Internal Revenue Service

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Person To Contact:
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Telephone Number:

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Date:
September 29, 2006

Taxpayer =
Date 1 =
Date 2 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
City =
State

Property =
A =
$ a =
$ b =
$c =
$d =
$e =
$ f =
$g =

Notice =
Airport Authority =

Dear :

This responds to your letter dated November 22, 2005, requesting rulings on whether your settlement proceeds should be treated as gain from the sale of a principal residence and, if so, whether you are eligible to exclude the gain under § 121(c) of the

Internal Revenue Code. You supplemented your request with letters and additional materials on April 26, 2006, and on September 20, 2006.

FACTS:

In Year 1, Taxpayer moved into the City. The City, located in State, is serviced by Airport. When Taxpayer first moved into the City metropolitan area, he lived in an apartment, located approximately A miles from Airport. On Date 1, Taxpayer purchased Property, also located about A miles from Airport, for $a. Taxpayer represents that he owned and used Property as his principal residence for slightly more than 20 months.

On Date 2, Taxpayer sold Property to an unrelated purchaser. Taxpayer's gross proceeds on the sale were $b; his amount realized, after paying a sales commission of $c, was $d. Taxpayer thus realized a nondeductible loss of $e ($d minus $a) on the sale of Property in Year 3, which Taxpayer properly did not claim on his Year 3 federal income tax return.

Shortly after purchasing and occupying Property, Taxpayer realized there was substantial noise from airplanes flying overhead during peak flight periods (early mornings and early evenings). Taxpayer represents that had he known or been advised how noisy the flight traffic would be, he would not have purchased Property. In Year 2, after Taxpayer had unsuccessfully sought to rescind the sale, he brought a civil action for damages against the sellers, their real estate agent, his own real estate agent, and the agencies with which the realtors were associated, arguing that the defendants had a duty to disclose the airport noise prior to the sale. In Year 4, the defendants paid Taxpayer $f in settlement of the litigation.

Under the law of State, sellers are expressly required to disclose noise from commercial nuisances affecting residential property and any notice from a governmental agency which may affect title to property. Residential property owners within the noise impact zone surrounding Airport also receive a specific Notice from the Airport Authority. The Notice advises such owners that: (1) their property is exposed to average aircraft noise levels which exceed typical ground-based, or background, noise; (2) State law requires sellers of property to disclose "any governmental notice affecting the property;" (3) the Notice is a governmental notice; (4) the Notice serves as a notice of potential aircraft noise impact upon the recipients' property; and (5) the Notice of potential noise impact should be disclosed to all prospective purchasers who may be considering use of the property for a residential purpose.

Taxpayer represents, and the material he submitted shows, that: (1) he had specifically advised his agent that he wanted to be away from a major highway or road and had rejected one home he was shown because of road noise; (2) he had briefly visited the Property a total of about 10 times, at different times of day and during both weekdays and the weekend; (3) he had not heard airplane traffic on any of those visits; (4) he had discussed the prevalence of noise with residents in the area before buying Property; and (5) he did not receive from the sellers or real estate agents the notice of potential airport noise expressly required by State law.

As noted above, the distances between the apartment and Airport, and between Property and Airport, were approximately the same. However, the apartment is located southeast of Airport, whereas Property is southwest of Airport. Due to this directional difference, residents of the subdivision in which Property is located are subject to significantly more airport noise than are residents of the apartment. An affidavit from an Airport Authority official obtained by Taxpayer in connection with his lawsuit against the seller and the real estate agents contains information to the effect that the subdivision in which Property was located was subject to five times more sound energy than was the area surrounding the apartment. This difference was due to the direction of Airport's runways. The official's affidavit also provides explanations of how it is possible for someone to briefly visit the subdivision in which Property is located and not hear aircraft noise.

Taxpayer has asked us to rule that the settlement proceeds received in Year 4 should be treated in the same manner as proceeds from the sale of his principal residence. Second, Taxpayer requests us to rule that the sale of Property was due to unforeseen circumstances and that any gain realized on the sale is excluded under § 121(c).

LAW AND ANALYSIS:

A. <u>Treatment of the settlement proceeds</u>

In determining how settlement proceeds should be taxed, the Service and the courts generally ask, in lieu of what was the settlement amount paid? *McKay v. Commissioner,* 102 T.C. 465, 482 (1994); *Robinson v. Commissioner,* 102 T.C. 116, 126 (1994); *Church v. Commissioner,* 80 T.C. 1104, 1109 (1983); *Raytheon Production Co. v. Commissioner,* 144 F.2d 110 (1st Cir. 1944), cert. denied, 323 U.S. 779 (1944). In determining the nature of the claim and thus the taxability of the proceeds, the most important factor to consider is the intent of the payor, considering all the facts and circumstances. *Allen v. Commissioner,* TC Memo 1998-406 (1998), *citing Knuckles v. Commissioner*, 349 F.2d 610, 613 (10th Cir. 1965), affg. T.C. Memo 1964-33. The essential question in such a case is: What is "the basic reason for the . . . payment," *Agar v. Commissioner*, 290 F.2d 283 (2d Cir. 1961).

Determining the payor's intent is a factual inquiry that requires consideration of all factors involved in resolving the claim, including the parties' allegations, evidence, arguments, and the terms of any settlement. In the present case, the pleadings consistently reflect Taxpayer's claims that the defendants failed to disclose that Property was affected by airport noise and that he was entitled to damages as a consequence of the failure to disclose. In effect, Taxpayer argued that his home was less valuable than he thought because of the airport noise. Thus, in our view, Taxpayer's lawsuit was directly tied to the property purchased by taxpayer and the proceeds he received should be treated in the same manner as proceeds from the sale of Property.

