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TRANSFERRING A RESIDENCE

THE DISPOSITION OF A RESIDENCE

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This article examines income tax rules that incentivize investment in a residence and the implications of transferring a residence.

The Residence as an Investment

It is often said that a residence is the largest investment that a person makes in a lifetime - part of the American dream. But should a residence be viewed as an investment? On the one hand, market value tends to increase significantly over time. On the other, a residence is a source of annual expenses rather than income. It would be difficult to find a stock, bond, or other traditional investment with this combination.

In 1776, Adam Smith identified three categories of capital in *The Wealth of Nations.* The first portion is reserved for immediate consumption and affords no revenue or profit. [1] This includes food, clothes, and household furniture. [2] The second category is fixed capital, which affords a revenue or profit without circulating or changing owners. [3] This includes machines, rental property (i.e., shops, warehouses, work houses, farm houses, stables, granaries, etc.), improvements of land, and the abilities of the citizens. [4] The third category is circulating capital, which affords a revenue only by circulating or changing owners, such as money, inventory, and raw materials. [5] Smith includes a residence in the first category with food, clothes, and household furniture because a residence is distinguishable from other real property used in a business. [6] The stock laid out for a residence, if it is to be the dwelling-house of the owner, ceases from that moment to serve in the function of a capital or to afford any revenue to the owner. [7] The dwelling-house, as such, contributes nothing to the revenue of its inhabitant. [8] Although it is, no doubt, extremely useful to the owner, it is as clothes and furniture are useful to the owner, which, however, make a part of expenses and not of revenue. **9**

Although Smith categorizes a residence as personal effects, the Internal Revenue Code of 1986, as amended, treats a residence as neither personal effects such as food, clothes, and household furniture, nor as a traditional investment such as stocks and bonds. Several provisions incentivize investment in a residence, particularly with respect to the disposition of a residence. Gain from the sale of a principal residence is excluded from gross income under **Section 121** , and a residence acquired from a decedent receives a new basis under **Section 1014** , which has the effect of eliminating built-in gain existing on the date of death. These provisions potentially permit income tax free appreciation for a residence. Application, however, depends on the disposition decision. Potential traps for the unwary exist where a homeowner expects the exclusion under **Section 121** and the new basis under **Section 1014** to apply in all situations, particularly with respect to trusts and entities.

A residence thus provides a unique combination of appreciation and day-to-day utility, paired with income tax incentives. Smith identifies three categories of capital, but a residence belongs in a fourth category of its own.

The Income Tax Incentives

The Code contains five key income tax provisions that incentivize investment in a residence. The first two are deductions. Certain expenses of a residence are deductible even though **Section 262(a)** otherwise disallows a deduction for personal, living, or family expenses such as rent, and **Section 163(h)(1)** disallows a deduction for personal interest. **10** **Section 163(h)(3)** allows an itemized deduction for qualified residence interest and **Section 164** allows an itemized deduction for state and local real property taxes. A deduction for depreciation, however, is not generally allowed for a residence. **11** These deductions mitigate the economic burden of carrying costs associated with homeownership.

The next two incentives are with respect to gain. Gain from the sale of a principal residence is excluded from gross income under **Section 121** even though gain derived from dealings in property is otherwise recognized under **Section 1001** and included in gross income under **Section 61(a)(3)** . Further, a residence acquired from a decedent receives a new basis under **Section 1014** , which has the effect of eliminating any built-in gain existing on the date of death. These provisions potentially permit income tax free appreciation for a residence.

The final provision that incentivizes investment in a residence is with respect to the applicable rate. Net long-term capital gain from the sale of a residence is subject to a maximum capital gains rate of 20% under **Section 1(h)(1)(D)** combined with a tax imposed under **Section 1411(a)(1)** for net investment income at a rate of 3.8% (jointly, 23.8%). Income tax is otherwise imposed at a maximum ordinary rate of 37% in 2024 under **Sections 1(a)** through (d).

Although all five provisions incentivize investment in a residence, the most potent are with respect to gain because of generous limitations. The exclusion under **Section 121** is subject to a significantly higher dollar limitation compared to amounts deductible, and the new basis under **Section 1014** has no dollar limitation at all.

Exclusion under Section 121 .

A residence is distinguishable from other real property used in a trade or business or the production of income. Smith wrote that a mere dwelling-house is very different from profitable buildings which are the means of procuring a revenue. **12** The Code draws a similar distinction.

In general, gain from the disposition of a residence is recognized and included in gross income. **13** **Section 61(a)(3)** provides that gross income means all income from whatever source derived, including gains derived from dealings in property. The amount of gain is calculated under **Section 1001(a)** by subtracting adjusted basis from the amount realized. An exclusion exists, however, with respect to a principal residence.

Section 121(a) provides that gross income does not include gain from the sale or exchange of property if, during the five-year period ending on the date of the sale or exchange, the property has been owned and used by the taxpayer as his principal residence for periods aggregating two years or more. This exclusion is one of the rare provisions in the Code that permit income tax free appreciation. **14** Assuming that gain is otherwise taxed at a rate of 23.8%, the exclusion of $250,000 from gross income saves income tax of $59,500 (250,000 × 0.238 = 59,500), and exclusion of $500,000 saves income tax of $119,000 (500,000 × 0.238 = 119,000). Reporting of the amount excluded is made on Form 8949, Sales and Other Dispositions of Capital Assets, and Form 1040, Schedule D, Capital Gains and Losses.

The exclusion under **Section 121** developed from different approaches to taxing the disposition of a residence. Before 1997, gain from the sale of a residence was subject to a nonrecognition rule that contemplated a rollover. Section 1034(a) provided, before repeal, that if an old residence used by a taxpayer as his principal residence is sold and, within a period beginning two years from the date of the sale and ending two years after the sale, a new residence is purchased and used by the taxpayer as a principal residence, then gain from the sale of the old residence is not generally recognized. **Section 121** was added to the Code effective for dispositions after December 31, 1963, and contemplated a one-time exclusion of gain from a principal residence by an individual who attains age 55 (previously, age 65) and elects for exclusion under **Section 121** to apply instead of the rollover rule under Section 1034. For sales and exchanges after May 6, 1997, Section 1034 was repealed and **Section 121** amended to apply without election. **15** A taxpayer is no longer required to rollover proceeds to a new residence or wait until age 55 to sell a residence to benefit from the exclusion under **Section 121** .

The current statutory framework is as follows. **Section 121(a)** provides for exclusion of gain from the sale of a principal residence. **Section 121(a)** also provides four requirements for application of the exclusion. **Sections 121(b)(1)** and (2) impose dollar limitations, and **Section 121(b)(3)** imposes a frequency limitation. **Section 121** is thus distilled into the following six elements: (1) a principal residence requirement; (2) an ownership requirement; (3) a use requirement; (4) a two-year requirement; (5) a dollar limitation; and (6) a frequency limitation.

Principal residence requirement.

An analysis of the exclusion under **Section 121** begins with determining the taxpayer's principal residence. Not all residences qualify for exclusion because **Section 121** applies only to the taxpayer's principal residence. **16** **Section 121(a)** provides that the exclusion applies to property that is the taxpayer's principal residence, which depends on the facts and circumstances. **17** Relevant factors include: (1) the taxpayer's place of employment; (2) the principal place of abode of the taxpayer's family members; (3) the address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card; (4) the taxpayer's mailing address for bills and correspondence; (5) the location of the taxpayer's banks; and (6) the location of religious organizations and recreational clubs with which the taxpayer is affiliated. **18** Unfortunately, the Service does not issue rulings or determination letters on this fact question. **19**

If a taxpayer alternates between two properties, using each as a residence for successive periods of time, the property that the taxpayer uses the majority of time during the year is ordinarily considered the taxpayer's principal residence. **20**

A residence includes the typical single family home, as well as an apartment that the taxpayer is entitled to occupy as a tenant/stockholder in a cooperative housing corporation, a houseboat, and a house trailer. **21** A principal residence also includes the residence portion of a farm. **22** If a portion of the property is used for residential purposes and a portion for non-residential purposes, then only gain allocable to the residential portion is excluded under **Section 121** . **23** For purposes of determining the amount of gain allocable to the residential and non-residential portion of the property, the taxpayer allocates basis and the amount realized between the two portions using the method of allocation that he uses to determine depreciation adjustments. **24**

Example: In 2020, A purchases a farm consisting of a house, stable, and 35 acres for $500,000. A uses the house and 7 acres for residential purposes. The stable and remaining 28 acres are used for non-residential purposes. In 2024, A sells the entire farm for $750,000. A recognizes gain of $250,000 (750,000 - 500,000 = 250,000). **25** A determines that $105,000 of the gain is allocable to the profit of the property used as a residence, and that $145,000 of the gain is allocable to the non-residential portion. **26** Gross income excludes $105,000 of the gain because A owned and used the residential portion of the farm for more than two years during the preceding five years, that part of the gain is within the $250,000 limitation, and A did not apply the exclusion under **Section 121** to another sale within the preceding two years. **27** Gross income includes the other $145,000 of gain allocated to the non-residential portion. **28**

Section 121 also applies to certain vacant land that is adjacent to a principal residence. The sale or exchange of vacant land is not a sale or exchange of the taxpayer's principal residence, unless (1) the vacant land is adjacent to land containing the dwelling unit of the taxpayer's principal residence; (2) the taxpayer owns and uses the vacant land as part of the taxpayer's principal residence; (3) the taxpayer sells or exchanges the dwelling unit in a sale or exchange that meets the requirements of **Section 121** within two years before or two years after the date of the sale or exchange of vacant land; and (4) the requirements of **Section 121** are otherwise met with respect to the vacant land. **29**

A residence does not include personal property that is not a fixture under local law. **30**

Ownership requirement.

The exclusion under **Section 121** applies to property that is owned by the taxpayer. **31** For spouses that file a joint return, the exclusion applies if either spouse owns the property. **32**

Use requirement.

The exclusion under **Section 121** applies to property that is used by the taxpayer as a principal residence. **33** Occupancy of the residence is required. **34** Short temporary absences, such as vacation or other seasonal absences are counted as periods of use. **35** For spouses that file a joint return, the exclusion applies if either spouse uses the property. **36**

Two-year requirement.

