1988

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DEDUCTIONS FOR A FORMER RESIDENCE:
DON'T LEAVE HOME WITHOUT THEM

Allan J. Samansky*

A homeowner sometimes moves out of his residence without having sold it. Occasionally, he is happy about this, probably planning to rent the former residence to others. More often he wants to sell it as quickly as possible, but has been unable to do so at an acceptable price. Although he is then holding the residence for sale, the owner may also offer it for rent in an attempt to mitigate the carrying costs, which would typically include interest, property taxes, insurance, repairs, and utilities.

This Article discusses the deductibility of expenses, depreciation, and loss on a sale in computing the federal income tax liability of an owner of a former residence. Courts have generally held

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1. See infra notes 28-43, 73-120, 205-39 and accompanying text.
2. See infra notes 28-43, 73-120, 240-66 and accompanying text.
3. See infra notes 267-87 and accompanying text.
4. This Article addresses deductions only for an owner who moves out of his residence and does not expect to reoccupy it. In this case the owner's only reason for retaining ownership of the former residence is to maximize revenues from selling or renting it. An owner who vacates his residence and expects to return (or is not sure about returning) presents different issues since he retains the residence for personal purposes.

Intentions can change, however, and a person who did not expect to reoccupy his former residence may move back. Nevertheless, his deductions for the period during which he did not
that a taxpayer who moves out of his residence and offers it for rent has “converted” it from personal property to “property held for the production of income,” even if he is holding the residence primarily for sale. He can then usually deduct “ordinary and necessary” expenses and depreciation without regard to rental income, although deductions may be limited by various special provisions of the Internal Revenue Code. On the other hand, courts have generally held that a taxpayer who has permanently moved from his residence and offered it only for sale has not converted it to property held for the production of income and therefore cannot deduct ordinary and necessary expenses and depreciation. He may, however, deduct real property taxes and, in most cases, mortgage interest.

The first three sections of the Article present and criticize current law concerning deduction of expenses and depreciation. Section I discusses the tax consequences when an owner has permanently moved out of a residence and does not offer it for rent. Section II discusses the tax consequences when the owner has permanently moved out and offers the residence for rent. In each section the basic rules are first described, and then the cases are explored. Section III discusses *Bolaris v. Commissioner*, a recent case in which the taxpayer not only deducted maintenance expenses and depreciation for a former residence, but also deferred the gain on sale under

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expect to return should not be affected by the change in plans, unless a specific provision of the Internal Revenue Code provides otherwise. See I.R.C. § 280A(c)(5), (d)(4) (1982 & Supp. IV 1986) (deductibility of losses possibly depending on whether owner reoccupies his residence). For application of the tax benefit doctrine, see infra note 232.
5. See I.R.C. §§ 167(a), 212 (1982).
6. See infra notes 121-49 and accompanying text.
10. See infra notes 44-72 and accompanying text.
11. See I.R.C. § 262 (1982). There is an exception to this rule, but it has been virtually impossible to utilize. A taxpayer who has not offered a former residence for rent is treated as having converted it to property held for the production of income if the residence is held for both future appreciation and for eventual sale at a price in excess of basis. For discussion of this exception, see infra notes 60-69 and accompanying text.
14. See infra notes 28-72 and accompanying text.
15. See infra notes 73-149 and accompanying text.
Although the consistency of these two positions was an important issue in the case, *Bolaris* demonstrates the shortcomings of the current rules for deducting expenses and depreciation, even aside from their interaction with section 1034. 

Sections IV and V address the questions of policy that have been raised in the first three sections. Section IV discusses the correct treatment of ordinary and necessary *expenses*; section V examines the correct treatment of *depreciation*. In both sections the Article demonstrates the unfairness of current law and presents other approaches that would improve it.

Section VI discusses a related topic, the deductibility of a loss realized on the sale of a former residence. An owner can deduct a loss on sale only if he has actually rented the former residence after having moved out; on the other hand, he can deduct depreciation if he has merely offered the property for rent. The use of a stricter standard for loss deductions than for depreciation is inconsistent with the basic purpose of the depreciation deduction, which is to compensate the taxpayer for an expected decline in value.

The correct relationship between the rules for deducting a loss on sale and those for deducting ordinary and necessary expenses and depreciation is discussed. 

Conclusions and recommendations are summarized in Section VII.
I. FORMER RESIDENCE NOT OFFERED FOR RENT

A. Conversion to Property Held for Production of Income

Owning one's principal residence is considered an activity that is not engaged in for profit. Therefore, ordinary and necessary expenses incurred to maintain the residence and depreciation are generally not deductible. Deductions for real property taxes and "qualified residence interest" are allowed, however, since they are deductible whether or not incurred with respect to a profit-seeking activity. "Qualified residence interest" usually includes interest on indebtedness secured by the taxpayer's principal residence.

When a taxpayer moves out of his residence, but continues to own it, the tax consequences depend on whether the residence has been "converted" from personal property to property used in a business or held for the production of income. Offering a former residence solely for sale is usually not sufficient to effect a conversion. If a former residence is not converted, it remains a personal asset,

31. I.R.C. § 163(h)(2)(D) (Supp. IV 1986). Deductions for casualty losses are also allowed, but they are subject to severe restrictions. See I.R.C. § 163(c), (h) (Supp. IV 1986). The current definition of qualified residence interest was added to the Internal Revenue Code by the tax provisions of the Omnibus Budget Reconciliation Act of 1987 and applies to taxable years beginning after December 31, 1987. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10,102, 1988 U.S. CODE CONG. & ADMIN. NEWS (101 Stat.) 1,384. Qualified residence interest is interest that is paid or accrued during the taxable year on "acquisition indebtedness" and on "home equity indebtedness." I.R.C. § 163(h)(3)(A) (West 1988). Acquisition indebtedness is any indebtedness which "is incurred in acquiring, constructing, or substantially improving any qualified residence" of the taxpayer and secured by such residence. I.R.C. § 163(h)(3)(B)(i) (West 1988). However, the maximum amount of indebtedness that may be treated as acquisition indebtedness is $1,000,000. I.R.C. § 163(h)(3)(B)(ii) (West 1988). Home equity indebtedness is indebtedness (other than acquisition indebtedness) secured by a "qualified residence" to the extent it does not exceed the excess of fair market value of the qualified residence over the acquisition indebtedness secured by such residence. I.R.C. § 163(h)(3)(C)(i) (West 1988). The maximum amount of indebtedness that may be treated as home equity indebtedness is $100,000. I.R.C. § 163(h)(3)(C)(ii) (West 1988). Indebtedness incurred on or before October 13, 1987 and secured by a qualified residence on that date (or indebtedness incurred to refinance qualifying indebtedness that was incurred on or before October 13, 1987) is subject to special rules. Such indebtedness is generally treated as acquisition indebtedness, but the $1,000,000 limitation is not applicable. I.R.C. § 163(h)(3)(D) (West 1988).
32. Qualified residences are defined as the taxpayer's primary residence and one other qualifying residence designated by the taxpayer. I.R.C. § 163(h)(4)(A) (West 1988). For discussion of a "qualified residence," see infra notes 36-38 and accompanying text.
and none of the deductions which depend on a profit-related motive are allowed. "Qualified residence interest" and real property taxes, however, remain deductible. Interest secured by the former residence is usually qualified residence interest if the taxpayer designates the former residence as a "qualified residence." The taxpayer is allowed to designate one residence, in addition to his principal residence, as a "qualified residence." Usually the taxpayer must use the designated residence for personal purposes a required minimum amount of time during the year in order for the interest on a loan secured by it to be considered qualified residence interest. If the residence is not rented at all during the year, however, the taxpayer does not need to use it for personal purposes.

It is possible, although not very likely, that a former residence is converted to property held for a profit-related purpose even if the taxpayer has not offered it for rent. He would be holding the former residence for future appreciation and for gain over its basis, and could generally deduct ordinary and necessary expenses and depreci-

34. See supra notes 30-31 and accompanying text.
37. Id. The taxpayer must use the residence for personal purposes for at least 14 days or 10% of the number of days that the residence is rented at fair market value during the taxable year, whichever is greater. I.R.C. § 280A(d)(1) (1982).
38. I.R.C. § 163(h)(4)(A)(iii) (West 1988). The statute currently provides that, if the taxpayer does not use a dwelling unit the required minimum amount of time for personal purposes, then the unit can be a qualified residence only if the taxpayer does not "rent or use" it at any time during the taxable year. Therefore, it cannot be a qualified residence if the taxpayer uses it for personal purposes a minimal amount of time. It is clear, however, that Congress intended that a dwelling unit should be a qualified residence if the taxpayer does not "rent" it to others at any time during the taxable year, regardless of personal use. Staff of Joint Comm. on Tax. N. 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 267 (Comm. Print 1987) [hereinafter General Explanation of the Tax Reform Act of 1986]. When enacted, the technical corrections bill will cause the statute to conform to congressional intent by providing that a dwelling unit is a qualified residence if the taxpayer does not "rent" (rather than "rent or use") it during the year. See Technical and Miscellaneous Revenue Act of 1988, H.R. 4333, 100th Cong., 2d Sess. § 1005(c)(7), 134 Cong. Rec. H10867 (daily ed. Oct. 21, 1988).

Temporary regulations state that a dwelling unit that is held solely for "resale" is "deemed to be rented" for purposes of § 163(h)(4)(A)(iii). Temp. Treas. Reg. § 1.163-10T(p)(3)(iii) (1987). This provision may mean that a former residence is not a "qualified residence" if the owner had offered it for sale and had not lived in the residence the required amount of time during the year. The interest would not be qualified residence interest, and thus would not be deductible. However, interpreting the word "rent" in the statute as including held for sale when the property had never even been offered for rent seems clearly inappropriate. If this is the intended interpretation of the temporary regulations, they are not consistent with the statute and should not be valid.
ation, as well as mortgage interest and property taxes.\textsuperscript{39} The deductions would, however, be subject to some restrictions. Section 280A would not allow any deductions other than qualified residence interest and property taxes in the year of conversion if the owner had lived in the residence more than fourteen days during the taxable year, but section 280A does not affect deductions in years after the taxpayer had moved out.\textsuperscript{40} Furthermore, expenses and depreciation would be deductible only if the taxpayer itemizes deductions,\textsuperscript{41} and, except for interest and property taxes, would be "miscellaneous itemized deductions."\textsuperscript{42} Section 67 allows a deduction for miscellaneous itemized deductions only to the extent they exceed two percent of adjusted gross income.\textsuperscript{43}

### B. The Cases

In 1943, the Tax Court held that a taxpayer who had moved out of her residence and offered it for either sale or rent had converted the former residence to property held for the production of

\textsuperscript{39} See Newcombe v. Commissioner, 54 T.C. 1298, 1302-03 (1970) (reviewed by the full court), discussed infra notes 53-69 and accompanying text. "Qualified residence interest" is specifically excluded from the definition of "investment interest," and, therefore, its deductibility is not restricted by \$ 163(d), I.R.C. \$ 163(d)(3)(B)(i) (Supp. IV 1986). For discussion of qualified residence interest, see supra notes 31, 35-38 and accompanying text. Interest other than qualified residence interest would, however, be investment interest. I.R.C. \$ 163(d)(5)(A) (Supp. IV 1986).

Holding a former residence for gain is not a "passive activity," I.R.C. \$ 469(c)(1), (6) (Supp. IV 1986); therefore, any net losses from holding the residence are not affected by \$ 469, which limits deductions of losses from passive activities. A passive activity generally includes a trade or business in which the taxpayer does not materially participate. I.R.C. \$ 469(e)(1) (Supp. IV 1986). It may also include an activity carried on for profit in which the taxpayer does not actively participate "to the extent provided in regulations." I.R.C. \$ 469(e)(6) (Supp. IV 1986). Holding property for future appreciation is not a trade or business, but is an activity carried on for profit. Treas. Reg. \$ 1.212-1(b) (as amended in 1975). Although regulations classifying activities carried on for profit as passive activities have not yet been published, it is very unlikely that they will classify holding property for future appreciation as a passive activity. Tucker & Schwinger, \textit{Passive Loss Rules, Other TRA Changes Will Require More Emphasis on Non-Tax Benefits}, 66 J. TAX'N 290, 292 (1987); see \textit{General Explanation of the Tax Reform Act of 1986}, supra note 38, at 217.

\textsuperscript{40} I.R.C. \$ 280A (1982 & Supp. IV 1986). Section 280A(a) generally limits deductions for dwelling units when the taxpayer's personal use has exceeded the period specified in \$ 280A(d)(1). Section 280A(b) overrides \$ 280A(a) and allows deduction for qualified residence interest and property taxes. However, \$ 280A(c), which provides for more general exceptions to \$ 280A(a), does not apply to a former residence that is held only for future appreciation and not for rent. For a discussion of \$ 280A, see infra notes 103-20 and accompanying text.

\textsuperscript{41} I.R.C. \$ 63 (Supp. IV 1986).

\textsuperscript{42} I.R.C. \$ 67(b) (Supp. IV 1986).

