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Rental of Principal Residence Pending Sale

Has Bolaris Set a New Precedent?

By Paula B. Thomas and Zoel W. Daughtrey

A decision rendered by the Ninth Circuit Court of Appeals in the *Bolaris* case¹ may set a new precedent for taxpayers who rent their former principal residence pending its sale. The court held that the taxpayers were entitled to both the exclusion of gain on the sale of their residence afforded under Internal Revenue Code Section 1034 and the deduction of rental expenses covered under Sections 167 and 212. Essentially, Section 1034 allows taxpayers in most situations to defer the gain on the sale of their principal residence. Section 212 allows a deduction for expenses incurred in the production of income, and Section 167 allows a deduction for depreciation of property held for the production of income. This article will highlight the significant facts of the *Bolaris* case, examine the points that apparently influenced the court's decision, and discuss planning opportunities and potential pitfalls for taxpayers in similar situations.

Overview of the Bolaris Case

Significant Facts. Stephen and Valerie H. Bolaris purchased a home in 1975 for \$44,000; this home was their principal residence until October 1977, when they moved into a more expensive new home they had constructed. The Bolarises had continually attempted to sell the first home from July 1977, until it was ultimately sold in August 1978 for \$70,000.

After trying unsuccessfully for ninety days to sell their home, the Bolarises rented it on a monthly basis to "lessen the burden of carrying the property."² Eight months

passed with no offers to purchase the house, and the couple decided that the property might be more saleable without the tenants. Six weeks after asking the tenants to leave, the Bolarises received and accepted the first offer to buy their former residence. Due to the buyers' difficulty in immediately obtaining financing, the Bolarises temporarily rented the home to the buyers; subsequently, financing was obtained, and the sale was consummated one month later.

The Bolarises excluded the gain on the sale of their old home and also deducted rental expenses and depreciation that exceeded their rental income, thus resulting in a tax loss from their rental activities.

Position Taken by the IRS. The IRS disallowed the rental expenses and depreciation, and on the day of the trial in Tax Court, filed an amended answer to also challenge the deferral of gain. Primarily, the IRS contended that the depreciation and rental expenses were not de-

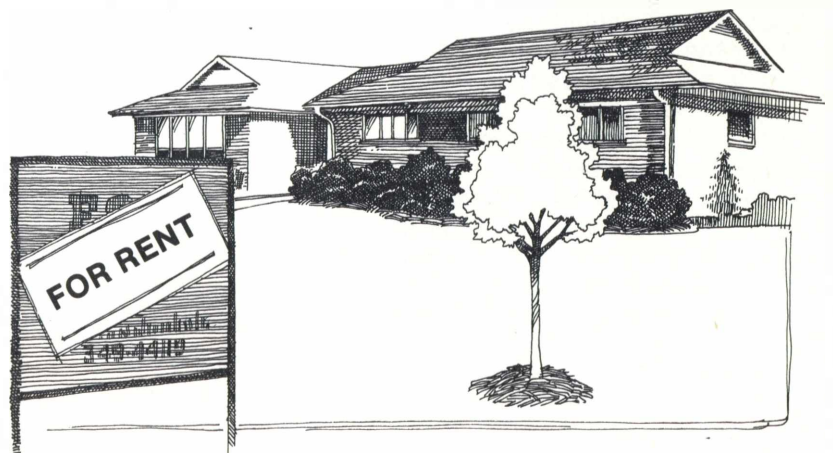
ductible under Sections 167 and 212. The IRS did not seriously question the Bolarises' right to defer gain from the sale of their former principal residence because the IRS contended that the house was never converted from personal use.

The IRS's theory was that deferral of gain (Section 1034) and depreciation and rental expenses (Sections 212 and 167) were mutually exclusive. They contended that property could not simultaneously be a principal residence and property held for the production of income. The IRS further claimed that permitting both rental expenses and nonrecognition of gain would provide an improper "windfall" to taxpayers.

The Tax Court, in a split decision, agreed with the IRS that a residence that qualifies for nonrecognition of gain under Section 1034 cannot, as a matter of law, also be held for the production of income under Sections 212 and 167.

Criteria Used by the Ninth Circuit Court. In the appeal filed in the Ninth Circuit Court of Appeals, three questions were posed for the court to address. First, did the sale of the Bolarises' principal residence qualify for nonrecognition of gain under Section 1034? If so, could the property simultaneously qualify for deduction of rental expenses under Sections 167 and 212; i.e., are Sections 167/212 and 1034 mutually exclusive? If the sections are not mutually exclusive, had the Bolarises successfully converted their property to income-producing property to allow deduction of these rental expenses?

