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## "Unforeseen Circumstances" Exception to Residence Exclusion

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## “Unforeseen Circumstances” Exception to Residence Exclusion

-by Neil E. Harl\*

A statutory exception<sup>1</sup> added in 1998 to the exclusion on gain from sale or exchange of the principal residence<sup>2</sup> has, as anticipated, broadened significantly the opportunity to utilize the exclusion.<sup>3</sup> The exception allows taxpayers who fail to meet the ownership and use requirements<sup>4</sup> by reason of a change of place of employment, health or other “unforeseen circumstances” to be able to exclude the fraction of the \$500,000 if married and filing a joint return (or \$250,000 for a separate return) equal to the fraction of the exclusion for the years the requirements are met.<sup>5</sup>

### Ownership and use requirements

The 1998 amendment involves the “ownership and use” requirements.<sup>6</sup> To be eligible for the exclusion, as a general rule a taxpayer must have owned the residence and occupied it as the principal residence for at least two of the last five years prior to the sale or exchange.<sup>7</sup> To be eligible for the exclusion, either spouse in the case of a married couple can meet the ownership test, both spouses must meet the use test and neither spouse can have sold or exchanged a residence within the past two years.<sup>8</sup>

### Change of employment

As for the “change of employment” exception, a safe harbor is provided if the change of employment occurs during the period of the taxpayer’s ownership and use of the property and the new place of employment is at least 50 miles farther from the residence sold or exchanged than was the former place of employment or, if there was no former place of employment, the distance between the new place of employment and the residence sold or exchanged is at least 50 miles.<sup>9</sup>

### Sale or exchange by reason of health

A sale or exchange is for reasons of health if the primary reason for the sale or exchange is to obtain, provide or facilitate the diagnosis, cure, mitigation or treatment of disease, illness or injury of a “qualified individual” or to obtain or provide medical or personal care for a “qualified individual” suffering from a disease, illness or injury.<sup>10</sup> A safe harbor is provided if the primary reason for the sale or exchange is for health reasons based upon a physician’s recommendations.<sup>11</sup>

A “qualified individual” for health reasons means the taxpayer, taxpayer’s spouse, co-owner of the residence or a person whose principal place of abode is in the same household

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as the taxpayer or a related individual within the meaning of I.R.C. § 152(a)(1) through (a)(8).<sup>12</sup> In a 2005 letter ruling, a co-owner in joint tenancy of a personal residence was allowed a reduced exclusion on sale for health reasons to move to an assisted living facility.<sup>13</sup>

#### **Sale or exchange by reason of “unforeseen circumstances”**

With respect to unforeseen circumstances, a sale or exchange meets the test if the primary purpose is the occurrence of an event the taxpayer could not reasonably have anticipated before purchasing and occupying the residence.<sup>14</sup> Safe harbors are provided in the event of – (1) an involuntary conversion of the residence; (2) natural or man-made disasters; or (3) acts of war or terrorism resulting in a casualty to the residence.<sup>15</sup> Also, in the case of a “qualified individual,” death, cessation of employment, change of employment or employment status that results in the taxpayer’s inability to pay housing costs and reasonable basic living expenses of the taxpayer’s household (but not for an “affluent or luxurious standard of living”) meets the test.<sup>16</sup> A “qualified individual” is defined the same as for health reasons except that it does not include those related within the meaning of I.R.C. § 152(a)(1) through (a)(8).<sup>17</sup> Finally, “unforeseen circumstances” includes divorce or legal separation under a decree of divorce or separate maintenance; multiple births from the same pregnancy; or an event determined by the Commissioner in published guidance.<sup>18</sup>

In a 2003 letter ruling, a neighbor’s vehement and violent protests to the purchase and occupancy of the residence was an “unforeseen circumstance” which allowed the exclusion to be claimed.<sup>19</sup> In a 2004 ruling, IRS held that “unforeseen circumstance” included a situation where a police officer was assigned to a K-9 unit and the officer’s townhouse did not permit dogs on the premises.<sup>20</sup> In 2005 rulings, the exclusion was allowed where a couple was assaulted by neighbors,<sup>21</sup> for a sale of the residence because of the birth of a child and the house was no longer large enough for their family<sup>22</sup> and where the taxpayers moved back to their original community after retirement, their daughter had lost her job and was divorcing, necessitating a sale of the residence.<sup>23</sup>

In an earlier IRS Notice,<sup>24</sup> IRS had taken the position that persons “affected by the events of September 11, 2001” were eligible for a reduced exclusion of gain on the principal residence if –(1) a spouse, home co-owner or person living with the taxpayer, was killed; (2) the taxpayer’s principal residence was damaged; (3) the taxpayer or an affected person became eligible for unemployment compensation; or (4) the taxpayer or an affected person had a change of employment or self-employment that resulted in inability to pay reasonable basic living expenses for the household.

#### **In conclusion**

The pace of recent rulings suggests that the special exceptions are being utilized and that the Internal Revenue Service is interpreting the regulations and the statute in a reasonable

and humane manner. In questionable instances, it may be necessary to request a private letter ruling although the guidance from published rulings already provides substantial help to taxpayers confronted with what they consider to be “unforeseen circumstances.”

#### **Footnotes**

<sup>1</sup> Internal Revenue Service Restructuring and Reform Act of 1998, § 6024, 112 Stat. 685 (1998).

<sup>2</sup> I.R.C. § 121(c)(1), (2).

<sup>3</sup> I.R.C. § 121(c). See Treas. Reg. § 1.121-3. See generally 6 Harl, *Agricultural Law* § 48.02 (2006); Harl, *Agricultural Law Manual* § 6.03[2] (2006). See also Harl, “Section 121 Exclusion and Like-Kind Exchanges on Same Property?” 16 *Agric. L. Dig.* 17 (2005); Harl, “More Detail on the Principal Residence Exclusion,” 14 *Agric. L. Dig.* 9 (2003); Harl, “Excluding Gain on Sale of Residence,” 14 *Agric. L. Dig.* 105 (2003).

<sup>4</sup> I.R.C. § 121(a).

<sup>5</sup> I.R.C. § 121(c)(1), (2).

<sup>6</sup> I.R.C. § 121(a).

<sup>7</sup> *Id.*

<sup>8</sup> I.R.C. § 121(b)(2). See Ltr. Rul. 200018021, January 21, 2000 (individual who lived in residence for 18 years not considered owner for purposes of exclusion; title in trust set up by mother with occupant having only life interest in trust).

<sup>9</sup> Treas. Reg. § 1.121-3(c)(2).

<sup>10</sup> Treas. Reg. § 1.121-3(d)(1).

<sup>11</sup> Treas. Reg. § 1.121-3(d)(2).

<sup>12</sup> Treas. Reg. § 1.121-3(f).

<sup>13</sup> Ltr. Rul. 200604013, October 18, 2005.

<sup>14</sup> Treas. Reg. § 1.121-3(e)(1).

<sup>15</sup> Treas. Reg. § 1.121-3(e)(2).

<sup>16</sup> Treas. Reg. § 1.121-3(e)(2).

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> Ltr. Rul. 200403049, September 26, 2003.

<sup>20</sup> Ltr. Rul. 200504012, October 14, 2004.

<sup>21</sup> Ltr. Rul. 200601009, September 30, 2005.

<sup>22</sup> Ltr. Rul. 200601022, September 30, 2005.

<sup>23</sup> Ltr. Rul. 200601023, September 30, 2005.

<sup>24</sup> Notice 2002-60, 2002-2 C.B. 482.