\textsuperscript{43} I.R.C. \$ 67(a) (Supp. IV 1986).
income and could deduct maintenance expenses and depreciation. The court stated that there must be an "unmistakable act of conversion or appropriation" for such expenses to be deductible and that efforts to sell are not sufficient.

Most cases followed Leslie until 1967. In that year, the Tax Court allowed the taxpayers in Smith v. Commissioner to deduct maintenance expenses and depreciation after they had moved out of a former residence and offered it for sale. The Tax Court in Smith did not cite Leslie or any of the other cases that had not allowed maintenance expenses or depreciation to be deducted by taxpayers who had offered a former residence solely for sale. The Ninth Circuit affirmed the Tax Court in Smith, but stated that the Tax Court's holding depended on a finding of fact and that "unusual cir-
cumstances” were present. Since the unusual circumstances were not apparent, the Ninth Circuit seemed to be saying that Smith had little value as precedent.

Three years after its opinion in Smith, the Tax Court effectively overruled it in Newcombe v. Commissioner, a decision reviewed by the entire court. Newcombe has been followed in numerous subsequent decisions. The taxpayers in Newcombe owned a residence in Arkansas. On or around December 1, 1965, they moved to a new residence in Florida and offered the old residence for sale, but not for rent. It remained unoccupied until it was sold about fourteen months later. The taxpayers claimed deductions for maintenance expenses and depreciation in 1966 and argued that the deductions were allowable since the former residence was being offered for sale and was no longer being used for personal purposes. The Service argued that the property must be rented or offered for rent in order for the deductions to be allowed.

The Tax Court refused to adopt the position of either the taxpayer or the Service. It stated that a “variety of factors must be weighed” and that it must determine the taxpayer’s intent “in light of the circumstances” at issue.

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52. 397 F.2d 804, 804 (9th Cir. 1968).
53. 26 T.C.M. 149 (1967).
54. 54 T.C. 1298 (1970). The Tax Court in Newcombe stated that Smith v. Commissioner had little precedent value. Id. at 1303. For discussion of Newcombe, see Byrne, Conversion of a Personal Residence to a Business or Investment Use for Tax Purposes, 8 Rut-Cam. L.J. 393, 405-14 (1977); Note, And You Thought Moving Was Bad—Try Deducting Depreciation and Maintenance Expenses on Your Unsold Residence, 26 U. Fla. L. Rev. 587, 592-98 (1974) (authored by Theodore A. Erck, III) [hereinafter Note, And You Thought Moving was Bad]; Note, The Newcombe Test for Allowing Depreciation on a Converted Residence—A Procrustean Reliance on Statutory Language, 31 Wash. & Lee L. Rev. 698 (1974) (authored by Steven E. Lewis).
56. Newcombe, 54 T.C. at 1299.
57. Id. at 1299.
58. Id. at 1299-300. The court stated that it took the following considerations into account: (1) the taxpayers used the residence for a substantial period of time; (2) the house was
of all the facts and circumstances. In fact, the Tax Court established rather specific guidelines for there to be a conversion, and the effect of its decision has been the same as if it had explicitly adopted the position of the Service.

The Tax Court judges were unanimous that, in the absence of his offering the former residence for rent, a taxpayer must have held the property for appreciation accruing after he had abandoned it as a residence in order to convert it to property held for the production of income. “[P]lacing the property on the market for immediate sale, at or shortly after the time of its abandonment as a residence, will ordinarily be strong evidence that a taxpayer is not holding the property for . . . appreciation” subsequent to its use as a residence. The court required that, in addition to holding the former residence for subsequent appreciation, the taxpayer must have intended to sell the property for more than its cost when he moved out. The taxpayers in Newcombe satisfied neither requirement and thus could not deduct maintenance expenses and depreciation.

There was no discussion in Newcombe justifying the requirement that, in the absence of attempts to rent, the taxpayers had to be holding the former residence for appreciation accruing subsequent to their moving out in order to deduct maintenance expenses and depreciation. A taxpayer who is holding a former residence for fu-
ture appreciation seems to be in a similar position to one who is holding it to realize the benefit from appreciation that had already occurred. The taxpaying ability of both would seem to be similarly affected by expenses incurred to maintain their former residences.

The majority in *Newcombe* would not only require a taxpayer to be holding the former residence for appreciation accruing after he had moved out, but also to be holding it for a gain over its cost.\(^6\)

The court reasoned that, under section 212,\(^6\) ordinary and necessary expenses are deductible only if the property is held for the production of income and that, if the taxpayer is holding the property only to recover part or all of his original cost, he is holding it to minimize loss, not to produce income.\(^6\) The statute does not mandate this result.\(^6\) One concurring opinion argued that the taxpayer is holding property for production of income if he is holding it for gain over its value at the time he has permanently moved out.\(^6\) It is anomalous to hold that a homeowner whose former residence has appreciated can deduct maintenance expenses, but one whose former residence has depreciated and who has no realistic hope that he will be able to sell it for more than its original cost cannot, if both are holding their former residences for appreciation after they have moved out. They are spending money in similar circumstances to realize gain on sale of their former residences.\(^6\)

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64. This requirement has not been a significant factor. No court has stated that its reason for disallowing deductions for expenses and depreciation was the taxpayer's failure to hold his former residence for gain over cost.


66. 54 T.C. at 1302.

67. Section 212 states, in relevant part:

[T]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the protection of income . . . .

I.R.C. § 212 (1982). The regulations provide the following interpretation:

Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under § 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.

Treas. Reg. § 1.212-1(b) (as amended in 1975).

68. 54 T.C. at 1304 (Forrester, J., concurring).

69. Although the majority opinion in *Newcombe* did not suggest this reasoning, the requirement that property be held for gain over its cost could be justified by the fact that a taxpayer cannot generally deduct a loss on the sale of a former residence. See *infra* notes 267-74 and accompanying text. Therefore, amounts spent to avoid or reduce the loss should also

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When a person has permanently moved out of a residence and offered it for sale, he is in the same position as an owner of property that was originally purchased for investment. Both owners are holding the property only because they hope to realize the highest possible value from it. Perhaps, the personal motive that existed when a person first purchased the residence should affect his tax treatment, but at some point past motives should become irrelevant. The Tax Court apparently accepted this conclusion in Newcombe and set forth conditions for a person who offers a former residence for sale to deduct ordinary and necessary expenses. However, the court never satisfactorily explained why or how these conditions transform personal property into property held for the production of income.

Whatever their theoretical justification, the requirements set forth in Newcombe have had the effect of preventing taxpayers who have not offered their former residence for rent from deducting maintenance expenses or depreciation. Since Newcombe, only one case, Lowry v. United States, has allowed a taxpayer to deduct ordinary and necessary expenses for a former residence, when he has not offered the property for rent. In Lowry, the court held that the taxpayer was holding a summer residence for future appreciation, but ignored facts that directly contradicted this conclusion.

This reasoning, however, is flawed. The loss is not deductible because it is assumed to be personal. The decline in value, from which the loss arises, is presumed to represent the cost of resources used to provide shelter. See infra note 274 and accompanying text. On the other hand, maintenance expenses for a residence that has been abandoned for personal use do not have a personal component and are only incurred to help the taxpayer realize the maximum value from the property.

70. 384 F. Supp. 257 (D.N.H. 1974). The taxpayer had a summer residence which he ceased using after moving his primary residence to New Hampshire. Id. at 259. The taxpayer kept the summer residence in good condition but did not rent it because he felt the expenses involved in renting would outweigh any profit incurred. Id. In holding in favor of the taxpayer, the court explained that the "[a]dministrative difficulty in determining when personal property is transformed into investment property should not create a rigid and inflexible barrier . . . [The taxpayer] gave sound and substantial business reasons for his failure to rent." Id. at 261.

71. In one letter ruling a taxpayer was able to deduct ordinary and necessary expenses, but the facts were quite unusual. Priv. Ltr. Rul. 8030017 (Apr. 22, 1980). The taxpayer, who lived in a nursing home, had been declared incompetent, and a bank was appointed the curator. Id. The bank did not sell the taxpayer's former residence because its value was increasing and did not rent it because the taxpayer had sufficient income. Id. The ruling held that the taxpayer could deduct ordinary and necessary expenses under § 212. Id. (citing Newcombe v. Commissioner, 54 T.C. 1298 (1970)).

72. The taxpayer sold the property approximately six years after he had first offered it for sale at the same price that another person had offered to him five years earlier. The taxpayer could not accept the earlier offer because the potential buyer did not get the needed approval of the homeowners' association. Lowry, 384 F. Supp. at 259.
II. FORMER RESIDENCE OFFERED FOR RENT

A. Conversion to Property Held for Production of Income

1. No Personal Use During Year.— Courts have often held that an owner who offers his former residence for rent has converted it from personal property to property held for the production of income. See, e.g., Robinson v. Commissioner, 2 T.C. 305 (1943); McBride v. Commissioner, 50 T.C. 1 (1968); Corson v. Commissioner, 24 T.C.M. (CCH) 1107 (1965), aff'd per curiam, 369 F.2d 367 (3d Cir. 1966); cf. Bolaris v. Commissioner, 81 T.C. 840, 848 (1983), aff'd in part, rev'd in part, 776 F.2d 1428 (9th Cir. 1985) (taxpayers conceding that it was not a trade or business). See generally infra note 122 (discussing the statutory allowance of deductions for a former residence). Even if the former residence is rented for 19 years, as in Heiner v. Tindle, 276 U.S. 582 (1928), or the taxpayer is holding it primarily for rent, as in McAuley v. Commissioner, 35 T.C.M. (CCH) 1236 (1976), courts have held that owning the former residence is not a trade or business. Courts have, however, held that owning a former residence is a trade or business when the owner sells it at a loss. See infra note 272 and accompanying text; see also Christie v. Commissioner, 39 T.C.M. (CCH) 1172 (1980) (owning a former residence may be either a trade or business or a profit-seeking activity); O'Madigan v. Commissioner, 19 T.C.M. (CCH) 1178, 1185 (1960) (same).

It usually does not make any difference whether ordinary and necessary expenses and depreciation for a former residence are deductible pursuant to § 162 and § 167(a)(1), which allow deductions for items incurred in connection with businesses, or pursuant to § 212 and § 167(a)(2), which allow deductions for items incurred in connection with profit-seeking activities that may not be businesses. I.R.C. §§ 162, 167(a), 212 (1982 & Supp. IV 1986). In either case, maintenance expenses and depreciation are not itemized deductions. See infra notes 78-81 and accompanying text. Whether owning a former residence is a business or an activity carried on for profit will, however, usually determine the characterization of any recognized loss. See infra note 272 and accompanying text.

74. Interest is no longer generally deductible because of § 163(h). Interest incurred in a passive activity, qualified residence interest, and interest incurred in a trade or business, however, are generally allowed as deductions. I.R.C. § 163(h)(2) (Supp. IV 1986). Offering a former residence for rent is probably a passive activity. See infra note 90. In addition, the interest may be qualified residence interest. For a discussion of qualified residence interest, see supra notes 31, 35-38 and accompanying text. For discussion of a former residence qualifying as a trade or business, see infra note 272.


76. I.R.C. §§ 167(a), 212 (1982); Treas. Reg. § 1.212-1(h) (as amended in 1975). If a former residence offered for rent were not considered property used in a business or held for the production of income, qualified residence interest and property taxes, as well as other expenses to the extent income exceeded those two items, would be deductible. I.R.C. § 183(b) (1982); see also supra notes 31, 35-38 and accompanying text (discussing qualified residence interest).
Because the deductions are "attributable to property held for the production of rents," they will not be "itemized deductions." Therefore, they will be deductible whether or not the taxpayer itemizes deductions and will not be affected by the floor of two percent of adjusted gross income for "miscellaneous itemized deductions."

Rental income and deductions for a former residence are generally calculated in the same way as for dwelling units that had been originally purchased as rental property, as long as the owner has not lived in the property at all during the year. There are, however, some special considerations in calculating depreciation deductions. First, the basis used in computing depreciation is the lesser of the adjusted basis or the fair market value at the time the property was converted to property held for the production of income. Second, a residence converted before January 1, 1987, is depreciated according to the statute that was in effect on the date the residence was purchased and available for personal use. A residence that is converted after December 31, 1986, however, is apparently depreciated according to the rules established by the Tax Reform Act of 1986.