Section 121(a) imposes a two-year requirement so that the exclusion applies to property that is owned and used by the taxpayer as a principal residence for two years of the five years preceding the sale. A taxpayer may exclude gain from the sale of a residence only if, during the five-year period ending on the date of the sale or exchange, the taxpayer owns and uses the property as the taxpayer's principal residence for periods aggregating two years or more. **37** This is satisfied by establishing ownership and use for 24 full months, or 730 days (365 × 2 = 730), and may be satisfied during nonconcurrent periods if both requirements are met during the five-year period ending on the date of sale or exchange. **38**

Dollar limitation.

Section 121(b)(1) generally imposes a dollar limitation of $250,000, without inflation adjustments. The amount of gain excluded under **Section 121** with respect to any sale or exchange may not exceed $250,000. **39** A taxpayer is eligible for only one maximum exclusion per principal residence. **40** A taxpayer may, therefore, exclude from gross income up to $250,000 of gain from the sale or exchange of the taxpayer's principal residence. **41**

The dollar limitation is increased for spouses that file a joint return. In that case, the amount of gain excluded from gross income under **Section 121** may not exceed $500,000, without inflation adjustments. **42** For this larger dollar limitation to apply, additional requirements must be satisfied: (1) either spouse meets the ownership requirement with respect to the property; (2) both spouses meet the use requirements with respect to the property; and (3) neither spouse is ineligible for the benefits of **Section 121** due to the frequency limitation of **Section 121(b)(3)** discussed below. **43** If, however, the additional requirements are not satisfied, then the larger dollar limitation is the sum of the $250,000 limitation that each spouse would otherwise be entitled to if the spouses had not been married. 44

The dollar limitation is also subject to a favorable rule for joint interests. If taxpayers jointly own a principal residence but file separate returns, then each taxpayer may exclude from gross income up to $250,000 of gain that is attributable to each taxpayer's interest in the property, if the requirements of **Section 121** are otherwise met. 45

Frequency limitation.

Section 121(b)(3) imposes a frequency limitation so that the exclusion under **Section 121** applies no more frequently than once every two years. The exclusion under **Section 121** does not apply to any sale or exchange by the taxpayer if, during the two-year period ending on the date of the sale or exchange, there was any other sale or exchange by the taxpayer to which the exclusion applies. 46 Accordingly, a taxpayer may not exclude from gross income the gain from a sale or exchange of a principal residence if, during the two-year period ending on the date of the sale or exchange, the taxpayer sold or exchanged other property for which gain is excluded under **Section 121** . 47

New basis under Section 1014 .

Section 1014(a) provides that the basis of property in the hands of a person acquiring the property from a decedent, or to whom the property passes from a decedent, is either: (1) the fair market value of the property at the date of the decedent's death; (2) in the case of an election under **Section 2032** for alternate valuation, its value at the applicable valuation date; (3) in the case of an election under **Section 2032A** for special use valuation, its value determined under that section; or (4) to the extent of the applicability of the exclusion under **Section 2031(c)** for a qualified conservation easement, the basis in the hands of the decedent.

This step up of basis for appreciated property under **Section 1014** has the effect of eliminating any built-in gain existing on the date of death. 48 As a result, **Section 1014** combined with the exclusion under **Section 102** for bequests, devises, and inheritances permits appreciation of a residence to escape income tax at death. Assuming that gain is otherwise taxed at a rate of 23.8%, a new basis under **Section 1014** saves income tax of $0.24 ([(1-0) × 0.238] - [(1-1) × 0.238] = 0.238) for every dollar of built-in gain that is eliminated. Moreover, **Section 1014** is not subject to any dollar limitation. It applies whether the value of a residence is $100,000, $1 million, or $100 million.

The purpose of **Section 1014** is to provide a basis for property acquired from a decedent that is equal to the value placed on the property for purposes of the federal estate tax. 49 Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of the property on the date of death. 50 Fair market value is the price at which the property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy or sell and both being reasonably informed as to all relevant facts. 51 The proper basis is the value of the property, undiminished by mortgages thereon, rather than the value of the "equity" with respect to property. **52** If an estate tax return is filed for the decedent's estate, then the value of real estate as appraised for purposes of the federal estate tax is deemed to be its fair market value. **53** The value placed upon real estate for purposes of local taxation, unsupported by any other evidence, is not accepted as determinative of fair market value, particularly in the absence of evidence of the method and purpose for which the local assessment is made. **54**

Application of **Section 1014(a)** to a residence depends on whether the residence is considered acquired from a decedent. **Section 1014(b)** currently provides several categories of property considered acquired from a decedent. **Section 1014(b)(1)** provides that property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, is considered acquired from a decedent. Importantly, **Section 1014(b)(9)** provides that property acquired from a decedent by reason of death, form of ownership, or other conditions and included in the decedent's gross estate is considered property acquired from a decedent. **55** The effect of **Section 1014(b)(9)** is to make the basis adjustment of **Section 1014(a)** applicable to practically all property includable in the gross estate. **56** It is not necessary that an estate tax return be required to be filed for the estate of the decedent, or that an estate tax be payable. **57** The fact that no estate tax may be due or that no estate tax return is required does not preclude the application of **Section 1014(b)(9)** if the property is otherwise required to be included in determining the decedent's gross estate. **58**

Exceptions exist. **Section 1014(c)** provides that **Section 1014(a)** does not apply to property that constitutes a right to receive an item of income in respect of a decedent under **Section 691** . **59** This situation often arises for a residence with respect to an executory contract. A sale of real property takes place for federal tax purposes when a deed transfers title or at the time possession and the burdens and benefits of ownership are transferred to the buyer. **60** Sales proceeds do not constitute income in respect of a decedent unless only ministerial obligations under the contract remain at death. **61**

Example: In 2020, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In September 2024, A enters into a contract to sell the residence for $750,000 with closing in October 2024. A dies before closing. A's estate closes the sale in April 2025. For federal income tax purposes, the sale takes place in April (rather than September) when title or possession and the burdens and benefits of ownership are transferred to the purchasers. The residence receives a new basis under **Section 1014** equal to fair market value as of A's date of death. **62** The sale proceeds do not constitute income in respect of a decedent. **63**

Section 1014(e) provides another exception for certain circular transfers so that **Section 1014(a)** does not apply if: (1) appreciated property is acquired by the decedent by gift during the one-year period ending on the date of the decedent's death; and (2) the property is acquired from the decedent by the donor of the property (or the spouse of such donor). **64** Instead, the donor receives a transferred basis in that situation so that the basis of the property in the hands of the donor (or spouse) is the same as the basis of the property in the hands of the decedent immediately before death. **65** If, however, the donee lives longer than one year from the date of the gift, then the exception under **Section 1014(e)** does not apply. 66 Without **Section 1014(e)** , a person could otherwise transfer appreciated property to a family member immediately prior to the family member's death anticipating that on the family member's death the donor would receive the property back through a bequest and obtain a new basis under **Section 1014(a)** . 67 In enacting **Section 1014(e)** disallowing a new basis under **Section 1014(a)** for transfers made within one year of death, Congress clearly contemplated that a donor must relinquish actual dominion and control over the property for a full year prior to death. 68 That is, unless the donor relinquishes actual dominion and control over property and has done so for a sufficient period of time, the property is not characterized as being acquired from the decedent even though it is includable in the decedent's gross estate. 69

The Disposition Decision

The disposition decision largely depends on the price of a residence. Smith observed that the ordinary market price of land depends everywhere on the ordinary market rate of interest. 70 The rate of interest in the improved parts of Europe in 1776 is nowhere higher than six percent, and in some of the most improved, it is so low as four, three, and two percent. 71 When interest is at ten percent, land is commonly sold for ten or twelve years purchase. 72 As interest sinks to six, five, and four percent, the price of land rises to twenty, twenty-five, and thirty years purchase. 73 Two hundred fifty years later, rates appear to be within the same range. Mortgage interest rates steadily declined from 2000 to 2021 and ultimately dropped below three percent in 2021, which corresponds with a significant increase of home prices over that period. From 2021 to 2023, rates sharply increased to more than seven percent in 2023.

Purchase price is the starting point for taxing the disposition of a residence. **Section 1012(a)** provides that the basis of a residence is the cost of the property, which is the amount paid for the property in cash or other property. 74 Basis is later increased under **Section 1016(a)(1)** for expenditures and other improvements to the property.

Example: In 2020, A purchases a residence for $500,000. The following year, A expends $75,000 for improvements. A's basis in the residence is $575,000 (500,000 + 75,000 = 575,000). 75

Going forward, a homeowner faces a perpetual disposition decision to either sell, gift, or retain the residence. The homeowner may also transfer title to a trust or entity. To maximize income tax benefits with respect to gain, a homeowner should sell a residence when the requirements of **Section 121** are satisfied and within applicable limitations, or, alternatively, hold the residence until death so that the property receives a new basis under **Section 1014** .

Sale by homeowner.

The sale of a residence by a homeowner results in imposition of tax depending on whether the requirements of **Section 121(a)** are satisfied and the amount of gain is within applicable limitations of

Section 121(b) . No income tax is due where the requirements of **Section 121(a)** are satisfied and the gain is within the limitations of **Section 121(b)** . In that case, gain from the sale of the residence completely escapes income tax.

Example: In 2020, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2024, A sells the property for $750,000. A recognizes gain of $250,000 (750,000 - 500,000 = 250,000). **76** Gross income does not include any of the gain because A owned and used the property for more than two years during the preceding five years, the amount of gain is within the $250,000 limitation, and A did not apply the exclusion under **Section 121** to another sale within the preceding two years. **77**

If the requirements of **Section 121(a)** are satisfied but the amount of gain exceeds the limitations of **Section 121(b)** , then income tax is imposed on part of the gain.

