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TAX CONSEQUENCES OF THE SALE, PURCHASE, OR EXCHANGE OF A PERSONAL RESIDENCE

CLARK E. BOWEN*

In 1951 an amendment was added to the Internal Revenue Code concerning the sale, purchase, or exchange of a personal residence.[1] Congress recognized the importance of the amendment by including the same provisions in the Internal Revenue Code of 1954, plus a few new additions of special benefit to the individual taxpayer.

This article deals with the tax consequences of the provisions in the 1954 code, including the additions as well as the treasury regulations under the old one. No new regulations have as yet been printed for the 1954 code,[2] so the old regulations will still have a great deal of influence on the 1954 tax law. Several suggestions involving the tax aspects of the sale and purchase of a personal residence have also been included. Since the numbered sections of the 1954 code are entirely different from the 1939 code, both sections are listed at the conclusion of the article.

It is important to remember that the Internal Revenue Code of 1954 in connection with the sale, purchase, or exchange of a personal residence applies only to principal residences sold or exchanged after December 31, 1953.[3]

The Internal Revenue Code states that if a gain is made on the sale of any property a tax must be paid on the gain.[4] There is a separate section of the tax law, however, that applies to gain on the sale or exchange of a personal residence.[5]

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[1]The Revenue Act of 1951, §318, 65 STAT. 494 (1951), added subsection (n) to INT. REV. CODE §112. The amendment provided for the nonrecognition of gain upon the sale or exchange of a residence made after Dec. 31, 1950. All sales taking place after Dec. 31, 1953, come under the 1954 Internal Revenue Code.

[2]T.D. 6091, 19 FED. REG. 5167 (1954).

[3]INT. REV. CODE §1034(a) (1954).

[4]INT. REV. CODE §§1001, 1002 (1954).

[5]INT. REV. CODE §1034(a) (1954).

PURCHASE AND SALE

What Constitutes a Personal Residence?

"Personal residence" means the place that the taxpayer calls his home. It is his principal residence; it can be any type of building or dwelling — a mansion, a hut, a trailer, a houseboat, or even land[6] under certain conditions. For example, a taxpayer sells land on which his principal residence is located and within a year, before or after the sale, buys another lot and moves the old building to the new lot and uses it as his principal residence. The special rule for sale of a residence applies to the sale of the land. Gain will be recognized only if the selling price of the old land, less the cost of moving, the foundations, the plumbing and electrical installations, and any other improvements at the new location during a period of one year before or after sale, exceeds the price of the new land.[7]

Proof of whether the property is used by the taxpayer as his principal residence depends upon the facts and circumstances of each individual case.

A stockholder in a co-operative housing corporation may claim as his principal residence his apartment in the project.[8] If the stock is sold, gain is treated in the same manner as on any ordinary residence. If there is any loss it is deductible only to the extent to which the apartment house is occupied by nonstockholder tenants.[9] See *Example 7 infra.*

Special Rule Provisions

The special rule in regard to a personal residence provides:

1. The taxpayer does not have to pay a tax on any gain on the sale of a personal residence at the time the sale is made[10] if

   (a) he buys a new residence and within one year sells the old one;[11] or

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[6]U.S. Treas. Reg. 118, §39.112 (n)-1 (b) (l) (i) (1953).
[7]Rev. Rul. 54-156, 1954 INT. REV. BULL. No. 19 at 9.
[8]INT. REV. CODE §§1034 (f), 216 (1954).
[9]*But see Barnum v. Commissioner,* 19 T.C. 401 (1952) (loss not allowed as a deduction under old §23, now §165).
[10]INT. REV. CODE §1034 (a) (1954).
[11]*Ibid.*

(b) he sells the old residence and within a year buys a new one and lives in it;[12] or

(c) he starts building a new home within a year either before or after selling the old residence and occupies the new one within eighteen months after the sale.[13] Mere improvement of a residence, as opposed to reconstruction, does not constitute a purchase.

(d) And if the adjusted sales price of the old residence does not exceed the cost of the new residence.[14] "Adjusted sales price" is used in the 1954 code instead of "selling price." The adjusted sales price is arrived at by deducting from the sales price the amount spent for repairs in order to make the sale.

2. If the adjusted sales price of the old residence exceeds the purchase price of the new one, any gain on the sale is taxable only to the extent that the adjusted sales price of the old residence exceeds the cost of the new one.[15] In figuring the selling price of his old residence the taxpayer should include, in addition to cash received, any mortgage, trust deed, note, bond, or similar instrument.[16]
3. The adjusted basis for gain on disposal of the newly acquired residence is determined by deducting from the purchase price the amount of gain not recognized on the sale of the old residence.[17]

The nonrecognition of gain in the buying and selling of a personal residence is not optional with the taxpayer.[18] Even if he wants to report a gain that is not recognized for tax purposes he is not allowed to do so. He must follow the provisions of the special rule. If it is desirable to report the nonrecognized gain, as it may be if the taxpayer has offsetting losses at the time, he should make it a recog-

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[12]*Ibid.*

[13]INT. REV. CODE §1034 (c) (5) (1954).

[14]INT. REV. CODE §1034 (a) (1954).

[15]*Ibid.*

[16]U.S. Treas. Reg. 118, §39.112 (n)-1 (b) (4) (1953).

[17]INT. REV. CODE §1034 (e) (1954).

[18]U.S. Treas. Reg. 118, §39.112 (n)-1 (a) (1953); H.R. REP. No. 586, 82d Cong., 1st Sess. 106 (1951).

nized gain by having another member of his family, preferably his wife, make the purchase of the new residence after he has sold the old one.[19] In such a situation the taxpayer is allowed to pay a tax on his gain. The same result can be accomplished by deferring purchase of the new residence.