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77. See infra notes 86-120 and accompanying text (discussing passive activity rules and personal use limitations).
78. I.R.C. § 62(a)(4) (Supp. IV 1986). It does not matter that the property is being offered for sale as well as for rent; the deductions are being allowed because the property is being offered for rent. See infra notes 121-46 and accompanying text.
79. I.R.C. § 63(d) (Supp. IV 1986); Christie v. Commissioner, 39 T.C.M. (CCH) 1172 (1980).
80. I.R.C. § 63(b) (Supp. IV 1986); Christie v. Commissioner, 39 T.C.M. (CCH) 1172 (1980).
82. The taxpayer must also not be "deemed" to have used the property "for personal purposes" in other ways. I.R.C. § 280A(d)(2) (1982). Use of the unit by a family member other than as a principal residence or by anyone when fair rental is not charged are among the ways the unit may be considered used for personal purposes. I.R.C. § 280A(d)(2), (3) (1982). For a discussion of possible tax consequences if the taxpayer has used the property for personal purposes, see infra notes 103-20 and accompanying text.
83. Treas. Reg. § 1.167(g)-1 (as amended in 1964).
Section 469, which was enacted by the Tax Reform Act of 1986,\(^86\) may defer the deduction of expenses from renting a former residence.\(^87\) It generally allows losses from "passive activities" to be deducted in any year only to the extent the taxpayer has income from "passive activities."\(^88\) Disallowed losses are carried forward and can be deducted against income from passive activities in subsequent years.\(^89\) Renting a former residence will usually be considered a passive activity.\(^90\) Passive activity losses, however, are computed without amended in 1973). Technical corrections for the Tax Reform Act of 1986, which have not been enacted at the time of this writing, would explicitly provide that the depreciation rules established by the Tax Reform Act would apply to "real property which was acquired before January 1, 1987, and was converted on or after such date from personal use to a use for which depreciation is allowable." Technical and Miscellaneous Revenue Act of 1988, H.R. 4333, 100th Cong., 2d Sess., § 1002(c)(7), 134 CONG. REC. H10867 (daily ed. Oct. 21, 1988).

The General Explanation of the Tax Reform Act of 1986 states that if a former residence is converted after December 31, 1986, it will be depreciated according to the statute that is in effect at the time of conversion when the depreciation is "less generous" than that provided by the statute when the property was purchased. General Explanation of the Tax Reform Act of 1986, supra note 38, at 112 n.6. Rules for depreciating real property after 1986 are generally less generous than they were between 1981 and 1986, but possibly more generous than they were before 1981. This definition of "placed in service," however, does not seem to be a reasonable interpretation of the statute.

88. I.R.C. § 469(a) (Supp. IV 1986).
89. I.R.C. § 469(b) (Supp. IV 1986).
90. A passive activity includes any "rental activity," I.R.C. § 469(c)(2) (Supp. IV 1986), which is defined as an activity where "payments are principally for the use of tangible property." I.R.C. § 469(j)(8) (Supp. IV 1986). However, temporary regulations provide that use of tangible property is not a rental activity, and thus not a passive activity, if rental of the property is incidental to holding it for investment. Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(D), (vi) (1988). Rental of property during a taxable year is incidental to holding it for investment if two conditions are satisfied. First, the principal purpose of holding the property during the taxable year is realization of gain from appreciation. Second, the gross rental income during the taxable year from the property is less than 2% of the lesser of the unadjusted basis or fair market value of the property. Temp. Treas. Reg. § 1.469-1T(e)(3)(vi)(B) (1988). It is not clear whether the first condition will be satisfied when an owner offers a former residence for rent, but holds it primarily for sale. The second condition, of course, depends on the amount of rental proceeds.

Technical corrections to the Tax Reform Act of 1986 provide that gain or loss from a residence will not be passive gain or loss if § 280A(c)(5) applies to its use during the taxable year. Technical and Miscellaneous Revenue Act of 1988, H.R. 4333, 100th Cong., 2d Sess., § 1005(a)(10), 134 CONG. REC. H10867 (daily ed. Oct. 21, 1988); see also Temp. Treas. Regs. § 1.469-1T(e)(5) (1988). Since former residences that are offered for rent are generally not subject to I.R.C. § 280A(c)(5) (1988), this provision should not apply when an owner offers a former residence for rent. See infra note 109 (discussing § 280A(c)(5)).
regard to "qualified residence interest," which is the interest on a loan secured by a principal or qualifying designated residence that can be deducted even if not incurred with respect to a profit-seeking activity.

Since deductibility of interest (other than qualified residence interest) and property taxes can be affected by section 469, the taxpayer may be adversely affected by the conversion of his residence to property held for the production of income. Without the conversion, he could deduct interest and property taxes in the current year. With the conversion, the deductibility of interest and property taxes...
in the current year could be restricted unless he has passive income from other sources. 95

Section 469, however, will not often be a problem for the middle-income taxpayer who offers a former residence for rent. He can deduct up to $25,000 of losses if his adjusted gross income (without regard to passive activity losses and with certain other minor modifications) is $100,000 or less and if he actively participates in the management of the former residence. 96 If his adjusted gross income is between $100,000 and $150,000, the maximum amount of losses that can be deducted is reduced proportionately from $25,000 to zero. 97

In addition, deferred losses from a passive activity will become deductible when the taxpayer sells his entire interest in the activity and recognizes the gain or loss. 98 Therefore, a taxpayer who was not able to deduct losses from a former residence because of section 469 will be able to deduct them when he sells the former residence and recognizes the gain or loss. 99 Often, however, a taxpayer who sells a former residence at a gain will not recognize some or all of the gain

95. The possibility of a taxpayer being adversely affected by converting his former residence to property held for the production of income can be illustrated with an example. A owns a former residence and pays $10,000 in mortgage interest and property taxes in the current year. Assume first that A does not use the former residence for personal purposes and does not offer it for rent during the year. He can deduct $10,000 since property taxes and qualified residence interest are deductible. I.R.C. § 164(a)(1) (1982); I.R.C. 163(h)(2)(D) (Supp. IV 1986). Despite questions raised by temporary regulations to § 163, the mortgage interest should generally be qualified residence interest. See supra notes 34-38 and accompanying text. On the other hand, if A successfully offers the former residence for rent during the year, the interest will not be qualified residence interest, and both the interest and property taxes will be subject to § 469. Assume that A had rented the property for only one month, receiving rental income of $500, and has no other passive income during the year. He is then able to deduct only $500 of interest and property taxes in the current year; the remaining $9500 (plus deductions for depreciation and maintenance expenses) is deferred under § 469. A may be better off deducting $10,000 than having rental income of $500, current deductions of $500, and large amounts of deferred deductions.

96. I.R.C. § 469(i) (Supp. IV 1986). The $25,000 amount and the income limit are generally reduced by one half for married taxpayers filing separately, but there is no exemption if they do not live apart during the year. I.R.C. § 469(i)(5)(Supp. IV 1986). A taxpayer should often have no trouble satisfying the requirement that he actively participate in the management of a former residence: "a taxpayer who owns and rents out an apartment that formerly was his primary residence . . . may be treated as actively participating even if he hires a rental agent and others provide services such as repairs." General Explanation of Tax Reform Act of 1986, supra note 38, at 244; see also S. Rep. No. 313, 99th Cong., 2d Sess. 738 (1986).


98. I.R.C. § 469(g) (Supp. IV 1986).

99. Id.
under section 121\textsuperscript{100} or section 1034\textsuperscript{101} and will then not be able to
deduct any deferred losses on sale.\textsuperscript{102}

2. Personal Use During Year.—If an owner uses a residence
for personal purposes in the same year that he offers it for rent,
there may be additional restrictions on the allowance of deductions.
Section 280A generally limits deductions for a dwelling unit when
the owner uses it for both personal and profit-related purposes during
the same year.\textsuperscript{103} The section prevents any deduction for mainte-
nance expenses and depreciation in the year the taxpayer moves out
of his residence if he does not successfully rent the property.\textsuperscript{104} Sec-
tion 280A, however, will not apply in years subsequent to the year
that the taxpayer has permanently moved out.\textsuperscript{105} Therefore, if the
taxpayer permanently moves out of his residence on December 31,
and offers the property for rent on January 1, section 280A does not
apply to the second year, which is the year in which ordinary and
necessary expenses and depreciation would normally be deductible.

When Congress passed section 280A in 1976, the drafters were
not thinking about a principal residence that was converted to prop-
erty used in a profit-related activity. Rather, Congress was con-
cerned about deductions for an office in the taxpayer's home and for
a vacation home that the taxpayer was both renting out and using
for personal vacations.\textsuperscript{106} In fact, in 1978 Congress specifically
amended section 280A so that one of its provisions would not apply
to a residence from which the taxpayer had permanently moved dur-
during the year.\textsuperscript{107} Nevertheless, other parts of section 280A are clearly

\textsuperscript{100} I.R.C. § 121 (1982), discussed \textit{infra} note 214 and accompanying text.
\textsuperscript{101} I.R.C. § 1034 (1982 & Supp. IV 1986), discussed \textit{infra} notes 167-68 and accompa-
nying text.
\textsuperscript{102} \textit{See generally} General Explanation of the Tax Reform Act of 1986, \textit{supra}
note 38, at 225-30. A taxpayer who sells a former residence at a loss will, pursuant to §
469(g), probably be able to deduct any operating losses that have been deferred. Although
some or all of the loss on sale is considered personal and thus nondeductible, the taxpayer can
always deduct any loss arising from a decline in value after he has successfully offered the
former residence for rent. For a discussion of loss deduction on sale of a former residence, see
\textit{infra} notes 267-74 and accompanying text.
\textsuperscript{104} I.R.C. § 280A(e)(1) (1982). For discussion of this provision, see \textit{infra} notes 111-17
and accompanying text.
\textsuperscript{105} \textit{See} I.R.C. § 280A(a), (e) (1982).
Cong. & Admin. News 4118, 4144-45; Staff of Joint Comm. on Tax'N, 94th Cong., 2d
Sess., General Explanation of the Tax Reform Act of 1976, at 136-46 (Comm. Print
1976).
\textsuperscript{107} Revenue Act of 1978, Pub. L. No. 95-600, §701(h), 92 Stat. 2767, 2904 (codified
applicable to a person who converts a former residence to property used in a profit-seeking activity by offering it for rent.

Two separate provisions of section 280A can limit deductions for a former residence, but neither affects those deductions that would be allowable without regard to a profit-seeking purpose. Section 280A(e)(1), which applies if there has been any personal use of the dwelling unit at all during the year, provides that deductions for expenses attributable to rental of a dwelling unit shall not "exceed an amount that bears the same relationship to such expenses as the number of days during each year that the unit . . . is rented at a fair rental bears to the total number of days during the year that the unit . . . is used." Therefore, for expenses like insurance, the taxpayer must prorate the insurance cost between the number of days that the property was rented at fair rental and the number of days the property was used; only the amount allocable to the period during which the property was rented can be deducted. The amount allowable may be less than would be allowed under section 162 or


108. It is not clear whether in 1978 Congress was aware of the continuing impact of § 280A on former residences; "[t]he Congress does not believe that the personal use of a principal residence for a portion of the taxable year should result in the disallowance of deductions for the period when the residence has been converted to rental property." STAFF OF JOINT COMM. ON TAX'N, 96TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, at 346 (Comm. Print 1979); see also S. REP. No. 745, 95th Cong., 2d Sess. 20 (1978) (similar view stated); STAFF OF JOINT COMM. ON TAX'N, 97TH CONG., 1ST SESS., SUMMARY OF H.R. 5159, at 11 (Comm. Print 1980) (same), reprinted in 2 TAX MANAGEMENT PRIMARY SOURCES, SERIES IV, § 280A, at 26 (1981).

109. One of the key provisions of § 280A does not generally apply to a residence that has been converted to property held for the production of income. I.R.C. § 280A (1982 & Supp. IV 1986). Section 280A(c)(5) prevents the taxpayer from deducting a loss from a dwelling unit when there is substantial personal use in the same year. A special rule, however, provides that there is no personal use of a principal residence for this purpose if the use is before a period during which the unit is held for rental and which ends with sale of the dwelling unit. I.R.C. § 280A(d)(4) (1982).


If the owner moves out of his residence and unsuccessfully offers it for rent in that year, section 280A(e)(1) will not allow him to allocate any of his ordinary and necessary expenses or depreciation to the period during which it was being held for rent. Thus no deduction, except for qualified residence interest and property taxes, will be allowed. The property must actually be rented for any allocation to be possible. Of course, if the owner is still trying to rent the property in the next year and has not reoccupied it, section 280A will not apply, and the deductions will be permitted.

Section 280A(g) can also limit deductions for a residence that has been converted to property held for the production of income, but it only applies if the taxpayer lives in the residence or uses it for other personal purposes for more than fourteen days. It provides that if a taxpayer rents his residence for less than fifteen days during the taxable year, then no deduction from the rental use of the property shall be allowed and the income derived from such rental will not be included in gross income. Therefore, if the owner moves out of his residence after having lived there more than fourteen days and successfully rents it for fourteen days or less in that year, section 280A(g) will not allow him to deduct ordinary and necessary expenses (other than qualified residence interest and property taxes) or depreciation. He will also not have to include the rental proceeds in income, but the loss of the deductions will often outweigh the benefit of not reporting the income.

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114. I.R.C. § 212 (1982 & Supp. IV 1986). For example, if a dwelling unit is used for personal purposes for 100 days and is rented at a fair value for 100 days, one half of the insurance costs would be allowed under § 280(e)(1). Yet, the insurance expense may have been greater for the time that the property was rented than for the time that it was used for personal purposes.


