Is an "Equitable Owner" Entitled to the $250,000 Home Sale Exclusion of IRC §121?

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Introduction

One of the home purchase situations that is becoming more and more common is for parents to help an adult child purchase his or her principal residence by providing the down payment and purchasing the residence for the child, while afterwards, the child pays for all expenses of the residence, including mortgage payments, utilities, taxes, maintenance and repairs.

During the years that the child makes the mortgage payments, he or she is entitled to deduct the interest and real estate taxes on the grounds of being the "equitable owner."

Several years later, when the residence is sold, the title company issues the Form 1099-S to the parents because they are the sole owners of the property. Since the parents never used the residence as their principal residence, they end up being taxed on the gain on the sale.

The child isn't entitled to the $250,000 home sale exclusion of IRC §121 because he or she is not the owner of the residence. Is there some way to use the "equitable ownership" rules for the child — rather than the parents — to report the gain on the sale and to use the exclusion?

Factual Scenario

Suppose that a couple's adult daughter is just starting out with a new job and wants to live in her own home. The daughter's parents want her to have the responsibility of owning her own home, but the daughter can't qualify for the mortgage loan on her own or as a co-owner with her parents.

To resolve this problem, the parents purchase the residence for their daughter. The parents make the down payment and qualify for the mortgage loan. The down payment is a gift to their daughter. The parents are the only people listed as owners on the grant deed, and they are solely liable for the mortgage loan.

The daughter lives in the home as her principal residence. The parents do not live there. The daughter pays for all expenses of the residence, including mortgage payments, utilities, real estate taxes, maintenance and repairs. There is an agreement between the daughter and her parents that upon future sale of the residence, the daughter will receive all of the proceeds from the sale or will bear the entire amount of the loss (if any).

Several years later, the daughter moves out and the parents sell the residence. The title company handling the sale issues Form 1099-S ("Proceeds From Real Estate Transactions") to the parents because they are the only people listed as owners on the grant deed.

The parents receive a check from the title company for the net proceeds from the sale, and as agreed, they endorse it over to their daughter.

The gain on the sale of the residence is less than $250,000. You prepare the parents' and the daughter's tax returns. The parents ask you to report the sale on their daughter's return and to claim the $250,000 home sale exclusion on her return.

Equitable Ownership

IRC §121(a) provides for an exclusion of gain on the sale or exchange of property if, during the 5-year period ending on the date of sale or exchange, the property has been "owned and used" by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.

Treas. Reg. §1.163-1(b) states, "Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness." Thus, a taxpayer who is an equitable owner of property may deduct mortgage interest even though the taxpayer is not the actual owner of the property or directly obligated on the mortgage loan. Many court cases have applied this rule.[1]

[1] See, e.g., *Uslu v. Commissioner*, T.C. Memo. 1997-551; *Trans v. Commissioner*, T.C. Memo. 1999-233; *Njenge v. Commissioner*, T.C. Sum. Op. 2008-84; *Adams v. Commissioner*, T.C. Memo. 2010-72; *Wheeler v. Commissioner*, T.C. Sum. Op. 2011-83; *Edosada v. Commissioner*, T.C. Sum. Op. 2012-17; *Loria v. Commissioner*, T.C. Memo. 1995-420; *Song v. Commissioner*, T.C. Memo. 1995-446; *Daya et al. v. Commissioner*, T.C. Memo. 2000-360; *Puentes v. Commissioner*, T.C. Memo.

But this rule applies only for deducting the home mortgage interest and real estate taxes. There is nothing in IRC §121, its legislative history, or related regulations that addresses whether a person who is an equitable owner of property (as opposed to an owner of a fee interest in the property) can satisfy the ownership test. Strictly construed, the statute requires the taxpayer to have "owned" the property.

Several cases and rulings decided under the former IRC §1034 (repealed by the Taxpayer Relief Act of 1997, P.L. 105-34) may be helpful in looking at this issue. Under this former section, a taxpayer must have purchased a new residence of greater cost than the adjusted sales price of the old residence in order to defer the gain on the sale. Several cases have held that to qualify for the deferral, the taxpayer must own a fee interest in the new residence.[2]

But the former IRC §1034 did not require the taxpayer to "own" either the old residence or new residence. IRC §1034(a) only required the taxpayer to have "sold" the old residence and to have "purchased" the new residence. The ownership requirement of the present IRC §121(a) is therefore much more restrictive because it specifies that the taxpayer must "own" the residence.

As a result, it appears that mere equitable ownership won't satisfy the ownership requirement of IRC §121; the taxpayer must actually "own" the residence to qualify for the exclusion.

What if the Child Has Acquired the "Benefits and Burdens of Ownership"?

What if the daughter had acquired the "benefits and burdens of ownership" despite **not** having legal title to the residence? Does this satisfy the ownership requirement of IRC §121?