A particular advantage of the special rule is given to members of the armed forces.[20] The one-year period for buying, as well as the construction period of eighteen months, is suspended for the time the serviceman is on extended active duty. The sale has to be made, however, before January 1, 1955; and the period of suspension will not extend beyond four years from the date of sale of the old residence or December 31, 1958, whichever is later.[21]

A personal residence is capital asset property.[22] If a taxpayer sells a residence that he has owned for less than six months he pays a tax on all of the gain,[23] but if he has owned the property for over six months he pays the tax on only one half of the gain.[24]

The holding period for determining long-term capital gain is the combined period of ownership of successive principal residences.[25] If the taxpayer sells his old residence for less than he paid for it the loss is considered a personal loss and is not deductible on his income tax return, regardless of whether he purchases a new residence. The capital loss provisions do not authorize deductions foreclosed by other provisions of the code.[26] A taxpayer who inherits residential property that he immediately attempts to sell or rent, however, is engaged in a transaction entered into for profit; and if there is a loss it is deductible on the income tax return.[27]

Example 1. An old residence cost $8,000 in January, 1950, and was sold for $10,000 in June, 1954. The seller purchased a new resi-

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[19]This would mean that the new residence could not be held in joint ownership at the time of purchase.

[20]INT. REV. CODE §1034 (h) (1954).

[21]*Ibid.*

[22]INT. REV. CODE §1222 (1) (1954).

[23]INT. REV. CODE §1222 (1) (1954).

[24]INT. REV. CODE §§1222 (3), 1202 (1954).

[25]INT. REV. CODE §1223 (7) (1954).

[26]INT. REV. CODE §§165 (c) (3), 262 (1954); YOUR FEDERAL INCOME TAX 111 (U.S. Treas. Dep't 1954).

[27]INT. REV. CODE §165 (a), (c) (2) (1954); Grier v. United States, 120 F. Supp. 395 (D. Conn. 1954). Grier was allowed a net operating loss because he had inherited the property. The court called it an incidental holding of rental property.

dence in July, 1954, for $13,000. No gain is recognized, since the selling price of the old house did not exceed the purchase price of the new one. Adjusted basis, $11,000. See 1 (b), (d) *supra.*

Example 2. A houseboat was purchased in January, 1951, for $6,000. In June, 1953, the construction of a house to cost $9,000 was begun. In May, 1954, the houseboat was sold for $9,000. Even if the new home is not finished until August 1955, there is no tax on the gain at the time of sale. Adjusted basis, $6,000. See 1 (c), (d) *supra.*

Example 3. A house was purchased in January, 1951, for $6,000, lived in for three years, and sold in February, 1954, for $4,000. The loss on the sale is not deductible on the tax return.

Example 4. A house costing $4,000 was sold after two years for $6,000. The seller failed to buy a new house within the requisite one-year period. Since the gain is a long-term capital gain, the seller pays a tax on one half of his gain.

Example 5. A trailer used as a residence and costing $4,000 was sold by taxpayer for $8,000. Within a year he bought a house for a residence at a cost of $6,000. The taxpayer pays a tax on one half of $2,000, the amount of his gain not in excess of the amount by which the selling price of the trailer exceeded the cost of the new house. Adjusted basis, $6,000. See 1 (b) and 2 *supra.*

Example 6. Taxpayer bought a house in August, 1950, for $5,000. He sold it in December, 1950, for $8,000 and purchased a new residence in January, 1951, for $10,000. He pays a tax on his gain of $3,000 because (1) he had not owned the residence for six months and (2) he had sold it before December 31, 1950; hence he would not come under the special rules of old code section 112 (n) or new code section 1034 (a).

Example 7. Taxpayer lived in a co-operative apartment house in which he owned stock. He sold the stock and moved out of the apartment in 1954. On that date the house was occupied as follows: stockholders 70%, nonstockholders 30%. The taxpayer's sale resulted in a loss of $600. The only loss he could deduct on his income tax return was $180, $600 loss times 30% nonstockholder residents. The remainder of the loss is the same as loss on a personal residence and as such not deductible.

If taxpayer's sale of stock had resulted in a gain of $600 he would have paid a tax on the entire amount, just as if he had made a gain on the sale of an ordinary residence, assuming that the property had not been held for six months and that he did not acquire another principal residence within the requisite period.

Only One Sale a Year

In order to come under the special rule for sale and purchase of a residence, there is a limitation of a single transaction per year.[28] If two residences are purchased within a year, and also a sale is made, only the second purchase comes under the special rule;[29] it is the "new residence."

When the taxpayer sells two residences in the same year, one at a loss and the other at a gain, he may be taxed on the entire gain from the one sale, while any loss on the sale of the other is not deductible. The two sales cannot be offset against one another, since they are considered as separate transactions and the loss is simply a nondeductible personal loss.[30] In order for the taxpayer to get an offset he would have to make both sales a part of the same transaction.[31]

Several Sales Over a Period of Time

If a transaction comes within the special rule for sale and purchase of a residence, no tax is paid at the time on any gain from the sale of an old residence unless the selling price exceeds the purchase price of the new one. If, however, there has been a gain, the tax will be collected ultimately if the taxpayer sells the new residence and does not replace it.[32] If there are several qualifying sales and purchases of personal residences over a period of years and there is a nonrecognized gain on each sale, no tax will be paid until a final sale is made.[33] Such a plan would work in the following manner:

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[28]INT. REV. CODE §1034(d) (1954).

[29]INT. REV. CODE §1034(c)(4) (1954).

[30]See note 26 *supra*.

[31]Rev. Rul. 54-95, 1954 INT. REV. BULL. No. 1 at 8; U.S. Treas. Reg. 118, §39.23(e)(1) (1953); Estate of Gutman v. Commissioner, 18 T.C. 112 (1952); Koehn v. Commissioner, 16 T.C. 1378 (1951).

[32]INT. REV. CODE §§1001, 1002, 1034(a) (1954).

[33]INT. REV. CODE §1034(a) (1954).