Deferral of Gain. Despite the lack of a serious challenge by the IRS to the Bolarises' right to defer recogni-



tion of gain under Section 1034, this was the first issue addressed by the Ninth Circuit Court. In supporting the taxpayer's right to exclude gain, the court relied on the legislative history of Section 1034:

The term "residence" is used on contra-distinction to property used in trade or business and property held for the production of income. Nevertheless, the mere fact that the taxpayer temporarily rents out either the old or the new residence may not, in the light of all the facts and circumstances in the case, prevent the gain from being not recognized. For example, if the taxpayer purchases his new residence before he sells his old residence, the fact that he rents out the new residence during the period before he vacates the old residence will not prevent the application of this subsection.³

It would appear that the court could have also used the "actual occupancy" rule⁴ to allow the taxpayers to avoid recognition of the gain under Code Section 1034. Since the taxpayers had occupied the residence during the statutory period required by Section 1034, the non-recognition could also have been allowed on that basis.

Sections 167/212 and 1034 — Mutually Exclusive? The Circuit Court secondly addressed the issue of whether property that qualifies for exclusion of gain under Section 1034 can, as a matter of law, also be property held for the production of income under Sections 167 and 212. Again, the legislative history of Section 1034 was examined. The statutory predecessors to Sections 167 and 212 were enacted in 1942; Section 1034 was enacted in 1951. In 1943, the Tax Court held in *Robinson*⁵ that an abandoned residence that has been diligently listed for sale or rent does qualify as property held for the production of income. The fact that the property in *Robinson* was never actually rented was not deemed a determining factor. In the *Bolaris* case, the Circuit Court noted that presumably Congress was aware of *Robinson* at the time of enactment of Section 1034. Accordingly, if Congress had intended the Sections to be mutually exclusive, a provision to that effect could have been included in Section 1034. The court also stated that the interpretation of the legislative history to mean

that a former residence could qualify for nonrecognition of gain despite its temporary rental, and also qualify as property held for the production of income, had never been questioned until *Bolaris*.

Deductibility of Rental Expenses. After determining that the property could simultaneously qualify as a principal residence and property held for the production of income, the court next addressed the Bolarises' right to deduct rental expenses.

The Court held that the taxpayers were entitled to both the exclusion of gain on the sale of their residence afforded under Internal Revenue Code Section 1034 and the deduction of rental expenses covered under Sections 167 and 212.

Code Sections 167 and 212 entitle taxpayers to a deduction for these expenses if "the individual [is engaged] in the activity with the predominant purpose and intention of making a profit."⁶

The Circuit Court adopted a non-exhaustive list of five factors set forth by the Tax Court in *Grant*⁷ to be considered in the determination of whether or not a residence has been converted to property held for the production of income:

1. the length of time the house was occupied by the individual as his residence before placing it on the market for sale;
2. whether the individual permanently [sic] abandoned all further personal use of the house;
3. the character of the property (recreational or otherwise);
4. offers to rent;
5. offers to sell.

The court pointed out several fac-

tors that supported the existence of the Bolarises' profit motive during the rental period, regardless of the fact that the ultimate objective was to sell the property. First, and most significantly, the taxpayer actually rented the former residence at fair market value. Secondly, the Bolarises permanently abandoned their old home when they moved to their new residence. Thirdly, the former residence offered the taxpayers no elements of personal recreation. The court found that the only benefit of the old residence was to generate income (which, in this case, could be used to minimize the negative cash flow of mortgage payments prior to the sale).

The IRS pointed out that the negative cash flow, even with fair market rental, was evidence of the lack of a profit motive. The Ninth Circuit Court countered this by quoting the majority opinion of the Tax Court: "renting the residence at its fair market value would normally suggest that the taxpayer had the requisite profit objective." The court concluded that sustained, unexplained losses are indicative of a lack of a profit motive, but they are only one factor to consider. In the opinion of the court, the other factors presented above outweighed the existence of the short-term losses incurred.

Divided Court Decision. The Ninth Circuit Court's decision to reverse the Tax Court's disallowance of rental expenses was not a unanimous one. In a dissenting opinion, Judge Reinhardt stated that he felt that Sections 167/212 and 1034 are mutually exclusive; he based his feeling upon the same legislative history of Section 1034 used in the majority opinion. This disagreement is likely to arise in other circuits as well, perhaps to the extent that *Bolaris* may not be followed.

