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INDIVIDUAL TAX MATTERS

Noise Qualifies As Unforeseen Circumstance for Home-Sale Exclusion

In LTR 200702032 [Sept. 29, 2006], the IRS concluded that a taxpayer who received a damage award for not being notified that the home he purchased (and shortly thereafter sold) was subject to excessive airplane noise could exclude the award as proceeds from the sale of a home due to an unforeseen circumstance.

Facts

When the taxpayer first moved to a new city, he lived in a rental apartment. He then purchased a home that was equidistant as the apartment from the city's airport. Shortly after purchasing and occupying the home, he realized that there was substantial noise from airplanes flying overhead during peak flight periods (early mornings and early evenings). When the taxpayer became aware of the noise, he sought to rescind the sale. After that effort was unsuccessful, he brought a civil action for damages against the sell-

ers, their real estate agent, his own real estate agent and the agencies with which the realtors were associated. The taxpayer argued that the defendants had a duty to disclose the airport noise prior to sale. Under state law, sellers are expressly required to disclose noise from commercial nuisances affecting residential property. Residential property owners within a noise impact zone surrounding the airport also receive a specific notice from the airport authority. The notice advises the owners that their property is exposed to average aircraft noise levels that exceed typical ground-based levels and state law requires sellers of property to disclose this governmental notice.

The taxpayer represented to the IRS that had he known or been advised of the noise level, he would not have purchased the property. After owning and using the home as his principal residence for only 20 months, the taxpayer sold the home at a

loss. The taxpayer did not claim the loss on his tax return.

The defendants made a payment to the taxpayer in settlement of the litigation. This payment was made in the year after the taxpayer sold the home. The taxpayer wanted to treat the payment as additional proceeds from the home sale, and he sought to use the home-sale exclusion in Code Sec. 121 to avoid owing tax to the extent those proceeds would represent a gain on the property's sale.

Legal Background

Code Sec. 121(a) provides that a taxpayer's gross income will not include gain from the sale or exchange of property if, during the five-year period ending on the date of the sale or exchange, the property has been owned and used by the taxpayer as his or her principal residence for periods aggregating two years or more. The full exclusion is available only once every two years.

Federal Tax Course Letter

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Code Sec. 121(b) provides that the maximum exclusion amount is \$250,000 (\$500,000 for married taxpayers). Code Sec. 121(c) provides for a reduced maximum exclusion for taxpayers who fail to satisfy the ownership and use tests or the limit of one sale every two years if the primary reason for sale or exchange is a change in place of employment, health or unforeseen circumstances.

The reduced maximum exclusion is computed by multiplying the maximum dollar limitation of \$250,000 (\$500,000 for certain joint filers) by a fraction. The numerator of the fraction is the shortest of the following periods: (1) the period of time that the taxpayer owned the property during the five-year period ending on the date of the sale or exchange, (2) the period of time that the taxpayer used the property as the taxpayer's principal residence during the five-year period ending on the date of the sale or exchange, or (3) the period of time between the date of a prior sale or exchange of property for which the taxpayer excluded gain under Code Sec. 121 and the date of the current sale or exchange. The numerator of the fraction may be expressed in days or months. The denominator of the fraction is 730 days or 24 months (depending on the measure of time used in the numerator).

Temporary Reg. §1.121-3T(b) provides the following factors for determining the taxpayer's primary reason for the sale: (1) the extent to which the sale and the circumstances giving rise to the sale are proximate in time; (2) the suitability of the property as the taxpayer's principal

residence materially changes; (3) the taxpayer's financial ability to maintain the property is materially impaired; (4) the taxpayer uses the property as the taxpayer's residence during the period of ownership of the property; (5) the circumstances giving rise to the sale are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and (6) the circumstances giving rise to the sale occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

Under Temporary Reg. §1.121-3T(e)(1), a sale results from unforeseen circumstances if the primary reason for the sale "is the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence." Example 5 of Temporary Reg. §1.121-3T(e)(4) illustrates a situation in which a taxpayer failed to satisfy the unforeseen circumstances test. In Example 5, C buys a house that he uses as his principal residence. The property is located on a heavily traveled road. C sells the property before two years has elapsed because he is disturbed by the traffic. The example concludes that C is not entitled to claim a reduced maximum exclusion under the unforeseen circumstances exception, because the primary reason for the sale was the traffic and C could reasonably have anticipated the traffic at the time he purchased and occupied the house.

IRS Analysis and Conclusion

The IRS found that the settlement proceeds received by the

taxpayer should be afforded the same tax treatment as proceeds from the sale of the property. When viewed in isolation, the settlement proceeds would be taxed as ordinary income because no sale or exchange occurred in the year the proceeds were received. However, based on case law (*e.g.*, *D.F. Arrowsmith*, SCt, 52-2 USTC ¶9527, 344 US 6, 73 SCt 71; *G.T. Kimbell*, CA-5, 74-1 USTC ¶9259, 490 F2d 203, *cert. denied*, 419 US 833, 95 SCt 58), the IRS concluded that the settlement proceeds must be characterized by reference to the sale transaction in the prior year and should therefore be treated as proceeds from the sale of a principal residence held for more than one year by the taxpayer. Accordingly, the settlement proceeds are a return of capital and are not includible in his gross income and the remaining portion of the proceeds are treated as gain from the sale of a principal residence.

The IRS held further that even though the taxpayer failed to satisfy the requisite

two-year ownership and use test used to determine whether a taxpayer may exclude gain from a home sale, the taxpayer qualified for a reduced maximum exclusion since the primary reason for the sale was unforeseen circumstances under Temporary Reg. §1.121-3T(e)(1) because the taxpayer did not anticipate airport noise prior to purchasing and occupying the residence.

The IRS noted that Example 5 of Temporary Reg. §1.121-3T(e)(4) illustrates a situation in which a taxpayer failed to satisfy the unforeseen circumstances test. But the IRS distinguished the facts in this example from the facts of the present case. The taxpayer in Example 5 clearly anticipated some noise, just not as much as was actually experienced. In contrast, the taxpayer did not anticipate airport noise when he purchased the property and contends that he would not have purchased the property if he had known about the excessive noise. Moreover, the taxpayer

did not receive the required governmental notice from the sellers or the real estate agents. This notice was expressly designed to alert prospective purchasers that the property was located within the noise impact zone and thus adversely affected by airport noise. The IRS concluded that the taxpayer conducted a reasonable investigation of the property and did not anticipate the airport noise before purchasing and occupying the property, as provided in Temporary Reg. §1.121-3T(e)(1).

Thus, the IRS concluded that the settlement proceeds should be treated as proceeds from the sale of a principal residence. Therefore, a portion of the money is taxed as a return of capital and the remainder is taxed as gain from the sale of a principal residence. Further, the primary reason for the sale was an unforeseen circumstance, so the reduced maximum exclusion in Code Sec. 121(c) applied to exclude the proceeds from tax. ■