Florida Law Review

Volume 26 | Issue 3 Article 9

March 1974

And You Thought Moving Was Bad--Try Deducting Depreciation and Maintenance Expenses on your Unsold Residence

Theodore A. Erck

AND YOU THOUGHT MOVING WAS BAD – TRY DEDUCTING DEPRECIATION AND MAINTENANCE EXPENSES ON YOUR UNSOLD RESIDENCE

Americans are on the move. Nearly 40 million people in the United States – one-fifth of the entire population – changed their home addresses at least once during 1973.[1] This amounted to nearly 16 million moves,[2] and it is estimated that the pace of movement is still increasing.[3] Census experts believe that the velocity of Americans is among the highest in the world, with the average American moving approximately fourteen times during his lifetime.[4]

The United States Supreme Court, at least partly responsible for this trend, has held that the right to travel from one state to another is a fundamental, constitutional right[5] that may not be unreasonably inhibited by statutes, rules, or regulations.[6] Nowhere is this concept more apparent than in the Internal Revenue Code, which indirectly encourages movement within the United States by allowing generous deductions for moving and related expenses[7] from gross income.[8] In addition, the Code permits a taxpayer to reduce the amount realized from the sale of his residence by qualified "fixing-up" expenses incurred to assist in its disposition,[9] and generally to defer the gain, perhaps

---

1. V. PACKARD, A NATION OF STRANGERS 7 (1972). In comparison, the latest figures from the Bureau of the Census show that 36,161,000 Americans (17.9%) changed residences during the period March 1970 to March 1971. U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 36 (93d ed. 1972). The census total, however, fails to reflect an increased population in 1973, as well as the moves of college students, certain military personnel, and others. V. PACKARD, *supra* at 8.

2. The exact number of moves each year is not known, since the census figures do not include the additional moves made by many Americans during a single year. A reliable estimate, however, can be made from statistics compiled by the American Telephone & Telegraph Company. Its records show that the disconnection rate for main residential telephones in service reached 25% in 1971, with almost all disconnections representing moves by subscribers. V. PACKARD, *supra* note 1, at 7-8. Since 92% of all households in the United States had main residential telephones in service on Jan. 1, 1973, and since there were approximately 68,251,000 households at that time, then roughly 15,697,730 total moves (68,251,000 X 92% X 25%) were made in 1973, assuming that the disconnection rate stayed about the same. INFORMATION PLEASE ALMANAC 105, 720 (D. Golenpaul ed., 28th ed. 1974).

3. V. PACKARD, *supra* note 1, at 8.

4. *Id.* at 6. The average Briton, for example, moves approximately eight times, while his counterpart in France moves seven times and the average Japanese moves about five times during his lifetime. *Id.* at 6-7.

5. United States v. Guest, 383 U.S. 745 (1966). In this case Justice Stewart declared: "The constitutional right to travel from one State to another . . . occupies a position fundamental to the concept of a Federal Union. It is a right that has been firmly established and repeatedly recognized." *Id.* at 757.

6. Shapiro v. Thompson, 394 U.S. 618 (1969).

7. INT. REV. CODE OF 1954, §217. *See also* §82.

8. *Id.* §62(8).

9. *Id.* §1034(b). Ordinarily, these expenses are of a personal nature and are therefore nondeductible. *Id.* §262. Section 1034(b)(2)(C), however, permits a reduction for fixing-up expenses if, *inter alia*, they are of the type that are *not* allowable as deductions in computing taxable income under §63(a).

indefinitely, if he invests in a new residence an amount at least as large as the adjusted sales price of his old residence.[10] In cases where the taxpayer has reached age 65 before the sale occurs, all or part of his gain may be tax-free, and there is no requirement for him to buy or build a new home.[11]

This encouraged mobility, however, has created problems in other sections of the Code. Many taxpayers are unable to sell their homes before leaving town, especially when an employer or new job opportunities dictate a sudden move. Frequently, considerable time will elapse before the residence is finally sold, necessitating maintenance, supervisory, and repair costs of a general nature in addition to any fixing-up expenses[12] incurred just prior to its sale. Although some taxpayers rent their vacated homes during this intervening period, many others prefer not to do so[13] and instead place them on the market for sale only. Their decision not to rent, however, may yield adverse tax consequences, for it immediately raises the increasingly litigated question: Does a mere listing for sale convert residential property into "property held for the production of income" within the meaning of sections 167(a)(2)[14] and 212(2)[15] of the Internal Revenue Code, thereby entitling a taxpayer to deductions for depreciation and maintenance expenses[16] incurred prior to its sale? The Commissioner and the Tax Court (with substantial internal disagreement) have each applied different tests to resolve this troublesome question,[17] and the

---

10. *Id.* §1034. In addition, tacking the holding period of the old residence is allowed if its sale resulted in §1034 nonrecognition of any part of the gain. *Id.* §1223(7).

11. *Id.* §121.

12. If, however, the taxpayer purchases and moves into his new residence but is unable to sell his old house within the subsequent year, §1034 is not applicable, and the fixing-up expenses can only be deducted, if at all, under §212(2).

13. *See* text accompanying notes 67-68 *infra.*

14. INT. REV. CODE OF 1954, §167 provides, in part:

SEC. 167. DEPRECIATION.

(a) GENERAL RULE. There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) —

. . . .

(2) of property held for the production of income.

15. INT. REV. CODE OF 1954, §212 provides, in part:

SEC. 212. EXPENSES FOR THE PRODUCTION OF INCOME.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year —

. . . .

(2) for the management, conservation or maintenance of property held for the production of income;

. . . .