A significant question arises in the interpretation of a key portion of House Report No. 586 (82d Congress): "Nevertheless, the mere fact that the taxpayer temporarily rents out either the old or the new residence may not, in light of all the facts and circumstances in the case, prevent the gain from being not recognized."⁸

The majority opinion of the Ninth Circuit Court appears to interpret this statement as a strong argument for allowing the rental as a "for

profit" activity, whereas the dissenting opinion appears to interpret this statement as primarily meaning that temporary rental does not "taint" the gain so as to disqualify the rented home as a principal residence. Other circuits will have to decide which line of reasoning is more nearly that originally intended by Congress.

New Opportunities for Taxpayers

If the other circuits do follow the precedent set by the Ninth Circuit Court, the *Bolaris* case is certainly a victory for taxpayers. However, taxpayers who find themselves in similar situations should be aware of criteria set forth by the court in its decision. In response to the IRS's contention that allowing nonrecognition of gain and deduction of rental expenses provides an improper windfall, the court made three significant points:

1. Not all rental expenses resulting from rentals of former residences will qualify as deductions from income-producing property. Specifically, rentals below fair market value will probably not qualify as property held for the production of income.⁹
2. Even if such a windfall does exist, it is limited to the statutory time designated by Section 1034, currently two years.
3. If Congress had intended to prevent this "windfall," a provision could have been included in Section 1034 that the application of that Section precluded rental expense deductions under Sections 167 and 212. The court significantly noted that since Congress had drafted no such provision, they refused to imply one. However, if the court has misinterpreted congressional intent, Section 1034 could be amended to include such a provision.

Even if the taxpayer is deemed under the particular facts and circumstances not to be holding the property for the production of income, he is still entitled to deductions for some expenses under Section 183. This Section allows all deductions that are not predicated on the existence of a profit motive (e.g., interest and taxes). It further

allows other deductions that are dependent upon the existence of a profit motive, but only to the extent that total deductions under this Section do not exceed income from the activity.¹⁰

More Questions Raised

MaDan. It is too soon to ascertain whether other circuits will follow the position of the Ninth Circuit. Although the facts and circumstances are not directly comparable, a decision rendered by the Tax Court earlier this year in *MaDan v. Commissioner*¹¹ (appealable to the Fourth Circuit) indicates current disagreement regarding this issue. MaDan moved out of his principal residence shortly after building it and subsequently allowed an employee, who was negotiating to purchase both the house and MaDan's business, to live in the residence. The employee paid utilities and maintenance costs, but no actual rent.

Because the house was listed for sale or rent with a broker only after the proposed sale to the employee had fallen through and the employee had vacated the property, the court held that it had not been converted from a residence to rental property. The court stated that the property was held primarily for sale rather than for the production of income through rents, implying that this automatically disqualifies the property from being income-producing property. This line of reasoning contradicts the Ninth Circuit Court's position in *Bolaris*, where the court, citing *Sherlock*¹² as support, viewed the taxpayers' desire to sell the home as an "insignificant factor in determining their profit motive."

A significant factual difference between *Bolaris* and *MaDan* is that MaDan did not rent the property for its fair market value. The question remains unanswered as to whether the court's opinion would have been different if the taxpayers had received fair market value rental.

Fair Market Value Rental — A Pre-requisite? Although the court cited the five factors noted in the *Grant* case to determine whether or not a residence has been converted to property held for the production of income, a strong point in the *Bolaris*' favor appears to be their rental of the property at its fair market value. It is interesting to note that

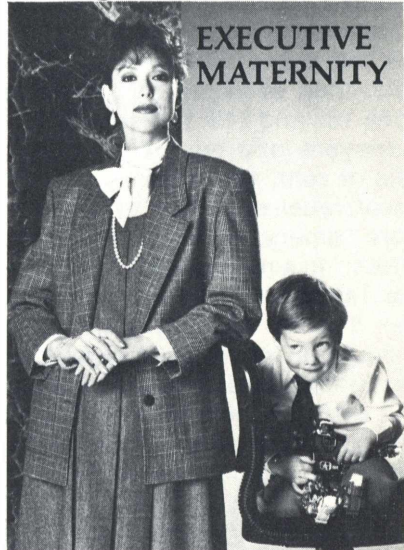
The IRS's theory was that deferral of gain (Section 1034) and depreciation and rental expenses (Sections 212 and 167) were mutually exclusive.

despite the rental at fair market value, the deductions for rental expenses and depreciation generated a net rental loss. The *Bolaris*'s mortgage payments alone exceeded the rental income, thus there was an absence of even the opportunity to make a short-term profit. Nonetheless, the court did not perceive this to be a determining factor in their decision; they felt that the other factors outweighed these short-term losses.