116. For the definition of qualified residence interest, see supra notes 31, 35-38 and accompanying text.


118. See I.R.C. § 280A(d) (1982), discussed supra note 82.

119. Section 280A(g) applies when a taxpayer uses the dwelling unit for personal purposes in excess of the greater of 14 days or 10% of the number of days during the year that the unit is rented at a fair rental. I.R.C. § 280A(d)(1), (g) (1982). If § 280A(g) is to apply, 14 days has to be greater than 10% of the number of days that the unit is rented, since a second requirement for § 280A(g) is that the unit be rented for less than 15 days.

120. I.R.C. § 280A(g) (1982).
B. The Cases

Most cases support the rule that, when the owner has permanently moved out of his residence and offered it for rent at fair market value, he has converted it from personal property to property held for the production of income.\(^\text{121}\) It is irrelevant whether the offer to rent is unsuccessful. One of the early cases is \textit{Robinson v. Commissioner},\(^\text{122}\) which was decided by the Tax Court in 1943. The taxpayer in \textit{Robinson} had moved out of her residence in 1931. She offered it for sale or rent, but was unsuccessful despite numerous negotiations.\(^\text{123}\) The court held that deductions for maintenance expenses and depreciation were allowable for the years 1936 and 1937 since the property had been "appropriated to income-producing purposes by affirmative action, in that the property had been abandoned as a residence and had been listed for rent or for sale with two real estate firms."\(^\text{124}\)

A taxpayer may deduct maintenance expenses and depreciation for a former residence, even if it seems clear that his primary goal is to sell and that an unsuccessful offer to rent is only a possible way of defraying some expenses until the property is sold. In \textit{Sherlock v.}\(^\text{122}\)

\(^{121}\) See, e.g., Bolaris v. Commissioner, 776 F.2d 1428, 1431 (9th Cir. 1985); Christie v. Commissioner, 39 T.C.M. (CCH) 1172, 1178 (1980); McAuley v. Commissioner, 35 T.C.M. (CCH) 1236, 1241 (1976) (former residence at first offered only for rent, not for sale); Sherlock v. Commissioner, 31 T.C.M. (CCH) 383, 386 (1972); Cowles v. Commissioner, 29 T.C.M. (CCH) 884, 884-85 (1970) (dictum); Corson v. Commissioner, 24 T.C.M. (CCH) 1107, 1113 (1965), \textit{aff'd per curiam}, 369 F.2d 367 (3d Cir. 1966), \textit{cert. denied}, 387 U.S. 919 (1967); O'Madigan v. Commissioner, 19 T.C.M. (CCH) 1178, 1185-86 (1960); Jones v. Commissioner, 22 T.C. 407, 414-15 (1954), \textit{rev'd on other grounds}, 222 F.2d 891 (7th Cir. 1955); Horrmann v. Commissioner, 17 T.C. 903, 907-08 (1951); Robinson v. Commissioner, 2 T.C. 305 (1943). \textit{But see} Melone v. Commissioner, 45 T.C. 501 (1966) (holding that taxpayers were not able to deduct maintenance expenses and depreciation because they rented their former residence for less than fair market value).

It should be noted that conversion for purposes of deducting ordinary and necessary expenses and depreciation does not necessarily mean that the taxpayer can deduct a loss on sale of the former residence. \textit{See infra} notes 267-81 and accompanying text.

\(^{122}\) 2 T.C. 305 (1943). The Tax Court interpreted new \S\ 121 of the Revenue Act of 1942, ch. 619, \S\ 121(a), (c), 56 Stat. 798, 819, which had enacted the predecessors of \S\ 212 and \S\ 167(a)(2) of the present Code and made them retroactive. Prior to the Revenue Act of 1942, taxpayers could deduct ordinary and necessary expenses and depreciation for a trade or business, but were not entitled to these deductions for property held for the production of income. A former residence that is offered for rent generally does not constitute a trade or business. \textit{See supra} note 73. The Third Circuit had originally held that the taxpayer in \textit{Robinson} could not deduct ordinary and necessary expenses and depreciation, but remanded to the Tax Court to consider the effect of the Revenue Act of 1942. \textit{Robinson}, 134 F.2d 168, 169 (3d Cir. 1943).

\(^{123}\) \textit{Robinson}, 2 T.C. at 307.

\(^{124}\) \textit{Id.}
Commissioner, the taxpayers had moved out of their residence in November, 1964, and offered it for sale only. When no offers to purchase were received in the first ninety days, the property was also offered for rent. The property was sold in 1966, without the taxpayers having received any offers from prospective renters. The Tax Court in a memorandum decision held that petitioners had "converted [their former residence] from personal residential property to 'property held for the production of income'" and allowed maintenance expenses and depreciation to be deducted. The court stated that the "primary factor in [the taxpayers'] favor is the presence of an offer to rent."

In Sherlock, the Service also challenged a deduction for depreciation separately from the deductibility of maintenance expenses. The Service argued that the former residence was not depreciable under section 167 for two reasons. The first was that the property had no depreciable basis because the taxpayers expected to sell it at a price in excess of its adjusted basis. The second was that the former residence had no depreciable life because the taxpayers were

125. 31 T.C.M. (CCH) 383 (1972).
126. Id. at 384.
127. Id.
128. Id.
129. Id. at 385.
130. Id.; see also Bolaris v. Commissioner, 776 F.2d 1428 (9th Cir. 1985). The taxpayers in Bolaris successfully rented their former residence, but their primary purpose was to sell. Id. at 1429. Although the taxpayers had a net loss from the rental activity, they were allowed to deduct maintenance expenses and depreciation. Id. at 1432-33. For a discussion of Bolaris, see infra notes 150-90 and accompanying text.
131. 31 T.C.M. (CCH) at 385. The court held that "[w]hile...a bona fide offer to rent is no longer considered the 'focal point,' [after Newcombe v. Commissioner, 54 T.C. 1298 (1970)], we still consider it of substantial importance so long as 'the adverse state of the market for rental property' does not rob such an offer of its significance." Sherlock v. Commissioner, 31 T.C.M. at 385 (quoting Newcombe v. Commissioner, 54 T.C. 1298, 1301 (1970)).
132. Sherlock, 31 T.C.M. (CCH) at 386.
133. I.R.C. § 167 (1982 & Supp. IV 1986). The Service made a similar argument in Newbre v. Commissioner, 30 T.C.M. (CCH) 705 (1971). In Newbre, the taxpayer was holding his former residence for sale only, and the court held that the residence was not converted to property held for the production of income. Id. at 707. Therefore, the court did not have to rule separately on the deductibility of depreciation. Id. In Sherlock, the court indicated that the Service's argument concerning depreciation had "substantial appeal" when the residence is held for sale only. 31 T.C.M. (CCH) at 386. However, this argument would be irrelevant when the residence is held only for sale. Depreciation is not deductible when the residence has not been converted to property held for the production of income. See supra note 33 and accompanying text.
134. Sherlock, 31 T.C.M. (CCH) at 386. Under § 167, the depreciable basis is the taxpayer's adjusted basis minus salvage value. Treas. Reg. § 1.167(a)-1(a) (as amended in 1972).
holding the residence for immediate sale.\footnote{135} Under section 167, the depreciable life is the amount of time the taxpayers expect to utilize an asset.\footnote{138}

The court held for the taxpayers and allowed depreciation to be deducted.\footnote{137} It reasoned that if the sales market had remained unfavorable and a good rental opportunity arose, the taxpayers probably would have continued to rent the property for its entire useful life.\footnote{138} Therefore, depreciation should be calculated in accordance with that assumption. The Service has apparently abandoned its position and has not made similar arguments in cases subsequent to \emph{Sherlock}.\footnote{139}

In order to deduct maintenance expenses and depreciation, the taxpayer must have a "reasonable expectation of realizing rental income" from the former residence.\footnote{140} Bona fide attempts to rent the property are not sufficient if due to the lack of a rental market, there is little likelihood of success.\footnote{141} Therefore, if a former residence becomes uninhabitable, the owner cannot convert it to property held for the production of income.\footnote{142}

Although many cases have held that a bona fide offer to rent at

\footnote{135} \textit{Sherlock}, 31 T.C.M. (CCH) at 386.  
\footnote{136} See Tres. Reg. § 1.167(a)-1(b) (as amended in 1972).  
\footnote{137} \textit{Sherlock}, 31 T.C.M. (CCH) at 386.  
\footnote{138} \textit{Id.} at 386-87.  
\footnote{139} The depreciation deduction is currently calculated under § 168 for residences that have been placed in service after December 31, 1980. I.R.C. § 168 (Supp. IV 1986). Under § 168, useful life and salvage value of a particular asset do not affect the depreciation deduction. Nevertheless, the holding in \textit{Sherlock} may have significance for property depreciated under the rules of § 168. To be depreciated under § 168, the property must be depreciable under § 167. I.R.C. § 168(a) (Supp. IV 1986). The argument in \textit{Sherlock} that the former residence did not have any useful life or that it did not have a depreciable basis may be equivalent to the argument that the property was not depreciable. Consequently, a holding in favor of the Service in \textit{Sherlock} could have been used to support challenges to the deduction of depreciation for former residences placed in service after December 31, 1980.  
\footnote{140} \textit{Meredith} v. Commissioner, 65 T.C. 34, 42 (1975). In \textit{Meredith} the taxpayer made little effort to rent her vacation home, but the possibility of renting it would have been very low even if she had made a greater effort. \textit{Id.} Although the court generally emphasized the taxpayer's lack of effort, it also indicated that a "reasonable expectation of realizing rental income" is a threshold requirement. \textit{Id.} Therefore, to deduct ordinary and necessary expenses and depreciation, I.R.C. §§ 167, 212 (1982 & Supp. IV 1986), the taxpayer would have to demonstrate bona fide efforts to rent the property and show that there was some reasonable expectation of rental. \textit{Meredith}, 65 T.C. at 42.  
\footnote{141} See supra note 140 (discussing \textit{Meredith} v. Commissioner).  
\footnote{142} See Leslie v. Commissioner, 6 T.C. 488 (1946), discussed supra notes 45-47 and accompanying text. In \textit{Leslie}, the taxpayers moved out and offered their residence for sale when it was damaged by a hurricane. \textit{Id.} at 489-90. Although the former residence was uninhabitable and the taxpayers therefore did not have the option of renting it, the Tax Court held that they could not deduct maintenance expenses. \textit{Id.} at 494-95.
FORMER RESIDENCES

fair market value converts a residence to property held for the production of income, the law is not completely settled. The Internal Revenue Service frequently takes the position that a taxpayer who offers to rent a former residence, but holds it primarily for sale, should not be allowed a deduction for maintenance expenses and depreciation. The Service was successful in *MaDan v. Commissioner*, but the court paid little attention to this issue and did not acknowledge that its decision was inconsistent with previous court cases.

Cases which hold that an offer to rent converts a residence have not attempted to justify this rule. Perhaps the courts have considered it obvious that a taxpayer trying to rent his former residence should have the same tax consequences as a taxpayer offering for rent property that he had never used as a residence. However, a taxpayer trying to sell a former residence does not have the same tax consequences as a person offering for sale property never used as a residence. The critical issue, which the courts have ignored, is whether an offer to rent transforms the taxpayer's motivation from one that is primarily personal to one that is primarily profit-seeking. This issue is explored in the following sections.

143. See cases cited supra note 121.

144. See cases cited supra note 121; cf. Priv. Ltr. Rul. 8132017 (Apr. 30, 1981) (disallowing a deduction for maintenance expenses and depreciation in excess of rental income). The government does not always contest the allowance of deductions. See Briley v. United States, 298 F.2d 161 (6th Cir. 1962) (deductibility conceded by government); Andrews v. Commissioner, 41 T.C.M. (CCH) 1533 (1981), aff'd, 685 F.2d 429 (4th Cir. 1982) (Service challenged some particular deductions, but not the taxpayer's right to deduct proper maintenance expenses and depreciation); Rogers v. Commissioner, 24 T.C.M. (CCH) 36, 37 n.3 (1965) (noting that Service allowed depreciation); Fagan v. Commissioner, 9 T.C.M. (CCH) 44 (1950) (deductibility not contested by government, but a dispute existed over basis).

145. 51 T.C.M. (CCH) 241 (1986).

146. The taxpayers wanted to deduct a loss of $17,632.64 stemming from the sale of their former residence and depreciation of $705. *Id.* at 242. The standard for deducting a loss on sale differs substantially from the standard for deducting depreciation. See infra notes 267-81 and accompanying text. The court concentrated on the rules and authority for deducting the loss on sale and appeared to assume that not allowing deduction of the loss also meant that there should be no allowance for depreciation. *Id.* at 242-43.

147. See cases cited supra note 121.

148. See supra notes 44-72 and accompanying text (discussing deductibility of maintenance and depreciation for property offered solely for sale).