House	Date Bought	Price	Date Sold	Price	Nonrecognized Gain
No. 1	Jan. 1950	$1,000	Aug. 1951	$2,000	$1,000
No. 2	Jan. 1952	2,000	Aug. 1952	4,000	2,000
No. 3	Jan. 1953	4,000	Aug. 1953	6,000	2,000
No. 4	Jan. 1954	6,000	Aug. 1954	6,000	-0-
				Total Gain	$5,000

No new purchase of a residence occurred in 1955. The total gain was on the sale of a capital asset held for over six months, and taxpayer paid a tax on only one half of $5,000 — the difference between the original cost and the last selling price — in his tax return for 1954. In the prior years taxpayer paid no tax on the sale of his residence, since he came under the special rule; but his basis for residence No. 4 was $1,000 because on the facts shown nothing would be added to his basis for residence No. 1.

Installment Sales

The tax on any gain, when the selling price of the old residence exceeds the cost of the new one or when there is a final sale with no further purchase, may be partially postponed by arranging the sale so as to have it qualify as an installment sale.[34] If the initial payments — all payments in the first year, including the down payment — do not exceed thirty per cent of the selling price, only a fraction of the total gain need be reported for each year of the payments. To find the amount of gain that is to be reported each year as taxable income on an installment sale, find the total profit and divide by the selling price. This gives the percentage of the selling price that is gain to the taxpayer and on which he must pay a tax each year. This plan enables the seller to spread the profit over the entire period during which the payments are made, so that he does not have to pay all of the tax on his gain in the year of sale.[35]

Example. In May, 1952, taxpayer bought a personal residence for $9,000. He sold it for $15,000 in July, 1952. He decided not to buy a new residence; hence he had a taxable gain of $6,000, as a short-term

[34]INT. REV. CODE §453 (b); Rev. Rul. 53-75, 1953-1 CUM. BULL. 83.
[35]*Ibid.*

capital gain, on which to pay a tax. He sold the house on the installment plan. The purchaser paid him $3,000 in cash and gave him a mortgage for $12,000, to be paid off in twelve yearly installments of $1,000 each. The total profit of $6,000, divided by the contract price of $15,000, equaled 40%, so the taxpayer paid a tax of 40% on the down payment and 40% on each installment.

Joint Ownership of Husband and Wife

If both husband and wife use the old and the new residences as their principal residence, the special rule for gain on the sale of the old residence is applied to both of them.[36] The consent of both is needed to make this joint ownership section of the rule apply; if no consent is given the general rule for recognition of gain on sale of a residence will apply.[37] Thus husband and wife acting singly or together benefit even though the one who sold the old residence is not the same as the one who buys the new one. The gain on the sale of the old residence that is not recognized and the adjustment to the basis of the new residence can be allocated between husband and wife or treated as a gain and adjustment only to the one who did the buying and selling.[38]

Example. Husband, who held title to his residence costing $5,000, sold it for $10,000. Within a year husband and wife bought a new residence for $10,000, taking title as tenants in common. The gain of $5,000 is not recognized as accruing to the husband; the adjusted basis of the husband's interest in the new residence is $2,500 and the wife's basis is also $2,500, if both of them consent to such treatment. If at a later date the residence is sold for $10,000, there being no purchase of a new residence, $2,500 will be recognized as the husband's gain and $2,500 as the wife's gain.

Transfer of Property by Reason of Death of Owner

If the taxpayer dies while owning a second purchased residence, neither he nor his heirs will ever pay any tax on the residential nonrecognized gain. The reason for this is that the residential property will be valued for estate tax purposes at its fair market value at the

[36]INT. REV. CODE §1034 (g) (1954).
[37]*Ibid.*
[38]*Ibid.;* SEN. REP. No. 781, 82d Cong., 1st Sess., pt. 1, p. 36 (1951).

date of the owner's death or within a one-year period after death.[39] The heirs will receive the property with a tax basis equal to the market value, regardless of the nonrecognition of the taxpayer's gain on an earlier sale. Although this transaction is not technically a purchase and sale, the applicable rules are analogous.

Example. If the original cost of a residence was $2,000, and selling price $9,000, the purchase price of the new residence $10,000, and purchaser died soon after the latter purchase, the fair market value of the new residence would be $10,000. The tax on the $7,000 gain is lost to the Government. This is one of the few remaining legal methods of permanently avoiding a tax on a residential gain. In most instances the special provision merely operates to postpone the tax because of the adjustment to basis that are required when the section applies.

EXCHANGE OF RESIDENCE

For Another Residence

If the taxpayer exchanges one residence for another instead of buying and selling, the same rules for nonrecognition of gain will apply.[40] The difference between the cost of the first residence and the fair market value of the second will be his possible gain or loss.[41] Thus if the cost of the taxpayer's residence was $1,000 in 1951 and the sales price of his second residence is $10,000 in 1960, and no money or other property has passed between the exchangers at any time, the taxpayer will pay a tax on one half of the difference between the two sums when he sells the second residence with no replacement.

If at any time the exchange price of the old residence exceeded the exchange price of the new residence, the gain would be the difference between the two amounts. The transaction would be taxable on the amount of excess at the time of the transaction.

For Other Property

An exchange by a taxpayer of his residence for other types of property is considered a sale, and the acquisition of a residence through

[39]INT. REV. CODE §§1014 (a), 2032 (1954).
[40]INT. REV. CODE §1034 (a), (c) (1) (1954).
[41]INT. REV. CODE §§1001 (b), 1034 (a), (e) (1954).

exchange for other property is considered a purchase.[42]

Example. Taxpayer, in 1954, exchanged a barn for a personal residence. The acquisition of the residence will be considered the same as the purchase of a residence.

CHANGE OF RESIDENCE TO INCOME PRODUCING PROPERTY

The income tax law provides that loss on the sale of a personal residence is not deductible. For example, taxpayer owns a house in 1954 that he wants to sell. The house cost $5,000 in 1950, but in selling it taxpayer realized only $3,000. He has a $2,000 loss which he is not allowed to deduct on his income tax return.