16. Normally, these are nondeductible, personal expenses. *Id.* §262.

17. *See* Frank A. Newcombe, 54 T.C. 1298 (1970). Basically, the Service will look to see if the property is rented or at least offered for rent. The Tax Court, on the other hand, holds that the presence of absence or rental offers is only one of a variety of factors to be considered in determining whether a personal residence has been converted into income-

resulting confusion prompted the Service to list it as a "prime issue"[18] for 1973 — one that the Commissioner will litigate, rather than settle or concede.

In examining the conversion problems peculiar to a personal residence in relation to sections 167(a)(2) and 212(2), this commentary will analyze recent case law in light of the legislative history of these sections. When applicable, the related notion of loss will also be considered, but a detailed discussion of section 165(c)(2)[19] is beyond the scope of this short work.[20] On the basis of the analysis contained herein, various recommendations and guidelines are proposed with the intention of eliminating much of the wasteful litigation that is presently occurring in the federal courts.

LEGISLATIVE HISTORY

The legislative history of section 217[21] indicates a congressional belief that a mobile labor force reduces unemployment and increases productive capacity,[22] therefore justifying the generous moving expense deductions allowed by that section. This desire is further illustrated by section 62(8), which permits all taxpayers to deduct moving expenses from gross income in arriving at adjusted gross income.[23] In addition, section 1034 was enacted to defer gain realized on the sale of the taxpayer's personal residence,[24] thus eliminating

---

producing property. In cases where the taxpayer vacates his house and merely lists it for sale, the court requires that he must also be seeking to realize a profit representing post-conversion appreciation in the market value of the property. *Id.* at 1299-1302. The concurring opinions of Judges Drennen and Forrester, however, point out basic disagreement among the judges as to the proper base to be used in measuring this post-conversion appreciation, whether adjusted cost basis or fair market value at the time of conversion. *Id.* at 1303-04. *See* text accompanying notes 62-63 *infra*.

18. 7 CCH 1973 STAND. FED. TAX REP. ¶¶6527, 8213. This issue was released by the Service under the Freedom of Information Act, 5 U.S.C. §552 (1970).

19. INT. REV. CODE OF 1954, §165.

20. Although presenting a companion problem, §165(c) employs a stricter, profit-seeking test for determining the deductibility of losses incurred in residential sales.

21. INT. REV. CODE OF 1954, §217.

22. The Tax Reform Act of 1969 broadened the categories of deductible moving expenses under §217. *See* H.R. REP. No. 91-413, 91st Cong., 1st Sess. 75 (1969), where the House Ways and Means Committee justified the changes:

> Employers frequently find it necessary to transfer employees from one location to another. Furthermore, the competition for skilled employees has led to an increasing movement of new employees to locations where more attractive job opportunities are available. The mobility of labor is an important and necessary part of a dynamic, full employment economy, since it reduces unemployment and increases productive capacity. Current estimates are that there are one-half million employees, including Government, military, and civilian, that are requested by their employers to move to new job locations each year. Substantial moving expenses often are incurred by taxpayers in connection with employment-related moves. Moreover, in an important sense, these expenses may be viewed as a cost of earning income.

Similarly, *see* S. REP. No. 91-552, 91st Cong., 1st Sess. 108 (1969).

23. INT. REV. CODE OF 1954, §62.

24. *Id.* §1034.

the hardship that existed under the 1939 Code, whereby gain on the sale was recognized and taxed.[25] Finally, Congress was aware that even the nonrecognition provisions of section 1034 placed an undesirable burden on senior citizens who desired to move into an apartment or less expensive home.[26] Therefore, section 121 was enacted, an elective provision that generally excludes from gross income a limited amount of gain realized from the sale of the taxpayer's personal residence if he has reached age 65 before the disposition occurs.[27]

Even though these statutes show a clear desire by Congress to encourage a mobile labor force, the deductibility of some related expenses incurred after moving, namely maintenance and depreciation on the taxpayer's unsold residence, remains quite unsettled at the present time. This curious development is partly explained by the legislative history of sections 167(a)(2) and 212(2), which reflects congressional concern with the deductibility of nonbusiness expenses in general rather than any specific concern for the converted residence situation.

The Revenue Act of 1916 provided that an individual could deduct from gross income the necessary expenses paid to carry on any trade or business, but not personal, living, or family expenses.[28] Between these two areas remained a "great borderland of doubt."[29] Since subsequent revenue acts and regulations failed to adequately define the phrase "carrying on a trade or business," considerable uncertainty and confusion developed as to whether a taxpayer could deduct reasonable expenses incurred in an income-producing activity that fell short of a trade or business.[30] The controversy reached its peak in the 1941 case of *Higgins v. Commissioner*,[31] in which the United States Supreme Court

---

25. Int. Rev. Code of 1939, ch. 1, §112, 53 Stat. 37. The House Ways and Means Committee, in explaining the new nonrecognition amendment (Act of Oct. 20, 1951, ch. 521, §318(a), 65 Stat. 494) to the 1939 Code, stated:

> The hardship is accentuated when the transactions are necessitated by such facts as an increase in the size of the family or a change in the place of the taxpayer's employment. In these situations the transaction partakes of the nature of an involuntary conversion. Cases of this type are particularly numerous in periods of rapid change such as mobilization or reconversion. For this reason the need for remedial action at the present time is urgent.

H.R. REP. No. 586, 82d Cong., 1st Sess. 27 (1951).

26. The nonrecognition provisions of §1034 generally apply whenever the taxpayer builds or purchases a more expensive residence within certain time limitations. The committee reports indicate that Congress deemed this to be "an undesirable burden on our elderly taxpayers," in that "[s]uch an individual may desire to purchase a less expensive home or move to an apartment . . . at another location. He may also require some or all of the funds obtained from the sale of the old residence to meet his and his wife's living expenses." H.R. REP. No. 749, 88th Cong., 1st Sess. 45 (1963). Similarly, *see* S. REP. No. 830, 88th Cong., 2d Sess. 51 (1964).