Example: In 2020, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2024, A sells the property for $800,000. A recognizes gain of $300,000 (800,000 - 500,000 = 300,000). **78** Gross income excludes $250,000 of the gain because A owned and used the property for more than two years during the preceding five years, that part of the gain is within the $250,000 limitation, and A did not apply the exclusion under **Section 121** to another sale within the preceding two years. **79** Gross income includes the other $50,000 of gain (300,000 - 250,000 = 50,000). **80**

If the requirements of **Section 121(a)** are not satisfied, then income tax is imposed on the disposition. Gross income includes all income from whatever source derived, including gains derived from dealings in the property. **81** The amount of gain from the disposition is the excess of the amount realized over the adjusted basis. **82** The amount realized is the sum of any money received plus the fair market value of property (other than money) received. **83** The adjusted basis for determining gain from the sale of a residence is generally cost. **84** The entire amount of gain is recognized, and income tax is imposed. **85**

Example: In 2023, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2024, A sells the property for $750,000. A recognizes gain of $250,000 (750,000 - 500,000 = 250,000). **86** The exclusion under **Section 121** does not apply because A owned and occupied the property for only one year, which is less than two years during the preceding five years. **87** Accordingly, gross income includes gain of $250,000. **88**

Sale by homeowner's estate.

The sale of a residence by a homeowner's estate benefits from a new basis under **Section 1014** that eliminates any built-in gain existing on the date of death. A residence acquired from a decedent generally receives a new basis under **Section 1014(a)** equal to the fair market value of the property on the date of death. This includes a residence acquired by a homeowner's estate from the deceased homeowner pursuant to **Section 1014(b)(1)** . **89** Further, a residence is included in the homeowner's gross estate to the extent of his interest therein and, thus, considered acquired from a decedent under **Section 1014(b)(9)** . **90**

Unfortunately, the sale of a residence by a homeowner's estate does not generally benefit from the exclusion under **Section 121** because the homeowner must first manifest an intent to engage in appropriate steps towards the sale of a residence before **Section 121** applies to a sale by his estate. **91** Income tax is thus imposed on post-death appreciation.

Example: In 2020, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2023, A dies when the property increases in value to $750,000. The property is included in the gross estate and receives a new basis of $750,000. **92** In 2024, the executor of A's estate sells the property to a third party for $850,000. The estate recognizes gain of $100,000 (850,000 - 750,000 = 100,000). **93** The exclusion under **Section 121** does not apply because the estate cannot occupy the property as a principal residence. **94** Accordingly, gross income includes gain of $100,000. **95**

An exception for income in respect of a decedent applies where a homeowner enters into a contract to sell a residence but dies before the sale is closed. A sale takes place for federal tax purpose when a deed transfers title or at the time possession and the burdens and benefits of ownership are transferred to the buyer. **96** If only ministerial obligations under the contract remain at death, then gain from the sale completed by the executor is considered income in respect of a decedent. **97** In that situation, the residence does not receive a new basis under **Section 1014(a)** , but gain from the sale is eligible for exclusion under **Section 121** . **98** The executor may "stand in the shoes" of the decedent for purposes of **Section 121** . **99** To the extent the gain is not excludible under **Section 121** , the provisions of **Section 691** with respect to income in respect of a decedent apply. **100**

Example: In 2020, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2023, A executes a contract to sell the property to a third party for $850,000. A dies shortly thereafter with only ministerial items remaining open. The property is included in the gross estate. **101** The gain constitutes income in respect of a decedent, and the property does not receive a new basis under **Section 1014** . **102** The sale is completed by A's executor who attends closing, executes a deed that transfers title, and receives sale proceeds. The estate recognizes gain of $350,000 (850,000 - 500,000 = 350,000). **103** Gross income excludes $250,000 of the gain because A owned and used the property for more than two years during the preceding five years, that portion of the gain is within the $250,000 limitation, and A did not apply the exclusion under **Section 121** to another sale within the preceding two years. **104** Gross income includes $100,000 of the gain as income in respect of a decedent. **105**

Transfer to spouse.

A basis discrepancy exists under the Code for property transferred to a spouse by bequest, which results in a new basis under **Section 1014** , compared to property transferred by gift, which does not. The transfer of a residence to a spouse via bequest provides more favorable income tax results and is, therefore, the preferred path.

A residence that a surviving spouse acquires from his or her deceased spouse generally receives a new basis under **Section 1014(a)** equal to the fair market value of the property on the date of death. **106** **Section 1014(b)(1)** provides that property acquired by bequest, devise, or inheritance is considered acquired from a decedent. **107** Further, a residence is included in the homeowner's gross estate to the extent of his interest therein and, thus, considered acquired from a decedent under **Section 1014(b)(9)** . **108**

Going forward, a special tacking rule for the ownership and use requirements under **Section 121** applies where the surviving spouse sells a principal residence. In the case of an unmarried individual whose spouse is deceased on the date of the sale or exchange of property, the period that the unmarried individual owned and used the property includes the period that the deceased spouse owned and used the property before death. **109** In other words, the surviving spouse is treated as owning and using the residence as his principal residence during any period that the deceased spouse owned and used the property as a principal residence before death if: (1) the surviving spouse's spouse is deceased on the date of the sale; and (2) the surviving spouse has not remarried at the time of the sale. **110** Moreover, in the case of a sale of a residence by a surviving spouse, the dollar limitation under **Section 121(b)** is increased to $500,000 (rather than $250,000) if the sale occurs not later than two years after the date of death of the deceased spouse and the requirements of **Section 121(b)(2)(A)** are met immediately before the date of death. **111**

Example: In 2011, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2023, A and B marry. In 2024, A dies when the property appreciates to $750,000. A's will bequeaths the property to B. The property is included in the gross estate. **112** B's basis in the property is $750,000. **113** In 2024, B sells the property for $1 million. B recognizes gain of $250,000 (1,000,000 - 750,000 = 250,000). **114** Although B owned and used the property for less than two years, B is considered to have satisfied the ownership and use requirements of **Section 121** because B's period of ownership and use includes the period that A owned and used the property before death. **115** Gross income does not include any of the gain because B is treated as owning and using the property since 2011, the gain is within the $500,000 limitation (for a surviving spouse), and B did not apply the exclusion under **Section 121** to another sale within the preceding two years. **116**

An inter vivos transfer to a spouse, in contrast, is a gift that results in a transferred basis. **Section 1041(b)** provides that a transfer of property from an individual to his spouse is treated as acquired by the transferee by gift, and the basis of the transferee in the property is the adjusted basis of the transferor. **117** This transferred basis under **Section 1041** for a gift transfer between spouses is less favorable than the new basis under **Section 1014** for property transferred to a spouse at death. Going forward, a special tacking rule for the ownership requirement (but not the use requirement) under **Section 121** applies. **Section 121(d)(3)** provides that, for purposes of **Section 121** , in the case of an individual holding property transferred in a transaction described in **Section 1041(a)** , the period that he or she owns such property includes the period that the transferor owned the property. **118**

Example: In 2011, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2023, A and B marry and B immediately occupies the property with A. In 2024, A transfers the property to B when it appreciates to $750,000. No gain or loss is recognized, and B's basis in the property is $500,000. **119** In 2025, B sells the property for $1 million. B recognizes gain of $500,000 (1,000,000 - 500,000 = 500,000). **120** B satisfies the ownership and use requirements of **Section 121** because B's period of ownership includes the period that A owned the property, and B used the property for more than two years. **121** Gross income does not include any of the gain because the gain is within the $500,000 limitation (for spouses filing a joint return), and B did not apply the exclusion under **Section 121** to another sale within the preceding two years. **122**

Transfer to child or more remote descendant.

A basis discrepancy also exists under the Code for property transferred to a child or more remote descendant by bequest, which results in a new basis under **Section 1014** , compared to property transferred by gift, which does not. The transfer of a residence to a child or more remote descendant via bequest provides more favorable income tax results and is, therefore, the preferred path.

A residence that a child or more remote descendant acquires from his or her deceased parent or ancestor generally receives a new basis under **Section 1014(a)** equal to the fair market value of the property on the date of death. **Section 1014(b)(1)** provides that property acquired by bequest, devise, or inheritance is considered acquired from a decedent. **123** Further, a residence is included in the homeowner's gross estate to the extent of his interest therein and, thus, considered acquired from a decedent under **Section 1014(b)(9)** . **124** Going forward, tacking for the exclusion under **Section 121** does not apply where a person other than a surviving spouse receives a bequest of a residence. **125** Income tax is imposed when the beneficiary sells the residence without meeting the requirements of **Section 121** .

Example: In 2011, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2024, A dies when the property appreciates to $750,000. A's will bequeaths the property to A's child, C. The property is included in the gross estate. **126** C's basis in the property is $750,000. **127** C immediately occupies the property as C's principal residence. In 2025, C sells the property for $1 million. C recognizes gain of $250,000 (1,000,000 - 750,000 = 250,000). **128** The exclusion under **Section 121** does not apply because C owned and occupied the property for only one year and, thus, less than two years during the preceding five years. **129** Accordingly, gross income includes gain of $250,000. **130**

In contrast, a gift to a child or more remote descendant results in a transferred basis. **Section 1015(a)** provides that if appreciated property is acquired by gift, then the basis is the same as it would be in the hands of the donor. **131** Tacking for the exclusion under **Section 121** does not apply where a person other than a surviving spouse receives a gift. **132**

Example: In 2011, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2024, A gifts the property to A's child, C, when the property appreciates to $750,000. C's basis in the property is $500,000. **133** C immediately occupies the property as C's principal residence. In 2025, C sells the property for $1 million. C recognizes gain of $500,000 ($1,000,000 - 500,000 = 500,000). **134** The exclusion under **Section 121** does not apply because C owned and occupied the property for only one year and, thus, less than two years during the preceding five years. **135** Accordingly, gross income includes gain of $500,000. **136**

Transfer to revocable trust.

