

INFORMATION PAPER

DAJA-LA
18 November 2003

Subject: Tax Treatment of Capital Gain on Sale of Home

1. Purpose: To provide information on the changes to the tax treatment of capital gains on the sale of a home by military personnel after The Military Family Tax Relief Act of 2003.

2. Discussion:

a. Prior to 1997, an extensive body of case law, as well as the Treasury Regulations enacted under Internal Revenue Code 1034, permitted a military member qualifying under a "facts and circumstances" test to maintain real property as a "principal residence" when living away from the home due to performing military duty. This permitted a member to maintain a *status quo* with other taxpayers with regard to deferral of capital gains on the sale of their home.

b. The Tax Relief Act of 1997 repealed section 1034 and added a new rule under section 121 that allowed home owners to exclude up to \$250,000 (\$500,000 for a married couple) of gain from the sale of their home provided they "owned and used" the property for 2 of the 5 years preceding the sale. The new law did not contain the "facts and circumstances" test under the prior law and thereby eliminated the *status quo* that service members were able to maintain with other taxpayers.

c. Under the Tax Relief Act of 1997, if the military taxpayer had not owned and used the home for 2 of the 5 years immediately preceding the date of sale, the full amount of the exclusion was unavailable. If the military member fails to meet this requirements by reason of a permanent change of station a partial exclusion was available.

d. Current Law:

1) The Military Family Tax Relief Act of 2003, signed by the President on 11 November 2003 provides some relief to military taxpayers who have not met the above test.

a) This Act allows a member of the Armed Forces or the Foreign Service to elect to suspend the running of the 5 year period described above for up to ten years during any period when the individual or their spouse is serving on qualified official extended duty.

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b) Qualified Extended duty means any extended duty while serving at a duty station which is at least 50 miles from the property or while residing under Government orders in Government quarters.

c) Extended duty is defined as any period of active duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period.

d) The taxpayer must make an election to suspend the running of the 5-year period and only one election may be made at a time. (If the service member owns more than one property, the election may be invoked with respect to only one property at a time.)

2) Example of the impact of this provision:

Military member lives in his home for one year; is called to active duty in the Middle East for four years; following completion of active duty the service member returns to the home; lives there for a year and sells the home. If the military member elected to suspend the running of the five-year period while he was on active duty, he will qualify for the full exclusion of gain realized on the sale of his personal residence.

3) Additionally, this provision operates retroactively. Sales or exchanges of property since May 7, 1997 may qualify for the exclusion of capital gain. While ordinarily the statute of limitations would bar amendments to tax returns more than 3 years old, the Military Family Tax Relief Act gives individuals one year from November 11, 2003 to claim an otherwise time-barred refund or credit.

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