27. INT. REV. CODE OF 1954, §121.

28. Act of Sept. 8, 1916, ch. 463, §5(a)(1st), 39 Stat. 759. A similar provision was contained in the Revenue Act of Oct. 3, 1913, ch. 16, §II(B), 38 Stat. 167.

29. 88 CONG. REC. 6376 (1942) (remarks of Representative Disney).

30. 4A J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION §25A.01 (1972).

31. 312 U.S. 212 (1941).

held that the taxpayer's rather substantial stock and bond investment activity did not constitute a trade or business. The resulting expenses, therefore, were not deductible.[32]

This extremely narrow judicial interpretation and inequitable result[33] prompted Congress in 1942 to amend sections 23(a)(1)[34] (relating to business expenses) and 23(*l*)[35] (relating to depreciation) of the 1939 Code by adding sections 23(a)(2)[36] and 23(*l*)(2).[37] These new amendments, predecessors of sections 212(2) and 167(a)(2), allowed a taxpayer to deduct the ordinary and necessary expenses, including depreciation, paid or incurred during the taxable year on "property held for the production of income,"[38] whether or not the property was used by the taxpayer in a trade or business.[39]

Although resolving the *Higgins* dispute, the amendments still left room for interpretational confusion in cases involving the conversion of residential property into property held for the production of income, primarily because of the inherent difficulty in determining when the requisite conversion takes place. Perhaps due to administrative convenience,[40] the IRS has consistently followed the rule that there is no conversion unless the property is actually rented or at least offered for rent while it is on the market for sale.[41] The tax-

---

32. The taxpayer, who lived in Paris, maintained an office staffed with several employees in New York, who assisted him in looking after his financial affairs. He spent over $36,000 in 1932 and 1933 for various expenses related to managing his stocks and bonds. *Id.* at 214.

33. *See* 88 CONG. REC. 6376 (1942) (remarks of Representative Disney). Said Mr. Disney: "Since the income from such investments is clearly taxable it is inequitable to deny the deduction of expenses attributable to such investments." *Id.* In addition, *see* H.R. REP. No. 2333, 77th Cong., 2d Sess. 46 (1942).

34. Int. Rev. Code of 1939, ch. 1, §23(a)(1), 53 Stat. 12 (now INT. REV. CODE OF 1954, §162).

35. Int. Rev. Code of 1939, ch. 1, §23(*l*), 53 Stat. 14 (now INT. REV. CODE OF 1954, §167).

36. Int. Rev. Code of 1939, §23(a)(2), *added by* Act of Oct. 21, 1942, ch. 619, §121(a), 56 Stat. 819 (now INT. REV. CODE OF 1954, §212).

37. Int. Rev. Code of 1939, §23(*l*)(2), *added by* Act of Oct. 21, 1942, ch. 619, §121(c), 56 Stat. 819 (now INT. REV. CODE OF 1954, §167).

38. The criteria for determining whether property is held for the production of income is the same under §§167 and 212. *See* Frank A. Newcombe, 54 T.C. 1298, 1299 (1970).

39. *See* H.R. REP. No. 2333, 77th Cong., 2d Sess. 74 (1942):

> This amendment allows a deduction for the ordinary and necessary expenses of an individual paid or incurred during the taxable year for the production and collection of income, or for the management, conservation, or maintenance of property held by the taxpayer for the production of income, whether or not such expenses are paid or incurred in carrying on a trade or business, and also allows a deduction for the exhaustion and wear and tear (including a reasonable amount for obsolescence) on property held for the production of income, whether or not such property is used by the taxpayer in a trade or business.

The language contained in the Senate Report is almost identical; see S. REP. No. 1631, 77th Cong., 2d Sess. 87 (1942).

40. *See* Warren Leslie, Sr., 6 T.C. 488, 494 (1946).

41. The asserted basis for this administrative yardstick is found in Treas. Reg. §1.212-1(h), T.D. 7198, 1972-2 CUM. BULL. 166, which provides:

payer, on the other hand, has vigorously asserted that his acts of vacating the residence and listing it for sale sufficiently manifest his intention to convert it into income-producing property. At various times the courts have accepted one contention or the other,[42] resulting in considerable confusion and widespread litigation. More recently, however, the Tax Court has refused to apply one test to the exclusion of the other, adopting instead a balancing approach to ascertain the intention of the taxpayer in each particular situation.[43]

JUDICIAL INTERPRETATION

Following the 1942 amendment and until 1967, the courts generally adopted the Commissioner's view that actual rental or at least an offer to rent was necessary to successfully convert a vacated residence into property held for the production of income.[44] Yet mindful that income includes "not merely income of the taxable year [for example, rent] but also . . . gain from the disposition of property,"[45] the Tax Court held in *Hulet P. Smith*[46] that the taxpayer's residence, vacated and listed only for sale, was sufficiently converted into property held for the production of income within the meaning of sections 167(a)(2) and 212(2) to entitle the taxpayer to deductions for depreciation and maintenance.

Three years later, however, the Tax Court decided that the *Smith* decision had unwisely opened the deduction door to abuse. In the leading case of *Frank A. Newcombe,*[47] the "sale only" liberality of *Smith* was limited to

---

> Ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held for use as a residence by the taxpayer are not deductible. However, ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held by the taxpayer as rental property are deductible even though such property was formerly held by the taxpayer for use as a home.

The Tax Court, however, has disregarded this restrictive interpretation in Frank A. Newcombe, 54 T.C. 1298, 1301 n.6 (1970). In addition, *see* Fasan, *Maintenance and Depreciation Deductions for a Personal Residence Offered for Sale,* 25 TAX L. REV. 269, 272 n.10 (1970).