Estate planning often involves the transfer of a residence to a revocable trust. This provides the benefits of probate avoidance and privacy in deed records, as well as continued application of **Section 121** and **Section 1014** . The sale of a residence by a revocable trust is eligible for exclusion under **Section 121** because a revocable trust is a grantor trust. **Section 676(a)** provides that the grantor is treated as the owner of any portion of a trust where at any time the power to revert title in the grantor is exercisable by the grantor. If the grantor is treated as the owner of a trust under **Section 676** , then a sale by the trust is treated as if made by the grantor and the exclusion under **Section 121** may be utilized if all requirements are met. **137** The grantor is treated as owning a residence held in a grantor trust for purposes of satisfying the two-year ownership requirement of **Section 121** , and a sale or exchange by the trust is treated as if made by the grantor. **138** In other words, if the grantor is considered owner of the entire trust, then the grantor is considered as owning the assets of the trust, including a residence held by the trust, and the grantor is entitled to the benefits of **Section 121** provided all of its other requirements are satisfied. **139**

Example: In 2011, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2023, A creates a revocable trust and executes a deed that transfers title of the residence to the trust. The trust is a grantor trust and A is treated as the owner of the residence. **140** In 2024, the trust sells the property for $750,000. The trust recognizes gain of $250,000 (750,000 - 500,000 = 250,000). **141** Gross income does not include any of the gain because A owned and used the property for more than two years during the preceding five years, the gain is within the $250,000 limitation, and A did not apply the exclusion under **Section 121** to another sale within the preceding two years. **142**

On the death of the grantor, a residence held by a revocable trust receives a new basis under **Section 1014** . **Section 2038(a)(1)** provides that the grantor's gross estate includes property of a trust to the extent of his power to alter, amend, revoke, or terminate the trust, regardless of the capacity exercisable and whether exercisable by the grantor alone or by the grantor in conjunction with another person. A residence held in a revocable trust is thus considered acquired from a decedent under **Section 1014(b)(9)** . Further, the residence is considered acquired from a decedent under **Sections 1014(b)(2)** and (3) where the trust pays income for life to the grantor or another person with direction from the grantor and the grantor reserves the power to alter, amend, revoke, or terminate the trust.

Example: A creates a revocable trust for the benefit of A to avoid probate, and transfers title to a residence to the trust. A later dies. All property of the trust is included in A's gross estate and receives a new basis under **Section 1014(a)** . **143**

Transfer to irrevocable trust.

Estate planning also frequently involves the transfer of a residence to an irrevocable trust. This potentially provides the estate tax benefit of exclusion of trust property from the gross estate. To avoid application of **Section 2038** , the grantor retains no power to alter, amend, revoke, or terminate. To avoid application of **Section 2036** for retained control, the grantor does not serve as trustee or retain any powers of over the trust other than the power to remove and replace the trustee with an unrelated trustee. **144** For income tax purposes, however, an irrevocable trust is a potential trap for the unwary because application of the exclusion under **Section 121** depends on whether the trust is a grantor trust and application of the new basis under **Section 1014** depends on whether property of the trust is included in the gross estate.

A residence transferred to an irrevocable trust initially maintains a transferred basis under **Section 1015** , which provides that the basis of appreciated property acquired by gift is the same as it would be in the hands of the donor.

Going forward, the exclusion under **Section 121** applies to the sale of a residence held in trust depending on whether the trust is a grantor trust. The substitution power under Section 675(4)(C) is the popular grantor trust power today because the Service has ruled that the grantor's retention of a substitution power results in grantor trust treatment without causing the trust to be included in the grantor's gross estate. **145** Section 675(4)(C) provides that a grantor is treated as the owner of any portion of a trust in respect of which the grantor retains a power of administration exercisable in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity, including the power to reacquire trust corpus by substituting other property of an equivalent value. If the grantor is treated as the owner of an entire trust under Section 675(4)(C), then a sale by the trust is treated as if made by the grantor. **146** In that case, **Section 121** may be utilized if all requirements of that section are met. **147** The grantor is thus treated as owning the residence for purposes of satisfying the two-year ownership requirement of **Section 121** . **148**

Example: In 2011, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2022, A moves out of the property and no longer uses it as a residence. In 2023, A creates an irrevocable trust for the benefit of A's child, C, and executes a deed that transfers title to the property to the trust when the fair market value of the property increases to $750,000. The trust's basis in the property is $500,000. **149** The trust agreement provides A the power to substitute property of the trust for other property of equivalent value. The trust is a grantor trust and A is treated as owner of the residence. **150** In 2024, the trust sells the property for $750,000. The trust recognizes gain of $250,000 (750,000 - 500,000 = 250,000). **151** Gross income does not include any of the gain because A owned and used the property for more than two years during the preceding five years, the gain is within the $250,000 limitation, and A did not apply the exclusion under **Section 121** to another sale within the preceding two years. **152**

A person other than the grantor can be treated as owner. This situation frequently arises where, to qualify a gift as a present interest for the annual exclusion under **Section 2503(b)** , a trust agreement provides a beneficiary a "Crummey" power to withdraw property from the trust. **Section 678(a)(1)** provides that a person other than the grantor is treated as the owner of any portion of a trust with respect to which the person has a power to vest the income or corpus of the trust in himself. **153** If a residence is owned by a trust and a beneficiary is treated as owner of the trust or a portion of the trust that includes the residence under **Section 678** , then the beneficiary is treated as owning the residence for purposes of satisfying the two-year ownership requirement of **Section 121** and the sale by the trust is treated as if made by the beneficiary. **154**

Example: In 2011, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2022, A moves out of the property and no longer uses it as a residence. In 2023, A creates an irrevocable trust for the benefit of A's child, C, and executes a deed that transfers title to the property to the trust when the fair market value of the property increases to $750,000. The trust's basis in the property is $500,000. **155** The trust agreement provides C the noncumulative power to withdraw from the principal of the trust in each calendar year an amount that does not exceed $5,000 or five percent of the market value of the principal of the trust, whichever is greater. C is treated as owner for each year of that portion of the trust that is subject to the withdrawal power. **156** In 2025, the trust sells the property for $750,000. The trust recognizes gain of $250,000 (750,000 - 500,000 = 250,000). **157** Gain on the residence is taxable to the trust, except to the extent that C is deemed the owner of a portion of the property pursuant to C's five or five power and **Section 121** applies only to the portion of the residence attributable to the five or five power. **158**

Without grantor trust treatment, a residence sold by an irrevocable trust is not eligible for exclusion under **Section 121** . A trust does not qualify as a person using a property as a principal residence. **159**

Example: In 2011, A purchases real property for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2022, A moves out of the property. In 2023, A creates an irrevocable trust for the benefit of A's child, C, and executes a deed that transfers title to the residence to the trust when the fair market value of the property increases to $750,000. The trust's basis in the property is $500,000. **160** The trust agreement does not provide a substitution or other power to A, or a withdrawal power to C, that causes grantor trust treatment. In 2025, the trust sells the property for $750,000. The trust recognizes gain of $250,000 (750,000 - 500,000 = 250,000). **161** The exclusion under **Section 121** does not apply because a trust cannot occupy a principal residence. Accordingly, gross income includes gain of $250,000. **162**

On the death of the grantor, a residence held by an irrevocable trust and excluded from the grantor's gross estate does not receive a new basis under **Section 1014** . **163**

Example: A establishes an irrevocable trust. The only power retained by A is a substitution power under Section 675(4)(C). The trust is a grantor trust and A is treated as the owner of all property of the trust. **164** A dies. Property of the trust is excluded from A's gross estate and does not receive a new basis under **Section 1014** . **165**

Transfer to QPRT.

A qualified personal residence trust, or "QPRT," is a type of irrevocable trust that provides the grantor continued use of a residence transferred to the trust, but with reduced value for gift tax purposes and potential for exclusion from the gross estate. A typical trust agreement for a QPRT provides that the grantor has the exclusive and rent-free use of a residence held in the trust for an initial term, that the grantor is permitted to rent the residence from the trust after the initial term expires, that the trust terminates on the grantor's death, and that remaining property of the trust is distributed to the grantor's children and more remote descendants. **166**

The transfer of a residence to an irrevocable trust is a completed gift. **167** Value depends on the terms of the trust agreement. A trust agreement that lacks required QPRT provisions results in special valuation under **Section 2702** so that the value of the retained interest is treated as zero and, thus, the value of the gift is the full fair market value on the date of the gift. To avoid application of **Section 2702** , a trust agreement includes eight QPRT provisions required by **Treas. Reg. 25.2702-5(c)** . **168** First, any income of the trust is distributed to the grantor at least annually. **169** Second, distributions of corpus to any beneficiary other than the grantor prior to the expiration of the initial term are prohibited. **170** Third, prepayment of the grantor's interest is prohibited. **171** Fourth, the trust ceases to be a QPRT when the residence ceases to be used or held for use as a personal residence of the grantor. **172** Fifth, the trust is generally prohibited from holding any other asset than one residence to be used or held for the use as a personal residence of the grantor. **173** Exceptions exist for sale proceeds held in a separate account, improvements, and cash for the payment of expenses. **174** The trust may also hold one or more policies of insurance on the residence. **175** Sixth, the trust agreement provides that, within thirty days after the date on which the trust ceases to be a QPRT with respect to certain assets, either (1) the assets are distributed outright to the grantor; or (2) the assets are converted and held for the balance of the grantor's term in a separate share meeting the requirements of a qualified annuity interest. **176** Seventh, the trust agreement provides that, if damage or destruction renders the residence unusable as a residence, then the trust ceases to be a QPRT on the date that is two years after the date of damage or destruction, unless, prior to such date, replacement of or repairs to the residence are completed or a new residence is acquired by the trust. **177** Eighth, the trust is prohibited from selling or transferring the residence directly or indirectly to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse during the initial term interest, or at any time after that the trust is a grantor trust. **178** Rulings are no longer issued on whether a trust agreement satisfies these requirements. **179** Instead, the Service has provided an annotated sample trust agreement that includes QPRT provisions. **180** By following the sample trust provisions, a taxpayer is assured that the Service will recognize a trust as meeting all of the requirements. **181**

A residence transferred to a QPRT initially maintains a transferred basis under **Section 1015** , which provides that the basis of appreciated property acquired by gift is the same as it would be in the hands of the donor. **182** Going forward, the exclusion under **Section 121** applies to a sale of the residence by the QPRT during the period that the QPRT is a grantor trust. **183** For the initial term, a QPRT holds a residence for use by the grantor and distributes any income to the grantor. **184 Section 677(a)** provides that the grantor is treated as the owner of any portion of a trust whose income may be distributed to the grantor without the approval or consent of any adverse party. **185** If the grantor is treated as owner of an entire trust, then a sale by the trust is treated as if made by the grantor and the grantor is treated as owning the residence for purposes of satisfying the two-year ownership requirement of **Section 121** . **186**

