Unforeseen Adoption Consequences and the Sale of a Residence
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To close out this tax season, we look at a recent IRS private letter ruling that gives what some might see as a surprisingly lenient view of what constituted an unforeseen circumstance for the purposes of gaining access to the relief found in §121(c) for the sale of a residence when the taxpayer fails to meet one of the two year tests.

General Rule

Section 121 allows taxpayers to exclude up to $250,000 (or $500,000 for married taxpayers) of gain on the sale of their residence. However, the exclusion generally can only be used once every two years, and the taxpayers must meet both a two year ownership test and a two year use test. However, taxpayers who fail the two year tests may be eligible for relief if they meet the criteria found in §121(c)(2).

That provision provides:

> **121(c)(2) SALES AND EXCHANGES TO WHICH SUBSECTION APPLIES.** --This subsection shall apply to any sale or exchange if --

> 121(c)(2)(A) subsection (a) would not (but for this subsection) apply to such sale or exchange by reason of --
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> 121(c)(2)(A)(i) a failure to meet the ownership and use requirements of subsection (a), or
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> 121(c)(2)(A)(ii) subsection (b)(3), and
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> 121(c)(2)(B) *such sale or exchange is by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances.*

The IRS promulgated Regulation §1.121-3 in August of 2004 that defines the statutory exceptions (employment and health) as well as outlining those items that would be defined as unforeseen circumstances by the IRS for the purposes of this exception.

In Regulation §1.121-3(e)(1) the IRS provided the test to be used for an "unforseen circumstance" under §121(c)(2)(B):

> (1) *In general.* --A sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer *could not reasonably have anticipated before purchasing and occupying the residence.* A sale or exchange by reason of unforeseen circumstances (other than a sale or exchange deemed to be by reason of unforeseen circumstances under paragraph (e)(2) or (3) of this section) does not qualify for the reduced maximum exclusion if the primary reason for the sale or exchange is a *preference for a different residence or an improvement in financial circumstances*.

The first italicized provision provides the "inclusion" test—the event must be one that could not have been reasonably anticipated before purchasing and occupying the residence. Note that we aren't asking if *taxpayer actually* anticipated the reason, but rather whether it is one that reasonably could have been foreseen.

As well, two exclusion tests are given—a reason won't qualify if it is merely a preference for a different residence or an improvement in financial circumstances.

The IRS then goes on to outline specific safe harbor events that will qualify:

> (2) *Specific event safe harbors.* --A sale or exchange is deemed to be by reason of unforeseen circumstances (within the meaning of paragraph (e)(1) of this section) if any of the events specified in paragraphs (e)(2)(i) through (iii) of this section occur during the period of the taxpayer's ownership and use of the residence as the taxpayer's principal residence:
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> (i) The involuntary conversion of the residence.
>
> (ii) Natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence (without regard to deductibility under section 165(h)).

> (iii) In the case of a qualified individual[1] described in paragraph (f) of this section --
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> (A) Death;
>
> (B) The cessation of employment as a result of which the qualified individual is eligible for unemployment compensation (as defined in section 85(b));
>
> (C) A change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household (including amounts for food, clothing, medical expenses, taxes, transportation, court-ordered payments, and expenses reasonably necessary to the production of income, but not for the maintenance of an affluent or luxurious standard of living);
>
> (D) Divorce or legal separation under a decree of divorce or separate maintenance; or
>
> (E) Multiple births resulting from the same pregnancy.

Taxpayer that have one of these events occur are deemed to have an "unforeseen circumstance" for the purpose of the exception.

As well, the IRS reserved the right to designate other events as "unforeseen circumstances" for this purpose in Regulation §1.121-3(e)(3):

> (3) *Designation of additional events as unforeseen circumstances.* --The Commissioner may designate other events or situations as unforeseen circumstances in published guidance of general applicability and may issue rulings addressed to specific taxpayers identifying other events or situations as unforeseen circumstances with regard to those taxpayers (see §601.601(d)(2) of this chapter).

Many commentators were interested in the last two designated exceptions. First, the divorce exception seemed to imply that while that is an unforeseen circumstance, a marriage would not generally meet that test (or at least not automatically). Similarly, it seemed that pregnancy resulting in the birth of a single child was not considered such a circumstance. Again, it's important to note that the fact they don't meet the safe harbor just means they IRS doesn't believe these events should automatically qualify, and that it

1 For this purpose that list would include:

(1) The taxpayer;

(2) The taxpayer's spouse;

(3) A co-owner of the residence;

(4) A person whose principal place of abode is in the same household as the taxpayer

appears in the mind of the regulation's authors that at least some marriages and births would be foreseen circumstances.

