

§ 1.1038-2

26 CFR Ch. I (4-1-02 Edition)

Gain returned by S as income for periods prior to the reacquisition	40	60
Limitation on amount of gain	40	
Gain resulting from the reacquisition of the property		10

(c) The basis of the reacquired real property at the date of the reacquisition is \$20, determined as follows:

Adjusted basis of P's indebtedness to S (\$50 - [\$50 × \$80/\$100])	\$10
Gain resulting from the reacquisition of the property	10
Basis of reacquired property	20

Example 5. (a) S purchases real property for \$80 and sells it to P for \$100, the property not being mortgaged at the time of sale. Under the contract P pays \$10 down and executes a note for \$90, with stated interest at 6 percent, to be paid in nine annual installments. At the time of sale P's note has a fair market value of \$90. S does not elect to report the gain on the installment method but treats the transaction as a deferred-payment sale. After the third \$10 annual payment P defaults and S forecloses. Under the foreclosure sale S bids in the property at \$70, cancels P's obligation of \$60, and pays \$10 to P. There are no other amounts paid by S in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is \$70.

(b) The gain derived by S on the reacquisition of the property is \$0, determined as follows:

Gain before application of the limitation:		
Money with respect to the sale received by S prior to the reacquisition		\$40
Less: Gain returned by S as income for periods prior to the reacquisition (\$10+\$90) - \$80	20	
Gain before application of limitation	20	
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at the time of sale	\$80	
Gain returned by S as income for periods prior to the reacquisition	20	
Amount of money paid by S in connection with the reacquisition	10	110
Limitation on amount of gain (not to be less than zero)		0
Gain resulting from the reacquisition of the property		0

(c) The basis of the reacquired real property at the date of the reacquisition is \$70, determined as follows:

Adjusted basis of P's indebtedness to S (face value at time of reacquisition)	\$60
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Gain resulting from the reacquisition of the property	0
Amount of money paid by S in connection with the reacquisition	10
Basis of reacquired property	70

[T.D. 6916, 32 FR 5925, Apr. 13, 1967; 32 FR 6971, May 6, 1967]

§ 1.1038-2 Reacquisition and resale of property used as a principal residence.

(a) *Application of special rules*—(1) *In general.* If paragraph (a) of § 1.1038-1 applies to the reacquisition of real property which was used by the seller as his principal residence and with respect to the sale of which an election under section 121 is in effect or with respect to the sale of which gain was not recognized under section 1034, the provisions of § 1.1038-1 (other than paragraph (a) thereof) shall not, and this section shall, apply to the reacquisition of such property if the property is resold by the seller within one year after the date of the reacquisition. For purposes of this section an election under section 121 shall be considered to be in effect with respect to the sale of the property if, at the close of the last day for making such an election under section 121(c) with respect to such sale, an election under section 121 has been made and not revoked. Thus, a taxpayer who properly elects, subsequent to the reacquisition, to have section 121 apply to a sale of his residence may be eligible for the treatment provided in this section. The treatment provided by this section is mandatory; however, see § 1.1038-3 for an election to apply the provisions of this section to certain taxable years beginning after December 31, 1957.

(2) *Sale and resale treated as one transaction.* In the case of a reacquisition to which this section applies, the resale of the reacquired property shall be treated, for purposes of applying sections 121 and 1034, as part of the transaction constituting the original sale of such property. In effect, the reacquisition is generally disregarded pursuant to this section and, for purposes of applying sections 121 and 1034, the resale of the property is considered to constitute a sale of such property occurring on the date of the original sale of such property.

(b) *Transactions not included.* (1) If with respect to the original sale of the property there was no nonrecognition of gain under section 1034 and an election under section 121 is not in effect, the provisions of § 1.1038-1, and not this section, shall apply to the reacquisition. Thus, for example, if in the case of a taxpayer not entitled to the benefit of section 121 there is no gain on the original sale of the property, the provisions of § 1.1038-1, and not this section, shall apply even though a redetermination of gain under this section would result in the nonrecognition of gain on the sale under section 1034. Also, if in the case of such a taxpayer there was gain on the original sale of the property but after the application of section 1034 all of such gain was recognized, the provisions of § 1.1038-1, and not this section, shall apply to the reacquisition.

(2) If the original sale of the property was not eligible for the treatment provided by section 121 and section 1034, the provisions of § 1.1038-1, and not this section, shall apply to the reacquisition of the property even though the resale of such property is eligible for the treatment provided by either or both of sections 121 and 1034.

(c) *Redetermination of gain required—*

(1) *Sale of old residence.* The amount of gain excluded under section 121 on the sale of the property and the amount of gain recognized under section 1034 on the sale of the property shall be redetermined under this section by recomputing the adjusted sales price and the adjusted basis of the property, and any adjustments resulting from the redetermination of the gain on the sale of such property shall be reflected in the income of the seller for his taxable year in which the resale of the property occurs.

