations specified in the contract for such losses and expenses.

(iii) In the case of a lump-sum settlement involving contested claims, the insured shall establish the amount reasonably allocable to increased living expenses, consistent with the terms of the contract and other facts of the particular case.

(iv) In no event may the amount of a lump-sum settlement which is allocable to increased living expenses exceed the coverage limitation specified in the contract for increased living expenses. Where, however, a coverage limitation is applicable to the total amount payable for increased living expenses and, for example, loss of rental income, the amount of an unitemized settlement which is allocable to increased living expenses may not exceed the portion of the applicable coverage limitation which bears the same ratio