A's friend B moves into A's house and A sells B a 50% interest in the house realizing a gain of $136,000. A may exclude the $136,000 of gain. In 2005 A sells his remaining 50% interest in the home to B realizing a gain of $138,000. A may exclude $114,000 ($250,000—$136,000 gain previously excluded) of the $138,000 gain from the sale of the remaining interest.

(f) No exclusion for expatriates. The section 121 exclusion will not apply to any sale or exchange by an individual if the provisions of section 877(a) (relating to the treatment of expatriates) applies to the individual.

(g) Election to have section not apply. A taxpayer may elect to have the section 121 exclusion not apply to a sale or exchange of property. The taxpayer makes the election by filing a return for the taxable year of the sale or exchange that includes the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. A taxpayer may make an election under this paragraph (g) to have section 121 not apply (or revoke an election to have section 121 not apply) at any time before the expiration of a 3-year period beginning on the last date prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred.

(h) Residences acquired in rollovers under section 1034. If a taxpayer acquires property in a transaction that qualifies under section 1034 (section 1034 property) for the nonrecognition of gain realized on the sale or exchange of another property and later sells or exchanges such property, in determining the period of the taxpayer's ownership and use of the property under section 121 the taxpayer may include the periods that the taxpayer owned and used the section 1034 property as the taxpayer's principal residence (and each prior residence taken into account under section 1223(7) in determining the holding period of the section 1034 property).

(i) [Reserved]

(j) Election to apply regulations retroactively. Taxpayers who would otherwise qualify under §§1.121–1 through 1.121–4 to exclude gain from a sale or exchange of a principal residence before December 24, 2002 but on or after May 7, 1997, may elect to apply §§1.121–1 through 1.121–4 for any years for which the period of limitation under section 6511 has not expired. The taxpayer makes the election under this paragraph (j) by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. Taxpayers who have filed a return for the taxable year of the sale or exchange may elect to apply the provisions of these regulations for any years for which the period of limitation under section 6511 has not expired by filing an amended return.

(k) Audit protection. The Internal Revenue Service will not challenge a taxpayer's position that a sale or exchange of a principal residence occurring before December 24, 2002 but on or after May 7, 1997, qualifies for the section 121 exclusion if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 121. Compliance with the provisions of the regulations project under section 121 (REG–105235–99 (2000–2 C.B. 447)) generally will be considered a reasonable, good faith effort to comply with the requirements of section 121.

(l) Effective date. This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions retroactively, see paragraph (j) of this section.

§ 1.122–1

(a) Rule applicable prior to January 1, 1966. In the case of a member or former member of the uniformed services of the United States (as defined in 37 U.S.C. 101(3)) who has made an election under Subchapter I of Chapter 73 of Title 10 of the U.S. Code (also referred to in this section as the Retired Serviceman’s Family Protection Plan (10 U.S.C. 1431)) to receive a reduced amount of retired or retainer pay, gross income shall include the amount of any reduction made in his retired or retainer pay before January 1, 1966, by reason of such election, unless such reduction, or portion thereof, is otherwise excluded from gross income under Part III of Subchapter B of Chapter 1 of the Internal Revenue Code of 1954 or any other provision of law.

(b) Rule applicable after December 31, 1965—(1) In a case of a member or former member of the uniformed services of the United States (as defined in 37 U.S.C. 101(3)), gross income shall not include the amount of any reduction made in his or her retired or retainer pay after December 31, 1965, by reason of—

(i) An election made under the Retired Serviceman’s Family Protection Plan (10 U.S.C. 1431), or

(ii) The provisions of Subchapter II of Chapter 73 of Title 10 of the U.S. Code (also referred to in this section as the Survivor Benefits Plan (10 U.S.C. 1447)).

(2)(i) In a case where a member or former member of the uniformed services has, pursuant to the election described in paragraph (a) of this section, received before January 1, 1966, a reduced amount of retired or retainer pay, he shall, after December 31, 1965, exclude from gross income under section 122(b) and this subdivision all amounts received as uniformed services retired or retainer pay until there has been so excluded an amount of retired or retainer pay equal to the “consideration for the contract” (as described in subdivision (iii) of this subparagraph).

(ii) Upon the death of a member or former member of the uniformed services, where the “consideration for the contract” (as described in subdivision (iii) of this subparagraph) has not been excluded in whole or in part from gross income under section 122(b) and this subdivision all amounts received as uniformed services retired or retainer pay until there has been so excluded an amount of retired or retainer pay equal to the “consideration for the contract” (as described in subdivision (iii) of this subparagraph).

(c) Effective date. This section is applicable for sales and exchanges on or after May 7, 1966.