The code, however, does permit a deduction to be taken when income-producing property is concerned.[43] Therefore, in order to prevent any further nondeductible loss, taxpayer has to rent the property before selling it, that is, change his personal residence into income-producing property. If the property is once rented and is subsequently sold, any loss sustained on the property after the conversion is deductible;[44] but no loss is deductible on the residential property before conversion.[45] The loss after conversion becomes loss on property used in taxpayer's business, and as such it is deductible from ordinary income on his tax return.[46]

Some of the other advantages available to the taxpayer in changing his personal residence property into income-producing property will be:

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[42]INT. REV. CODE §1034 (c) (1) (1954).

[43]See note 26 *supra;* Grier v. United States, *supra* note 27; Emery v. Commissioner, 17 T.C. 308 (1951). In the *Grier* case the court held that the renting of a single residence by a taxpayer not engaged in renting for a livelihood did not constitute a trade or business, and ordinary loss deduction was not allowed. Yet most other courts and decisions have given an opposite opinion, *e.g.*, Hazard v. Commissioner, 7 T.C. 372 (1946).

[44]Horrmann v. Commissioner, 17 T.C. 903 (1951). Taxpayer sold his home at a loss after unsuccessfully attempting to rent it. The court allowed deductions for depreciation and maintenance expenses but disallowed a loss on the ground that the residence had not been sold under a transaction entered into for profit. *Accord,* Johnson v. Commissioner, 19 T.C. 93 (1952).

[45]See note 26 *supra. But cf.* Wilcox v. Commissioner, 20 T.C. 38 (1953) (loss on sale of residence obtained in a transaction entered into for profit but temporarily occupied by owners who had a permanent home elsewhere allowed as a loss deduction).

[46]INT. REV. CODE §1231 (a), (b) (1954). Loss must not exceed the excess of

1. A deduction of all repair and maintenance expenses on the rental property.[47] When repairs or replacements are made on rental property separate bills should be kept for each. Repairs are deductible as an expense;[48] replacements are not deductible.[49]
2. A deduction for depreciation from the date of renting the property.[50] Deductions for depreciation should be started on the day the property is rented.[51] If depreciation is skipped for any period of time it cannot be reclaimed.[52] Depreciation cannot be deducted on a personal residence in which the owner lives unless part of it is used for business purposes.[53]

Example. The cost of a house and land in 1945 was $10,000; $8,000 was allocated as cost of the house and $2,000 as cost of the land. In 1946 the owner added a room to the house at a cost of $2,000. When he moved away in 1948 the value of the property had dropped to $10,000. He rented the property for two years, made repairs costing $1,000, and then sold it for $6,000 in 1950. The owner claimed a loss of $3,360 on the sale and deducted the entire amount on his income tax return for the year 1950.[54] The loss was figured as follows:

Year		House	Land	Property
1945	Cost	$8,000	$2,000	$10,000
1946	Addition of new room	2,000	- 0 -	12,000
1947	Adjusted basis of property	10,000	2,000	12,000
1948	Value dropped by $2,000 to	8,000	2,000	10,000

value at time of conversion, however. U. S. Treas. Reg. 118 §39.23 (e)-1 (e) (1953).

[47]U.S. Treas. Reg. 118, §39.23 (a)-1,-4 (1953). When a residence is converted into business property maintenance expenses become deductible at that time, Robinson v. Commissioner, 2 T.C. 305 (1943).

[48]I.T. 1550, II-I CUM. BULL. 83 (1923). Outside painting and inside painting and papering of rental property are in the nature of ordinary expenses, and the cost is a deductible expense.

[49]INT. REV. CODE §263 (a) (1) (1954).

[50]INT. REV. CODE §167 (a) (1954). Depreciation is allowable only from date of conversion of the property and is based on the lower of (1) cost if purchased or other basis (gift, inheritance), or (2) fair market value at time of conversion. See Meurer v. Commissioner, 20 T.C. 84 (1953).

[51]*Ibid.*

[52]U.S. Treas. Reg. 118, §39.23 (l)-5 (1953).

[53]U.S. Treas. Reg. 118, §39.23 (l)-2 (1953).

[54]See note 46 *supra.*

1948	Adjusted basis when converted	8,000	2,000	10,000
1949	Repairs made, deducted as expense	(1,000)		(1,000)
1950	House depreciated for 2 years at 4%	640		
	Land depreciation not allowed[55]		-0-	
1950	Adjusted basis at time of sale	7,360	2,000	9,360
1950	Selling price	4,000	2,000	6,000
1950	Loss on sale	3,360	-0-	3,360

The owner is able to deduct the full amount of his loss from ordinary income because the property was taken out of the capital asset category when he converted it into rental property.[56]

Temporary Possession

If the taxpayer leaves his home and rents it, no repairs should be made until he has left; they are then deductible as an expense.[57]

If a new residence is bought and then sold before the old one is sold, the new residence will not come under the special rule.[58] A person may temporarily rent the old home until able to sell it, however, and it will still come under the special rule;[59] he may also rent the new home before taking occupancy.[60] He does not have to be living in his old residence at the time of exchange or sale in order to qualify for the special rule.[61]

PART PERSONAL, PART BUSINESS RESIDENCE

Many people — farmers, owners of two family houses, doctors, lawyers, dentists — use their property partly for a residence and partly for business or the production of income. When there is a sale or exchange of such a residence the part of the property that is being used by the owner as a residence will come under the special rule.[62] A proper allocation of the gain and the selling price of an old residence occupied partly as a personal residence and partly as a business is necessary when obtaining the basis for a newly purchased personal