The IRS provides a number of examples of situations that would or would not qualify under these rules. The more interesting set are those that don't qualify.

> *Example 5.* In 2003 C buys a house that he uses as his principal residence. The property is located on a heavily traveled road. C sells the property in 2004 because C is disturbed by the traffic. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reason for the sale, the traffic, is not an unforeseen circumstance because C could reasonably have anticipated the traffic at the time he purchased and occupied the house. Consequently, the sale of the house is not by reason of unforeseen circumstances and C is not entitled to claim a reduced maximum exclusion under section 121(c)(2).

Note that it appears not to matter that C may have discovered only after the fact that he could not tolerate the traffic—the IRS believes that was foreseeable even if, clearly, C himself did not foresee it. That is, it's reasonable to assume C would not have bought the house had he known he couldn't stand the traffic.

> *Example 7.* In 2003 F buys a small condominium that she uses as her principal residence. In 2005 F receives a promotion and a large increase in her salary. F sells the condominium in 2004 and purchases a house because she can now afford the house. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reason for the sale of the house, F's salary increase, is an improvement in F's financial circumstances. Under paragraph (e)(1) of this section, an improvement in financial circumstances, even if the result of unforeseen circumstances, does not qualify for the reduced maximum exclusion by reason of unforeseen circumstances under section 121(c)(2).
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> *Example 8*. In April 2003 G buys a house that he uses as his principal residence. G sells his house in October 2004 because the house has greatly appreciated in value, mortgage rates have substantially decreased, and G can afford a bigger house. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reasons for the sale of the house, the changes in G's house value and in the mortgage rates, are an improvement in G's financial circumstances. Under paragraph (e)(1) of this section, an improvement in financial circumstances, even if the result of unforeseen circumstances, does not qualify for the reduced maximum exclusion by reason of unforeseen circumstances under section 121(c)(2).
>
> ...
>
> *Example 10*. In 2003, J buys a small house that she uses as her principal

> residence. After J wins the lottery, she sells the small house in 2004 and buys a bigger, more expensive house. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reason for the sale of the house, winning the lottery, is an improvement in J's financial circumstances. Under paragraph (e)(1) of this section, an improvement in financial circumstances, even if the result of unforeseen circumstances, does not qualify for the reduced maximum exclusion under section 121(c)(2).

These two cases are fairly clear cases of the taxpayer being financially better off, either directly (due to an increased salary and winning the lottery) or indirectly (through changes in mortgage rates that allow the taxpayer to afford a larger house).

One example where the taxpayer was deemed to face an unforeseen circumstance may be important in understanding the letter ruling that we'll discuss:

> *Example 9*. H works as a police officer for City X. In 2003 H buys a condominium that he uses as his principal residence. In 2004 H is assigned to City X's K-9 unit and is required to care for the police service dog at his home. Because H's condominium association does not permit H to have a dog in his condominium, in 2004 he sells the condominium and buys a house. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale, H's assignment to the K-9 unit, is an unforeseen circumstance because H could not reasonably have anticipated his assignment to the K-9 unit at the time he purchased and occupied the condominium. Consequently, the sale of the condominium is by reason of unforeseen circumstances and H is entitled to claim a reduced maximum exclusion under section 121(c)(2).

The fact that actually forced the taxpayer out (association rules that prohibit a dog) existed at the date he acquired the residence, as well as his employment by the police department. However, the combination of his reassignment and the existence of the association rules combined to create a situation that was deemed unforeseen.

Adoption Situations

As noted above, the birth of a single child is not an automatic exception, apparently because the IRS believes it is often a foreseeable circumstance. In that case, it would seem at first glance that a voluntary adoption would be an even more “forseeable” circumstance and would not qualify. However, under a very specific set of facts, the IRS decided that a case could meet that criteria.

In Letter Ruling 200613009 the IRS was presented with a situation where a taxpayer purchased a three bedroom house, where the taxpayer and spouse occupied one bedroom and their three sons had use of the other two bedrooms (clearly, two were sharing one bedroom). After they moved into the house, they decided they wanted to adopt a foreign

child.

It appears they wanted to adopt a girl or that was the only option open. They also discovered that they could only adopt a girl if they could provide her with a sizable separate bedroom. Since they could not do that (apparently the sons couldn't all use one bedroom), they could not pass the "home study" part of the process.

They were also informed that once the home study began, there could be no changes in the relevant circumstances or they'd have to start the process all over again. The taxpayer was in the military and was scheduled to be transferred to a new post of duty at a point in the future that appears to make holding the residence for two years and then letting the process start not appear feasible.