Arrowsmith v. Commissioner, 344 U.S. 6 (1952), also is instructive in determining the tax treatment of the settlement proceeds. *Arrowsmith* involved two taxpayers who in 1937 decided to liquidate and divide the proceeds of a corporation in which they had equal stock ownership. All distributions were made by 1940 and the taxpayers properly reported the profits obtained from the distributions as capital gains. In 1944, a judgment was rendered against the old corporation and against one of the taxpayers, individually. The two taxpayers, as transferees of the corporation's assets, were required to and did pay the judgment for the corporation. The taxpayers argued that because (1) each taxable year stands on its own under the annual accounting principle, and (2) there was no sale or exchange in 1944, they were entitled to an ordinary business deduction in that year. This view was rejected by the Court, however, which accepted the Service's position that the loss was capital because it was part of the original liquidation transaction (and, in essence, was a diminution of the original proceeds).

The Court agreed that the returns from 1937 through 1940 should not be re-opened and readjusted, but rejected the argument that annual accounting required ordinary loss treatment in 1944. In essence, by holding that characterization of a later-year transaction was determined in correlation with a prior-year transaction, the Court dispensed with the need for an actual (or deemed) sale or exchange in the later year.

Arrowsmith has been applied in many cases and rulings.[1] In particular, see *Kimbell v. United States*, 490 F.2d 203 (1974), cert. denied, 419 U.S. 833 (1974) (sale of interest in oil and gas leases resulted in capital gain; taxpayer's subsequent-year settlement of claim involving illegal slanting of wells treated as capital loss by reference to prior-year transaction, rather than as a deduction against ordinary income for payment of an ordinary and necessary business expense); and Rev. Rul. 79-278, 1979-2 C.B. 302 (corporation which incurred a short-term capital loss on sale of stock entitled to treat settlement proceeds in later year as short-term capital gain).

Viewed in isolation, the settlement proceeds received by Taxpayer in Year 4 would be ordinary income because there was no sale or exchange. However, under *Arrowsmith* and the other case law discussed above, the Year 4 settlement proceeds are characterized by reference to the sale transaction occurring in Year 3, and thus are treated as proceeds from the sale of a principal residence held for more than one year by Taxpayer. Accordingly, $<u>e</u> of the settlement proceeds received by Taxpayer is a return of capital and not includible in his gross income. The remaining portion of the proceeds, $g, is treated in Year 4 as gain from the sale of a principal residence.

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[1] See generally Bittker & Lokken, <u>Federal Taxation of Income, Estates and Gifts</u>, Vol. 2, paragraph 47.9.6 (3d ed. 2000, Warren, Gorham & Lamont).

B. Section 121.

Taxpayer also argues that the sale of Property was due to unforeseen circumstances and that any gain realized on the sale (including the settlement proceeds treated as gain) is excluded under § 121(c).

Section 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, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more. The full exclusion is available only once every two years.

Section 121(b) provides that the maximum exclusion amount is $250,000 ($500,000 for married taxpayers). 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.

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 section 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).

Section 1.121-3T(b) of the temporary Income Tax Regulations 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 § 1.121-3T(e)(1), a sale is by reason of 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 § 1.121-3T(e)(4) illustrates a situation in which a taxpayer did not meet 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.

We believe that Taxpayer conducted a reasonable investigation of Property and did not anticipate the airport noise before purchasing and occupying Property, as provided in § 1.121-3T(e)(1). Moreover, Example 5 of § 1.121-3T(e)(4) is distinguishable from the facts of the present case.

First, Property was the same distance from Airport as was the apartment from which Taxpayer moved, and the apartment was not affected by airport noise. Second, Taxpayer's visits to Property did not put him on actual notice of airport noise. Taxpayer's statement that he visited Property on multiple occasions without hearing such noise was buttressed by the affidavit of the Airport Authority official, which provided explanations why such noise might not occur during a series of brief visits. Also, prior to his purchase of Property, Taxpayer talked to future neighbors who did not mention the airport noise. Third, Taxpayer did not receive the required governmental notice from the sellers or the real estate agents, a notice expressly designed to alert prospective purchasers that Property was located within the noise impact zone and thus adversely affected by airport noise. Finally, we accept Taxpayer's assertion that he would not have purchased Property had he known of the airport noise.

Additionally, Example 5 of § 1.121-3T(e)(1) is distinguishable from the facts of the present case. Taxpayer did not move next to Airport in the same way the taxpayer in Example 5 moved next to a heavily-traveled highway. The taxpayer in the example clearly anticipated some noise, just not as much as was actually experienced. In contrast, Taxpayer did not anticipate airport noise when he purchased Property. As the affidavit from the Airport official demonstrates, the difference in noise between the apartment and Property is a function of the runways' orientation. Thus, the difference in airport noise was due not to Taxpayer's distance from Airport, but rather, direction. This fact supports Taxpayer's contention that he did not anticipate any airplane noise at all.

Based on the facts, representations, and the relevant law as set forth above, we rule as follows:

1. The settlement proceeds are to be treated as proceeds from the sale of a principal residence held for more than a year by Taxpayer. Thus, $<u>e</u> of the settlement proceeds received by Taxpayer is a return of capital and not includible in his gross income. The

remaining portion of the proceeds, $g, is treated as gain from the sale of a principal residence.

2. Taxpayer's primary reason for the sale of Property was an unforeseen circumstance. Consequently, Taxpayer is allowed to exclude the $g of gain under § 121(c) in Year 4.

CAVEATS:

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 ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter. In addition, no opinion is expressed or implied as to whether Taxpayer has used Property as his principal residence.

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

Sincerely,

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

Enclosure:
Copy for § 6110 purposes