Example: In 2011, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2023, A creates an irrevocable trust and executes a deed that transfer title of the residence to the trust. The trust agreement satisfies the requirements of a QPRT under **Treas. Reg. 25.2702-5(c)** . The trust is a grantor trust and A is treated as the owner of the residence. **187** In 2024, the trust sells the property for $750,000. The trust recognizes gain of $250,000 (750,000 - 500,000 = 250,000). **188** Gross income does not include any of the gain because A owned and used the property for more than two years during the preceding five years, the gain is within the $250,000 limitation, and A did not apply the exclusion under **Section 121** to another sale within the preceding two years. **189**

On the death of the grantor, property of the trust receives a new basis under **Section 1014** depending on whether the grantor survives the initial term and pays fair market value rent. If the grantor survives the initial term and thereafter pays the trust fair market value rent for the use of the residence, then the residence is excluded from the gross estate and does not receive a new basis under **Section 1014** . **190**

Example: In 2011, A establishes an irrevocable trust. The trust agreement satisfies the requirements of a QPRT under **Treas. Reg. 25.2702-5(c)** . The trust agreement provides that A has the right to the exclusive rent-free use of the property held in trust for a term of eight years. Following expiration of the term, A pays fair market value rent for the use of the property held in the trust. In 2024, A dies. The residence is excluded from A's gross estate and does not receive a new basis under **Section 1014** . **191**

If, however, the grantor does not survive the initial term, or survives the initial term but does not pay fair market value rent for the continued use of the residence, then property of the trust is included in the gross estate and receives a new basis under **Section 1014** . **192**

Example: In 2011, A establishes an irrevocable trust. The trust agreement satisfies the requirements of a QPRT under **Treas. Reg. 25.2702-5(c)** . The trust agreement provides that A has the right to the exclusive rent-free use of the property held in trust for a term of eight years or until A's prior death. In 2015, A dies. The property of the trust is included in A's gross estate and receives a new basis under **Section 1014** . **193**

Transfer to bypass trust.

A bypass trust, also known as a credit shelter trust, is another type of irrevocable trust that is testamentary in nature and designed to be excluded from the gross estate. To avoid application of **Section 2041** for a general power of appointment, the trust agreement provides that distributions are limited to the ascertainable standard of health, education, maintenance, and support, and that powers of appointment are limited to a class of persons not including the beneficiary, creditors of the beneficiary, the estate of the beneficiary, and creditors of the estate of the beneficiary.

A residence transferred to a bypass trust on the death of a homeowner initially receives a new basis under **Section 1014** equal to the fair market value of the property on the date of death. **Section 1014(b)(1)** provides that property acquired by bequest, devise, or inheritance is considered acquired from a decedent. **194** Further, the residence is included in the gross estate to the extent of the decedent's interest therein and, thus, considered acquired from a decedent pursuant to **Section 1014(b)(9)** . **195**

Going forward, however, a sale of a residence by a bypass trust is not eligible for exclusion under **Section 121** because a bypass trust is not a grantor trust and does not qualify as a person using a property as a principal residence. **196** Income tax is imposed on gain from a sale after the homeowner's death.

Example: In 2011, A purchases real property for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2021, A and B marry. In 2022, A dies when the property appreciates to $750,000. A's will bequeaths the property to a bypass trust for the benefit of B. Distributions are made to B for health, education, maintenance, and support, and B has a testamentary nongeneral power of appointment limited to A's descendants. The trust agreement also provides that B has the right to occupy all real property of the trust, and that B may direct the trustee to sell real property and replace it with another residence selected by B. The property is included in the gross estate. **197** The trust's basis in the property is $750,000. **198** B continues to occupy the property. In 2024, the bypass trust sells the property for $1 million. The trust recognizes gain of $250,000 (1,000,000 - 750,000 = 250,000). **199** The exclusion under **Section 121** does not apply because a trust cannot occupy a residence. Accordingly, gross income includes gain of $250,000. **200**

When a beneficiary of a bypass trust dies, a residence held by the trust is not included in the gross estate and, therefore, does not receive a new basis under **Section 1014** at that time. **201**

Example: In 2011, A purchases real property for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2021, A and B marry. In 2022, A dies when the property appreciates to $750,000. A's will bequeaths the property to a bypass trust for the benefit of B. Distributions are made to B for health, education, maintenance, and support, and B has a testamentary nongeneral power of appointment limited to A's descendants. The trust agreement also provides that B has the right to occupy all real property of the trust, and that B may direct the trustee to sell real property and replace it with another residence selected by B. The property is included in the gross estate. **202** The trust's basis in the property is $750,000. **203** B continues to occupy the property. In 2024, B dies when the value of the property increases to $1 million. The property of the bypass trust is not included in B's gross estate and does not receive a new basis under **Section 1014** as a result of B's death. **204**

A bypass trust presents the clearest risk of detrimental income tax results because the trust is not eligible for the exclusion under **Section 121** or a new basis under **Section 1014** on a beneficiary's death. Both provisions are inapplicable. To avoid this potential trap for the unwary, a bequest of a residence is instead made to a beneficiary outright and free of trust or, for a surviving spouse, to a QTIP trust. **205**

Transfer to QTIP trust.

A qualified terminable interest property trust, or "QTIP trust," is another type of irrevocable trust that is testamentary in nature and designed to qualify for the marital deduction under **Section 2056(b)(7)** . All income is payable to the surviving spouse at least annually, and no person has a power to appoint any part of the trust to any person other than the surviving spouse. **206**

A residence transferred to a QTIP trust on the death of a homeowner initially receives a new basis under **Section 1014** equal to the fair market value of the property on the date of death. **Section 1014(b)(1)** provides that property acquired by bequest, devise, or inheritance is considered acquired from a decedent. **207** Further, the residence is included in the gross estate to the extent of the decedent's interest therein and, thus, considered acquired from a decedent pursuant to **Section 1014(b)(9)** . **208**

Application of **Section 121** going forward depends on whether a surviving spouse has a withdrawal right. If the trust agreement for the QTIP trust provides the surviving spouse a power to withdraw corpus of the trust, which is an optional provision and not required to satisfy the requirements of **Section 2056(b)(7)** , then the trust is treated as a grantor trust. **Section 678(a)(1)** provides that a person other than the grantor is treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself. The surviving spouse is thus treated as owning the residence for purposes of satisfying the two-year ownership requirement of **Section 121** . **209**

Example: In 2011, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2021, A and B marry. In 2022, A dies when the property appreciates to $750,000. A's will bequeaths the property to a QTIP trust for the benefit of B that satisfies the requirements of **Section 2056(b)(7)** . The property is included in the gross estate. **210** The trust's basis in the property is $750,000. **211** B continues to occupy the property. The trust agreement provides that B has the right to occupy all real property of the trust, and that B may direct the trustee to sell real property and replace it with another residence selected by B. The trust agreement also provides that B may withdraw all property of the trust. The trust is a grantor trust and B is treated as the owner of the residence. **212** In 2024, the QTIP trust sells the property for $1 million. The trust recognizes gain of $250,000 (1,000,000 - 750,000 = 250,000). **213** Gross income does not include any of the gain because B owned and used the property for more than two years during the preceding five years, the gain is within the dollar limitation, and B did not apply the exclusion under **Section 121** to another sale within the preceding two years. **214**

If, however, a surviving spouse does not have the power to withdraw corpus of a QTIP trust, which is more typical, then the trust is not a grantor trust and a sale of the residence by the trust is not eligible for exclusion under **Section 121** during the surviving spouse's lifetime. A trust does not qualify as a person using a property as a principal residence. **215**

Example: In 2011, A purchases real property for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2021, A and B marry. In 2022, A dies when the property appreciates to $750,000. A's will bequeaths the property to a QTIP trust for the benefit of B that satisfies the requirements of **Section 2056(b)(7)** . The trust agreement provides that B has the right to occupy all real property of the trust, and that B may direct the trustee to sell real property and replace it with another residence selected by B. The property is included in the gross estate. **216** The trust's basis in the property is $750,000. **217** B continues to occupy the property. In 2024, the QTIP trust sells the property for $1 million. The trust recognizes gain of $250,000 (1,000,000 - 750,000 = 250,000). **218** The exclusion under **Section 121** does not apply because a trust cannot occupy a principal residence. Accordingly, gross income includes gain of $250,000. **219**

A QTIP trust (without a withdrawal right) and a bypass trust are similar in that both are generally ineligible for exclusion under **Section 121** . For basis, however, a QTIP trust and a bypass trust are like two sides of the same coin. Property of a QTIP trust is included in the surviving spouse's gross estate and receives a new basis under **Section 1014** . **220** In contrast, property of a bypass trust is excluded from the beneficiary's gross estate and does not receive a new basis under **Section 1014** . **221**

Example: In 2011, A purchases real property for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2021, A and B marry. In 2022, A dies when the property appreciates to $750,000. A's will bequeaths the property to a QTIP trust for the benefit of B that satisfies the requirements of **Section 2056(b)(7)** . The trust agreement provides that B has the right to occupy all real property of the trust, and that B may direct the trustee to sell real property and replace it with another residence selected by B. The executor of A's estate makes a QTIP election under **Section 2056(b)(7)** on A's estate tax return, Form 706. The property is included in the gross estate. **222** The trust's basis in the property is $750,000. **223** B continues to occupy the property. In 2024, B dies when the value of the property increases to $1 million. The property of the QTIP trust is included in B's gross estate and receives a new basis under **Section 1014** . **224**

Transfer to entity.

Application of **Section 121** with respect to a residence transferred to an entity depends on the treatment of the entity for federal tax purposes. If a residence is owned by an eligible entity with a single owner and disregarded for federal tax purposes as an entity separate from its owner under **Treas. Reg. 301.7701-3** , then the owner is treated as owning the residence for purposes of satisfying the two-year ownership requirement of **Section 121** , and the sale or exchange by the entity is treated as if made by the owner. **225**

Example: In 2020, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2023, A forms a limited liability company treated as a disregarded entity for federal tax purposes. **226** A executes a deed that transfers title of the residence to the LLC. In 2024, the LLC sells the property for $750,000. The sale by the LLC is treated as if made by A as owner. **227** A recognizes gain of $250,000 (750,000 - 500,000 = 250,000). **228** Gross income does not include any of the gain because A is treated as owning and using the property for more than two years during the preceding five years, the gain is within the $250,000 limitation, and A did not apply the exclusion under **Section 121** to another sale with the preceding two years. **229**

If, however, title to a residence is held by an entity treated as a corporation or partnership for federal tax purposes, then **Section 121** is not applicable because the entity cannot occupy the property as a principal residence.