42. *Compare* Warren Leslie, Sr., 6 T.C. 488 (1946) (maintenance expenses denied where the residence was not rented or offered for rent), *with* Hulet P. Smith, 26 CCH Tax Ct. Mem. 149 (1967), *aff'd per curiam,* Commissioner v. Smith, 397 F.2d 804 (9th Cir. 1968) (abandoning the old residence, offering it for sale, and moving to another city 400 miles away converted the residence into property held for the production of income).

43. Frank A. Newcombe, 54 T.C. 1298 (1970).

44. *See, e.g.,* William C. Horrmann, 17 T.C. 903 (1951); Mary Laughlin Robinson, 2 T.C. 305 (1943).

45. H.R. REP. No. 2333, 77 Cong., 2d Sess. 75 (1942). The language contained in Treas. Reg. §1.212-2(b), T.D. 7198, 1972-2 CUM. BULL. 166, is almost identical.

46. 26 CCH Tax Ct. Mem. 149 (1967), *aff'd per curiam,* Commissioner v. Smith, 397 F.2d 804 (9th Cir. 1968). This decision caused a flurry among legal commentators. *See, e.g.,* Fasan, *supra* note 41; 66 MICH. L. REV. 562 (1968).

47. 54 T.C. 1298 (1970) (reviewed by the court). The case is discussed in Note, *Maintenance and Depreciation Deductions Are Not Available on a Residence Vacated and Offered for Sale but Not for Rent Unless Taxpayer Intends To Profit,* 49 TEX. L. REV. 581 (1971).

situations where the taxpayer was holding the property to realize post-conversion appreciation in value. At the same time the court declared its earlier decision "inapposite and of little precedential value."[48]

In *Newcombe* the taxpayer and his wife retired to Florida and purchased a home in Naples. He immediately listed his vacated Arkansas residence for sale at a price in excess of its existing fair market value but slightly below his adjusted cost basis. Fourteen months later the house was finally sold, during which time the taxpayer made no attempt to rent or personally use the property.

Claiming deductions for maintenance and depreciation on his 1966 income tax return, the taxpayer asserted that his abandonment of personal use and offer for sale sufficiently converted the Arkansas house into income-producing property. The Commissioner, on the other hand, clung to his longstanding argument that there can be no conversion unless the residence is rented or at least offered for rent. The Tax Court did not share this "penchant for polarization,"[49] but instead it weighed a variety of factors to ascertain the intention of the taxpayer in light of all the surrounding facts and circumstances.[50] These factors included: (1) the length of time the house was occupied by the taxpayer as his residence before placing it on the market for sale,[51] (2) whether the taxpayer permanently abandoned all further personal use of the house,[52] (3) the character of the property (recreational or otherwise),[53] (4) offers to rent, and (5) offers to sell.

---

48. 54 T.C. at 1303.

49. *Id.* at 1299.

50. *Id.* at 1300-01.

51. The court found this factor indicative of the personal nature of any expenses subsequently incurred. *Id.* at 1300. For example, if the taxpayer does not occupy the house for any substantial period of time but merely acquires it by purchase or inheritance and then offers it for sale, the courts have generally found the house to be in the nature of an investment and the resulting expenses deductible. *See, e.g.*, Glendale O. Scott, 27 CCH Tax Ct. Mem. 835 (1968) (purchase); William C. Horrmann, 17 T.C. 903 (1951) (Inheritance).

52. 54 T.C. at 1300. *E.g.*, Mary Laughlin Robinson, 2 T.C. 305 (1943). *But see* James J. Sherlock, 31 CCH Tax Ct. Mem. 383 (1972), where the taxpayer's daughter continued to reside in the otherwise vacated house offered for sale or rent. In allowing the nonbusiness deductions, the Tax Court found that the daughter would have moved out "at a moment's notice if a sale or rental possibility arose," and that "it would be unrealistic and extremely harsh to force petitioners to leave the property vacant for purposes of achieving a complete conversion." *Id.* at 386.

53. 54 T.C. at 1300. *See* Marjorie M. P. May, 35 T.C. 865 (1961), *aff'd*, May v. Commissioner, 299 F.2d 725 (4th Cir. 1962), involving a yacht, where the court found that the use of property for recreational purposes conflicted with the taxpayer's assertion that it could be converted into income-producing property by merely listing it for sale; Carkhuff v. Commissioner, 425 F.2d 1400 (6th Cir. 1970), where the court disallowed deductions for depreciation and maintenance expenses incurred in renting the taxpayer's summer home in the absence of a reasonable profitseeking motive; Walter E. Beckjord, 32 CCH Tax Ct. Mem. 541, 543 (1973), where the court denied deductions for repairs and depreciation on the taxpayer's motor home, stating that there exists an "adverse presumption attending assertions that property is held for the production of income in cases involving pleasure or recreational property . . . ."; INT. REV. CODE OF 1954, §183.

The court found that the presence or absence of rental offers was not the determinative factor, as the Commissioner insisted,[54] but nevertheless recognized that such offers constitute an important element in ascertaining whether the requisite conversion has taken place.[55] In contrast to its earlier decision in *Smith* on similar facts, the majority ruled that the mere offering of property for sale did not *necessarily* effectuate a conversion into income-producing property. An essential requirement is that the taxpayer must hold his vacated residence for the production of *income* rather than as a recoupment of his original investment. Since Mr. Newcombe had listed his Arkansas house for sale only and at a price slightly below his adjusted cost basis, the Tax Court determined that the property was in fact being held for the production of loss rather than of income.[56]

In so holding, the majority recognized that section 1.212-1(b) of the regulations permits a deduction for nonbusiness expenses arising from investment property, even though it is quite unlikely that the property will be sold for a profit and even though the property is merely being held to minimize an inherent loss.[57] The court, however, determined that the property must first be "held for investment" before those provisions would apply.[58] In other words, a taxpayer who offers his house for sale and not for rent must "be seeking to realize a profit representing *postconversion* appreciation in the market value of the property."[59] Moreover, he must prove that this post- conversion appreciation[60] would produce a tax gain; that is, the price at which

54. A taxpayer may have sound business reasons for not offering the property for rent, and sometimes even the presence of rental offers may be insignificant due to the adverse state of the rental market. Additionally, the court found that the second sentence in Treas. Reg. §1.212-1(h), T.D. 7198, 1972-2 CUM. BULL. 166, *quoted in* note 41 *supra,* merely illustrated that §212 expenses could properly be claimed on rental property which had formerly been used as the taxpayer's residence, rather than mandating that such property must in fact be rented in order to claim a deduction. 54 T.C. at 1301 & n.6.

