



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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1999-009
August 30, 1999
Attachment 1

ACTION ON DECISION

SUBJECT: Internal Revenue Service v. Waldschmidt (In re Bradley), (M.D. Tenn. 1999), aff'g 222 B.R. 313 (Bankr. M.D. Tenn. 1998)

Issue: Whether gain on the sale of the debtor's residence is excluded from gross income of the bankruptcy estate to the extent provided by I.R.C. §121 and in accord with section 1398.

Discussion: A Chapter 7 bankruptcy trustee sold the debtor's residence, resulting in a gain. On the bankruptcy estate's 1997 tax return, the trustee declared the gain on the sale of the residence but excluded the gain from income pursuant to section 121. The trustee asserted that, under amended section 121, where a bankruptcy trustee sells a debtor's residence, any resulting capital gain is excluded from income if the debtor would have qualified for the exclusion had the debtor sold the property. The Service responded that the section 121 exclusion is personal to the debtor and not available to a bankruptcy estate. The district court affirmed the bankruptcy court's holding that the bankruptcy estate could take the exclusion.

Prior to its amendment in 1997, section 121 provided that taxpayers who have attained the age of 55 years before the sale or exchange were entitled to elect a one-time exclusion of \$125,000 on the sale of the taxpayer's residence if the taxpayer had owned and used the property as his or her principal residence for three of the last five years. The two cases addressing this issue under section 121 prior to its amendment both concluded that a bankruptcy trustee could not use the exclusion. In re Mehr, 153 B.R. 430 (Bankr. D.N.J. 1993); In re Barden, 205 B.R. 451 (E.D.N.Y. 1996), aff'd 105 F.3d 821 (2d Cir. 1997). The courts reasoned that only individuals can possess the section 121 requirements.

The Taxpayer Relief Act of 1997 amended section 121 to provide that the gain from a sale or exchange of property is excluded from gross income up to the amount of \$250,000 (\$500,000 in the case of certain joint returns) if during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more. There is no age restriction and the exclusion is not limited to one sale or exchange during the taxpayer's lifetime. In In re Popa, 218 B.R. 420 (Bank. N.D.Ill. 1998), the court interpreted amended section 121 in light of section 1398 and, declining to follow Mehr and Barden, held that a bankruptcy estate steps into the debtor's shoes

for purposes of section 121 and is entitled to use the exclusion. See also United States v. Arkison (In re Kerr), (W.D. Wash. 1999); United States v. Arkison (In re Sevy), (W.D. Wash. 1999); and United States v. Arkison (In re Cooper), (W.D. Wash. 1999). But see In re Winch, 226 B.R. 591 (Bankr. S.D. Ohio 1998). The Bradley court followed the rationale of the Popa court in arriving at its decision.

The Popa court found authority for the bankruptcy estate's use of the section 121 exclusion in several subsections of section 1398. Section 1398 treats a bankruptcy estate as a separate taxable entity. Subsection (c) provides that the taxable income of the bankruptcy estate shall be computed in the same manner as for an individual. Subsection (f)(1) provides that the transfer (other than by sale or exchange) of an asset from the debtor to the estate shall not be treated as a disposition, and the estate shall be treated as the debtor would be with respect to such asset. Subsection (g)(6) provides that in the case of any asset acquired (other than by sale or exchange) by the estate from the debtor, the estate shall succeed to and take into account the basis, holding period, and character the asset had in the hands of the debtor.

In the Service's view, sections 1398(c)(1), (f)(1), and (g)(6), when read together, support the bankruptcy estate's claim to the section 121 exclusion. Further support for this result is found in the Seventh Circuit's decision in In the Matter of Kochell, 804 F.2d 84 (7th Cir. 1986), involving the liability of the bankruptcy trustee for the penalty under section 408(f)(1) for early distributions from an IRA.

Recommendation: Acquiescence.

Reviewers

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OR OTHERWISE CITED AS PRECEDENT BY TAXPAYERS