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[55] U.S. Treas. Reg. 118, §39.23 (1)-2 (1953).
[56] See note 46 *supra.*
[57] INT. REV. CODE §162 (a) (1954).
[58] INT. REV. CODE §1034 (c) (3) (1954).
[59] U.S. Treas. Reg. 118, §39.112 (n)-1 (b) (l) (i) (1953).
[60] *Ibid.*
[61] *Ibid.*
[62] U.S. Treas. Reg. 118, §39.112 (n)-1 (b) (1) (ii) (1953).

residence.[63] Only that part of the gain allocable to the residential portion is not recognized, and only so much of the selling price as is allocable to the residential part of the old property need be reinvested in the new residence.[64]

The holding period to determine gain or loss on this class of property begins from the date of the taxpayer's ownership and not from the date of conversion to business property. The same would be true if the entire residence were converted to business property.[65]

In determining the gain or loss on such a sale there must be an actual allocation of the amounts representing cost, selling price, selling expense, and depreciation to the respective portions of property in the same manner as if there were two separate transactions.[66]

Example 1. Gain on Sale. Taxpayer was a lawyer. In 1947 he bought a nine-room house for $15,000. He used three of the rooms for his office. In 1951 he sold the house for $20,000 and bought another for $24,000. This is how the taxpayer figured his gain on the three rooms used for business purposes:

(a) $15,000 (cost) *x* 3/9 (business rooms) *x* 4 (years) *x* 4% (yearly depreciation) = $800, total depreciation.
(b) $15,000 (cost) - $800 (depreciation) = $14,200, adjusted basis of old residence.
(c) $20,200 (selling price) - $14,200 (adjusted basis) = $6,000, total gain on sale.
(d) $6,000 (gain) *x* 3/9 (business rooms) = $2,000, gain on business part of residence.
(e) $6,000 (gain) - $2,000 = $4,000, nonrecognized gain.
(f) $24,000 (purchase price of new residence) - $4,000 (nonrecognized gain) = $20,000, basis of new residence.

Taxpayer paid a tax on his long-term capital gain of $2,000 recognized on the business part of the residence at the time of sale but did not pay a tax on the nonrecognized gain, since it came under the special rule.

Example 2. Loss on Sale. The original cost of the property was

[63] *Ibid.*
[64] *Ibid.*
[65] I.T. 3041, 1937-1 CUM. BULL. 148.
[66] REV. RUL. 286, 1953-2 CUM. BULL. 95.

$60,000; it was sold for $45,000. Eighty per cent of the property was used as income-producing property and twenty per cent for residential purposes.

	Income Property	Residential
Selling price	$36,000	$ 9,000
Cost	48,000	12,000
Depreciation to date	12,000	-0-
Adjusted basis	36,000	12,000
Loss	-0-	3,000
Expense of sale	2,400	600
Net loss	$ 2,400 (deduction)	$ 3,600 (no deduction)

INVOLUNTARY CONVERSION AND CASUALTY LOSS

Involuntary conversion occurs when the residence is partly or wholly destroyed as a result of fire, flood, storm, or other casualty and is replaced by other property.[67] Under the old law such a conversion for the purpose of recognition of gain was treated as a sale of the residence; under the new law it is treated the same as any other property that has been involuntarily converted.[68] Any loss on the condemnation of a personal residence, however, is not considered as a casualty loss.

The new code provision allows the taxpayer a longer period of time in which to invest in a replacement residence. It will also simplify matters in cases in which the property converted is part residence and part business.

If no proceeds are received as a result of the casualty loss, or there are proceeds and either a replacement or no replacement, the amount of loss deductible is the lesser of (1) the difference between the value of the residence before and the value after casualty; or (2) the difference between the adjusted basis of the property and its value after the casualty.[69]

Under the 1954 code, whether the residence property destroyed is converted directly into other similar property, or into money from

[67]Casualty is due to some sudden, unexpected, or unusual cause, Matheson v. Commissioner, 54 F.2d 537 (2d Cir. 1931).

[68]INT. REV. CODE §1034 (i) (1954).

[69]G.C.M. 16255, XV-1 CUM. BULL. 115 (1936); see also G.C.M. 21013, 1939-1 CUM. BULL. 101 (loss for market value applies only to residences).

insurance proceeds or condemnation awards, or into dissimilar property, the following rules apply:[70]

1. If converted property is replaced by similar property there is no taxable gain.[71]
2. If proceeds received are less than or equal to replacement cost there is no gain, hence no tax.[72]
3. If proceeds exceed cost of replacement a tax is paid only on the excess amount received.[73]

For nonrecognition of gain there is a time limit on replacing a destroyed residence with another residence. The time begins with the date of destruction and ends one year after the end of the tax year in which any gain on the conversion is realized.[74]

The statutory period for assessment of a deficiency on any gain in an involuntary conversion transaction is suspended until the Internal Revenue Service has been notified by the taxpayer of the replacement of the converted property or his intention not to replace it.[75]

Example 1. Proceeds Exceed Cost of Replacement. A residence with a basis of $5,000 owned for five years is destroyed by a tornado. The owner receives $6,000 in payment as insurance proceeds. He buys a new residence for $5,500. The excess $500 is considered as a long-term capital gain. The basis of the new residence is $5,500.

Example 2. Loss and No Insurance. A residence worth $8,000 is completely destroyed by fire. A new residence is built at a cost of $7,000. The adjusted basis of the old home is $8,000.

Value before casualty	$8,000
Value after casualty	-0-
Deductible loss (difference in value)	$8,000

Adjusted basis of the new residence is $7,000.

[70]INT. REV. CODE §1033 (1954).
[71]INT. REV. CODE §1033 (a) (1) (1954).
[72]INT. REV. CODE §1033 (a) (3) (A) (1954).
[73]*Ibid.*
[74]INT. REV. CODE §1033 (a) (3) (B) (1954). Taxpayer also has the privilege of applying for a longer replacement period when a residential casualty is involved.
[75]INT. REV. CODE §1033 (a) (3) (C) (1954).

