

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.

§ 1.121-5 [Removed]

Par. 3. Section 1.121-5 is removed.

Par. 4. Section 1.1398-3 is added to read as follows:

§ 1.1398-3 Treatment of section 121 exclusion in individuals' title 11 cases.

(a) *Scope.* This section applies to cases under chapter 7 or chapter 11 of title 11 of the United States Code, but only if the debtor is an individual.

(b) *Definition and rules of general application.* For purposes of this section, section 121 exclusion means the exclusion of gain from the sale or exchange of a debtor's principal residence available under section 121.

(c) *Estate succeeds to exclusion upon commencement of case.* The bankruptcy estate succeeds to and takes into account the section 121 exclusion with respect to the property transferred into the estate.

(d) *Effective date.* This section is applicable for sales or exchanges on or after December 24, 2002.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved: December 11, 2002.

Pamela F. Olson,
Assistant Secretary of the Treasury.
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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9031]

RIN 1545-BB02

Reduced Maximum Exclusion of Gain From Sale or Exchange of Principal Residence

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the exclusion of gain from the sale or exchange of a taxpayer's principal residence in the case of a taxpayer who has not owned and used the property as the taxpayer's principal residence for two of the preceding five years or who has excluded gain from the sale or exchange of a principal residence within the preceding two years. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: *Effective Date:* These regulations are effective December 24, 2002.

Applicability Date: For dates of applicability, see § 1.121-3T(l).

FOR FURTHER INFORMATION CONTACT: Sara Paige Shepherd, (202) 622-4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 121(c) relating to the exclusion of gain from the sale or exchange of the principal residence of a taxpayer who has not owned and used the property as the taxpayer's principal residence for two of the preceding five years or who has excluded gain on the sale or exchange of a principal residence within the preceding two years.

Under section 121(a), a taxpayer may exclude up to \$250,000 (\$500,000 for certain joint returns) of gain realized on the sale or exchange of the taxpayer's principal residence if the taxpayer owned and used the property as the taxpayer's principal residence for at least two years during the five-year period ending on the date of the sale or exchange. Section 121(b)(3) allows the taxpayer to apply the maximum exclusion to only one sale or exchange during the two-year period ending on the date of the sale or exchange. Section

121(c) provides that a taxpayer who fails to meet any of these conditions by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances, may be entitled to an exclusion in a reduced maximum amount.

On October 10, 2000, a notice of proposed rulemaking (REG-105235-99) under section 121 was published in the **Federal Register** (65 FR 60136). The proposed regulations did not define change in place of employment, health, or unforeseen circumstances for purposes of the reduced maximum exclusion. Comments were specifically requested regarding what circumstances should qualify as unforeseen. A public hearing was held on January 26, 2001.

The IRS and Treasury Department received numerous comments regarding the reduced maximum exclusion and have concluded that many of these comments should be adopted. However, because the rules formulated in response to these comments are extensive, the IRS and Treasury Department have concluded that the rules relating to the reduced maximum exclusion should be issued as proposed and temporary regulations to provide the public with adequate notice and opportunity to comment. Final regulations under section 121 addressing provisions other than the reduced maximum exclusion are set forth elsewhere in this edition of the **Federal Register**.

Explanation of Provisions

1. General Provisions

Under the temporary regulations, a reduced maximum exclusion limitation is available to a taxpayer who has sold or exchanged property owned and used as the taxpayer's principal residence for less than two of the preceding five years or who has excluded gain on the sale or exchange of a principal residence within the preceding two years. This reduced maximum exclusion applies only if the sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances. A sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances only if the taxpayer's primary reason for the sale or exchange is a change in place of employment, health, or unforeseen circumstances. The taxpayer's primary reason for the sale or exchange is determined based on the facts and circumstances. The temporary regulations provide a list of factors that may be relevant in determining the taxpayer's primary reason. These factors

are suggestive only. No single fact or particular combination of facts is determinative of the taxpayer's entitlement to the reduced maximum exclusion.

In addition, for each of the three grounds for claiming a reduced maximum exclusion, the temporary regulations provide a general definition and one or more safe harbors. If a safe harbor applies, the taxpayer's primary reason for the sale or exchange is deemed to be a change in place of employment, health, or unforeseen circumstances.