149. See cases cited supra note 121.
III. CONVERSION AND NONRECOGNITION OF GAIN ON SALE OF A FORMER RESIDENCE

A. Bolaris v. Commissioner

1. Facts and Presentation of Issues.— In Bolaris v. Commissioner,160 the issue was not only whether the taxpayers had converted their former residence to property held for the production of income, but also whether gain on its sale would not be recognized pursuant to section 1034, which generally applies to property used by the seller as a principal residence.161 The issue of whether a residence that qualified for nonrecognition of gain could also be held for the production of income had not been previously considered in other cases, and the Bolaris opinions discussed whether the taxpayers' positions were inconsistent.162 Bolaris, however, demonstrates the shortcomings of the current approach of allowing deductions for a former residence, even aside from any relationship to deferral of gain under section 1034.163

The taxpayers, husband and wife, began construction of a new house in July 1977, and offered their old residence for sale.164 They moved out of their old residence in October 1977 when the new one was completed.165 After the old residence had been for sale for ninety days and no offers to purchase had been received, the taxpayers decided to offer it for rent while they continued efforts to sell.166 The property was rented from October 1977 to May 1978 under a month-to-month lease. The Bolarises eventually asked the tenant to leave because they thought their chances of selling the house would improve if it were empty.167 The tenant moved out in May 1978, and

152. See 81 T.C. at 845-49 (Tax Court opinion); 776 F.2d at 1428 (Ninth Circuit opinion). For further discussion of these opinions, see infra notes 172-204 and accompanying text.
153. See infra notes 191-204 and accompanying text.
154. Bolaris, 81 T.C. at 842.
155. Id.
156. Id.
157. Id.
the Bolarises accepted an offer to purchase the house about six weeks later. Since the purchasers were having trouble obtaining the necessary financing, the Bolarises leased the house to them for about a month before the sale became final. The house, which had been purchased in 1975 for $44,000, was sold on August 14, 1978, for $70,000.

Although the Bolarises rented the property, the findings of the Tax Court make it clear that their primary goal was to sell. "[T]hey intended and always wanted to sell the old residence as soon as they received a reasonable offer." The Bolarises also had no illusions about the possibility of covering their expenses by renting. The Tax Court's findings stated that "[t]hey had no expectation or intention of making a profit from the rental of their old residence, but instead rented it simply to 'lessen the burden of carrying the property.'" They received gross rental income of $1,271 in 1977 and $2,717 in 1978. In each year the mortgage interest and property taxes attributable to the period that the house was rented exceeded the rental income.

In 1977 and 1978, the Bolarises deducted depreciation, insurance, and miscellaneous expenses incurred while renting their former residence, as well as mortgage interest and property taxes. The

<table>
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<th>1977</th>
<th>1978</th>
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<td>Mortgage interest</td>
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<td>$4911.68</td>
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<tr>
<td>Property taxes</td>
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<td>720.32</td>
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<td>Insurance</td>
<td>236.00</td>
<td>0.</td>
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<tr>
<td>Miscellaneous expenses</td>
<td>542.67</td>
<td>692.12</td>
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<tr>
<td>Depreciation for house and certain appliances</td>
<td>373.00</td>
<td>1120.16</td>
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With rental income of $1271 in 1977 and $2717 in 1978, the taxpayers had a loss of $3638 in 1977 and $4727.28 in 1978. The Internal Revenue Service disallowed deductions of $1153 in 1977 and $1812 in 1978, which are the amounts for insurance, miscellaneous expenses, and depreciation in each year. The interest and real property taxes could be deducted whether or not the residence was held for the production of income. I.R.C. § 183(b)(1) (1982).

The Tax Court opinion states that the taxpayers had reported a loss of $3,738 in 1977.
Bolarises also did not report gain from the sale of the former residence in 1978.\textsuperscript{166} Although realized gain must generally be recognized, gain from sale of property “used by the taxpayer as his principal residence”\textsuperscript{167} is not recognized under section 1034 if a new principal residence, with a purchase price at least as great as the adjusted sale price of the old residence, is purchased within the required time.\textsuperscript{168} Property that had been used as a principal residence and then converted from the taxpayer’s principal residence to rental property does not, however, qualify for the nonrecognition of gain.\textsuperscript{169}

The Internal Revenue Service made alternative arguments in \textit{Bolaris}. It took the position that the taxpayers should not qualify for nonrecognition of gain on sale of the former residence, but that was not its preferred result.\textsuperscript{170} The primary position of the Service was that the taxpayers should not be able to deduct maintenance expenses and depreciation, since they had not held the property in a business or profit-seeking activity.\textsuperscript{171}

\section*{2. Opinions of the Tax Court and Ninth Circuit.—} The Tax Court judges in \textit{Bolaris} unanimously agreed that the taxpayers should not recognize the gain on sale of their former residence.\textsuperscript{172} “Temporary rentals”\textsuperscript{173} of a former residence that are “necessitated

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\textsuperscript{166} \textit{Bolaris}, 81 T.C. at 843.

\textsuperscript{167} I.R.C. § 1034(a) (1982); see also Treas. Reg. § 1.1034-1(c)(3) (as amended in 1979) (defining property used as principal residence).

\textsuperscript{168} I.R.C. § 1034(a) (1982).

\textsuperscript{169} Rogers v. Commissioner, 45 T.C.M. (CCH) 318 (1982) (almost seven years between taxpayer's moving from residence and sale); Houlette v. Commissioner, 48 T.C. 350 (1967) (almost five years between taxpayer's moving from residence and sale).

\textsuperscript{170} 81 T.C. at 844. The Service raised in an amended answer for the first time the issue of the applicability of I.R.C. § 1034 (1982 & Supp. IV 1986). 81 T.C. at 844.

\textsuperscript{171} 81 T.C. at 848.

\textsuperscript{172} There was one concurring opinion, \textit{id.} at 850 (Körner, J., concurring), and one dissenting opinion, \textit{id.} at 852 (Wilbur, J., dissenting). For discussion of the concurring and dissenting opinions, see infra notes 180-81 and accompanying text.

\textsuperscript{173} 81 T.C. at 846-47.
by the exigencies of the real estate market" do not preclude the application of section 1034.\footnote{174} A majority of the Tax Court, however, held that the taxpayers in Bolaris were not holding the property for production of income and could deduct neither insurance and miscellaneous expenses under section 212 nor depreciation under section 167(a)(2).\footnote{176} The majority opinion reported the Service’s position as follows: “[T]he very factors that demonstrate that petitioners’ rental activities did not preclude the application of section 1034 also demonstrate that their former residence was never held for the production of income within the meaning of sections 167(a)(2) and 212.” The opinion then stated:

[S]uccessfully renting one’s former residence would normally establish that the residence had been “converted” from personal use to business use, and that renting the residence at its fair market value would normally suggest that the taxpayer had the requisite profit objective . . . However, under the facts presented here, we think that the respondent’s position is sound . . . .

. . . [T]he factors cited above in support of petitioners’ entitlement to nonrecognition treatment under section 1034 clearly show that the rental activities in question were not undertaken for . . . purpose [of making a profit]. The very nature of petitioners’ rental activity . . . demonstrates that it was not engaged in for the objective of making a profit.\footnote{178}

The Tax Court majority, however, did not cite a single case where a court had concluded that a taxpayer who had rented property for its fair market value was not holding it for the production of income.\footnote{179} A dissenting opinion would have allowed the Bolarises to

\footnotesize{174. Id. at 847 (quoting Clapham v. Commissioner, 63 T.C. 505, 512 (1975)).

175. The majority opinion in Bolaris relied on Clapham v. Commissioner, 63 T.C. 505 (1975). The taxpayers in Clapham had vacated their old residence in August 1966 and moved to rented housing. Id. at 506-07. When they were unable to sell their former residence, the taxpayers accepted an offer to rent. Id. The house was rented two separate times for a cumulative period exceeding one year. Id. The taxpayers purchased a new residence in September 1968, and their old residence was sold in June 1969. Id. at 507. The Tax Court in Clapham held that gain on sale of the old residence was not recognized pursuant to § 1034. Id. at 512.


177. 81 T.C. at 848.

178. Id. at 849.

179. The only supporting case cited by the Tax Court for disallowance of the deductions was Jasionowski v. Commissioner, 66 T.C. 312 (1976). See 81 T.C. at 849. The taxpayer in Jasionowski leased a residence to a friend for substantially less than fair market value. Jasionowski, 66 T.C. at 314-16. Citing § 183, the Tax Court held that the taxpayer did not have the requisite profit motive and could not deduct expenses and depreciation in excess of rental income.}
deduct insurance and miscellaneous expenses, as well as depreciation. This opinion cited several cases where taxpayers who had moved out of a residence and offered it for sale or rent were able to deduct ordinary and necessary expenses and depreciation.

According to the Ninth Circuit, the Tax Court held "as a matter of law" that a residence which qualifies for nonrecognition of gain pursuant to section 1034 cannot also be held for the production of income. Although the Tax Court majority never explicitly stated such a proposition, the opinion seems to imply it. It said that renting at fair market value, as the Bolarises did, would "normally" allow taxpayers to take the disputed deductions. The Tax Court agreed with the Service's position that the "very factors that . . . did not preclude application of section 1034 . . . demonstrate" that the deductions should not be allowed, and concluded that the Service's "position is sound." The Ninth Circuit affirmed the Tax Court in part and reversed in part. Specifically, the Ninth Circuit rejected the position that a residence could not both qualify for nonrecognition of gain pursuant to section 1034 and be considered held for the production of income. Rather, the court held that the taxpayers did not recognize gain on the sale of the former residence under section 1034 and that they were entitled to deduct both maintenance expenses and depreciation. Judge Reinhardt dissented on the second issue, reasoning

income. Id. at 319.

180. Bolaris, 81 T.C. at 852 (1983) (Wilbur, J., dissenting). Judge Körner also wrote a concurring opinion, although he concurred both in "the result and the reasoning" of the majority opinion. 81 T.C. at 850 (Körner, J., concurring). The concurring opinion clarified that, under the reasoning of the majority, § 183 would have allowed the taxpayers to deduct the disputed expenses and depreciation if there had been sufficient rental income. Id. at 850-52. For a discussion of § 183, see supra note 76.

181. 81 T.C. at 853 (Wilbur, J., dissenting) (citing Briley v. United States, 298 F.2d 161 (6th Cir. 1962); Horrmann v. Commissioner, 17 T.C. 903 (1951); Robinson v. Commissioner, 2 T.C. 305 (1943)). For additional cases that the dissent could have cited, see supra note 121.

182. 776 F.2d 1428, 1431 (9th Cir. 1985).

183. 81 T.C. at 849.

184. Id. at 848.

185. Id. at 849. The court limited its agreement to the "facts presented here," see id., but that does not appear to be a meaningful qualification.

186. 776 F.2d at 1434.


189. The Service took the position that allowing both rental expense deductions and nonrecognition of gain would create an improper "windfall" to the taxpayer. Bolaris, 776 F.2d
that section 1034, on the one hand, and sections 167 and 212, on the other, are "mutually exclusive."\textsuperscript{100}

B. Problems with the Bolaris Decisions

The case law strongly supports both allowance of the disputed deductions in \textit{Bolaris v. Commissioner} and the nonrecognition of gain on sale of the taxpayers' former residence.\textsuperscript{191} Since neither the Tax Court majority nor Judge Reinhardt's dissent directly questioned the validity of the cases, their conclusion that the two positions are inconsistent is unconvincing. Judge Reinhardt cited the House Report for the Revenue Act of 1951, which enacted the predecessor of section 1034, but it is ambiguous:

The term "residence" [in the predecessor to section 1034] is used in contradistinction to property used in trade or business and property held for the production of income. Nevertheless, the mere fact that the taxpayer temporarily rents out either the old or the new residence may not, in the light of all of the facts and circumstances in the case, prevent the gain from being not recognized.\textsuperscript{192}

It is unclear whether the second sentence in the quoted statement is an exception to the first sentence or merely a clarification. In addition, the Tax Court in 1981 allowed the taxpayers in \textit{Andrews v. Commissioner}\textsuperscript{193} to qualify for nonrecognition under section 1034 after it had approved deductions for maintenance expenses and depreciation\textsuperscript{194} without even raising the issue of inconsistency.

The position of the Ninth Circuit majority and the dissenting judges in the Tax Court is also troubling. A deduction by the Bolarises of a net loss from holding and renting their former residence can be justified only if they had converted it to rental property and at 1432. The Ninth Circuit concluded that this concern was not convincing for three reasons: (1) not all rentals of former residences would qualify; (2) any windfall which existed was limited to a period of two years under I.R.C. § 1034(a); and (3) if Congress had intended to prevent such a windfall, it could have limited the application of § 1034 to residences that do not qualify under § 167 and § 212. 776 F.2d at 1432.

\textsuperscript{190} 776 F.2d at 1434 (Reinhardt, J., dissenting).

\textsuperscript{191} \textit{See supra} notes 172-81 and accompanying text.


\textsuperscript{193} 41 T.C.M. (CCH) 1533 (1981), \textit{aff'd}, 685 F.2d 429 (4th Cir. 1982). The \textit{Andrews} decision was not cited by any member of the \textit{Bolaris} court.