Example 3. Replacement Exceeds Cost. A house costing $5,000 is destroyed by flood. The owner receives $5,000 insurance proceeds. He builds a new home at a cost of $8,000. There is no gain or loss. Adjusted basis of the new residence is $8,000.

EXPENSES

Selling and Buying Expenses

Expenses incurred in developing or improving the property, or legal expenses incurred in defending the title, are considered as part of the cost and are added to the basis of the property.[76]

Commissions and other expenses paid or incurred by the taxpayer in the purchase of a new residence are included as part of his costs.[77] Commissions and other selling expenses, which are not considered as working expenses, paid or incurred by the taxpayer on the sale of an old residence are not to be taken into account[78] in determining the selling price.[79]

The provision in the regulations excluding commissions and selling expenses does not mean that such expenses cannot be deducted, but it does mean that the selling expenses are not to be included in the "amount realized" by the seller. For example, a residence is listed for sale with a broker for $10,000; the broker makes the sale and charges a commission of $1,000; $10,000 minus $1,000 commission equals $9,000, the amount realized. Expenses incurred in preparing the property for sale are deducted from the amount realized in order to obtain the adjusted sales price. Of course if there are no selling expenses the price actually received represents the amount realized. Under past rulings[80] and decisions real estate commissions and other selling expenses have been allowed as a reduction of the selling price

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[76]U.S. Treas. Reg. 118, §§39.23(a)-15, 39.24(a)-2. But see Ehrick, *Exception to Rule that Amounts Spent in Defense of Title Are Capital Expenditures*, 47 MICH. L. REV. 1037 (1949), in which several cases allowing the taxpayer a deduction as a business expense are cited.

[77]U.S. Treas. Reg. 118, §39.112(n)-1(b)(5) (1953).

[78]U.S. Treas. Reg. 118, §39.112(n)-1(b)(4) (1953). But see Rev. Rul. 168, 1953-2 CUM. BULL. 19 (penalty payments made to obtain release from mortgage on property deductible; ruling might apply to homes).

[79]Under the new code the words "amount realized" are used instead of "selling price."

[80]I.T. 2305, V-II CUM. BULL. 108 (1926).

and will continue to be so allowed under the new code.

Repairs and Replacements

A repair is an expenditure for the purpose of keeping property in efficient operating condition; it does not add to the value of the property or prolong its life.[81] A replacement or improvement, such as a new floor or roof, prolongs the life of the property, increases its value, or makes it possible to adapt the property to a new use.[82] When property is sold or exchanged all bills and canceled checks should be saved, in order to prove the cost of improvements and the purchase price of the property.[83]

A repair is deductible as an expense on property that is rented by the owner to another,[84] but it is not ordinarily deductible as an expense on a personal residence.[85] The cost of any replacement or improvement on either a personal residence or rental property is added to the original cost, however;[86] thus the taxable gain will be lower or the loss greater when the property is sold.

An important addition to the new code, in so far as homeowners are concerned, is the provision allowing a credit for repair of a residence when readying it for sale.[87] These repair expenses may be deducted from the selling price in order to obtain the adjusted selling price.[88] As used in the new code, the term "adjusted sales price" means the amount realized from the sale, reduced by the expenses incurred for work performed on the old residence in order to assist in its sale. The provision applies only to sales after December 31,

[81]Illinois Merchants Trust Co., Ex'r, 4 B.T.A. 103 (1926).

[82]*Ibid.*

[83]U.S. Treas. Reg. 118, §39.41-2,-3; Herbert v. Riddell, 103 F. Supp. 369 (S.D. Cal. 1952).

[84]INT. REV. CODE §162 (a) (1954).

[85]INT. REV. CODE §262 (1954).

[86]INT. REV. CODE §263 (a) (1954). The following items have been classified as replacements and added to cost of residence: new roof, paving of street, concrete driveway, graveled driveway, kitchen sink, back-yard fence, chicken house, trees and shrubs, front concrete walk and steps, and general overhaul of house to get it ready for sale, Crossland v. United States, CCH 1953 FED. TAX REP. ¶9243 (T.C. 1953).

[87]INT. REV. CODE §1034 (b) (1954).

[88]INT. REV. CODE §1034 (b) (1) (1954). If the subsection is to be strictly interpreted, it is possible that it refers only to a situation in which the seller buys another home within the statutory limitations.

1953, to old residences, and to expenses[89] (1) for work performed during the ninety-day period ending on the day the contract to sell the old residence is made, (2) paid for within thirty days after the sale, (3) not otherwise deducted as an expense, (4) not figured in computing the amount realized from the sale of the old residence. These expenses may even be incurred for work performed ninety days before January 1, 1954, as long as the old residence is not sold before that date.[90]

Example. Taxpayer's residence was purchased in September, 1954, for $3,000. He sold it in September, 1954, for $8,000. He had made necessary repairs of $1,000 before selling the residence. The $8,000 selling price minus the $1,000 expenses equals $7,000, the adjusted sales price.

Taxpayer bought a new residence for $10,000. He had a nonrecognized gain of $2,000 ($7,000 adjusted sales price minus $5,000 cost) on the old residence on which he did not have to pay any tax at the time of sale. The $10,000 original basis of the new residence minus $2,000 nonrecognized gain on the old equals $8,000, the adjusted basis of the new residence.

If minor repairs, such as painting and papering, are made by the new owner immediately after the purchase of a personal residence, the expense may be added to the cost of the residence because it was necessary to make the residence suitable for occupancy.[91] If done some time after the purchase the taxpayer can never get credit for this type of expenses. The following chart shows how advantageous present repairs can be:

		Repairs	
Date		Present	Deferred
May, 1954	Cost of residence	$14,000	$14,000
June, 1954	Repairs made, added to cost	3,000	
November, 1954	Repairs made, not added		(3,000)
January, 1955	Basis for new sale	17,000	14,000
July, 1955	Property sold for	20,000	20,000
	Gain on sale (long term)	3,000	6,000

[89]INT. REV. CODE §1034 (b) (2) (1954).