2. Change in Place of Employment

The temporary regulations provide that a sale or exchange is by reason of a change in place of employment if the taxpayer's primary reason for the sale or exchange is a change in the location of the employment of a qualified individual. *Employment* is defined as the commencement of employment with a new employer, the continuation of employment with the same employer, or the commencement or continuation of self-employment. A *qualified individual* is defined as the taxpayer, the taxpayer's spouse, a co-owner of the residence, or a person whose principal place of abode is in the same household as the taxpayer.

The temporary regulations adopt a safe harbor, suggested by commentators, that provides that the primary reason for the sale or exchange is deemed to be a change in place of employment if the new place of employment of a qualified individual is at least fifty miles farther from the residence sold or exchanged than was the former place of employment. If the individual was unemployed, the distance between the new place of employment and the residence sold or exchanged must be at least fifty miles. This standard is derived from section 217(c)(1) relating to the moving expense deduction. The safe harbor applies only if the change in place of employment occurs during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence. If a sale or exchange does not satisfy this safe harbor, a taxpayer may still qualify for the reduced maximum exclusion by reason of a change in place of employment if the facts and circumstances indicate that a change in place of employment is the primary reason for the sale or exchange.

3. Sale or Exchange by Reason of Health

Commentators proposed that, for purposes of determining whether a sale or exchange is by reason of health, the regulations adopt standards similar to

those for the deductibility of medical expenses under section 213(a). Commentators also suggested that the regulations provide that the reduced maximum exclusion by reason of health apply to sales and exchanges due to (1) advanced age-related infirmities, (2) the taxpayer's need to move in order to care for a family member, (3) severe allergies, and (4) emotional problems.

In response to these comments, the temporary regulations provide the general rule that a sale or exchange is by reason of health if the taxpayer's primary reason for the sale or exchange is (1) to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual, or (2) to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. A sale or exchange that is merely beneficial to the general health or well-being of the individual is not a sale or exchange by reason of health.

One commentator suggested that the regulations establish a safe harbor allowing a taxpayer to claim a reduced maximum exclusion if the taxpayer obtains documentation of a specific medical condition from a licensed physician. The temporary regulations provide a safe harbor that the primary reason for the sale or exchange is deemed to be health if a physician (as defined in section 213(d)(4)) recommends a change of residence for reasons of health.

For purposes of the reduced maximum exclusion by reason of health, the term *qualified individual* includes the taxpayer, the taxpayer's spouse, a co-owner of the residence, a person whose principal place of abode is in the same household as the taxpayer, and certain family members of these individuals. The definition of qualified individual in the case of health is broader than the definition that applies to the exclusions by reason of change in place of employment and unforeseen circumstances to encompass taxpayers who sell or exchange their residence in order to care for sick family members.

4. Sale or Exchange by Reason of Unforeseen Circumstances

The temporary regulations provide that a sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence.

Many commentators provided suggestions regarding circumstances that should qualify as unforeseen. A large number of commentators

suggested that unforeseen circumstances should encompass divorce or the termination of a permanent residential relationship. Others suggested that unforeseen circumstances should include death, birth, marriage, bankruptcy, the loss of employment, incarceration, admission to an institution of higher learning, natural and man-made disasters, involuntary conversions, and a substantial increase in medical or living expenses leading to a significant change in economic circumstances. One commentator suggested that any delay of over three years in selling the residence due to a decline in the real estate market should be deemed an unforeseen circumstance. A few commentators suggested that unforeseen circumstances should include unfavorable changes affecting the desirability of the property, such as environmental problems, zoning-law changes, slovenly neighbors, and serious nuisance or safety concerns.

The temporary regulations adopt many of these suggestions as safe harbors. A taxpayer's primary reason for the sale or exchange is deemed to be unforeseen circumstances if one of the safe harbor events occurs during the taxpayer's ownership and use of the property. The safe harbor events include the involuntary conversion of the residence, a natural or man-made disaster or act of war or terrorism resulting in a casualty to the residence, and, in the case of a qualified individual: (1) Death, (2) the cessation of employment as a result of which the individual is eligible for unemployment compensation, (3) a change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household, (4) divorce or legal separation under a decree of divorce or separate maintenance, and (5) multiple births resulting from the same pregnancy. The Commissioner may designate other events or situations as unforeseen circumstances in published guidance of general applicability or in a ruling directed to a specific taxpayer. A taxpayer who does not qualify for a safe harbor may demonstrate that the primary reason for the sale or exchange is unforeseen circumstances, under a facts and circumstances test.