(2) *Sale of new residence.* If gain was not recognized under section 1034 on the original sale of the property, the adjusted basis of the new residence shall be redetermined under this section. If the new residence has been sold, the amount of gain returned on such sale of the new residence which is affected by the redetermination of the recognized gain on the sale of the old residence shall be redetermined under this section, and any adjustments re-

sulting from the redetermination of the gain on the sale of the new residence shall be reflected in income of the seller for his taxable year in which the resale of the old residence occurs.

(d) *Redetermination of adjusted sales price.* For purposes of applying sections 121 and 1034 pursuant to this section, the adjusted sales price of the reacquired real property shall be redetermined by taking into account both the sale and the resale of the property and shall be—

(1) The amount realized, which for purposes of section 1001 shall be—

(i) The amount realized on the resale of the property, as determined under paragraph (b)(4) of § 1.1034-1, plus

(ii) The amount realized on the original sale of the property, determined as provided in paragraph (b)(4) of § 1.1034-1, less that portion of any obligations of the purchaser arising with respect to such sale which at the time of reacquisition is secured by such property and is unpaid, less

(iii) The amount of money and the fair market value of other property (other than obligations of the purchaser to the seller secured by the real property) paid or transferred by the seller in connection with the reacquisition of such real property,

reduced by

(2) The total of the fixing-up expenses (as defined in par. (b)(6) of § 1.1034-1) incurred for work performed on such real property to assist in both its original sale and its resale.

For purposes of applying paragraph (b)(6) of § 1.1034-1, there shall be two 90-day periods, the first ending on the day on which the contract to sell is entered into in connection with the original sale of the property, and the second ending on the day on which the contract to sell is entered into in connection with the resale of the property. There shall also be two 30-day periods for such purposes, the first ending on the 30th day after the date of the original sale, and the second ending on the 30th day after the date of the resale. For determination of the obligations of the purchaser arising with respect to the original sale of the property, see

paragraph (b)(3) of § 1.1038-1. For determination of amounts paid or transferred by the seller in connection with the reacquisition of the property, see paragraph (c)(4) of § 1.1038-1.

(e) *Determination of adjusted basis at time of resale.* For purposes of applying sections 121 and 1034 pursuant to this section, the adjusted basis of the reacquired real property at the time of its resale shall be—

(1) The sum of—

(i) The adjusted basis of such property at the time of the original sale, with proper adjustment under section 1016(a) in respect of such property for the period occurring after the reacquisition of such property, and

(ii) Any indebtedness of the purchaser to the seller which arose subsequent to the original sale of such property and which at the time of reacquisition was secured by such property, reduced by

(2) Any indebtedness of the purchaser to the seller which at the time of reacquisition was secured by the reacquired real property and which, for any taxable year ending before the taxable year in which occurs the reacquisition to the seller which was secured by the seller as having become worthless or partially worthless by taking a bad debt deduction under section 166(a).

The reduction under the preceding sentence by reason of having treated indebtedness as worthless or partially worthless shall not exceed the amount by which there would be an increase in the basis of such indebtedness under paragraph (f)(3) of § 1.1038-1 if section 1038(d) had been applicable to the reacquisition of such property.

(f) *Treatment of indebtedness secured by the property—*(1) *Year of reacquisition.* No debt of the purchaser to the seller which was secured by the reacquired real property shall be considered as becoming worthless or partially worthless as a result of a reacquisition of such real property to which this section applies. Accordingly, no deduction for a bad debt shall be allowed, as a result of the reacquisition, in order to reflect the noncollectibility of any indebtedness of the purchaser to the seller which at the time of reacquisition was secured by such real property. In

addition, no deduction shall be allowed, for the taxable year in which occurs a reacquisition of real property to which this section applies, in respect of any indebtedness of the purchaser secured by such property which has been treated by the seller as having become worthless or partially worthless in such taxable year but prior to the date of such reacquisition.

(2) *Prior taxable years.* For reduction of the basis of the real property for indebtedness treated as worthless or partially worthless for taxable years ending before the taxable year in which occurs the reacquisition, see paragraph (e) of this section.

(3) *Basis of indebtedness.* The basis of any indebtedness of the purchaser to the seller which was secured by the reacquired real property, to the extent that such indebtedness is not discharged upon the reacquisition of such property, shall be zero.

(g) *Date of sale.* Since the resale of the property, by being treated as part of the transaction constituting the original sale of the property, is treated as having occurred on the date of the original sale, in determining whether any of the time requirements of section 121 or section 1034 are satisfied for purposes of this section the date of the original sale is used, except to the extent provided in paragraph (d)(2) of this section.