Example: In 2020, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. In 2023, A forms a limited partnership treated as a partnership for federal tax purposes. **230** A executes a deed that transfers title of the residence to the partnership. In 2024, the partnership sells the property for $750,000. The partnership recognizes gain of $250,000 (750,000 - 500,000 = 250,000). **231** The exclusion under **Section 121** does not apply because a partnership cannot occupy a residence. Accordingly, gross income includes gain of $250,000. **232**

Similarly, application of **Section 1014** with respect to a residence held by an entity when an entity owner dies depends on the treatment of the entity for federal tax purposes. A residence held by a disregarded entity receives a new basis under **Section 1014** on the death of the single owner because the entity is disregarded as an entity separate from its owner. **233** Also, a residence held by a partnership with a **Section 754** election in place receives a basis adjustment under **Section 743** on the death of a partner. **234**

Example: In 2020, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. A's basis in the property is the cost of $500,000. **235** In 2023, A creates a limited liability company treated as a disregarded entity for federal tax purposes. **236** The value of the property increases to $750,000, and A executes a deed that transfers title to the LLC. In 2024, A dies. Property of the LLC is included in A's gross estate and receives a new basis under **Section 1014** equal to $750,000. **237**

In contrast, the basis of a residence held by a partnership without a **Section 754** election does not receive a basis adjustment on the death of a partner, and the basis of a residence held by a corporation does not receive a basis adjustment on the death of a shareholder. **238**

Example: In 2020, A purchases a residence for $500,000. Title is taken in the name of A, and A immediately occupies the property as A's principal residence. A's basis in the property is the cost of $500,000. **239** In 2023, A creates a limited liability company treated as a partnership for federal tax purposes. **240** The value of the property increases to $750,000, and A executes a deed that transfers title to the LLC. In 2024, A dies and a **Section 754** election is not timely made. The basis of the residence is not adjusted under **Section 743(b)** because a **Section 754** election is not timely made. **241**

The Invisible Hand

A residence belongs in a category of its own. Personal effects are useful to the owner, but rarely provide appreciation. Conversely, stocks, bonds, and other traditional investments provide income and appreciation, but rarely offer day-to-day utility. A residence provides both utility to the owner and significant appreciation despite ongoing annual expenses associated with homeownership. In addition to this unique economic combination, the Code contains several income tax incentives to encourage investment in a residence. Favorable income tax implications follow disposition of a residence when the requirements of **Section 121** are satisfied and within applicable limitations, or, alternatively, when the residence is retained until death so that it receives a new basis under **Section 1014** .

Smith's other concept of the invisible hand also appears applicable today for the disposition decision. He recognizes that it is not the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. **242** We address ourselves, not to their humanity, but to their self-love, and never talk to them of our own necessities, but of their advantages. **243** The old clothes which another bestows upon him he exchanges for other clothes which suit him better, or for lodging. **244** Ultimately, the disposition decision for a residence depends on the homeowner's own interest.

1 Adam Smith, *The Wealth of Nations,* 161 (Simon & Brown 2012).

2 *Id*.

3 *Id*. at 162.

4 *Id*.

5 *Id*.

6 *Id*. (Secondly, of all those profitable buildings which are the means of procuring a revenue, not only to the proprietor who lets them for a rent, but to the person who possesses them, and pays that rent for them; such as shops, warehouses, work-houses, farm-houses, with all their necessary buildings, stables, granaries, etc. These are *very different* from mere dwelling-houses. They are a sort of instruments of trade, and may be considered in the same light.). (Emphasis added).

7 See Note 1, *supra*.

8 *Id*.

9 *Id*.

10 **Treas. Reg. 1.262-1(b)(3)** (Personal, living, and family expenses are illustrated in the following examples: *** (3) Expenses of maintaining a household, including amount paid for rent.).

11 **I.R.C. Section 167(a)** otherwise allows a deprecation deduction for property used in a trade or business, or property held for the production of income. See, also, **I.R.C. Section 280A** .

12 See Note 3, *supra*.

13 **I.R.C. Section 1001(c)** ; **I.R.C. Section 61** .

14 The Code also permits income tax free growth with respect to life insurance under **I.R.C. Section 101** , and a Roth IRA under **I.R.C. Section 408A** .

15 Taxpayer Relief Act of 1997, P.L. 105-34, section 312(b).

16 Compare, **I.R.C. Sections 163(h)(3)** & (4)(A) (With respect to the deduction for qualified residence interest, the term "qualified residence" means the principal residence of the taxpayer and one other residence.).

17 Treas. Reg. 1.121-1(b)(1) .

18 Treas. Reg. 1.121-1(b)(2) .

19 Rev. Proc. 2024-3, 2024-1 IRB 143, section 3.01(32) .

20 Treas. Reg. 1.121-1(b)(2) .

21 Treas. Reg. 1.121-1(b)(1) ; see, e.g., *Hahn*, **110 TC 140** (1998); and, AOD 2001-006 (with respect to shares of a co-op apartment).

22 I.R.C. Section 464(d)(2)(B)(i) .

23 Treas. Reg. 1.121-1(e)(1) .

24 Treas. Reg. 1.121-1(e)(3) .

25 I.R.C. Section 1001 .

26 Treas. Reg. 1.121-1(e)(3) .

27 I.R.C. Section 121 .

28 I.R.C. Section 61(a)(3) ; **Treas. Reg. 1.121-1(e)(1)** ; **Treas. Reg. 1.121-1(e)(4)(ex. 1)** .

29 Treas. Reg. 1.121-1(b)(3) .

30 Treas. Reg. 1.121-1(b)(1) .

31 I.R.C. Section 121(a) .

32 I.R.C. Section 121(d)(1) .

33 I.R.C. Section 121(a) .

34 **Treas. Reg. 1.121-1(c)(2)(i)** .

35 *Id*.

36 **I.R.C. Section 121(d)(1)** .

37 **Treas. Reg. 1.121-1(a)** .

38 **Treas. Reg. 1.121-1(c)(1)** .

39 **I.R.C. Section 121(b)(1)** .

40 **Treas. Reg. 1.121-2(a)(1)** .

41 *Id*.

42 **I.R.C. Section 121(b)(2)** .

43 **I.R.C. Sections 121(b)(2)(A)(i)** - (iii); **Treas. Reg. 1.121-2(a)(3)(i)** .

44 **I.R.C. Section 121(b)(2)(B)** ; **Treas. Reg. 1.121-2(a)(3)(ii)** .

45 **Treas. Reg. 1.121-2(a)(2)** .

46 **I.R.C. Section 121(b)(3)** .

47 **Treas. Reg. 1.121-2(b)(1)** .

48 Compare, **I.R.C. Section 1015(a)** (If appreciated property is acquired by gift after December 31, 1920, then the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift.). **I.R.C. Section 1015** thus provides for a transferred basis with respect to gifts so that any built in gain remains after the gift.

49 **Treas. Reg. 1.1014-1(a)** .

50 *Id*.

51 Treas. Reg. 20.2031-1(b) .

52 *Crane*, 331 U.S. 1 (1947).

53 Treas. Reg. 1.1014-3(a) ; PLR 6205155380A.

54 *Gilmartin*, **TC Memo 1973-247** (1973).

55 Treas. Reg. 1.1014-2(b) . **I.R.C. Section 1014(b)(9)** is a catch-all provision for property included in the gross estate.

56 Rev. Rul. 56-215, 1956-1 CB 324 .

57 Treas. Reg. 1.1014-2(b)(2) .

58 Rev. Rul. 56-215, 1956-1 CB 324 .

59 Treas. Reg. 1.1014-1(c)(1); **Treas. Reg. 1.691(a)-3(a)** .

60 Rev. Rul. 69-93, 1969-1 CB 139 .

61 Rev. Rul. 78-32, 1978-1 CB 198 ; **Rev. Rul. 82-1, 1982-1 CB 26** .

62 I.R.C. Sections 1014(a)(1) & (b)(9).

63 *Napolitano*, **TC Memo 1992-316** (1992); PLR 6205155380A; PLR 6901150520A.

64 "Appreciated property" means any property if the fair market value of the property on the day it was transferred to the decedent by gift exceeds it adjusted basis. **I.R.C. Section 1014(e)(2)(A)** .

65 I.R.C. Section 1014(e)(1) . In the case of any appreciated property described in **I.R.C. Section 1014(e)(1)(A)** sold by the estate of the decedent or by a trust of which the decedent is the grantor, rules similar to the rules of **I.R.C. Section 1014(e)(1)** apply to the extent the donor (or the spouse of the donor) is entitled to the proceeds from the sale. **I.R.C. Section 1014(e)(2)(B)** .

66 **I.R.C. Section 1014(e)(1)(A)** .

67 PLR 9308002.

68 *Id*.

69 *Id*.

70 See Note 1, *supra*, at 207.

71 See Note 1, *supra*, at 194.

72 See Note 1, *supra*, at 207.

73 *Id*.

74 **Treas. Reg. 1.1012-1(a)** .

75 **I.R.C. Section 1012(a)** ; **I.R.C. Section 1016(a)(1)** ; **Treas. Reg. 1.1016-2(b)** .

76 **I.R.C. Section 1001** .

77 **I.R.C. Section 121** .

78 **I.R.C. Section 1001** .

79 **I.R.C. Section 121** .

80 **I.R.C. Section 61(a)(3)** ; **I.R.C. Section 121(b)** .

81 **I.R.C. Section 61(a)(3)** .

82 **I.R.C. Section 1001(a)** .

83 **I.R.C. Section 1001(b)** .

84 I.R.C. Section 1011 ; **I.R.C. Section 1012(a)** .

85 I.R.C. Section 1001(c) ; **I.R.C. Section 1** .

86 I.R.C. Section 1001 .

87 I.R.C. Section 121(a) .

88 I.R.C. Section 61(a)(3) .

89 Treas. Reg. 1.1014-2(a)(1) .

90 I.R.C. Section 2033 ; **Treas. Reg. 1.1014-1(a)** ; **Treas. Reg. 1.1014-2(b)(1)** .

91 PLR 9530020. Before repeal, **I.R.C. Section 121(d)(11)** provided that the exclusion under **I.R.C. Section 121** applied to property sold by estates of certain decedents dying in 2010.