For purposes of the reduced maximum exclusion by reason of unforeseen circumstances, a *qualified individual* includes the taxpayer, the taxpayer's spouse, a co-owner of the residence, and a person whose principal place of abode is in the same household as the taxpayer.

The regulations include examples illustrating the application of the safe harbors and the facts and circumstances test.

5. Election To Apply Regulations Retroactively

The regulations provide that taxpayers who would otherwise qualify under these temporary regulations to exclude gain from a sale or exchange that occurred before the effective date of the regulations but on or after May 7, 1997, may elect to apply all of the provisions of the temporary regulations to the sale or exchange. A taxpayer may make the election 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 all of the provisions of these regulations for any years for which the period of limitations under section 6511 has not expired by filing an amended return.

6. Audit Protection

The temporary regulations provide that the IRS will not challenge a taxpayer's position that a sale or exchange before the effective date of these regulations 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.

7. Effective Date

These temporary regulations apply to sales and exchanges on or after December 24, 2003.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in the Proposed Rules section in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business

Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Sara Paige Shepherd, Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.121-3T is added to read as follows:

§ 1.121-3T Reduced maximum exclusion for taxpayers failing to meet certain requirements (temporary).

(a) [Reserved] For further guidance, see § 1.121-3(a).

(b) *Primary reason for sale or exchange.* In order for a taxpayer to claim a reduced maximum exclusion under section 121(c), the sale or exchange must be by reason of a change in place of employment, health, or unforeseen circumstances. A sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances only if the primary reason for the sale or exchange is a change in place of employment (within the meaning of paragraph (c) of this section), health (within the meaning of paragraph (d) of this section), or unforeseen circumstances (within the meaning of paragraph (e) of this section). Whether the requirements of this section are satisfied depends upon all the facts and circumstances. If the taxpayer qualifies for a safe harbor described in this section, the taxpayer's primary reason is deemed to be a change in place of employment, health, or unforeseen circumstances. If the taxpayer does not qualify for a safe harbor, factors that may be relevant in determining the taxpayer's primary reason for the sale or exchange include (but are not limited to) the extent to which—

(1) The sale or exchange and the circumstances giving rise to the sale or exchange are proximate in time;

(2) The suitability of the property as the taxpayer's principal residence materially changes;

(3) The taxpayer's financial ability to maintain the property materially changes;

(4) The taxpayer uses the property as the taxpayer's residence during the period of the taxpayer's ownership of the property;

(5) The circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and

(6) The circumstances giving rise to the sale or exchange occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

(c) *Sale or exchange by reason of a change in place of employment*—(1) *In general.* A sale or exchange is by reason of a change in place of employment if, in the case of a qualified individual described in paragraph (f) of this section, the primary reason for the sale or exchange is a change in the location of the individual's employment.

(2) *Distance safe harbor.* The primary reason for the sale or exchange is deemed to be a change in place of employment (within the meaning of paragraph (c)(1) of this section) if—

(i) The change in place of employment occurs during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence; and

(ii) The individual's new place of employment is at least 50 miles farther from the residence sold or exchanged than was the former place of employment, or, if there was no former place of employment, the distance between the individual's new place of employment and the residence sold or exchanged is at least 50 miles.

(3) *Employment.* For purposes of this paragraph (c), *employment* includes the commencement of employment with a new employer, the continuation of employment with the same employer, and the commencement or continuation of self-employment.