\textsuperscript{194} The Service in \textit{Andrews} had unsuccessfully argued that the taxpayer did not qualify for nonrecognition of gain under § 1034. 41 T.C.M. (CCH) at 1544. The Service had not contested the deductibility of ordinary and necessary expenses and depreciation, but had challenged some of the particular deductions. \textit{Id.} at 1543.
were thus holding it for the production of current and future income. On the other hand, a residence that has been converted to rental property does not qualify for nonrecognition of gain pursuant to section 1034. In order to qualify for nonrecognition of gain under section 1034, the property must retain its status as principal residence. The purpose of holding one's residence is presumed to be personal, and that purpose normally precludes characterizing the property as held for the production of income. It appears that these are two mutually exclusive positions.

The problem here comes from the line of cases holding that an owner who is holding a former residence primarily for sale, but who offers it for rent while awaiting sale, has converted the residence to property held for the production of income. As the next two sections of this Article demonstrate, deductibility of ordinary and necessary expenses and depreciation for a former residence should not depend on whether the owner has offered the property for rent. The Tax Court should have directly questioned the continuing validity of the cases, rather than apparently accepting them except in those cases where the taxpayer is also claiming nonrecognition of gain under section 1034.

In fact, the Ninth Circuit may have been troubled by the Bolarises' deducting a net loss when their primary intent was to sell a former residence. It stated that "[w]e view the Bolarises' ancillary desire to sell the old home as an insignificant factor in determining their profit-motive." The statement is incorrect. The Bolarises' de-
sire to sell was clearly primary, not ancillary; their desire to rent was ancillary. When they decided that renting the property was interfering with their chances of selling it, they asked the tenant to leave.202 By misstating the facts, the Ninth Circuit avoided the hard issue. It may also be more than an oversight that the Tax Court, in a recent memorandum decision, did not allow a homeowner to deduct depreciation when the homeowner listed the property for sale or rent.203 Despite the many cases to the contrary, the opinion simply stated that “[i]n the absence of an actual bona fide rental, the listings are not sufficient.”204

IV. DEDUCTING ORDINARY AND NECESSARY EXPENSES

A. Problems with Current Law

The conclusion that the Bolarises should be able to deduct rental expenses and depreciation can be questioned apart from their qualification for deferral of gain under section 1034. The Tax Court majority in Bolaris v. Commissioner stated that the taxpayers would “normally” be entitled to deduct rental expenses and depreciation because they had rented the property at fair market value.205 None of the opinions in Bolaris nor in any of the other cases, however, has examined whether such a rule treats taxpayers fairly.

The Bolarises’ primary goal was always to sell; renting was secondary.206 A basic question that was consistently ignored is why the Bolarises should be treated so favorably in comparison with a person who only tries to sell his former residence. The person who offers a former residence solely for sale cannot generally deduct out-of-pocket expenses incurred to maintain the property or any depreciation.207 The Bolarises, who were renting merely as a stopgap, were not treating their residence very differently from the person who is only trying to sell. Although their rental activity generated a net tax loss, they were allowed to deduct maintenance expenses and depreciation. The person who is offering a former residence solely for sale

similar statement appears in Judge Wilbur’s opinion, it has a much less significant role there than it does in the Ninth Circuit’s opinion.

202. Bolaris, 81 T.C. at 842.
204. Id. at 243.
205. 81 T.C. at 849.
206. Id. at 842.
207. See supra notes 53-69 and accompanying text.
can deduct neither maintenance expenses nor depreciation and is being treated unfairly relative to taxpayers like the Bolarises.

An offer to rent by an owner whose primary purpose is to sell should not determine whether a former residence has been converted to property held for the production of income. Allowing ordinary and necessary expenses and depreciation to be deducted whenever there is an offer to rent is unfair to the person who is offering a former residence only for sale. Furthermore, an owner may offer his former residence for rent solely to deduct expenses and he may hope that his offer will be unsuccessful.

Two possible approaches for determining when deductions for ordinary and necessary expenses should be allowed are presented directly below. The first is generally allowing deductions for a former residence in excess of rental income only if the owner's primary

208. *See supra* notes 53-69 and accompanying text.

209. To illustrate this inequitable treatment, consider two individuals, Smith and Jones. Both move out of their homes on December 31 and purchase new ones. Smith offers his former residence solely for sale. Jones also wants to sell his former residence, but successfully offers it for rent while awaiting an offer to purchase and has rental income of $800. Assume that in the year after they have moved out both Smith and Jones have interest and property tax deductions of $1,000 and incur out-of-pocket expenses of $500 in maintaining their former residences. If a deduction for depreciation were allowed, each could deduct $400. Neither sells his residence during that year. Since Smith neither rents nor uses his former residence during the year, the interest is qualified residence interest and can be deducted. For definition of qualified residence interest, *see supra* notes 31, 35-38 and accompanying text.

According to Bolaris, Jones can deduct $1,900 (interest and property taxes of $1,000, expenses of $500, and depreciation of $400), while Smith can deduct only $1,000 (interest and property taxes). Jones has $800 of rental income and thus ends up with a net deductible loss of $1100 from owning his former residence. (Deductibility of the loss may be restricted by § 469. See I.R.C. § 469 (Supp. IV 1986), discussed *supra* notes 86-102 and accompanying text.) Smith's deductions, on the other hand, total $1,000.

This result makes no sense. Suppose Smith and Jones have the same income and deductions, and would pay the same tax, except for the differences in connection with their former residences. Jones and Smith are now equal in all respects, except that Jones has $800 of rental income that Smith does not have. Jones will pay less tax than Smith, although he clearly has the greater ability to pay. Jones should pay more, not less, tax than Smith.

The assumption in the example that Jones' maintenance expenses are no greater than Smith's may, of course, not be valid. To the extent that renting has caused Jones to have greater costs than Smith, Jones should be able to deduct them. Many of the expenses that the cases would allow Jones to deduct, however, would also be incurred by Smith in maintaining his property while awaiting a buyer. (For a discussion of their relative expenses, *see infra* notes 227-28 and accompanying text.) Furthermore, Jones could deduct maintenance expenses and depreciation even if his offer to rent were unsuccessful. *See supra* notes 121-31 and accompanying text (discussing when the courts have allowed deductions for maintenance and depreciation). In that event, since the primary motivation of both Smith and Jones is to sell, both are in similar positions and should have equal income. Smith, who cannot deduct maintenance expenses and depreciation, is once again being treated unfairly.

purpose is to rent.\textsuperscript{211} Usually the owner of a former residence wants to sell the property, and he will therefore be able to deduct expenses, other than qualified residence interest and property taxes, only to the extent rental income exceeds these two items.\textsuperscript{212} Courts should adopt this approach since it produces sensible results that are an improvement over current law. The second possible approach is to allow deductions as soon as the owner has permanently moved out of his residence.\textsuperscript{213} This would be the correct approach if gains from sales of residences were generally subject to tax, but should probably not be adopted if sections 121\textsuperscript{214} and 1034\textsuperscript{215} are retained in the Internal Revenue Code. In any event, this approach would represent a radical change from current law and should not be adopted without action by Congress. Deductions for depreciation introduce special problems, and are discussed in the following section.\textsuperscript{216}

Sections 469\textsuperscript{217} and 280A\textsuperscript{218} are not considered in the discussion below. The correct approach for conversion of a former residence to property held for the production of income should be determined according to the general rules for distinguishing between deductible profit-seeking expenses and nondeductible personal expenses. These general rules have been established, and should be applied, without regard to such narrowly focused provisions.

\textsuperscript{211} See infra notes 219-29 and accompanying text.

\textsuperscript{212} I.R.C. § 183(b) (1982). For definition of qualified residence interest, see supra notes 31, 35-38 and accompanying text.

\textsuperscript{213} See infra notes 230-39 and accompanying text. A third possible approach would be to not allow any deductions other than qualified residence interest and property taxes to a taxpayer holding a former residence primarily for sale, even if he successfully rents it while awaiting sale. Therefore, he would include the rental proceeds in income, but would not be able to deduct maintenance expenses. This approach would, however, conflict with the general rule that expenses incurred in an activity that is not carried on for profit can generally be deducted to the extent of income from that activity. I.R.C. § 183(b) (1982). There is no reason to treat former residences differently in this respect from hobbies or other activities that are not carried on for profit. In addition, requiring an owner of a former residence to include a gain in income when he has incurred a net loss, as may happen under this approach, will be hard to justify.

\textsuperscript{214} I.R.C. § 121 (1982). Section 121, which applies to persons who are at least 55 years old and can only be used once by each taxpayer, generally provides that gain, up to a maximum of $125,000, is not recognized on the sale of a primary residence. I.R.C. § 121(b)(1) (1982).


\textsuperscript{216} See infra notes 240-66 and accompanying text.

\textsuperscript{217} I.R.C. § 469 (Supp. IV 1986) (passive activity rules), discussed supra notes 86-102 and accompanying text.

\textsuperscript{218} I.R.C. § 280A (1982 & Supp. IV 1986) (limitations on deductions when there are combined personal and rental or business uses), discussed supra notes 103-20 and accompanying text.
B. Two Possible Approaches

1. The Recommended Approach: "Conversion" When Primary Purpose is to Rent.— The law could be changed so that a former residence would not be converted to property held for the production of income unless the owner were holding it primarily for rent. Therefore, an owner who was holding his former residence primarily for sale generally could not deduct maintenance expenses, even if he was also offering it for rent. The primary intent to sell would make holding the property an activity not engaged in for profit. An owner holding primarily for sale would, however, be able to deduct qualified residence interest and property taxes, as well as other expenses to the extent rental income exceeds those two items. Only the net loss, if any, would generally not be deductible.

A person who permanently moves out of a residence that he still owns usually wants to sell it as quickly as possible. If he rents it, the likely reason is that he cannot sell it at an acceptable price. Therefore, in most cases, the proposed rule would generally not allow a person who permanently moves out of a residence that he still owns usually wants to sell it as quickly as possible. If he rents it, the likely reason is that he cannot sell it at an acceptable price. Therefore, in most cases, the proposed rule would generally not allow a

219. A good example of such a taxpayer may be found in Bolaris v. Commissioner, 81 T.C. 840 (1983), aff'd in part, rev'd in part, 776 F.2d 1428 (9th Cir. 1985), discussed supra notes 149-90 and accompanying text. The taxpayers in Bolaris moved out of their residence and then offered it for rent on a short-term basis after they were unable to sell it. See supra notes 150-64 and accompanying text (discussing the facts in Bolaris).


222. Qualified residence interest and property taxes are generally deductible regardless of profit-seeking intent. I.R.C. §§ 163(h)(2)(D), 164(a)(1) (1982 & Supp. IV 1986). In addition, ordinary and necessary expenses for an activity that is not carried on for profit can be deducted to the extent income exceeds those amounts, such as interest and property taxes, that are deductible without regard to a profit-seeking intent. I.R.C. § 183(b)(2) (1982).

223. The example utilized supra note 209 can be used to illustrate this approach:

Smith, who offers his former residence solely for sale, would have the same tax consequences under this approach as under current law; he would be allowed to deduct interest and property taxes, which total $1,000. The tax consequences would, however, differ for Jones, who successfully offers his former residence for rent while holding it primarily for sale and receives rental income of $800. Since his rental income is less than his deductions for interest and property taxes of $1,000, Jones would only be able to deduct $1,000 under the recommended approach. Of course, he would also have to include the $800 rent in gross income. See I.R.C. § 61(a)(3) (Supp. IV 1986).

We can change the facts slightly and assume that Jones has $1200 of rental income (instead of $800). Then, Jones would be able to deduct $1,000 for interest and property taxes and $200 for other expenses since rental income exceeds interest and property taxes by $200. Furthermore, if rental income exceeded $1,900 (which is the sum of interest, property taxes, maintenance expenses, and depreciation), Jones would be allowed to deduct the entire $1,900 of expenses. But see infra notes 259-66 (recommending changes in the current law concerning depreciation).
taxpayer to deduct net losses incurred with respect to a former residence even if he successfully offers it for rent.

This change could be adopted by the courts, although many cases, including Bolaris v. Commissioner,\textsuperscript{224} would have to be overruled. Not allowing a taxpayer who is holding a former residence primarily for sale to deduct net losses does not seem a radical idea. The change would improve current law. The anomaly of substantial tax consequences depending on an offer to rent when the owner's primary purpose is to sell would no longer be present. The person who offers his former residence solely for sale would no longer be treated unfairly in comparison to the person who, while holding his former residence primarily for sale, unsuccessfully offers it for rent. Neither could generally deduct ordinary and necessary expenses. The person who successfully offers his former residence for rent, while holding it primarily for sale, could deduct expenses to the extent of rental income, but a successful offer to rent seems to be a reasonable test for allowing deductions. Furthermore, allowance of deductions would not depend on what might be questionable offers to rent.\textsuperscript{225} To prevent abuses, courts could adopt a rule that a person who has offered his former residence for sale, absent compelling circumstances, is presumed to be holding it primarily for sale until he has entered into a lease that covers substantially more than one year.

