## Section 1(h).—Maximum Capital Gains Rate

*(Also: § 121)*

**Gross income; sale of principal residence.** If an individual elects under section 311(e) of the Tax Reform Act of 1997 to treat the individual's principal residence as being both sold and reacquired on January 1, 2001, for an amount equal to its fair market value on that date, the individual cannot exclude from gross income under section 121 of the Code any of the gain from the deemed sale.

## Rev. Rul. 2001–57

ISSUE

If an individual elects under § 311(e) of the Taxpayer Relief Act of 1997 ("TRA 97"), 1997–4 (Vol. 1) C.B. 1, 49-50, to treat the individual's principal residence as being both sold and reacquired on January 1, 2001, for an amount equal to its fair market value on that date ("§ 311(e) election"), can the individual exclude from gross income under § 121 of the Internal Revenue Code any of the gain resulting from the deemed sale?

FACTS

*A* makes a § 311(e) election with respect to *A*'s principal residence on *A*'s federal income tax return for the year including January 1, 2001. On January 1, 2001, the residence had a fair market value that was $250,000 greater than *A*'s basis. If, on that date, *A* had actually sold the residence for its fair market value, § 121 would have entitled *A* to exclude from gross income the full $250,000 of gain realized on the sale.

LAW AND ANALYSIS

Under § 121, a taxpayer may exclude from gross income up to $250,000 ($500,000 in the case of certain jointly filed returns) of gain realized on the sale or exchange of property, if that property was owned and used as the taxpayer's principal residence for an aggregate period of two years or more during the 5-year period ending on the date of the sale or exchange. The full exclusion is available only once every two years.

Under § 1(h)(1), gain resulting from the sale or exchange of most capital assets is taxed at a capital gains rate of 20 percent (10 percent for gain otherwise taxed at an ordinary rate of 15 percent or less).

Section 1(h)(2) provides reduced capital gains rates for qualified 5-year gain, generally defined in § 1(h)(9) as "the aggregate long-term capital gain from property held for more than 5 years." Section 1(h)(2)(B) provides that the 20-percent capital gains rate is reduced to 18 percent for qualified 5-year gain resulting from the sale or exchange of property with a holding period beginning after December 31, 2000.

Section 311(e) of TRA 97 allows a noncorporate taxpayer holding a capital asset on January 1, 2001, to elect to treat that asset as having been both sold and reacquired on that date for an amount equal to its fair market value. Thus, if the election is made, the holding period for the asset begins after December 31, 2000, making the asset eligible for the 18-percent rate if it is later sold when the taxpayer has a holding period of more than five years in the asset. Section 311(e)(2)(A) of TRA 97 provides, "Any gain resulting from [a § 311(e) election] shall be treated as received or accrued on the date the asset is treated as sold . . . and shall be recognized notwithstanding any provision of the . . . Code."

Pursuant to *A*'s § 311(e) election, *A* is deemed to have both sold and reacquired *A*'s principal residence for an amount equal to its fair market value on January 1, 2001. As stated above, § 121 would entitle *A* to exclude from gross income gain from an actual sale. Thus, the question presented is how to reconcile the requirement that the gain from the deemed sale be "recognized notwithstanding any other provision" of the Code and the mandate in § 121 that "[g]ross income shall not include gain" from a qualifying sale or exchange of a principal residence.

In interpreting an internal revenue statute, it is necessary to infer legislative intent from all of the facts and circumstances. These factors include the role that the provision at issue plays in the structure of the internal revenue law, the statutory language, and all relevant legislative history. *See U.S. v. Amer. Trucking Ass'ns*, 310 U.S. 534, 542–45 (1940); *U.S. v. Dickerson*, 310 U.S. 554, 561–62 (1940).

A § 311(e) election confers tax benefits on the electing taxpayer (a holding period that begins after December 31, 2000, and a step-up in basis), but it imposes a tax cost as well (current recognition of gain resulting from any existing appreciation in the asset). Exclusion of the gain from the deemed sale would frustrate this balancing of benefits and burdens. For this reason, the statutory requirement that gain be recognized "notwithstanding any other provision" of the Code necessarily precludes application of the exclusion from gross income under § 121, or else the intended consequences of the mandated recognition (taxation of the gain) would be prevented. The legislative history of the § 311(e) election is consistent with this conclusion. "If the election is made, any gain is recognized (and any loss disallowed)." H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 383 (1997)

HOLDING

If an individual elects under § 311(e) of TRA 97 to treat the individual's principal residence as being both sold and reacquired on January 1, 2001, for an amount equal to its fair market value on that date, the individual cannot exclude from gross income under § 121 any of the gain resulting from the deemed sale.

DRAFTING INFORMATION

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