(h) *Illustrations.* The application of this section may be illustrated by the following examples:

Example 1. (a) On June 30, 1964, S, a single individual over 65 years of age, sells his principal residence to P for \$25,000, the property not being mortgaged at the time of sale. S properly elects to apply the provisions of section 121 to the sale. Under the contract, P pays \$5,000 down and executes a note for \$20,000 with stated interest at 6 percent, the principal being payable in installments of \$5,000 each on January 1 of each year and the note being secured by the real property which is sold. At the time of sale P's note has a fair market value of \$20,000. S does not elect to report the gain on the installment method but treats the transaction as a deferred-payment sale, title to the property being transferred to P at the time of sale. S uses the calendar year as the taxable year and the cash receipts and disbursements method of accounting. After making two annual payments of \$5,000 each on the note, P defaults on the contract, and on March 1,

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1967, S reacquires the real property in full satisfaction of P's indebtedness, title to the property being voluntarily reconveyed to S. On November 1, 1967, S sells the property to T for \$35,000. The assumption is made that no fixing-up expenses are incurred for work performed on the principal residence in order to assist in the sale of the property in 1964 or in the resale of the property in 1967. At the time of sale in 1964 the property has an adjusted basis of \$15,000. S does not treat any indebtedness with respect to the sale in 1964 as being worthless or partially worthless or make any capital expenditures with respect to the property after such sale. In his return for 1964, S includes in income \$2,000 capital gain from the sale of his residence.

(b) The results obtained before and after the reacquisition of the property are as follows:

	Before reacquisition	After reacquisition
Adjusted sales price:		
\$5,000+\$20,000	\$25,000	.....
\$15,000+\$35,000 .....	.....	\$50,000
Less: Adjusted basis of property at time of sale	15,000	15,000
Gain on sale	10,000	35,000
Gain excluded from income under section 121:		
\$10,000×\$20,000/\$25,000	8,000	.....
\$35,000×\$20,000/\$50,000 .....	.....	14,000
Gain included in income after applying section 121:		
\$10,000 - \$8,000	2,000	.....
\$35,000 - \$14,000 .....	.....	21,000

(c) S is required to show the additional inclusion of \$19,000 capital gain (\$21,000 - \$2,000) in income on his return for 1967.

Example 2. (a) The facts are the same as in example (1) except that on April 1, 1965, S purchases a new residence at a cost of \$30,000 and qualifies for the nonrecognition of gain under section 1034 in respect of the sale of his principal residence on June 30, 1964. In his return for 1964, S does not include any capital gain in income as a result of the sale of the old residence.

(b) The results obtained before and after the reacquisition of the property are as follows:

	Before reacquisition	After reacquisition
Application of section 121 (see example (1)):		
Adjusted sales price	\$25,000	\$50,000
Less: Adjusted basis of property at time of sale	15,000	15,000
Gain on sale	10,000	35,000
Gain excluded from income under section 121	8,000	14,000

	Before reacquisition	After reacquisition
Gain not excluded from income under section 121	2,000	21,000
Application of section 1034: Adjusted sales price:		
\$25,000 - \$8,000	17,000	.....
\$50,000 - \$14,000 .....	.....	36,000
Less: Cost of new residence	30,000	30,000
Gain recognized under section 1034 on sale of old residence	0	6,000
Gain not recognized under section 1034 on sale of old residence:		
(\$10,000 - [\$8,000+\$0])	2,000	.....
(\$35,000 - [\$14,000+\$6,000]) .....	.....	15,000
Adjusted basis of new residence on April 1, 1965:		
\$30,000 - \$2,000	28,000	.....
\$30,000 - \$15,000 .....	.....	15,000

(c) The \$6,000 of capital gain on the sale of the old residence is required to be included in income on the return for 1967. The adjusted basis on April 1, 1965, for determining gain on a sale or exchange of the new residence at any time on or after that date is \$15,000, after taking into account the reacquisition and resale of the old residence.

Example 3. The facts are the same as in example (2) except that S sells the new residence on June 20, 1965, for \$40,000 and includes \$12,000 of capital gain (\$40,000 - \$28,000) on its sale in his income on the return for 1965. S is required to include the additional capital gain of \$13,000 [(\$40,000 - \$15,000) - \$12,000] on the sale of the new residence in his income on the return for 1967. For this purpose, the assumption is also made that there are no additional adjustments to the basis of the new residence after April 1, 1965.

[T.D. 6916, 32 FR 5929, Apr. 13, 1967; 32 FR 6971, May 6, 1967]

§ 1.1038-3 Election to have section 1038 apply for taxable years beginning after December 31, 1957.

(a) *In general.* If an election is made in the manner provided by paragraph (b) of this section, the applicable provisions of §§ 1.1038-1 and 1.1038-2 shall apply to all reacquisitions of real property occurring in each and every taxable year beginning after December 31, 1957, and before September 3, 1964, for which the assessment of a deficiency, or the credit or refund of an overpayment, is not prevented on September 2, 1964, by the operation of any law or rule of law. The election so made shall apply to all taxable years beginning