

THE PRACTITIONER | MITCHELL A. JACOBS AND DAVID L. MARCUS

Section 1034 Rollover of Gain From Sale of Residence

Internal Revenue Code section 1034 provides that gain from the sale of a principal residence shall not be reported during the year of the sale if the taxpayer purchases a new principal residence either two years before or within two years after the sale. The amount of the deferred gain cannot exceed the net proceeds from the sale.

Any gain from the sale of the residence that cannot be deferred must be reported on the return for the year of the sale, which often, as a practical matter, requires an amended return. The basis of the new residence is then lowered by the amount that qualified for deferral.

Several issues arise when section 1034 is applied in the context of marital dissolutions. One concern is, if the spouses jointly owned the residence that was sold, is each spouse solely responsible for reporting one-half of any gain and entitled to one-half of the amount eligible for deferral. (The rules in section 1034 and attendant regulations for determining the actual amount eligible for deferral and the basis of a new residence are not relevant to this discussion.)

In *In re Marriage of Harrington*, 6 Cal.App.4th 1847 (1992), the parties sold their principal residence during the pendency of their dissolution action and equally divided the gain.

Within two years after the sale, the husband purchased a new principal residence and was able to defer the entire amount of his half of the gain. The wife, however, purchased a new principal residence that cost less than her one-half of the sale proceeds, resulting in a tax liability.

The court rejected the wife's motion to require the husband to pay one-half of this tax liability. The court stated that at the time of the judgment it was not appropriate for the trial court to speculate as to the potential tax liability of each party, since the eventual liability would depend on "individual income two years later, individual savings, receipt of gifts or

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inheritance, ability to borrow money, and other circumstances not pertinent to the division of community property."

It appears that the reasoning of *Harrington* would not apply if the residence were sold two years before entry of judgment, since the tax liability is not speculative.

Probably the most important issue in the dissolution context is whether a residence can be considered a spouse's "principal residence" if that spouse does not live in the residence.

A typical situation is one in which one spouse moves out of the residence and the residence is then sold with the out-spouse still on the title to the residence.

The regulations provide that whether a home is a principal residence "depends upon all the facts and circumstances in each case, including the good faith of the taxpayer." Treas. Reg. section 1.1034-1(c) (3) (ii) (1992).

An older case held that when a party moves out of a residence, the test of whether or not the residence remains that party's principal residence is whether or not the party "abandoned" the residence. *Stolk v. Commissioner*, 326 F.2d 760 (2d Cir. 1964, affirming 40 T.C. 345).

Young v. Commissioner, T.C. Memo 1985-127, is the only decision in the divorce context addressing the issue of whether a residence is the "principal residence" of a spouse who moved out of the family residence.

In *Young*, the divorce decree of the parties awarded 75 percent of the family residence to the wife and 25 percent to the husband. The decree further provided that the wife was awarded the exclusive use of the residence. The husband moved out of the family residence on the day the divorce decree was entered.

Twenty months after the husband moved out, he sold his interest in the

residence. Then one year later he bought another residence.

The tax court held that section 1034 did not apply to the husband because the family residence ceased to be the husband's "principal residence" when he moved out.

The court reasoned that in order for a residence to be considered a "principal residence," the taxpayer must have "actual use" of the residence. The court stated that "a divorce, while often unpleasant and unwanted, is uniquely personal and is not the type of external, objective, circumstance that allows a taxpayer not in possession of a home to be deemed a resident therein for purposes of section 1034 (a)." *Young*, T.C. Memo 1985-127 at 1004.

On May 17, 1994, the U.S. House of Representatives passed the Tax Simplification and Technical Corrections Bill of 1993 (H.R. 3419), which would provide some relief for the out-spouse by providing that section 1034 applies if the following two conditions are met:

(1) the house is sold pursuant to a divorce decree or marital separation agreement, and

(2) the taxpayer used the residence as his or her "principal residence" at any time during the two years before the sale. However, the Senate took no action on this issue this term.

Until section 1034 is amended, several solutions to the problem have been suggested:

First, the in-spouse could purchase the out-spouse's half of the residence immediately upon the out-spouse's moving out. This approach, however, requires a very early determination as to which party will be awarded the residence. Also, the buy-out amount is usually related to the division of the entire community property estate and sometimes to support as well.

Second, the parties can continue to reside together in the residence, a solution that is generally untenable to most clients.

Third, the parties could alternate occupancy of the residence. It is unclear whether the residence would still qualify as the principal residence of the parties, however. See *Hogoboom, California Practice Guide, Family Law*, section 10:343.

Still another issue arises if an amended joint return is required to report gain from the sale of the residence and one party refuses to sign the return.

If the reporting is required because one party failed to qualify to defer his or her half of the gain, then that party must still file the joint return without the other party's signature, attaching a letter explaining that the other party refuses to sign the return. The party who cannot defer his or her half of the gain is responsible for the entire amount of taxes on the amount of gain reported on the amended return.

This brief discussion highlights some of the issues involved in applying section 1034 in the dissolution context. One commentator recommends that the family law practitioner take one of the following three precautions to avoid malpractice liability before the client signs a judgment or marital settlement agreement:

(1) inform the client in writing that the family law practitioner is not qualified to advise on the tax implications of the settlement agreement and did not purport to advise the client concerning the tax implications of the agreement;

(2) recommend to the client that the client seek the advice of a tax expert before signing or acting upon the agreement;

(3) retain on the family lawyer's own account a tax specialist to give advice concerning the situation. *Deferred Sale of Home Orders and Their Tax Consequences*, XV Family Law, News and Review, L.A. County Bar Association no. 3, 18.

We believe, however, that family law practitioners should become experts on tax issues that arise in divorces, since these issues occur regularly. At the very least, they should be able to spot tax issues and advise clients accordingly.

Practitioners should take whatever actions they believe are necessary to protect their clients and to avoid malpractice as soon as possible after learning that a client has moved out of the residence or that the residence of the parties will be sold. Of course, practitioners also should be aware that section 1034 could be amended in the near future.