(4) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1. A is unemployed and owns a townhouse that she has owned and used as her principal residence since 2002. In 2003 A obtains a job that is 54 miles from her townhouse, and she sells the townhouse. Because the distance between A's new place of employment and the townhouse is at least 50 miles, the sale is within the safe harbor of paragraph (c)(2) of this section and A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 2. B is an officer in the United States Air Force stationed in Florida. B

purchases a house in Florida in 2001. In May 2002 B moves out of his house to take a 3-year assignment in Germany. B sells his house in January 2003. Because B's new place of employment in Germany is at least 50 miles farther from the residence sold than is B's former place of employment in Florida, the sale is within the safe harbor of paragraph (c)(2) of this section and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 3. C is employed by Employer R at R's Philadelphia office. C purchases a house in February 2001 that is 35 miles from R's Philadelphia office. In May 2002 C begins a temporary assignment at R's Wilmington office that is 72 miles from C's house, and moves out of the house. In June 2004 C is assigned to work in R's London office, and as a result, sells her house in August 2004. The sale of the house is not within the safe harbor of paragraph (c)(2) of this section by reason of the change in place of employment from Philadelphia to Wilmington because the Wilmington office is not 50 miles farther from C's house than is the Philadelphia office. Furthermore, the sale is not within the safe harbor by reason of the change in place of employment to London because C is not using the house as her principal residence when she moves to London. However, C is entitled to claim a reduced maximum exclusion under section 121(c)(2) because, under the facts and circumstances, the primary reason for the sale is the change in C's place of employment.

Example 4. In July 2002 D buys a condominium that is 5 miles from her place of employment and uses it as her principal residence. In February 2003 D, who works as an emergency medicine physician, obtains a job that is located 51 miles from D's condominium. D may be called in to work unscheduled hours and, when called, must be able to arrive at work quickly. Therefore, D sells her condominium and buys a townhouse that is 4 miles from her new place of employment. Because D's new place of employment is only 46 miles farther from the condominium than is D's former place of employment, the sale is not within the safe harbor of paragraph (c)(2) of this section. However, D is entitled to claim a reduced maximum exclusion under section 121(c)(2) because, under the facts and circumstances, the primary reason for the sale is the change in D's place of employment.

(d) *Sale or exchange by reason of health*—(1) *In general.* A sale or exchange is by reason of health if the primary reason for the sale or exchange is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual described in paragraph (f) of this section, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. A sale or exchange that is merely beneficial to the general health or well-being of the individual is not a sale or exchange by reason of health.

(2) *Physician's recommendation safe harbor.* The primary reason for the sale or exchange is deemed to be health if a physician (as defined in section 213(d)(4)) recommends a change of residence for reasons of health (as defined in paragraph (d)(1) of this section).

(3) *Examples.* The following examples illustrate the rules of this paragraph (d):

Example 1. In 2002 A buys a house that she uses as her principal residence. A is injured in an accident and is unable to care for herself. As a result, A sells her house in 2003 and moves in with her daughter so that the daughter can provide the care that A requires as a result of her injury. Because, under the facts and circumstances, the primary reason for the sale of A's house is A's health, A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 2. H's father has a chronic disease. In 2002 H and W purchase a house that they use as their principal residence. In 2003 H and W sell their house in order to move into the house of H's father so that they can provide the care he requires as a result of his disease. Because, under the facts and circumstances, the primary reason for the sale of their house is the health of H's father, H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 3. H and W purchase a house in 2002 that they use as their principal residence. Their son suffers from a chronic illness that requires regular medical care. Later that year their doctor recommends that their son begin a new treatment that is available at a medical facility 100 miles away from their residence. In 2003 H and W sell their house to be closer to the medical facility. Because, under the facts and circumstances, the primary reason for the sale is to facilitate the treatment of their son's chronic illness, H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 4. B, who has chronic asthma, purchases a house in Minnesota in 2002 that he uses as his principal residence. B's doctor tells B that moving to a warm, dry climate would mitigate B's asthma symptoms. In 2003 B sells his house and moves to Arizona to relieve his asthma symptoms. The sale is within the safe harbor of paragraph (d)(2) of this section and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 5. In 2002 H and W purchase a house in Michigan that they use as their principal residence. H's doctor tells H that he should get more exercise, but H is not suffering from any disease that can be treated or mitigated by exercise. In 2003 H and W sell their house and move to Florida so that H can increase his general level of exercise by playing golf year-round. Because the sale of the house is merely beneficial to H's general health, the sale of the house is not by reason of H's health. H and W are not entitled to claim a reduced maximum exclusion under section 121(c)(2).

(e) *Sale or exchange by reason of unforeseen circumstances*—(1) *In*

general. A sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence.