92 I.R.C. Section 2033 ; **I.R.C. Sections 1014(a)** , (b)(1), & (b)(9).

93 I.R.C. Section 1001 .

94 I.R.C. Section 121(a) .

95 I.R.C. Section 61(a)(3) ; *Branson*, **113 TC 6** (1999), *aff'd*, 264 F.3d 904 (9th Cir. 2001) (shares of stock).

96 Rev. Rul. 69-93, 1969-1 CB 139 .

97 Rev. Rul. 78-32, 1978-1 CB 198 .

98 I.R.C. Section 1014(c) ; **Rev. Rul. 82-1, 1982-1 CB 26** .

99 I.R.C. Section 6903(a) (A person acting for another in a fiduciary capacity shall assume the powers, rights, duties, and privileges of such other person.); **Treas. Reg. 301.6903-1(a)** ; **Rev. Rul. 78-32, 1978-1 CB 198** ; **Rev. Rul. 82-1, 1982-1 CB 26** .

100 Treas. Reg. 1.691(a)-1(d) (Any item excluded from gross income is not income in respect of a decedent.); **Rev. Rul. 78-32, 1978-1 CB 198** ; **Rev. Rul. 82-1, 1982-1 CB 26** .

101 I.R.C. Section 2033 .

102 I.R.C. Section 691 ; **I.R.C. Section 1014(c)** .

103 I.R.C. Section 1001 .

104 I.R.C. Section 121 .

105 I.R.C. Section 61(a)(13) ; **I.R.C. Section 691(a)** ; **Rev. Rul. 82-1, 1982-1 CB 26** ; *revoking*, **Rev. Rul. 70-459, 1970-2 CB 22** ; **GCM 37890** ; **GCM 38576** ; but see, PLR 6901150520A.

106 *Crane*, 331 U.S. 1 (1947).

107 Treas. Reg. 1.1014-1(a) (Property acquired from a decedent includes, *principally*, property acquired by bequest, devise, or inheritance.) (Emphasis added.).

108 I.R.C. Section 2033 ; **Treas. Reg. 1.1014-1(a)** ; **Treas. Reg. 1.1014-2(b)(1)** .

109 I.R.C. Section 121(d)(2) .

110 Treas. Reg. 1.121-4(a)(1) .

111 I.R.C. Section 121(b)(4) ; **Treas. Reg. 1.121-2(a)(4)(ex. 5)** .

112 I.R.C. Section 2033 .

113 I.R.C. Sections 1014(a) , (b)(1), & (b)(9).

114 I.R.C. Section 1001 .

115 I.R.C. Section 121(d)(2) .

116 I.R.C. Section 121 ; *Crane*, 331 U.S. 1 (1947); *Balsamo*, TC Memo 1987-477 (1987); *Bissey*, TC Memo 1994-540 (1994); Treas. Reg. 1.121-4(a)(2) (ex.).

117 Treas. Reg. 1.1041-1T(a) (A-2) (I.R.C. Section 1041 is not limited to transfers of property incident to divorce.); Treas. Reg. 1.1041-1T(a) (A-11) (In all cases, the basis of the transferred property in the hands of the transferee is the adjusted basis of such property in the hands of the transferor immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of transfer. Thus, this rule is different from the rule applied in I.R.C. Section 1015(a) for determining the basis of property acquired by gift.).

118 I.R.C. Section 121(d)(3)(A) ; Treas. Reg. 1.121-4(b)(1) .

119 I.R.C. Section 1041 .

120 I.R.C. Section 1001 .

121 I.R.C. Section 121(d)(3) .

122 I.R.C. Section 121 .

123 Treas. Reg. 1.1014-1(a) (Property acquired from a decedent includes, *principally*, property acquired by bequest, devise, or inheritance.) (Emphasis added).

124 I.R.C. Section 2033 ; Treas. Reg. 1.1014-1(a) ; Treas. Reg. 1.1014-2(b)(1) .

125 CCA 199929008 (I.R.C. Section 121 does not provide that the deemed one year holding period under Section 1223(11) can be used to satisfy the ownership requirement under I.R.C. Section 121(a) .). An exception exists for a decedent that dies in 2010. In that narrow situation, a person that receives a principal residence from a decedent may still apply repealed I.R.C. Section 121(d)(11) , which provides that for property acquired from a decedent the taxpayer may take into account the ownership and use by the decedent for determining eligibility to excluded gain on the sale of the property. CCA 201429022.

126 I.R.C. Section 2033 .

127 I.R.C. Sections 1014(a) , (b)(1), & (b)(9).

128 I.R.C. Section 1001 .

129 I.R.C. Section 121(a) .

130 I.R.C. Section 61(a)(3) ; *Hill*, **TC Memo 1981-10** (1981); *Pullin*, **84 TC 789** (1985); PLR 8249014; CCA 199929008.

131 Treas. Reg. 1.1015-1(a)(1) . An exception exists for property with built in loss. If basis is greater than the fair market value of the property at the time of the gift, then, for purposes of determining loss, the basis is the fair market value. **I.R.C. Section 1015(a)** ; **Treas. Reg. 1.1015-1(a)(1)** .

132 CCA 199929008; but see, CCA 201429022.

133 I.R.C. Section 1015(a) .

134 I.R.C. Section 1001 .

135 I.R.C. Section 121(a) .

136 I.R.C. Section 61(a)(3) .

137 Rev. Rul. 66-159, 1966-1 CB 162 ; **Rev. Rul. 85-45, 1985-1 CB 183** .

138 I.R.C. **Treas. Reg. 1.121-1(c)(3)(i)** .

139 PLR 8239055.

140 I.R.C. Section 671 ; **I.R.C. Section 676** .

141 I.R.C. Section 1001 .

142 I.R.C. Section 121 ; PLR 8006056; PLR 8025027; PLR 8007050; PLR 8221147; PLR 8313025; PLR 8549046; PLR 8717010; PLR 9309023; PLR 199912026.

143 I.R.C. Section 2036 ; **I.R.C. Section 2038** ; **I.R.C. Sections 1014(b)(2)** , (3), & (9); **Rev. Rul. 58-395, 1958-2 CB 398** ; **Rev. Rul. 72-359, 1972-2 CB 478** ; PLR 5711145270A; PLR

7202240310A; PLR 7914034; PLR 8721056; PLR 8904046; PLR 9321050.

144 Rev. Rul. 95-58, 1995-2 CB 191 .

145 Rev. Rul. 2008-22, 2008-1 CB 796 ; **Rev. Rul. 2011-28, 2011-49 IRB 830** .

146 Rev. Rul. 66-159, 1966-1 CB 162 .

147 Rev. Rul. 85-45, 1985-1 CB 183 .

148 Treas. Reg. 1.121-1(c)(3)(i) .

149 I.R.C. Section 1015 .

150 I.R.C. Section 671 ; I.R.C. Section 675(4)(C).

151 I.R.C. Section 1001 .

152 I.R.C. Section 121 ; PLR 8239055; PLR 9309023; PLR 9321050, reversing, PLR 9026036.

153 Rev. Rul. 67-241, 1967-2 CB 225 .

154 Treas. Reg. 1.121-1(c)(3)(i) .

155 I.R.C. Section 1015 .

156 I.R.C. Section 678(a)(1) .

157 I.R.C. Section 1001 .

158 PLR 200104005.

159 Rev. Rul. 54-583, 1954-2 CB 158 ; PLR 8239055.

160 I.R.C. Section 1015 .

161 I.R.C. Section 1001 .

162 I.R.C. Section 61(a)(3) ; **Rev. Rul. 54-583, 1954-2 CB 158** ; PLR 200018021 (Because the trust beneficiary has never had the power to vest the trust corpus or income therefrom in herself, **I.R.C. Section 671** and **I.R.C. Section 678** are inapplicable, and taxpayer is not considered the owner of the residence held by the trust for federal income tax purposes. Therefore, the trust beneficiary is not considered the owner of the residence for purposes of satisfying the ownership requirements of **I.R.C. Section 121** .).

163 Rev. Rul. 2008-22, 2008-1 CB 796 ; **Rev. Rul. 2011-28, 2011-49 IRB 830** ; **Rev. Rul. 2023-2, 2023-16 IRB 658** .

164 I.R.C. Section 671 .

165 Rev. Rul. 2008-22, 2008-1 CB 796 ; **I.R.C. Section 1014(b)(9)** ; **Rev. Rul. 2023-2, 2023-16 IRB 658** ; CCA 200937028.

166 See, e.g., PLR 200617002; PLR 200825004; PLR 200822011.

167 Treas. Reg. 25.2511-2(b) (As to any property of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete.); PLR 9718007 (In the present case, upon transfer of Property to Trust, Taxpayer will part with dominion and control over the remainder interest in Trust. *** Accordingly, we conclude that Taxpayer's transfer of the contingent remainder interest in Trust is a completed gift for gift tax purposes, the value of which is equal to the fair market value of Property transferred to Trust minus (a) the present value of Taxpayer's retained income interest in Property determined under **Section 7520** and (b) Taxpayer's retained contingent reversion in Property determined under **Section 7520** .).

168 Treas. Reg. 25.2702-5(a)(1) (**Section 2702** does not apply to a transfer in trust meeting the requirements of this section.); **Treas. Reg. 25.2512-5(d)(2)** (When a donor transfers property in trust and retains an interest therein, generally, the value of the gift is the value of the property transferred less the value the donor's retained interest.); **Treas. Reg. 25.2702-5(c)(1)** .