55. *Id.* at 1300. *See* James J. Sherlock, 31 CCH Tax Ct. Mem. 383, 385 (1972).

56. 54 T.C. at 1301-02.

57. Treas. Reg. §1.212-1(b), T.D. 7198, 1972-2 CUM. BULL. 166 provides, in part:

> Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto.

58. 54 T.C. at 1302. The court cursorily defined investment property as property held for the production of income. Said the court: "Once that condition is attained, the subsequent absence of the economic indicators of profit, during any given period of time, will not preclude a deduction." *Id.*

59. *Id.* (emphasis added).

60. Inherent in the term "post-conversion appreciation" are several basic, though easily-overlooked, concepts: (1) preconversion appreciation (appreciation that occurred while the property was being used as a personal residence) is excluded; and (2) placing the property on the market for immediate sale within a short period of time before or after abandonment by the taxpayer ordinarily precludes any notion of holding it to realize upon post-conversion *appreciation* in value, since the taxpayer will normally list the property at its fair

the residence is offered for sale must exceed his basis in the property. Since the taxpayer in *Newcombe* was not seeking to realize a tax gain, the court accordingly denied his claimed deductions for depreciation and maintenance expenses.[61]

Seven judges, although concurring with the conclusion reached by the majority on the particular facts presented, believed that the proper base to be used in measuring post-conversion appreciation should be the fair market value of the property at the time it was abandoned as the taxpayer's residence, rather than his tax basis in the property.[62] According to Judge Forrester, this was "the only sensible answer . . . for otherwise the owner of a residence which had declined in value during his occupancy would be precluded from any tax benefits in attempting to minimize his loss even though it were quite apparent that the property would appreciate in value after he had abandoned it as a residence . . . ."[63]

In the decisions that have followed, the Tax Court has applied the *Newcombe* criteria and the majority's tax gain test to determine whether a taxpayer intended to, and did in fact, convert his former residence into income-producing property prior to its sale.[64] Moreover, the *Newcombe* decision has gained the approval of a district court judge,[65] and this trend may soon spread into other federal courts.

AN ANALYSIS OF *Newcombe*

The decision in *Newcombe* is laudable in that it takes the middle ground between two rather extreme views — the Commissioner's rental rule and the offer-for-sale test of *Smith*. Both of these latter tests are easy to apply, confining conversion to a single, overt act, but both can be abused to produce inequitable results.

The rental rule, for example, is satisfied by merely offering the residence for rent. Then, however, it can easily be abused by a less-than-honest taxpayer who sets his rental price slightly above that which the market will bear, or who finds some plausible excuse for continually rejecting all potential tenants, or who drafts a one-sided rental contract to discourage all inquiries.[66] By relying

---

market value. *See, e.g.*, Paul M. Butler, Jr., 29 CCH Tax Ct. Mem. 880 (1970) (residence listed for sale shortly before it was vacated); Frank A. Newcombe, 54 T.C. 1298 (1970) (upon abandonment); Raymond L. Opper, 31 CCH Tax Ct. Mem. 485 (1972) (shortly after abandonment); Charles D. Mayes, 30 CCH Tax Ct. Mem. 363 (1971) (shortly after abandonment).

61. 54 T.C. at 1303.

62. *Id.* at 1303-04 (Drennen, Tietjens, Forrester, Hoyt, Irwin, Sterrett & Raum, JJ., concurring).

63. *Id.* at 1304.

64. *See, e.g.*, Walter E. Beckjord, 32 CCH Tax Ct. Mem. 541 (1973); Raymond L. Opper, 31 CCH Tax Ct. Mem. 485 (1972); James J. Sherlock, 31 CCH Tax Ct. Mem. 383 (1972); Richard N. Newbre, 30 CCH Tax Ct. Mem. 705 (1971); Charles D. Mayes, 30 CCH Tax Ct. Mem. 363 (1971); Paul M. Butler, Jr., 29 CCH Tax Ct. Mem. 880 (1970).

65. Lewis v. United States, 73-1 U.S. Tax Cas. 80,486 (S.D. Ohio 1973).

66. *See* 66 MICH. L. REV. 562, 569 n.24 (1968). In situations where there has been a

heavily on the formalities of the transaction as an indicator of the taxpayer's intent, the Commissioner's test constitutes a trap for the unwary. In addition, it may produce inequitable results even for the sophisticated taxpayer who finds it more profitable to sell rather than to rent,[67] or who discovers that a binding lease would substantially inhibit his efforts to locate a buyer.[68] Furthermore, the Commissioner's adherence to labels produces some conceptual difficulties. For example, in a lease-purchase situation where the property is rented with an option to apply the rental payments toward the purchase price if the lessee elects to buy, can it be said that the taxpayer has successfully converted his residence into income-producing property, or is this merely a protracted sale?

Similarly, the *Smith* test invites abuse by allowing deductions on personal rather than income-producing property. By permitting a "For Sale" sign to be the sole indicator of the taxpayer's intent, the *Smith* decision would seemingly allow sizable deductions for depreciation and maintenance expenses on a vacated residence although no real intent to sell existed. Of course, the genuineness of his intentions can always be challenged by the IRS,[69] but, on the surface at least, he has complied with the *Smith* guidelines.

