

## INFORMATION PAPER

DAJA-LA  
1 September 2000

SUBJECT: Tax Treatment of Capital Gain on Home Sale

1. Purpose. To provide information on the tax treatment of capital gain on sale of a home.

2. Facts.

a. Background:

(1) The Taxpayer Relief Act of 1997 significantly modified section 121 of the Internal Revenue Code. For home sales after 6 May 1997, a single taxpayer may exclude up to \$250,000 of gain from the sale of a home. Married couples that file jointly may exclude up to \$500,000. To qualify for the exclusion, the taxpayer must have both owned and used the property as a principal residence for 2 years or more during the 5-year period ending on the date of sale.

(2) The modifications to section 121 repealed section 1034 -- the "roll over" rules. These rules allowed homeowners to defer the gain from the sale of a "principal residence" by purchasing a new home of equal or greater value. Determination of "principal residence" was based on facts and circumstances. To qualify, it must have been the taxpayer's "principal residence" at the time of sale.

(3) Given the proper facts, case law applying the "roll over" rules allowed a homeowner to be absent from his or her principal residence for an extended period without it losing its status as the principal residence. Additionally, the roll over rules gave military homeowners as many as 8 years after the sale to purchase a new residence (complete the roll over) to defer tax on any gain.

(4) Under the new law, for houses sold after 6 May 1997, a military member must actually "own and use" the property for 2 years of the 5-year period immediately preceding the sale to qualify the property for the complete exclusion. This test is strictly applied. The "facts and circumstances" test is no longer used.

(5) Military homeowners are often assigned away from the home they consider to be their principal residence. Many military members have been absent from their homes for extended periods assuming they could "roll over" any gain upon sale. For sales after 6 May 1997, this is no longer true. Those who have been absent from their homes for periods greater than three years and sell after 6 May 1997 will fail the strict time requirement of the "owned and used" test. Upon sale of the property, the military member may be subject to tax on part or all of the gain.

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(6) Sales on or before 6 May 1997 still are controlled by the "roll over" rules. The military homeowner has 4 years (up to 8 years if stationed overseas) to complete the roll over and defer the gain from the sale. However, if the homeowner fails to timely complete the rollover, the gain from the sale will be taxed.

b. Proposed Changes: Two bills were introduced in the 106th Congress (S. 309 and H.R. 865) to provide relief to military homeowners who either face, or have already incurred, unexpected capital gains for the sale of their home. Both bills would have allowed a service member to be assigned away from his home without losing the ability to exclude the capital gain from income that exists under the tax code for most homeowners. Neither bill was enacted.

c. Current Law:

(1) Read and interpret IRC § 121 literally. If the taxpayer has not owned and used the home for 2 of the 5 years immediately preceding the date of sale, he will not qualify for the full exclusion.

(2) No special relief provisions exist for the members of the Armed Forces or absences from the home due to military service. Recent efforts to enact such legislation were unsuccessful.

(3) The Armed Forces Tax Counsel continues to pursue relief for the military homeowner.

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