Nevertheless, the recommended approach could produce unfair results when a person who holds his former residence primarily for sale and does not rent it is compared to a person who receives sufficient rental income from his former residence to cover his expenses.\textsuperscript{226} Both persons may be incurring similar expenses in connec-

\textsuperscript{224} 776 F.2d 1428 (9th Cir. 1985).
\textsuperscript{225} See supra text accompanying notes 209-10.
\textsuperscript{226} Another example illustrates the problem:

Consider two individuals, Adams and Blair. They have both moved out of their homes on December 31 and purchased new ones. They want to sell their former residences, but have been unable to do so, and both have offered their former residences for rent in order to mitigate costs. Assume both Adams and Blair have interest and property deductions of $1,000 and incur out-of-pocket expenses of $600 in maintaining their former residences. (For a discussion of deductions for depreciation, see infra notes 240-66 and accompanying text.) Adams has rented his former residence and has gross rental income of $1,600. Blair has been unable to rent his former residence. Under the proposed change, Adams would have gross income of $1,600 and deductions of $1,600 as a result of owning his former residence. Therefore, his net income from owning the former residence is zero. Blair, however, would have no gross income and would have deductions of $1,000, which are the interest and property taxes.

Suppose Adams and Blair have the same income and deductions, and would pay the same tax, except for the differences in connection with their former residences. Taking into account their former residences, Adams' taxable income will be $1,000 higher than Blair's; however,
tion with their former residences, such as for insurance, utilities, and repairs, but only the person who has successfully rented his former residence would be able to deduct the expenses.\textsuperscript{227} The proposed rule produces unfair results to the extent the person who rents his former residence can deduct expenses that are also incurred by the person who does not rent his.\textsuperscript{228} It is clearly an improvement over current law, however, and should be adopted.\textsuperscript{229}

their economic positions are identical, except that Adams has $1,600 of income that Blair does not have. Adams' ability to pay is $1,600 higher than Blair's ability to pay. Therefore, the proposed change treats Blair unfairly in comparison to Adams. Blair's taxable income should be $1,600 less than that of Adams, not $1,000 less.

227. This same problem occurs when a person who loses money in a hobby is compared with another who carries on the same type of activity, enjoys it just as much, but makes a profit. The latter, but not the former, is allowed to deduct all expenses even though both get the same enjoyment from carrying on the activity. See Samansky, \textit{Hobby Loss or Deductible Loss: An Intractable Problem}, 34 U. FLA. L. REV. 46, 61-64 (1981).

228. There will often be greater expenses for a house occupied by tenants than for a vacant house. The proposed rule should allow a person who rents his house to deduct any expenses that he would not have incurred but for the occupancy of tenants, but allowance of such deductions would be difficult to implement. In fact, the proposed rule would generally allow ordinary and necessary expenses to be deducted to the extent rental income exceeds qualified residence interest and property taxes. It would, therefore, treat the owner who does not rent his former residence fairly in comparison with the owner who does rent his if the latter's extra expenses equalled the excess of rental income over interest and property taxes that both can deduct. There is, however, no reason to expect that expenses resulting from renting a former residence would generally equal that amount.

229. Under the proposed rule, it is possible that § 67 may apply to deductible maintenance expenses and depreciation. Section 67 only allows "miscellaneous itemized deductions" in excess of 2\% of adjusted gross income to be deducted. Expenses for investment property and for activities not engaged in for profit are generally miscellaneous itemized deductions, but expenses attributable to "property held for the production of rents" are not. Interest and property taxes are specifically excepted from the definition of miscellaneous itemized deductions. I.R.C. § 67(b)(1), (2) (Supp. IV 1986).

Under current law, expenses and depreciation for former residences held for sale or rent are not affected by § 67 because the property is considered held for the production of rents. See supra notes 78-81 and accompanying text (discussing limitation of deductions under § 67). Under the proposed rule, a residence held for sale or rent may not be considered held "for the production of rents" if a taxpayer's primary intent is to sell. Renting is only a means of mitigating costs until the former residence is sold, and deductions are allowed only to the extent of rental income.

Nevertheless, the risk that, if the proposed rule were adopted, § 67 would apply to maintenance expenses and depreciation for a former residence held for sale or rent is probably small. The property could be considered "held for the production of rents" even if rental income is an ancillary goal. The Internal Revenue Service considers vacation homes that are both used for personal purposes and rented to others to be held "for the production of rents," although they may be used primarily for personal vacations. Deductions attributable to rental use of such property are not considered itemized deductions, and thus the vacation homes are considered held "for production of rents." I.R.C. §§ 62(a)(4), 63(d)(1) (Supp. IV 1986); see \textit{Internal Revenue Service, Instructions for Preparing Form 1040}, at 26 (1986); cf. Prop. Treas. Reg. § 1.280A-3(d)(4), 45 Fed. Reg. 52,406 (1980) (classifying interest and
2. An Alternative Approach: "Conversion" When Owner Has Permanently Moved Out.— A former residence could be considered "property held for the production of income" under section 212 immediately after the owner has permanently moved out. If this proposal were adopted, a residence would be converted to property held for the production of income, and ordinary and necessary expenses incurred with respect to the property would be deductible, when the homeowner has moved out and offered it for sale. Of course, ordinary and necessary expenses for a former residence would also be deductible if the owner offered it for sale or rent or solely for rent.

This proposal represents a basic change in current law. Characterization of expenses that had always been assumed to be personal and nondeductible would change. Although courts could adopt this proposal, it is probably the role of Congress to effect such a major change. Since the proposal would allow costs of holding former residences to be generally deductible, Congress should adopt the proposal only if it has also taken into account the treatment of gain from their sale.

Current law, as well as the previous proposal, treat the expenses...
incurred to maintain a residence after the owner has moved out and offered it for sale as personal. Once the homeowner has permanently moved out, however, there can be no personal benefit from any of the expenditures. The only reason for incurring the expenditures is to facilitate sale or rental and thus maximize future or current revenues. Furthermore, when purchasing a residence, the owner usually cannot predict the carrying costs he will subsequently incur in trying to sell it. Therefore, these costs should not be viewed as a likely expense that is assumed whenever one buys a house.

There are, however, several possible objections to the proposed rule. It may treat the person who continues to live in a residence and makes expenditures for repairs or maintenance unfairly. He cannot deduct these expenses since they are presumed to be for his personal benefit. This justification is usually wrong when the homeowner is offering the residence for sale or plans to in the very near future. In that situation the homeowner's primary motivation is probably to facilitate future sale and is very similar to that of the person who has permanently moved out of the residence. The two should be treated equally, but under the proposed rule only the latter will be able to deduct expenses for maintenance and repairs.234

This inequity, however, is inevitable. Determining the motivation for making repairs is impossible when the owner is living in the residence. In all but a very few situations, there will be a strong personal component. Once the person has permanently moved out, however, there can be no personal component. At that point there is no reason to deny a deduction on the ground that the repairs were motivated by personal reasons.

Maintenance costs for a former residence that is held primarily for sale could also be considered nondeductible personal expenses because they are part of the cost of moving.235 These costs, however, directly relate to the attempt to maximize proceeds from sale of the former residence and are, therefore, different from costs such as transporting furniture. The maintenance costs could almost always be avoided by accepting a sufficiently low purchase price for the

234. The scope of this objection can be broadened. Even when a homeowner does not plan to move in the near future, many of the expenses incurred for the residence are justified by the expectation that they will cause the residence to maintain or increase its value.

235. Generally, moving expenses are considered personal and nondeductible. Commissioner v. Mendel, 351 F.2d 580, 583 (4th Cir. 1965). When the taxpayer's move is connected with a new principal place of work, however, § 217 may allow some moving expenses to be deducted. See I.R.C. § 217 (1982).
house.

The basic objection to the proposed rule is that the expenses are deductible currently from ordinary income, but the gain from selling the house will usually not be recognized in the current year. This mismatching is not uncommon and would occur even if sections 121236 and 1034237 were not applicable. Expenses incurred to maintain property held for production of future gain are currently deductible,238 and the gain is not included in income until the property is sold. The expenses should be capitalized and offset any gain (or increase any loss) recognized on sale of the property. Gain on sale of residences, however, receives unusually favorable treatment. Because of sections 121 and 1034, a taxpayer often does not recognize gain when he sells a residence. Under the proposed rule, therefore, mismatching between deduction of expenses and recognition of income would be a more pervasive and serious problem for residences than for other types of property.239

V. DEDUCTING DEPRECIATION

A. Problems with Current Law

Depreciation is an allowance for “exhaustion, wear and tear, and obsolescence” of property used for income-producing purposes.240 Although depreciation is calculated annually according to mandated formulas that make no attempt to match actual declines in value on a year-by-year basis, the basic purpose of the depreciation deduction is to reflect over time the expected decline in value of

239. A taxpayer can deduct ordinary and necessary expenses for a former residence and then not recognize gain on its sale in certain circumstances under current law. See Bolaris v. Commissioner, 776 F.2d 1428 (9th Cir. 1985). Deduction of ordinary and necessary expenses and nonrecognition of gain would, however, be much more prevalent with the proposed rule since many more persons could deduct expenses for a former residence. Under current law a taxpayer must be trying to make a current profit to hold property for the production of income, and that purpose arguably conflicts with the property’s qualification as a “residence” for purposes of § 1034. See supra notes 195-98 and accompanying text (discussing conflict between property’s being held for production of income and its qualification as a residence). But see Bolaris v. Commissioner, 776 F.2d 1428 (9th Cir. 1985) (holding that property held for the production of income may also be eligible for non-recognition of gain). With the proposed rule, however, this conflict would not exist. A former residence would be considered held for the production of income only because the taxpayer was trying to realize its full value on sale, and that purpose is compatible with the concept of a personal residence.
240. I.R.C. § 167(a) (1982); see also Treas. Reg. § 1.167(a)-1 (as amended in 1972) (defining key terms used in § 167).
property. It can be seen as an exception to the general rule that a decline in value can be deducted only after there has been a realization event.

Depreciation should be deductible when an exception to the realization requirement is appropriate. For example, depreciation is generally allowed for an asset used in a business. Annual income from the business should be measured after allowance has been made for the expected decline in value of the asset during the year. On the other hand, a person who is holding inventory or stock in trade is not allowed a deduction for depreciation since there is no reason to allow a deduction for a decline in value before the asset is sold. The owner is probably expecting the asset to increase in value, not decrease. Furthermore, the asset only generates profit when it is sold. If there is a decline in value, it is properly taken into account when the loss is realized.

Current law allows depreciation for a former residence to be deducted whenever maintenance expenses are deductible. This treatment seems to comply with the statutory framework. Since section 167 allows a depreciation deduction for property "used in a trade or business" or "held for the production of income," courts have held that it applies whenever expenses would be deductible.

245. See supra notes 121-39 and accompanying text (discussing the development of current law). The cases dealing with property that taxpayers had not used as a residence support allowing depreciation for former residences. They allow investors in real estate to deduct depreciation even when the investors are not receiving current income and are holding the property only for future appreciation. See Nash v. Commissioner, 60 T.C. 503, 519 (1973); Rockwell v. Commissioner, 31 T.C.M. (CCH) 596, 612 (1972), aff'd, 512 F.2d 882 (9th Cir.), cert. denied, 423 U.S. 1015 (1975); Mitchell v. Commissioner, 47 T.C. 120, 128-29 (1966); Camp Wolters Enters. v. Commissioner, 22 T.C. 737, 754 (1954), aff'd, 230 F.2d 555 (5th Cir.), cert. denied, 352 U.S. 826 (1956). If these investors are allowed deductions for depreciation, then owners of a former residence who can deduct ordinary and necessary expenses should also be allowed depreciation deductions.

under section 162 or 212. The propriety of the depreciation deduction can, however, be questioned. The taxpayers in Bolaris v. Commissioner were holding their former residence primarily for sale and were probably not expecting any decline in its value while they were offering it for sale or rent. Since they were not holding the former residence for current income, there was no reason to allow them to increase the loss attributable to it by an allowance for a decline in value of questionable existence. Any change in value of the former residence should be taken into account when the gain or loss is recognized.

Furthermore, the depreciation deduction in Bolaris presented special problems, which all the opinions ignored. Since a deduction for depreciation reduces basis, allowing the deduction is usually a timing issue. If the depreciation deduction exceeds the decline in value of the asset, the taxpayer will recognize offsetting gain. On the other hand, it seems likely that the depreciation deductions in Bolaris exceeded any decline in value of the residence, but no gain was recognized. It was deferred under section 1034, and will continue to be deferred as long as the taxpayers, whenever they sell a principal residence, purchase a new residence with a cost greater than the adjusted selling price of the old one. Once the taxpayers become fifty-five years old, a large part (if not all) of the gain will be forgiven even if no new residence is purchased. Therefore, the taxpayers in Bolaris were allowed a deduction to reflect a decline in value that probably did not occur; for the immediate future, and probably longer, they will not have taxable gain to offset this unwar-

249. See supra notes 161-64 and accompanying text.
252. I.R.C. § 1034 (1982 & Supp. IV 1986). In many other nonrecognition transactions where there is a carryover basis, the replacement property will be depreciable. Therefore, the depreciation deductions will have an immediate adverse consequence. They will cause the basis of the replacement property to be lower and reduce the depreciation that will be allowed with respect to it. For example, the replacement property in like-kind exchanges and involuntary conversions will often be depreciable. See I.R.C. §§ 1031, 1033 (1982 & Supp. IV 1986).
ranted tax benefit.