The *Newcombe* balancing approach corrects some of these abuses, but the test's inherent subjectiveness and the majority's cryptic language[70] inject new doubt and confusion into this area. According to the majority, residential property listed for sale and not for rent can be held for the production of income only where the taxpayer intends to profit from post-conversion appreciation in excess of his total investment. Taxable income would then result, apparently in harmony with Code sections 61(a)(3),[71] 167(a)(2), 212(2), and regulation section 1.212-1(a)(1).[72]

A strict application of the tax gain test, however, would be a triumph of literalism over reality. Many, if not most, of today's moves are business motivated. If a taxpayer is unable to sell his home when business requires him to move, then he is forced into an investment situation. Accordingly, any

---

rental offer but little or no rental income, the IRS should check more closely to insure that the offer is bona fide. *See* Carkhuff v. Commissioner, 425 F.2d 1400 (6th Cir. 1970); Kanter v. United States, 73-1 U.S. Tax Cas. 80,653 (E.D. Va. 1973).

67. For example, the residential rental market may be poor due to the land's propinquity to a busy highway, although the commercial sales value of the property may be great. And even if the house could be profitably rented in this situation, a relentless barrage of new expenses — liability insurance, broker's fees, advertising, supervision, increased maintenance, et cetera — may quickly turn it into a losing proposition.

68. The lease may be long term, or the tenants destructive.

68. *Cf.* Charles F. Neave, 17 T.C. 1237 (1952).

70. Besides defining "investment property" as property held for the production of income, the court implied that fair market value could be used under appropriate circumstances as the base in measuring post-conversion appreciation. It held, however, to the contrary. 54 T.C. at 1303. Stated Judge Forrester: "By way of dictum the majority seems to require just such excessive [tax gain] . . . postconversion appreciation and I think that this dictum is wrong." 54 T.C. at 1304.

71. INT. REV. CODE OF 1954, §61.

72. Treas. Reg. §1.212-1(a)(1), T.D. 7198, 1972-2 CUM. BULL. 166.

depreciation and maintenance expenses that he subsequently incurs should be viewed as a cost of earning income,[73] rather than as personal, living, or family expenses. Moreover, since the taxpayer generally has little control over the market value of his residence upon moving, it seems inherently unfair to deny him nonbusiness deductions merely because his property has declined in value during his occupancy.[74] Addressing this problem, the concurring opinions of Judges Drennen and Forrester would allow the owner of a residence, which had declined in value during his occupancy, to deduct maintenance and depreciation expenses, with the latter deduction reducing basis and thus minimizing his loss within the purview of regulation section 1.212-1(b).[75]

This line of reasoning appears warranted from another viewpoint. Admittedly, the concept of "conversion" is the key in all residential sale cases. If residential property is successfully converted into income-producing property, then the tax benefits of sections 167(a)(2) and 212(2) will naturally follow. In this context, regulation section 1.167(g)-1 provides:[76]

> In the case of property which has not been used in the trade or business or held for the production of income and which is thereafter converted to such use, the fair market value on the date of such conversion, if less than the adjusted basis of the property at that time, is the basis for computing depreciation.

If the lower fair market value constitutes the proper basis for computing depreciation on *converted* property that has declined in value, then it seems only consistent to apply the same rationale initially to determine whether the residence has in fact been converted into income-producing property.

Although not considered in the concurring opinions, the fair market value approach does not overlook the definition of "income" for purposes of applying sections 212 and 167. Regulation section 1.212-1(b) echoes the committee reports to the 1942 Act in providing:[77]

> The term "income" for the purpose of section 212 includes not merely income of the taxable year *but also income which the taxpayer* has realized in a prior taxable year or *may realize in subsequent taxable years;* and is not confined to recurring income but applies as well to gains *from the disposition of property.*

---

73. In this context, *see* H.R. REP. No. 91-413, 91st Cong., 1st Sess. 75 (1969) (last sentence), *quoted in part* in note 22 *supra*. As to the involuntary nature of the transaction, see H.R. REP. No. 586, 82d Cong., 1st Sess. 27 (1951) (second sentence), *quoted in part* in note 25 *supra*.

74. At best, fair market value is an inexact standard, subject to overnight fluctuations due to rumors, natural forces, buyers' tastes, rezoning, and a host of other unpredictable variables.

75. Treas. Reg. §1.212-1(b), T.D. 7198, 1972-2 CUM. BULL. 166, is *quoted in part* in note 57 *supra*.

76. Treas. Reg. §1.167(g)-1, T.D. 6712, 1964-1 CUM. BULL. 106. *See also* Treas. Reg. §1.165-9(b)(2), T.D. 6712, 1964-1 CUM. BULL. 106.

77. Treas. Reg. §1.212-1(b), T.D. 7198, 1972-2 CUM. BULL. 166 (emphasis added).

Therefore, in cases where the residence has declined in value prior to its conversion and where the taxpayer, in holding the property for appreciation over its fair market value at the time of conversion, deducts depreciation in order to minimize his loss, gradually the loss will shrink to zero and then suddenly emerge as a gain, representing "income which the taxpayer . . . *may* realize in subsequent taxable years . . . from the disposition of property."[78]

The inherent logic and consistency of the concurring opinions point out the majority's overemphasis of tax gain as the appropriate indicator of the taxpayer's intent. From a standpoint of public policy, it seems inequitable to deny nonbusiness deductions to a taxpayer whose property has declined in value, especially when in a relative sense, he *is* holding the property for appreciation over its *real* value — fair market value.[79]

THE RELATED NOTION OF LOSS

No discussion of sections 167(a)(2) and 212(2) would be complete without some mention of section 165(c)(2).[80] Like the former two statutes, section 165(c)(2) has given rise to a tremendous amount of litigation in converted residence cases.[81] Unlike these sections, however, a loss deduction will generally be denied unless the taxpayer actually rents his residence[82] or otherwise unequivocally appropriates it to income-producing purposes.[83] Unsuccessful efforts to rent do not constitute a conversion within the meaning of section 165(c)(2).[84]

---

78. *Id. But see* Kanter v. United States, 73-1 U.S. Tax Cas. 80,653 (E.D. Va. 1973).