The taxpayer rented a larger house and moved into that as their principal residence for the duration of the home study, selling the original residence the day after they started occupying the rental property. Before moving out of the residence they had taken a number of steps required to adopt the girl. The IRS allowed that this was an unforeseen circumstance allowing for a prorated maximum gain exclusion.

What Does It Mean?

First, although many tax services will summarize this ruling by noting that adoption was treated as an unforeseen circumstance, it's important to note that only *this* adoption can be said to meet that test. As is often the case, the exact facts of the situation were crucial—the taxpayers had not decided to adopt before they bought the residence (so their failure to uncover this restriction was apparently not forseeable, since at that point had they known about this restriction it would have seemed irrelevant) but they had taken substantial steps towards the adoption before selling (note that the ruling does not say the actual adoption took place or has become final yet). So you should not use this ruling to say that all taxpayers who undertake an adoption can make use of §121(c).

Second, the taxpayers were in a position where outside factors eliminated the possibility of "waiting out" the time frame—they had to get the home study underway in order to complete it before the taxpayer was due to be reassigned and they could not hold the current home with the proviso they would replace it if they otherwise qualified to adopt.

Third, it does illustrate that the IRS is willing to consider situations where the taxpayer's voluntary actions at least partially create the situation in question, so long as it doesn't appear the taxpayer was already considering this action before occupying the residence.

IRS Letter Ruling 200613009

December 19, 2005

This letter is in response to a request for a ruling that you and your spouse (hereinafter "you") are entitled to the reduced maximum exclusion on gain from the sale of Residence under § 121(c) of the Internal Revenue Code.

FACTS

You purchased Residence (which contains three bedrooms) on Date 1 and immediately used it as your principal residence. You occupied one of the bedrooms and your three sons occupied the remaining two bedrooms.

After moving into Residence, you decided that you wanted to adopt an orphan girl from a foreign country. You contacted various agencies about adopting a foreign child. You learned that under State law you could not adopt a girl unless she had a separate sizable bedroom. Thus, you could not pass the home study, which is the first step toward adoption, at Residence because you could not provide a girl with a separate bedroom.

You were also informed that once the home study begins, all information must be consistent throughout the entire adoption process, or the home study inspections and reviews would have to be completely redone. Further, Taxpayer A is currently in the military and is scheduled to be transferred to a new post of duty in the summer or the fall of Year 1. It is important that you start and complete the process of adoption so that the adoption process is completed before the transfer. If the adoption is not completed before the transfer, the entire adoption process must start over. Thus, you decided to rent a larger home with an additional room in which a girl could have her own bedroom. You used this rented residence to provide the required information for the home study concerning the home in which an adopted girl would live.

During Date 2, you received the initial paperwork for the home study. The instructions stated that the entire application must be completed, along with all medical forms and home inspections, before submitting the application with associated fees.

Prior to moving out of Residence, you took many steps required to adopt a girl. For example, you obtained birth, marriage, divorce, and driving records, and letters of recommendation, ordered and obtained required medical tests for you and your sons, submitted Form I-600A, Application for Advance Processing of Orphan Petition to the Immigration and Naturalization Service, and arranged for inspections of the rented residence. You paid substantial amounts in fees for these and other services in connection with the adoption process before moving out of Residence. On Date 3, you sold Residence, which you had used and owned as your principal residence for less than two years. The day before the sale, you moved into the rented residence.

LAW AND ANALYSIS

Section 121(a) provides that a taxpayer's gross income will 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, the property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two year or more. The full exclusion is available only once every two years. Section 121(b)(3).

Section 121(b) provides that the maximum exclusion amount is $500,000 if (1) a husband and wife file a joint return for the taxable year of the sale, (2) both spouses meet the 2-year use test, (3) at least one of the spouses meets the 2-year ownership test, and (4) neither spouse used the § 121 exclusion during the last two years.

Section 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.

Section 1.121-3(e)(1) of the Income Tax Regulations provides that a sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence.

Section 1.121-3(g) provides that 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 5-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 5-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 § 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).

CONCLUSIONS

Based on all of the facts and circumstances as represented and the authority set forth above, we conclude that your primary reason for the sale of Residence was an unforeseen circumstance. Accordingly, we conclude that you are entitled to exclude gain up to the reduced maximum exclusion amount under § 121(c).

Except as specifically ruled upon in the preceding paragraph, no opinion is expressed or implied regarding the income tax consequences of any transaction, or any item discussed or referenced in this letter. In addition, no opinion is expressed or implied as to whether you used Residence as your principal residence.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter showing the deletions proposed to be made when it is disclosed under § 6110.

Sincerely, Michael J. Montemurro, Branch Chief, Office of Associate Chief Counsel (Income Tax & Accounting).