The current IRC §121 was enacted by the Taxpayer Relief Act of 1997 (P.L. 105-34). The former IRC §121 allowed a taxpayer who was age 55 or older to claim a one-time exclusion of gain of $125,000 on the sale of the taxpayer's residence. This section had the same "own and use" requirement as the current IRC §121. Here's IRC §121(a), prior to amendment by the Taxpayer Relief Act of 1997:

> (a) GENERAL RULE.—At the election of the taxpayer, gross income does not include gain from the sale or exchange of property if—
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> (1) the taxpayer has attained the age of 55 before the date of such sale or exchange, and
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> (2) 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 his principal residence for periods aggregating 3 years or more.

The language I have highlighted is nearly identical to the current IRC §121(a) (see below). The only difference is that "his" was changed to "the taxpayer's" and that "3 years or more" was changed to "2 years or more."

> (a) EXCLUSION.—Gross income shall not include gain from the sale or exchange of property 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 2 years or more.

In two cases, the Tax Court considered whether the taxpayer satisfied the "ownership" requirement of the former IRC §121(a)(2) by considering the "benefits and burdens of ownership" test.

In one case,[3] the taxpayers owned 100 acres of land in Louisiana on which they had built their principal residence. In 1988, they transferred 32 acres (including the residence) to their son and his wife and retained a life interest in the 32 acres. The taxpayers reported this as a sale and excluded the gain under IRC §121. Then, in 1989, they sold the remaining acreage to an unrelated party and claimed the IRC §121 exclusion again. The IRS ruled that they weren't entitled to the 1989 exclusion, and the Tax Court agreed. The Court ruled that the 1989 sale to an unrelated party was separate from the 1988 transfer to the taxpayers' son and his wife, and the 1989 sale did not include the residence, therefore, no exclusion was allowable. In addition, since the taxpayers retained a life interest in the 32 acres that included the residence, the Court said that they hadn't transferred the "benefits and burdens of ownership" in the 1988 transfer to their son and his wife.

2014-224; *Phan v. Commissioner*, T.C. Sum. Op. 2015-1.

[2] See *Boesel v. Commissioner*, 65 T.C. 378 (1975) (75-year lease didn't constitute a purchase); *Yakira v. Commissioner*, T.C. Memo. 1998-415 (new residence purchased by taxpayer's corporation); *Kirst v. Commissioner*, T.C. Memo. 1997-353 (taxpayer didn't take title to new residence); *Moreno v. Commissioner*, T.C. Memo. 1997-218 (equitable ownership of new residence didn't qualify); *De Ocampo v. Commissioner*, T.C. Memo. 1997-161 (taxpayer's parents were legal owners of new residence). See also Rev. Rul. 88-29, 1988-1 C.B. 75 (lease interest doesn't qualify as an ownership interest).

[3] *Roy v. Commissioner*, T.C. Memo. 1995-23.

In another case,[4] the Tax Court ruled that the taxpayers did not have the "benefits and burdens of ownership" of a Spokane, Washington residence for at least 3 years, and therefore, they were not entitled to the IRC §121 exclusion. In this case, in March and June 1989, the taxpayers remitted deposits for the purchase of the residence, and obtained legal title in January 1990. They occupied the residence as their principal residence for 38 months (August 1989 to October 1992), paid all expenses and made improvements, and then sold it in October 1992. They held legal title for 33 months (January 1990 to October 1992), which was less than the 3 years required for the IRC §121 exclusion. To qualify for the IRC §121 exclusion, they argued that for the entire 38 months, including the period before they obtained legal title, they had the "benefits and burdens of ownership," and therefore satisfied the ownership test.

In order to decide this, the Tax Court considered whether the taxpayers had satisfied the "benefits and burdens" of ownership.[5] For the period before they obtained legal title (August 1989 to January 1990), the Court considered whether they (a) had the right to possess the property and to enjoy the use, rents, and profits thereof; (b) had the duty to maintain the property; (c) were responsible for insuring the property; (d) bore the risk of loss of the property; (e) were obligated to pay taxes, assessments, and charges against the property; (f) had the right to improve the property without the seller's consent; and (g) had the right to obtain legal title at any time by paying the balance of the purchase price. The Court found that during this period, they failed (a), (c), (d), (e), (f) and (g), and therefore did not have enough of these benefits and burdens of ownership to be treated as the owners of the property for purposes of IRC §121 for 3 years or more.

These cases demonstrate that the Tax Court is willing to consider the benefits and burdens of ownership in determining whether the ownership test of IRC §121 has been met.