How long can such losses continue without invalidating the transaction as one entered into for profit? Or is the length of time not as impor-

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tant as receiving fair market value rental? In *Jasionowski*¹³, the Tax Court determined that the taxpayers were not renting their property with the requisite profit motive and, accordingly, were not allowed to deduct expenses in excess of their rental income. *Jasionowski* appears to have committed two errors: (1) rental of property below its fair market value, and (2) receiving for seven years rent income that only covered insurance and taxes; he was bound to incur a loss. The Tax Court noted that although the fact that petitioners "incurred losses instead of profits in connection with leasing the house . . . does not, in itself, negate the presence of a profit motive . . . the voluntary acceptance of rent at an amount substantially below fair market value is a clear indication" that the taxpayers lacked the requisite profit motive. Thus, the court's implication is that losses do not negate the existence of a profit motive, as long as the property is rented at fair market value. One is again left to surmise whether the court's decision would have been different if the property had been rented at fair market value, even though the taxpayer might still have consistently incurred losses.

The courts have previously reached decisions where the lack of actual rental of the property at its fair market value did not preclude deduction of expenses under Sections 167 and 212. In *Sherlock*¹⁴, the taxpayers offered their house for sale or rent, and even though they never received offers to rent, they were "amenable to any reasonable offers." In a memorandum decision, the Tax Court held that the house was held by the taxpayers for the production of income, despite the fact that the house was never rented, and thus no income was received. The court noted that "the primary factor in petitioner's favor is the presence of an offer to rent." The decisions in *Sherlock* and *MaDan* appear to be at odds; the Tax Court noted in *MaDan* that "listings . . . exclusively for rent would not be sufficient to establish a profit motive."

The line of reasoning in *Sherlock* is consistent with the decision reached by the Tax Court in *Newcombe*¹⁵, where the petitioners were denied deductions for expenses (in-

cluding depreciation) on property that had formerly been their principal residence. Continuous efforts were made by *Newcombe* to sell, but at no time was the property held for rent. Accordingly, the court decided

The court concluded that sustained, unexplained losses are indicative of a lack of a profit motive, but they are only one factor to consider.

that the property was not held for the production of income within the meaning of Sections 167 and 212.

The court, elaborating in *Sherlock*, stated that "While, under *Newcombe*, a bona fide offer to rent is no longer considered the 'focal point,' we still consider it of substantial importance so long as 'the adverse state of the market for rental property' does not rob such an offer of its significance."

Thus, actual rental of the property at its fair market value is a decidedly strong point in the taxpayer's favor; nevertheless, its absence will not automatically negate the claim that the property is held for the production of income. As *Sherlock* and *MaDan* indicate, the mere offering of property for rent has met with mixed reactions from the courts.

In their determination of whether or not the residence qualifies as income-producing property, the courts do not ignore the potential for capital appreciation. In *Newcombe*, the court noted that:

The placing of the property on the market for immediate sale, at or shortly after the time of its abandonment as a residence, will ordinarily be strong evidence that a taxpayer is not holding the property for postconversion appreciation in value. Under such circumstances, only a most exceptional situation will permit a finding that the statutory requirement has been satisfied. On the other hand, if a taxpayer believes that the value of the property may appreciate and decides to hold it for some period in order to realize upon such anticipated appreciation, as well as an excess over his investment, it can

be said that the property is being 'held for the production of income.' And this would be true regardless of whether his expectation of gain was reasonable.

It appears that even though a former residence may not qualify as income-producing property based on a fair market rental, it may nonetheless qualify if circumstances indicate that it is being held for postconversion appreciation in the market value.

Limit of the "Windfall" Period?

The consideration of the rental losses incurred by *Bolaris* poses another interesting question. The Ninth Circuit Court noted that even if the IRS's claim that allowing both non-recognition of gain and deduction of rental expenses provides a "windfall" to taxpayers is valid, such benefits would be short-lived. This windfall would be limited to the statutory period dictated in Section 1034, which is currently two years.¹⁶

However, in several cases the courts have allowed exceptions to the statutory time requirements set forth in Section 1034 when the facts and circumstances have so suggested. For example, the Tax Court noted in *Clapham*¹⁷ that "each case arising under Section 1034 must be decided on the facts and circumstances presented." *Clapham* had tried to sell his principal residence for almost three years before he received his first offer. Financial circumstances dictated sporadic rental of the property during the interim period. In concluding that *Clapham* was entitled to Section 1034 non-recognition, the Tax Court noted that Congress clearly intended that a taxpayer could lease either his old or new residence for a "temporary" period, but the difficult issue is arriving at a definition of "temporary."