79. This seems particularly true in the current tight-money market, where high interest rates discourage many potential buyers. Indeed, the homeowner who seeks to realize post-conversion appreciation over the property's fair market value under such circumstances would certainly seem to be holding it as an investment.

80. INT. REV. CODE OF 1954, §165 provides, in part:

> SEC. 165. LOSSES.
>
> (c) LIMITATION ON LOSSES OF INDIVIDUALS. — In the case of an individual, the deduction under subsection (a) shall be limited to —
>
> . . . .
>
> (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business;
>
> . . . .

81. *See* 5 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION §28.78 (1969).

82. *See, e.g.,* Heiner v. Tindle, 276 U.S. 582 (1928); Leland Hazard, 7 T.C. 372 (1946). *Compare* Edward L. Parker, 19 B.T.A. 171 (1930) (loss on sale allowed where the house had been leased for six months), *with* Ginsburg v. Campbell, 65-2 U.S. Tax Cas. 96,794 (N.D. Tex. 1965) (loss on sale disallowed where the house had been rented for only eleven days).

83. *See, e.g.,* Rumsey v. Commissioner, 82 F.2d 158, 160 (2d Cir.), *cert. denied,* 299 U.S. 552 (1936) (remodeling for business purposes would constitute an irrevocable appropriation); Morgan v. Commissioner, 76 F.2d 390, 391 (5th Cir.), *cert. denied,* 296 U.S. 601 (1935) (remodeling for business purposes would constitute an irrevocable appropriation). The making of improvements to facilitate the sale, however, does not cause the loss subsequently incurred to be deductible. Jones v. Commissioner, 152 F.2d 392 (9th Cir. 1945).

84. *See, e.g.,* William C. Horrmann, 17 T.C. 903 (1951).

This different test for conversion is perplexing in view of the very similar language employed. Sections 167(a)(2) and 212(2) express the profit-seeking test in terms of "property held for the production of income," while section 165(c)(2) states the test as being "any transaction entered into for profit." Though slight, this difference in terminology is responsible for the development of the stricter, profit-seeking test under section 165(c)(2).

It is a curious fact that the Internal Revenue Code, ordinarily replete with prodigal verbosity, nowhere defines the phrase "entered into for profit." The term first appeared in the Revenue Act of 1916,[85] which was modified slightly three years later[86] into essentially its present-day form. Although the 1916 Senate discussion[87] reveals that Congress desired to place a taxpayer engaged in a profit-seeking activity on an equal footing with an individual engaged in a trade or business, the committee reports[88] failed to explain what constituted a transaction entered into for profit. Consequently, taxpayers turned to the courts for guidance. In the early leading case of *Heiner v. Tindle*,[89] the Supreme Court allowed the loss deduction on a residence that had been vacated by the taxpayer and leased for nineteen years prior to its sale. In the decisions that followed, this actual rental rule became firmly established as the appropriate criterion to be used in residential loss cases.[90]

But this test has not gone unchallenged. Leading commentators[91] have argued that the same profit-seeking test should be used to determine the deductibility of expenses under sections 167(a)(2) and 212(2), and the deductibility of losses under section 165(c)(2). Recent cases have questioned the soundness of using two different tests,[92] with one court allowing a loss deduction even though the residence was offered for sale only and not for rent.[93]

Indeed, the present distinction is ambiguous and should not remain. By applying the *Newcombe* criteria, mere offers to rent or sell can effectuate a conversion of residential property into property held for the production of income within the meaning of sections 167(a)(2) and 212(2). In contrast, these same offers are insufficient to convert the residence into a transaction entered into for profit under section 165(c)(2), even though regulation section 1.165-9

---

85. Act of Sept. 8, 1916, ch. 463, §5(a)(5th), 39 Stat. 759.

86. Act of Feb. 24, 1919, ch. 18, §214(a)(5), 40 Stat. 1067.

87. 53 CONG. REC. 13,264 (1916) (remarks of Senator Williams).

88. *See, e.g.*, H.R. REP. No. 922, 64th Cong., 1st Sess. (1916); H.R. REP. No. 767, 65th Cong., 2d Sess. 10 (1918).

89. 276 U.S. 582 (1928).

90. *See, e.g.*, Rumsey v. Commissioner, 82 F.2d 158 (2d Cir.), *cert. denied*, 299 U.S. 552 (1936); William C. Horrmann, 17 T.C. 903 (1951); Theodore H. Cowles, Jr., 29 CCH Tax Ct. Mem. 884 (1970).

91. *See* 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION 365 (1972).

92. *E.g.*, Theodore H. Cowles, Jr., 29 CCH Tax Ct. Mem. 884 (1970).

93. H. V. Watkins, 32 CCH Tax Ct. Mem. 809 (1973). Although this case involved an inherited residence, the taxpayer occupied it for four months and did not offer the house for rent prior to its sale. Nevertheless, the court found a profit motive in the taxpayer's conduct and allowed a loss deduction on the subsequent sale.

expressly allows a loss deduction if the house is "rented or otherwise appropriated to *income-producing purposes*"[94] prior to its sale. The importance of this judicial distinction is also lessened in the hobby loss provisions of section 183, where Congress defined an activity *not* engaged in for profit as "any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212."[95] Clearly, the negative inference is that section 212(2) income-producing activities are also activities engaged in for profit. If so, then it only seems appropriate to apply the same profit-seeking test across the board.