[90]INT. REV. CODE §1034 (b) (3) (1954).

[91]INT. REV. CODE §263 (a) (1954). Repairs can then be classified as replacements to improve the property and get it ready for occupancy.

The tax saving in Column No. 1 is $320.00. In Column 2 the owner did not actually have a gain of $6,000, since he had spent $3,000 for repairs that were not deductible nor could they be added to the original cost of the house.

TAXES OTHER THAN INCOME

Property Taxes

Another important addition to the new code is the section dealing with real property taxes.[92] Under the Internal Revenue Code of 1939 property taxes could not be apportioned between the buyer and the seller of residential property. Only one of them was allowed to treat the real property tax as a federal tax deduction.

The general rule in the 1954 code for apportionment of real property taxes between buyer and seller[93] is that each can deduct on his federal income tax return the amount of real property tax that is allocable to him for the time he has owned the property. If real property is sold during any real property tax year (1) so much of the tax as is properly allocable to the part of the year ending on the day before the date of sale shall be recognized as a tax to the seller;[94] and (2) that part of the year beginning on the date of sale shall determine the tax of the buyer.[95]

If a taxpayer, because of his system of accounting or the state real property law, is not able to deduct any amount for taxes unless paid by him at the time, for sale or otherwise, the tax can be apportioned as in the general rule and the taxpayer can get credit for the amount that is apportioned to him.[96]

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[92]INT. REV. CODE §164(d) (1954). This provision is one of the additions to the 1954 code that agrees with general accounting practices. The old federal method concerning deduction of real property taxes was inconsistent with common practice and sense. *E.g.*, in Florida real property taxes become a lien on the property as of Jan. 1st for that year. If taxpayer bought a house on January 2d and then paid the taxes for the entire year when they became due in November, according to the federal rule he could not use those taxes as a deduction on his federal tax return. Nor could the seller of the property claim a deduction, for he had not paid the taxes. Yet in actual practice it is a well-known fact that taxpayers involved in the buying and selling of property prorate the taxes between themselves and each claims a deduction for the amount he has paid.

[93]INT. REV. CODE §164(d)(1) (1954).

[94]INT. REV. CODE §164(d)(1)(A) (1954).

[95]INT. REV. CODE §164(d)(1)(B) (1954).

[96]INT. REV. CODE §164(d)(2)(A) (1954).

Another part of the apportionment rule states that if neither party is liable for the tax the party who holds the property at the time the tax becomes a lien and who pays the tax shall be allowed the deduction for tax purposes.[97]

Example. Taxpayer buys a residence on July 1, 1954, on which the real property taxes of $1,000 for the year have been a lien since January 1, 1954. Half of the tax payment is recognized as chargeable to the buyer and half to the seller. The two parties can arrange between themselves at the time of sale as to who will pay the real property tax and as to how he will be reimbursed by the other party to the transaction.

Stamp Taxes

The Internal Revenue Code imposes a stamp tax on conveyances of real estate when the value of the property conveyed exceeds $100.[98] The stamp tax does not apply to a mortgage or a deed conveying realty as a gift.[99] Some states also place a documentary stamp tax on such transactions. Federal stamp taxes are not deductible as a tax but are added to the cost of the property transferred.[100] State stamp tax costs are deductible in full on the federal tax returns.[101]

BASIS FOR FIGURING GAIN OR LOSS

The starting point for figuring gain or loss is the basis of any property.[102] If a residence is acquired by gift after December 31, 1920, the basis is the same as it was to the donor or to the last one who paid

[97]INT. REV. CODE §164 (d) (2). Under the accrual method of accounting the taxpayer has to make an election before the date of sale to ratably accrue his real property taxes. He may do this without consent of the Internal Revenue Service if he does it within his first taxable year after Dec. 31, 1953, and before he files his tax return for such year. Under some state laws taxes on real property for the year 1954 are assessed on April 1, 1955, and become a lien on that date. A taxpayer using the accrual method of accounting can treat the taxes as having accrued ratably over the twelve months in 1954 and take advantage of the new provision.

[98]INT. REV. CODE §3482 (1941).

[99]*Ibid.*

[100]INT. REV. CODE §164 (b) (3) (1954).

[101]INT. REV. CODE §164 (a) (1954).

[102]INT. REV. CODE §1012 (1954). Real property taxes paid by purchaser are not part of the cost of residence.

value for the property.[103] If property is acquired by inheritance the basis is the fair market value on the death of the decedent.[104] If acquired by purchase the basis is the purchase price. In any event there may be added the cost of any improvements made after acquisition.[105] The basis for gain or loss is increased by adding the cost of any improvements made between acquisition and sale.[106]

The basis for the adjusted sales price of the old residence is found by reducing the amount realized on the sale of the residence by the aggregate of the expenses for work performed in order to assist in its sale.[107]

When any part of the new residence is acquired by gift or inheritance the taxpayer uses as the basis only that part that is replaced or constructed by him during the one-year period before or after receiving the residence.[108]

Example. If taxpayer received a $10,000 residence as a gift and then spent $5,000 on additions to it, only $5,000 would be treated as taxpayer's cost of purchase for the purpose of applying the special rule of Section 1034.