(2) *Specific event safe harbors.* The primary reason for the sale or exchange is deemed to be unforeseen circumstances (within the meaning of paragraph (e)(1) of this section) if any of the events specified in paragraphs (e)(2)(i) through (iii) of this section occur during the period of the taxpayer's ownership and use of the residence as the taxpayer's principal residence—

(i) The involuntary conversion of the residence;

(ii) Natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence (without regard to deductibility under section 165(h));

(iii) In the case of a qualified individual described in paragraph (f) of this section—

(A) Death;

(B) The cessation of employment as a result of which the individual is eligible for unemployment compensation (as defined in section 85(b));

(C) A change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household (including amounts for food, clothing, medical expenses, taxes, transportation, court-ordered payments, and expenses reasonably necessary to the production of income, but not for the maintenance of an affluent or luxurious standard of living);

(D) Divorce or legal separation under a decree of divorce or separate maintenance; or

(E) Multiple births resulting from the same pregnancy; or

(iv) An event determined by the Commissioner to be an unforeseen circumstance to the extent provided in published guidance of general applicability or in a ruling directed to a specific taxpayer.

(3) *Examples.* The following examples illustrate the rules of this paragraph (e):

Example 1. In 2003 A buys a house in California. After A begins to use the house as her principal residence, an earthquake causes damage to A's house. A sells the house in 2004. The sale is within the safe harbor of paragraph (e)(2)(ii) of this section and A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 2. H works as a teacher and W works as a pilot. In 2003 H and W buy a house that they use as their principal

residence. Later that year W is furloughed from her job for six months. H and W are unable to pay their mortgage during the period W is furloughed. H and W sell their house in 2004. The sale is within the safe harbor of paragraph (e)(2)(iii)(C) of this section and H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 3. In 2003 H and W buy a two-bedroom condominium that they use as their principal residence. In 2004 W gives birth to twins and H and W sell their condominium and buy a four-bedroom house. The sale is within the safe harbor of paragraph (e)(2)(iii)(E) of this section, and H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 4. B buys a condominium in 2003 and uses it as his principal residence. B's monthly condominium fee is \$X. Three months after B moves into the condominium, the condominium association decides to replace the building's roof and heating system. Six months later, B's monthly condominium fee doubles. B sells the condominium in 2004 because B is unable to pay the new condominium fee along with the monthly mortgage payment. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale is unforeseen circumstances, and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 5. In 2003 C buys a house that he uses as his principal residence. The property is located on a heavily trafficked road. C sells the property in 2004 because the traffic is more disturbing than he expected. C is not entitled to claim a reduced maximum exclusion under section 121(c)(2) because the safe harbors of paragraph (e)(2) of this section do not apply and, under the facts and circumstances, the traffic is not an unforeseen circumstance.

Example 6. In 2003 D and her fiancé E buy a house and live in it as their principal residence. In 2004 D and E cancel their wedding plans and E moves out of the house. Because D cannot afford to make the monthly mortgage payments alone, D and E sell the house in 2004. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale is unforeseen circumstances, and D and E are each entitled to claim a reduced maximum exclusion under section 121(c)(2).

(f) *Qualified individual.* For purposes of this section, *qualified individual* means—

(1) The taxpayer;

(2) The taxpayer's spouse;

(3) A co-owner of the residence;

(4) A person whose principal place of abode is in the same household as the taxpayer; or

(5) For purposes of paragraph (d) of this section, a person bearing a relationship specified in sections 152(a)(1) through 152(a)(8) (without regard to qualification as a dependent) to a qualified individual described in

paragraphs (f)(1) through (4) of this section, or a descendant of the taxpayer's grandparent.

(g) [Reserved]. For further guidance, see § 1.121-3(g).

(h) *Election to apply regulations retroactively.* Taxpayers who would otherwise qualify under this section to exclude gain from a sale or exchange before December 24, 2002 but on or after May 7, 1997, may elect to apply all of the provisions of this section for any years for which the period of limitations under section 6511 has not expired. The taxpayer makes the election under this paragraph (h) 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 all the provisions of this section for any years for which the period of limitations under section 6511 has 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).

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

Approved: December 11, 2002.

Pamela F. Olson,

Assistant Secretary of the Treasury.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1, 301, and 602

[TD 9032]

RIN 1545-AW24

Election To Treat Trust as Part of an Estate

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.