SUGGESTED REFORMS

Depreciation and maintenance expenses, and a possible loss on the subsequent sale, are often an inherent and unavoidable part of moving. Since Congress has so plainly manifested its desire to encourage mobility within the United States, it seems inconsistent to force a taxpayer into court whenever he decides not to rent his vacated house prior to its sale. In this context, form should not prevail over substance.

It is recommended that in situations where a taxpayer moves for business reasons, section 217 should be expanded to include depreciation and maintenance expenses that he subsequently incurs on his unsold residence. Realistically, these expenses should be viewed as a cost of earning income, as are moving expenses, rather than as nonbusiness expenses, which may or may not be allowed, depending upon whether the property is being held for the production of income. Similarly, a business-inspired loss incurred on the subsequent sale should be deductible under section 165(c)(1) without regard to whether the underlying transaction was entered into for profit.

On the other hand, in situations where the taxpayer moves for personal reasons, the yardstick for measuring his intent should employ the same profit-seeking criteria for sections 165(c)(2), 167(a)(2), and 212(2). Basically, the *Newcombe* approach is a step in the right direction, although it does little to curb the wasteful litigation bred by these sections.

With this in mind, the following guidelines are proposed as a test for conversion in nonbusiness situations:

> (1) The residence must be actually abandoned by the taxpayer and his family. This is not an absolute test, however, since the taxpayer should be allowed to reoccupy his former home for brief and reasonable periods of time in order to make necessary repairs.
>
> (2) The taxpayer's intent to convert his personal residence into a profit-seeking transaction must be manifested by some affirmative, overt act:

---

94. Treas. Reg. §1.165-9(b)(1), T.D. 6712, 1964-1 (pt. 1) CUM. BULL. 106 (emphasis added). Abuse seems to be prevented by allowing a loss deduction to the extent that the lesser of the fair market value of the property at the time of conversion or the adjusted basis exceeds the amount realized from the sale. *Id.* §1.165-9(b)(2).

95. INT. REV. CODE OF 1954, §183.

(a) actual rental, or
(b) a bona fide offer to rent, or
(c) if the property is offered for sale only, by holding it for post-coversion appreciation over its fair market value at the time it was abandoned as the taxpayer's residence.

Actual rental would continue to provide an accurate indication of the taxpayer's intent, as would a mere offer to rent, if bona fide. Offering the residence for sale only would also suffice, if the taxpayer can prove that he is holding the property as an investment to realize upon post-conversion appreciation over its fair market value at the time of conversion. In this context, newspaper advertisements and broker listings would aid in proving the legitimacy of his offer to sell, and one or more certified and independent real estate appraisals would help to establish the fair market value of the property at the time of conversion. Copies of these documents could easily be attached to a federal income tax return in support of claimed deductions.

To prevent abuse, the genuineness of the taxpayer's profit-seeking intent would still be subject to challenge by the IRS, even in cases of actual rental.[96] In addition, the following proposed special rules would apply in nonbusiness situations:

(1) In cases where the residence is offered for sale only, depreciation allowed under section 167(j)(5) could be claimed, computed using the building's estimated useful life and salvage value on the date of conversion.[97]
(2) If the taxpayer or any member of his immediate family (as defined in section 267(c)(4))[98] were to reoccupy the dwelling as his principal residence at any time, then the taxpayer's earlier deductions would be retroactively disallowed to prevent a distortion of his income. This proposal would be a hybrid of the "tax-benefit" rule[99] and the depreciation recapture

96. *E.g.*, Charles F. Neave, 17 T.C. 1237 (1952).

97. The calculation of depreciation is in itself a thorny problem. The Government has successfully argued that even if a mere offer for sale converts residential property into property held for the production of income, no deduction for depreciation is allowable. This is because a residence held solely for immediate sale has no reasonably ascertainable useful life, and consequently no depreciable basis, since its estimated salvage value would equal its fair market value as of the date of conversion. *See* Richard N. Newbre, 30 CCH Tax Ct. Mem. 705, 707 (1971); Fasan, *Maintenance and Depreciation Deductions for a Personal Residence Offered for Sale*, 25 TAX L. REV. 269, 276-79 (1970). The Tax Court, however, has disregarded this argument in cases where the property is held for rent or sale. *See* James J. Sherlock, 31 CCH Tax Ct. Mem. 383, 386-87 (1972); Randolph D. Rouse, 39 T.C. 70 (1962). In these cases depreciation was allowed based on the number of years the residence was expected to function profitably in use.

98. INT. REV. CODE OF 1954, §267.

99. *See, e.g.*, Commissioner v. South Lake Farms, Inc., 324 F.2d 837 (1962). A special, statutory "tax benefit" rule appears in §111, relating to the recovery of bad debts, prior taxes, and delinquency amounts. *See* Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967).

provisions of sections 1245[100] and 1250.[101] In other words, to the extent that he was able to obtain a tax saving from his earlier deductions, then his or his family's subsequent use of the house as a residence would automatically convert these prior deductions into income, taxable at the rates prevailing in the year of recovery.

CONCLUSION

Guidelines such as these are needed to provide more certainty to this area, which "is of benefit to taxpayer and Internal Revenue Service alike."[102] Moreover, since moving is such a common event, these proposals would hopefully eliminate much of the needless litigation that is presently occurring. Unquestionably, these two objectives should always be foremost in the minds of Congress and the courts when formulating and applying the nation's tax laws.

THEODORE A. ERCK, III

100. INT. REV. CODE OF 1954, §1245.
101. *Id.* §1250.
102. Estate of Dwight B. Roy, Jr., 54 T.C. 1317, 1322 (1970).