169 Treas. Reg. 25.2702-5(c)(3) .

170 Treas. Reg. 25.2702-5(c)(4) .

171 Treas. Reg. 25.2702-5(c)(6) .

172 Treas. Reg. 25.2702-5(c)(7)(i) . A residence is held for use as a personal residence of the term holder so long as the residence is not occupied by any other person (other than the spouse or a dependent of the term holder) and is available at all times for use by the term holder as a personal residence. *Id*. If the trust agreement does not permit retention of trust proceeds, then the trust agreement must provide that the trust ceases to be a QPRT upon the sale of the residence. **Treas. Reg. 25.2702-5(c)(7)(ii)** . On the other hand, if the trust agreement permits retention of sale proceeds, then the trust agreement must provide that the trust ceases to be a QPRT with respect to the proceeds not later than the earlier of (1) the date that is two years after the date of sale; (2) the termination of the term holder's interest in the trust; or (3) the date on which a new residence is acquired by the trust. *Id*.

173 Treas. Reg. 25.2702-5(c)(5)(i) .

174 Treas. Regs. 25.2702-5(c)(5)(ii)(A) , (B), & (C). The governing instrument may permit a QPRT to hold additions of cash in a separate account, in an amount which, when added to the cash already held in the account, does not exceed the amount required (1) for the payment of trust expenses (including mortgage payments) already incurred or reasonably expected to be paid by the trust within six months from the date the addition is made; (2) for improvements to the residence to be paid by the trust within six months from the date the addition is made; (3) for the purchase by the trust of the initial residence, within three months of the date the trust is created, provided that no addition may be made for this purpose, and the trust may not hold any such addition unless the trustee has previously entered into a contract to purchase that residence; and (4) for the purchase by the trust of a residence to replace another residence, within three months of the date the addition is made, provided that no addition may be made for this purpose, and the trust may not hold any such addition, unless the trustee has previously entered into a contract to purchase that residence. **Treas. Reg. 25.2702-5(c)(5)(ii)(A)(1)** . If the trust agreement permits additions of cash to the trust, then the governing instrument must also require that the trustee determine, not less frequently than quarterly, the amounts held by the trust for payment of expenses in excess of the amounts permitted and must require that those amounts be distributed immediately thereafter to the term holder. **Treas. Reg. 25.2702-5(c)(5)(ii)(A)(2)** . In addition, the trust agreement must require, upon termination of the term holder's interest in the trust, any amounts held by the trust that are not used to pay trust expenses due and payable on the date of termination be distributed outright to the term holder within thirty days of termination. *Id*. The governing instrument may permit improvements to the residence to be added to the trust and may permit the trust to hold such improvements, provided that the residence, as improved, meets the requirements of a personal residence. **Treas. Reg. 25.2702-5(c)(5)(ii)(B)** .

175 Treas. Reg. 25.2702-5(c)(5)(ii)(D) .

176 Treas. Reg. 25.2702-5(c)(8)(i) .

177 Treas. Reg. 25.2702-5(c)(7)(iii) .

178 Treas. Reg. 25.2702-5(c)(9) .

179 Rev. Proc. 2024-3, 2024-1 IRB 143 , section 4.01(59); compare, PLR 9718007; and, PLR 200109017; with, PLR 200825004; and, PLR 200822011.

180 Rev. Proc. 2003-42, 2003-1 CB 993 .

181 PLR 200825004; PLR 200822011.

182 PLR 200617002.

183 The Regulations contemplate treatment of a QPRT as a grantor trust. **Treas. Reg. 25.2702-5(c)(9)** (The trust agreement must prohibit the trust from selling or transferring the residence directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse during the retained term interest of the trust, or at any time after the retained term interest that the trust is a *grantor trust*. *** For purposes of this paragraph, a *grantor trust* is a trust treated as owned in whole or in part by the grantor or the grantor's spouse pursuant to **Sections 671** through **678** .). (Emphasis added).

184 I.R.C. Section 2702(a)(3)(ii); **Treas. Reg. 25.2702-5(c)** .

185 Treas. Reg. 1.677(a)-1(b)(2) ; **Treas. Reg. 1.677(a)-1(a)(1)** (**Section 677** deals with the treatment of the grantor of a trust as the owner of a portion of the trust because he has retained an interest in the income from that portion.).

186 Treas. Reg. 1.121-1(c)(3)(i) ; **Rev. Rul. 66-159, 1966-1 CB 162** .

187 I.R.C. Section 671 ; **I.R.C. Section 677** .

188 I.R.C. Section 1001 .

189 I.R.C. Section 121 ; PLR 9718007; PLR 200825004; PLR 200822011.

190 I.R.C. Section 1014(b)(9) ; **Rev. Rul. 2023-2, 2023-16 IRB 658** ; compare, *Barlow*, **55 TC 666** (1971) (Because the decedent was obligated to pay fair market value rent from the date of the transfer and there was no express or implied agreement at the date of the transfer that the decedent could continue to occupy the premises whether or not rent was paid, the court held that the property is not includable in the decedent's gross estate under **Section 2036** .); with, *Maxwell*, 3 F.3d 591 (1993); and, **Rev. Rul. 70-155, 1970-1 CB 189** (The donor's continued rent-free occupancy until death pursuant to an understanding resulted in inclusion of the property under **Section 2036** .).

191 I.R.C. Section 2036 ; **I.R.C. Section 1014(b)(9)** ; PLR 200825004; PLR 200822011.

192 I.R.C. Section 2036 ; **I.R.C. Sections 1014(a)** & (b)(9).

193 I.R.C. Section 2036 ; **I.R.C. Section 1014(b)(9)** ; **Treas. Reg. 20.2036-1(c)(2)(iv)(F)** (ex. 6).

194 Treas. Reg. 1.1014-1(a) (Property acquired from a decedent includes, *principally*, property acquired by bequest, devise, or inheritance.) (Emphasis added).

195 I.R.C. Section 2033 ; **Treas. Reg. 1.1014-1(a)** ; **Treas. Reg. 1.1014-2(b)(1)** .

196 Rev. Rul. 54-583, 1954-2 CB 158 .

197 I.R.C. Section 2033 .

198 I.R.C. Sections 1014(a) , (b)(1), & (b)(9).

199 I.R.C. Section 1001 .

200 I.R.C. Section 61(a)(3) ; **Rev. Rul. 54-583, 1954-2 CB 158** ; PLR 200018021; PLR 200104005.

201 I.R.C. Section 1014(b)(9) ; **Rev. Rul. 2023-2, 2023-16 IRB 658** .

202 I.R.C. Section 2033 .

203 I.R.C. Sections 1014(a) , (b)(1), & (b)(9).

204 I.R.C. Section 2041 ; **I.R.C. Section 1014(b)(9)** .

205 Estate tax benefits should be weighed against income tax burdens, and vice versa.

206 I.R.C. Section 2056(b)(7)(B) .

207 Treas. Reg. 1.1014-1(a) (Property acquired from a decedent includes, *principally*, property acquired by bequest, devise, or inheritance.) (Emphasis added).

208 I.R.C. Section 2033 ; **Treas. Reg. 1.1014-1(a)** ; **Treas. Reg. 1.1014-2(b)(1)** .

209 Treas. Reg. 1.121-1(c)(3)(i) .

210 I.R.C. Section 2033 .

211 I.R.C. Sections 1014(a) , (b)(1), & (b)(9).

212 I.R.C. Section 671 ; **I.R.C. Section 678(a)(1)** .

213 I.R.C. Section 1001 .

214 I.R.C. Section 121 ; **Rev. Rul. 85-45, 1985-1 CB 183** (Since W is treated as the owner of the entire trust under **Section 678** and **Section 671** , the sale by the trust is treated for federal income tax purposes as if made by W. Therefore, W excludes from gross income the gain from the sale of the trust, as the requirements of **Section 121** have otherwise been met.).

215 Rev. Rul. 54-583, 1954-2 CB 158 .

216 I.R.C. Section 2033 .

217 I.R.C. Sections 1014(a) , (b)(1), & (b)(9).

218 I.R.C. Section 1001 .

219 I.R.C. Section 61(a)(3) .

220 I.R.C. Section 2044 ; **I.R.C. Sections 1014(a)** & (b)(10).

221 I.R.C. Section 2041 ; **Treas. Reg. 20.2041-1(c)** ; **I.R.C. Section 1014(b)(9)** ; **Rev. Rul. 2023-2, 2023-16 IRB 658** . The bypass trust is an example of a traditional estate planning technique that leads to favorable estate tax implications to the detriment of income tax implications.

222 I.R.C. Section 2033 .

223 I.R.C. Sections 1014(a) , (b)(1), & (b)(9).

224 I.R.C. Section 2044 ; **I.R.C. Section 1014(b)(10)** ; PLR 9309023.

225 Treas. Reg. 1.121-1(c)(3)(ii) .

226 Treas. Reg. 301.7701-3 .

227 Treas. Reg. 1.121-1(c)(3)(ii) .

228 I.R.C. Section 1001 .

229 I.R.C. Section 121 .

230 Treas. Reg. 301.7701-3 .

231 I.R.C. Section 1001 .

232 I.R.C. Section 61(a)(3) ; *Farah*, **TC Memo 2007-369** (2007) (When selling the property they listed the Family Partnership as its owner. It was not until the taxpayers realized that ownership of the property through the Family Partnership produced adverse tax consequences that they held themselves out as the owners of the property. Taxpayers were free to organize their affairs as they chose; nevertheless, having done so, they must accept the tax consequences of their choices, whether contemplated or not.); PLR 200119014, *revoking*, PLR 200004022.

233 Treas. Reg. 301.7701-3(b)(1)(ii) .

234 I.R.C. Section 743(a) ; **I.R.C. Section 754** .

235 I.R.C. Section 1012 .

236 Treas. Reg. 301.7701-3 .

237 I.R.C. Section 2033 ; **I.R.C. Section 1014(b)(9)** .

238 Treas. Reg. 1.743-1(a) .

239 I.R.C. Section 1012 .

240 Treas. Reg. 301.7701-3 .

241 I.R.C. Section 743(a) ; *Dupree*, 391 F.2d 753 (5th Cir. 1968) (with respect to a partnership); *Skaggs*, **75 TC 191** (1980), *aff'd*, 672 F. 2d 756 (9th Cir. 1982) (with respect to a partnership); *C. G. Sloan & Co.*, **38 TC 203** (1962) (with respect to a corporation); *Barkley Co. of Ariz.*, **TC Memo 1988-324** (1988) (with respect to a corporation).

242 See Note 1, *supra* at 13.

243 *Id*.

244 *Id*.