The courts have consistently held that transfer of ownership is completed upon the passage of title, or the passage of the benefits and burdens of ownership, whichever occurs first. The time that title passes and the legal rights thereby created are determined under state law.[6]

Under California law, title to real property passes when the seller delivers a grant deed to the buyer or the buyer's designee.[7] The deed must grant a present interest in the property and must represent an intent to pass title to the grantee.[8]

Whether the taxpayer has acquired the benefits and burdens of ownership is essentially a question of fact to be resolved by a consideration of all surrounding facts and circumstances. Factors considered are passage of title, transfer of possession, and substantial performance of conditions imposed upon the buyer.[9]

The leading case on the benefits and burdens of ownership is *Grodt & McKay Realty, Inc.*,[10] which has been cited in many subsequent cases. In this case, the Tax Court held that the factors to be considered in determining whether the benefits and burdens of ownership have passed from one party to the other are (1) whether legal title passed; (2) whether the parties treated the transaction as a sale; (3) whether the purchaser acquired an equity interest in the property; (4) whether the sale contract obligated the seller to execute and deliver a deed and obligated the purchaser to make payments; (5) whether the purchaser is vested with the right of possession; (6) whether the purchaser pays property taxes after the transaction; (7) whether the purchaser bears the risk of economic loss or physical damage to the property; and (8) whether the purchaser receives the profit from the property's operation, retention and sale.

None of these factors, alone, is necessarily determinative. Rather, whether the benefits and burdens have passed depends on all the facts and circumstances.[11] In addition, the factors are not equally weighted. Some factors may be more important in some situations than others, and some

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[4] *Blanton v. Commissioner*, T.C. Memo. 1998-211.

[5] The Tax Court cited *Derr v. Commissioner*, 77 T.C. 708, 724-725 (1981); and *Ryan v. Commissioner*, T.C. Memo. 1995-579.

[6] *Fletcher v. United States*, 436 F.2d 413 (7th Cir. 1971); *Commissioner v. Stuart*, 300 F.2d 872 (3d Cir. 1962); *Guest v. Commissioner*, 77 T.C. 9, 18 (1981); *Greer v. Commissioner*, 70 T.C. 294, 304 (1978), acq. 1979-2 C.B. 2, affd. 634 F.2d 1044 (6th Cir. 1980); *Alioto v. Commissioner*, T.C. Memo. 1980-360, affd. in an unpublished opinion 692 F.2d 762 (9th Cir. 1982).

[7] See California Civil Code §§1054 and 1059.

[8] *Carman v. Athearn*, 175 P.2d 926, 77 C.A.2d. 585 (1947); *Olson v. Cornwell*, 25 P.2d 879, 134 C.A. 419 (1933).

[9] See *Clodfelter v. Commissioner*, 426 F.2d 1391 (9th Cir. 1970), and cases cited therein; *Haggard v. Commissioner*, 24 T.C. 1124, 1129 (1955), affd. 241 F.2d 288 (9th Cir. 1956).

[10] *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237-1238 (1981).

[11] *Sollberger v. Commissioner*, 691 F.3d 1119 (11th Cir. 2012); *H.J. Heinz Co. & Subsidiaries v. United States*, 76 Fed.Cl. 570 (Ct.Fed.Cl. 2007).

factors may not be relevant.[12] The factors that are relevant, and the weight to be given to each factor, must be determined in light of the nature of the property involved.[13]

The *Roy* and *Blanton* cases demonstrate that taxpayers may satisfy the ownership requirement of IRC §121 if they had acquired the benefits and burdens of ownership for periods totaling at least 2 years during the 5-year period prior to the sale of the residence. They do not need to have legal title.

Will This Work in Every Case?

No. You must have good facts to demonstrate that the child had acquired the benefits and burdens of ownership of the residence.

For example, in some cases, the parents want the child to reimburse them for the down payment out of the proceeds from the sale. In such a case, the parents have an ownership interest in the residence, which makes it more difficult to argue that the child had the benefits and burdens of ownership.

In other cases, the child may not earn enough to pay for the expenses of the home, so the parents provide additional funds to the child. There may or may not be an expectation of reimbursement out of the proceeds of a future sale. Again, these facts weaken the argument that the child had the benefits and burdens of ownership.

You will have to decide on your own, after considering the factors listed in the *Blanton* and *Grodt & McKay Realty, Inc.* cases, whether the child had acquired the benefits and burdens of ownership, and if so, whether they were held for at least 2 years during the 5-year period prior to the sale of the residence.

Conclusion

In the situation where parents help a child purchase his or her principal residence by providing the down payment and purchasing the residence in the parents' name, but where the child pays for all the expenses of the residence and occupies it as his or her principal residence, a gain on the future sale of the residence may be considered as taxed to the child. The child may be entitled to the $250,000 home sale exclusion of IRC §121 if the child had acquired the benefits and burdens of ownership for at least 2 years during the 5-year period prior to the sale.

In order to determine whether the child had acquired the benefits and burdens of ownership, you must consider and weigh many factors listed in court cases.

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[12] *Calloway v. Commissioner*, 691 F.3d 1315 (11th Cir. 2012).

[13] *Torres v. Commissioner*, 88 T.C. 702 (1987).