Penalties and Deficiencies

A taxpayer who has sold his old residence and has not purchased a new one within the prescribed period of time should pay the tax on any gain without delay, because after the prescribed period has elapsed interest on the gain must be paid.[109]

The Internal Revenue Code of 1954 provides that if it is the taxpayer's intention not to replace his old residence, or if the period expires during which replacement may result in nonrecognition of gain, or if the cost of purchasing the new residence is less than the selling price of the old residence, the recognized gain shall be included in the gross income for the taxable year in which the gain was realized. An amended return is made in such a case.[110] If the taxpayer has

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[103]Int. Rev. Code §1015 (a) (1954).
[104]Int. Rev. Code §§1014 (a), 2032 (1954).
[105]U.S. Treas. Reg. 118, §§39.24 (a)-2, 39.112 (n)-1 (b) (5) (1953).
[106]*Ibid.*
[107]See note 88 *supra.*
[108]Int. Rev. Code §1034 (c) (2) (1954).
[109]Rev. Rul. 122, 1953-2 Cum. Bull. 227.
[110]U. S. Treas. Reg. 118, §39.112 (n)-1 (e) (2) (1953).

not met the prescribed conditions for sale and purchase of residence, the additional income tax resulting therefrom is a deficiency[111] for the taxable year in which the sale occurred.[112]

The statutory period for the assessment of any deficiency shall not expire prior to the expiration of three years from (1) the date the taxpayer notifies the Internal Revenue Service of the nonrecognition of any gain, or (2) notification of his intention not to purchase a new residence within the specified period, or (3) the failure to make a purchase within the specified period. The deficiency may also be assessed prior to the expiration of the three-year period.[113] This means that the taxpayer has to notify the Internal Revenue Service, usually by filing his income tax return and noting thereon any sale of residence during the year; otherwise the Service can assess a deficiency whenever the transaction is uncovered. Such a deficiency can be costly to the taxpayer.

Example. Taxpayer sold his old residence, which cost him $5,000, for $10,000, with the intent to purchase a new residence within a year. Of his $5,000 gain only $2,500 was taxable. Taxpayer did not notify the Revenue Service of his sale and did not pay any tax on the gain. The transaction was uncovered by a tax agent twenty years later, and a deficiency was assessed with interest. By this time the interest alone amounted to $612, or a good share of the taxpayer's entire taxable gain. The taxpayer could also incur other penalties that would amount to more than his gain.

Reporting Resident Sale Transactions

The following rules must be observed in reporting the sale or exchange of a personal residence:

1. Report the details in Schedule D of Form 1040 for the year in which the sale or exchange took place.[114]

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[111]Rev. Rul. 122, 1953-2 Cum. Bull. 227. The assessment and collection of interest on a deficiency is mandatory and may not be waived by the Internal Revenue Service regardless of the circumstances that caused the deficiency.

[112]Int. Rev. Code §6601 (a), (f) (1954). Interest upon the amount determined as a deficiency shall be assessed at the same time as the deficiency, shall be paid upon notice and demand from the collector, and shall be collected as a part of the tax at the rate of 6% per year.

[113]Int. Rev. Code §1034 (j) (1954).

[114]U.S. Treas. Reg. 118, §39.112 (n)-1 (e) (2) (1953).

2. If there is to be no replacement under the special rule for sale of residence, report the gain in Schedule D in the regular manner.[115]
3. If there has been a sale of an old residence and a purchase of a new one within the year, report the amount of taxable gain, if any, in Column 8 of Schedule D. Attach a separate statement showing the purchase price, date of purchase, and date of occupancy of the new residence.[116]
4. If the old residence has been sold but purchase of a new one has not yet been completed, and if the period of time for replacement has not expired, report "None" in Column 8 of Schedule D. When the purchase has been completed advise the District Director of Internal Revenue in writing, giving full details of the transaction.[117]
5. If after a sale it is decided not to purchase a new residence, or if the replacement period has expired, report the sale in an amended return. The amount of gain should be shown in the usual way in Schedule D and a tax paid on the gain,[118] plus interest at six per cent.[119]

In conclusion, there are three very important factors to remember in the sale of a personal residence:

1. If a taxpayer sells his residence and expects to purchase another, he should buy within a year; or if he constructs a new residence he should move in within eighteen months after sale of the old one.
2. If it is desired to avoid any payment of tax on a gain made in sale or exchange, the selling price of the old residence must not exceed the cost of the new one.
3. All transactions that come under the special rule for sale and exchange of a personal residence must be reported to the Internal Revenue Service.

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[115]*Ibid.*
[116]*Ibid.*
[117]*Ibid.*
[118]*Ibid.*
[119]INT. REV. CODE §6601 (a) (1954).

COMPARISON OF 1954 AND 1939 CODE SECTIONS

1954 Code	1939 Code	1954 Code	1939 Code
61 (a)	22 (a)	1034 (a)	112 (n) (1)
164 (a)	23 (c)	(b)	none
(b) (3)	23 (c) (1) (F)	(b) (1)	none
(d) (1)	none	(b) (2)	none
(d) (1) (A)	none	(b) (3)	none
(d) (1) (B)	none	(c) (1)	112 (n) (2) (A)
(d) (2) (A)	none	(c) (2)	112 (n) (2) (D)
165 (a)	23 (e)	(c) (3)	112 (n) (2) (E)
(c)	23 (e)	(c) (4)	112 (n) (2) (F)
167 (a)	23 (l)	(c) (5)	112 (n) (2) (G)
216	23 (z)	(d)	112 (n) (3)
263 (a)	24 (a) (2), (3)	(e)	112 (n) (4)
453 (b)	44 (b)	(f)	112 (n) (5)
1001	111	(g)	112 (n) (6)
1002	112 (a)	(h)	112 (n) (8)
1012	113 (a)	(i)	112 (n) (2) (B)
1014 (a)	113 (a) (5)	(j)	112 (n) (7)
1015 (a)	113 (a) (2)	1202	117 (b)
1033	112 (n) (2) (B)	1221	117 (a)
(a) (i)	112 (n) (2) (B)	1222 (1)	117 (a) (2)
(a) (3) (A)	112 (n) (2) (C)	(3)	117 (a) (4)
(a) (3) (B) (i)	112 (n) (1)	1223 (7)	117 (h)
(a) (3) (C)	112 (n) (7)	1231 (a)	117 (j) (2)
		6601 (a)	292 (a)

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