If this same reasoning can be applied to the *Bolaris* decision, it appears that in appropriate "facts and circumstances," the door may be open for longer periods of rental than dictated by the statutory requirements of Section 1034. This would suggest that taxpayers who otherwise meet the requirements of *Bolaris*, but who, for reasons beyond their control, are unable to sell their residence during the statutory period set forth in Section 1034, may nonetheless be able to claim the benefits of *Bolaris* under the criteria noted in *Clapham*.

Even if the taxpayer is deemed under the particular facts and circumstances not to be holding the property for the production of income, he is still entitled to deductions for some expenses under Section 183.

It should be pointed out that the question of the deductibility of rental expenses was not raised in *Clapham*. The only issue was whether the sale qualified for nonrecognition of gain under Section 1034. In holding for the taxpayer, the Tax Court noted that his "dominant motive was to sell the property at the earliest possible date rather than to hold the property for the realization of income." This comment runs counter to the spirit of *Bolaris*, where the court noted that "the Bolarises' ancillary desire to sell the old home [was] an insignificant factor in determining their profit motive."¹⁸

Conclusion

Several tax planning considerations can be derived from the *Bolaris* case.

1. The former residence should be offered for rent only at a fair market value and not at a bargain price.
2. A negative cash flow is not necessarily determinative of the absence of a profit motive.
3. If the former residence is leased, the lease term should not be so long as to interfere with an opportunity for an actual sale within a reasonable time frame.
4. There should clearly be a permanent abandonment of the old house. Temporary use may taint the transaction, especially if the opportunity for recreational use exists.
5. The purchase of the new residence and the sale of the old residence should occur within

the two-year time frame required by Section 1034, even if the rental of the old residence continues for an extended period.

Although *Bolaris* is undeniably a victory for taxpayers, the full impact of its ramifications remains unsettled. The opinions of the courts are not consistent despite the similarity of facts and circumstances. Even if other circuits do follow the precedent set by *Bolaris*, taxpayers must be alert for the pitfalls the court noted in its opinion, particularly the requirement that the property be rented at its fair market value. Taxpayers and tax advisors should carefully weigh potential risks and rewards before relying on the Ninth Circuit decision in *Bolaris*.

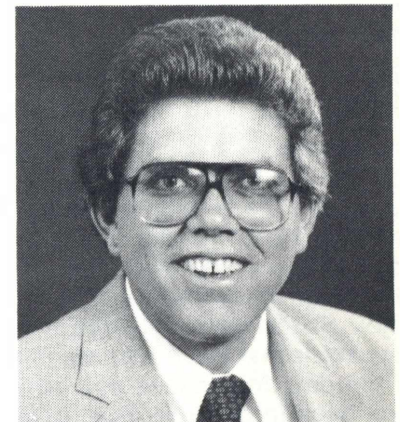
Even though *Bolaris* has given the taxpayer the potentiality of being able to both exclude gain and deduct rental expenses in excess of rental income, the Ninth Circuit Court's decision may have only started the controversy. *Bolaris* probably will not be the last case before the issue is settled. Ω

NOTES

1. *Bolaris v. Commissioner*, 776 F.2d 1428 (CA-9, 1985), 85-2 USTC 9822, 56 AFTR2d 85-6472 aff'g, rev'g, and rem'g 81 TC 840 (1983).
2. *Bolaris*, supra.
3. H.R. Rep. No. 586, 82d Cong., 1st Sess. 109, reprinted in 1951 U.S. Code Cong. & Ad. News 1781, 1896.
4. See for example, "Sale or Exchange of Personal Residence: Section 1034," 31 Tax Law Review 531 (1976), at pp. 535-536.
5. *Robinson v. Commissioner*, 2 TC 305 (1943).
6. *Allen v. Commissioner*, 72 T.C. 28 (1979). See also Code Sections 167(a)(2) and 212.
7. *Grant v. Commissioner*, 84 T.C. 809 (1985).
8. See note 3.
9. See for example, *Jasionowski v. Commissioner*, 66 T.C. 312 (1976).
10. Code Section 183(b) and *Jasionowski* (note 9).
11. *MaDan v. Commissioner*, 51 TCM January 7, 1986 (CCH Dec. 42, 808(M)), T.C. Memo 1986-7.
12. *Sherlock v. Commissioner*, 31 TCM 383 (1972).
13. See note 9.
14. *Sherlock*, supra.
15. *Newcombe v. Commissioner*, 54 TC 1298 (1970).
16. *Bolaris*, supra.
17. *Clapham v. Commissioner*, 63 TC 505 (1975).
18. *Bolaris*, supra.



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