The same type of problem can also exist when owners of a former residence have realized a loss on its sale. A decline in value that occurred while the taxpayers were living in the residence would be nondeductible. Depreciation deductions that might be allowed after the taxpayers had moved out would lower basis and reduce the amount of a loss. If the loss is nondeductible, however, there would be no adverse consequences from the loss being smaller. By deducting depreciation, the taxpayers would have transformed a nondeductible personal loss into one that can be deducted.

Rules for deducting depreciation should differ from those for deducting ordinary and necessary expenses. It is argued in Part B of this section that those who are holding a former residence primarily for sale should not be able to deduct depreciation, regardless of the deductibility of ordinary and necessary expenses, and that courts currently have authority to adopt this rule. If the owner is entitled to a deduction for a decline in value, the time of sale is the appropriate time to recognize it. A possible alternative position is that the homeowner should be able to deduct depreciation when ordinary and necessary expenses are deductible, but only to the extent that there is net rental income as computed before any allowance for depreciation. Either approach could be adopted even if the present tax treatment of ordinary and necessary expenses is retained.

B. The Recommended Approach

The person who is holding a former residence primarily for sale should not be allowed a deduction for depreciation whether or not he offers it for rent while awaiting an offer to purchase. It would not matter whether either of the recommendations in the previous section were implemented or whether the taxpayer could deduct ordinary and necessary expenses according to current law. He is not holding the former residence for current income and is probably not expecting it to decline in value during the time he owns it. There is no reason not to wait until he sells the property and realizes a loss.

255. If a loss on sale of a former residence is allowed, the deduction is limited to the decline in value that took place after the property had been rented. See infra notes 273-74 and accompanying text (discussing the effect of basis rules on loss upon sale).
258. Id.; Treas. Reg. § 1.121-1 (as amended in 1975).
259. See supra notes 219-39 and accompanying text (discussing the two recommendations).
before allowing him a deduction for a decline in value. He should be treated like the owner of inventory. Courts could establish different rules for deducting depreciation than for deducting ordinary and necessary expenses by holding that a former residence held primarily for sale has no determinable useful life and that its salvage value is greater than its basis. The former residence would not then qualify as depreciable property. The Tax Court should reconsider its rejection of these arguments in Sherlock v. Commissioner. If the former residence does not qualify as depreciable property, then depreciation cannot be deducted even if the owner successfully rents it and earns a net profit. This result seems appropriate. The owner probably does not expect the value to go down while he holds the former residence. If there is a loss, it would be recognized at time of sale. On the other hand, the former residence could be treated like buildings held for sale in the ordinary course of business. The owner of such buildings may rent the buildings while holding them primarily for sale. Depreciation is then only allowable to the extent of net income (as computed before any deduction for depreciation). It is, however, difficult to justify this treatment under the present statute if ordinary and necessary expenses are deductible whether or not there is net income. If property is depreciable, section 167 allows a deduction for depreciation whenever ordinary and necessary expenses are deductible.

The person whose primary intent is to rent a former residence should be allowed a full deduction for depreciation. He should be treated no differently than the person who holds property that had been originally purchased for investment or business purposes.

260. The taxpayer, however, might not have a deductible loss even if the value of the property goes down during the period that he is offering it for rent. The decline in value may be less than the appreciation that occurred while he was living in the residence. Since he would not have realized a loss on sale of the property, it is appropriate, of course, that there be no deductible loss when it is sold.

261. See supra note 242 and accompanying text (discussing tax treatment of stock in trade and inventory).

262. The statutory useful life and zero salvage value mandated by § 168 are applicable only if the asset is depreciable under § 167. I.R.C. § 168(a) (Supp. IV 1986).

263. 31 T.C.M. (CCH) 383 (1972), discussed supra notes 132-39 and accompanying text.


265. I.R.C. § 167(a) (1982); see supra notes 134-38 and accompanying text.
termining when the taxpayer is holding the former residence primarily for rent may, however, be difficult. As suggested above, a taxpayer who has offered a former residence for sale could, absent compelling circumstances, be presumed to be holding it primarily for sale until he has entered into a lease that covers substantially more than one year.266

VI. DEDUCTION OF LOSS ON SALE

A. Problems with Current Law

An individual generally cannot deduct a personal loss,267 but can deduct a loss “incurred in a trade or business” or “in a transaction entered into for profit.”268 Owning one’s residence is, of course, a personal activity, and loss from its sale is nondeductible.269 If the taxpayer moves out of his residence and offers it for rent, loss from its sale does not necessarily become deductible. Offering a former residence for rent is usually not considered a trade or business,270 and is not a “transaction entered into for profit” unless the owner has actually rented it.271 Therefore, if an owner permanently moves out of his residence and sells it at a loss, he can deduct the loss only if he has successfully offered the property for rent after he had moved out.

If a loss is allowed, it will probably be an ordinary loss.272 In

266. See supra text accompanying notes 225-26.
268. I.R.C. § 165(c)(1), (2) (Supp. IV 1986).
270. See supra note 73 (discussing qualification of a former residence as a trade or business).
271. Christensen v. Commissioner, 47 T.C.M. (CCH) 1558 (1984); Henry v. Commissioner, 46 T.C.M. (CCH) 186 (1983); McAuley v. Commissioner, 35 T.C.M. (CCH) 1236 (1976); Brinker v. Commissioner, 34 T.C.M. (CCH) 1054 (1975); Newbre v. Commissioner, 30 T.C.M. (CCH) 705 (1971); Cowles v. Commissioner, 29 T.C.M. (CCH) 884 (1970); Rogers v. Commissioner, 24 T.C.M. (CCH) 36 (1965); Stutz v. Commissioner, 24 T.C.M. (CCH) 888 (1965); Horrman v. Commissioner, 17 T.C. 903 (1951); Warner v. Commissioner, 6 T.C.M. (CCH) 582 (1947); Leslie v. Commissioner, 6 T.C. 488 (1946). The leading case that allowed a loss when the taxpayer successfully rented his former residence is Heiner v. Tindle, 276 U.S. 582 (1928).
272. Courts have generally held that an owner who has successfully offered a former residence for rent, and then recognized a loss on its sale, has used the residence in a trade or business. See Wasnok v. Commissioner, 30 T.C.M. (CCH) 39 (1971); Hajas v. Commissioner, 23 T.C.M. (CCH) 2015 (1964); Hazard v. Commissioner, 7 T.C. 372 (1946). But see Grier v. United States, 120 F. Supp. 395 (D.C. Conn. 1954), aff’d per curiam, 218 F.2d 603 (2d Cir. 1955). Therefore, the loss will usually be an ordinary loss under § 1231, I.R.C. § 1231 (1982).
addition, the adjusted basis in computing the loss (before adjustments for improvements or depreciation subsequent to the conversion) is the lesser of fair market value at time of conversion or the adjusted basis at time of conversion.\(^273\) When the loss is calculated in this way, the amount deductible is limited to the decline in value, after adjustments for depreciation, that occurred after the property had been rented. Any loss prior to that time is deemed attributable to the personal use of the residence and thus is nondeductible.\(^274\)

Sections 167 and 212 allow deductions for depreciation and ordinary and necessary expenses incurred with respect to property that is held for the “production of income.”\(^275\) A former residence that is unsuccessfully offered for rent is generally considered held for the production of income.\(^276\) Therefore, if a former residence is unsuccessfully offered for rent, deductions will be allowed for maintenance expenses and depreciation, but a loss on sale will not be deductible.\(^277\)

The different standards for deducting a loss on sale of a former residence and for deducting maintenance expenses and depreciation are not compelled by the statute. For example, courts could conclude that offering a former residence for rent is a “transaction entered into for profit.”\(^278\) A realized loss would then be deductible whenever

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\(^273\) Treas. Reg. § 1.165-9(b)(2) (as amended in 1964). The “time of conversion” for this purpose is when the former residence is actually rented, not when it is merely offered for rent. Hamilton v. Commissioner, 30 B.T.A. 160 (1934).

\(^274\) This conclusion can be questioned. A homeowner’s expectation, which is borne out in most cases, is that his residence will not go down in value while he lives in it. If there is a decline in value, it is typically the result of some unexpected factor such as a decline in attractiveness of the neighborhood or an overall economic decline in the region. The loss probably does not reflect the value of the benefits provided by the residence to its owners, but rather the effect of some external development. Therefore, loss on sale of a residence should arguably be deductible. This conclusion, however, involves issues that are beyond the scope of this Article. For a discussion of those issues, see generally Epstein, The Consumption and Loss of Personal Property Under the Internal Revenue Code, 23 Stan. L. Rev. 454 (1971); Subotnik, Easing the Pain of Modern Home Economics, 30 Tax Notes 267 (1986).

\(^275\) I.R.C. §§ 167(a)(2), 212(2) (1982).

\(^276\) See supra notes 121-49 and accompanying text (discussing allowance of deductions when there is an unsuccessful offer to rent).

\(^277\) In several cases, a taxpayer has been allowed to deduct maintenance expenses and depreciation for a former residence, but has not been able to deduct a loss on sale. See McAuley v. Commissioner, 35 T.C.M. (CCH) 1236 (1976); Cowles v. Commissioner, 29 T.C.M. (CCH) 884 (1970) (dictum); Rogers v. Commissioner, 24 T.C.M. (CCH) 36 (1965) (depreciation deduction not contested); Stutz v. Commissioner, 24 T.C.M. (CCH) 888 (1965); Horrmann v. Commissioner, 17 T.C. 903 (1951); see also Byrne, supra note 54, at 395-405.

\(^278\) The regulations do not impede adoption of this rule. They merely state that the loss shall be allowed under § 165(a) if a former residence is “rented or otherwise appropriated to
maintenance expenses and depreciation are deductible. Furthermore, courts have not attempted to justify the difference on policy grounds, perhaps because there does not seem to be any justification. A depreciation deduction compensates the taxpayer for an expected decline in value, even though the loss has not been realized.\(^9\) It is inconsistent to allow deductions for depreciation but not for the actual decline in value after the loss has been realized.

The Tax Court has indicated that, if the law were not so settled, it would reexamine the use of different standards for deducting a loss on sale and for deducting maintenance expenses and depreciation.\(^{280}\) However, the difference in treatment can be traced back as far as 1943,\(^{281}\) and probably will not change absent a fundamental reexamination of the general tax treatment of former residences.

### B. The Correct Approach

Deductibility of loss on sale of a former residence should correspond to the rule for deducting ordinary and necessary expenses. After the residence has been converted to property held for the production of income, both expenses incurred to maintain its value and a loss suffered from a decline in value accruing after conversion should be deductible. A loss on sale might be deductible even though depreciation had not been allowed. Depreciation presents a special problem because it involves a deduction for a decline in value before there has been a realization event. Obviously that problem does not apply to deducting a loss on sale.\(^{282}\)

Given current law on the deduction of expenses, a loss on sale of a former residence should generally be allowed whenever the property has been offered for rent. The loss accruing before the taxpayer had offered the former residence for rent would still, however, be

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\(^{279}\) See supra notes 240-44 and accompanying text (discussing when depreciation deductions should be allowed).

\(^{280}\) See, e.g., McAuley v. Commissioner, 35 T.C.M. (CCH) 1236, 1241 n.8 (1976); Cowles v. Commissioner, 29 T.C.M. (CCH) 884, 885 (1970).

\(^{281}\) Compare Robinson v. Commissioner, 2 T.C. 305 (1943) (reviewed by the full court) (holding that maintenance expenses and depreciation allowed as a deduction when unsuccessful offer to rent) with Morgan v. Commissioner, 76 F.2d 390 (5th Cir.), cert. denied, 296 U.S. 601 (1935) (holding that deduction for loss not allowed when unsuccessful offer to rent).

\(^{282}\) The problem with current law is that the standard for deducting a loss is more stringent than that for deducting depreciation. This result makes no sense. See supra note 279 and accompanying text.
considered attributable to his personal use. The deduction would, therefore, be limited to the decline in value (after adjustments for depreciation) that had accrued subsequent to the taxpayer offering the residence for rent.

One recommendation offered above is that ordinary and necessary expenses for a former residence be generally deductible only if the taxpayer is holding the property primarily for rent. A former residence held primarily for sale would be considered a personal asset even if the owner had successfully offered it for rent to mitigate carrying costs. If this proposal were adopted, a loss on sale of a former residence would be a personal loss and should not be deductible unless the taxpayer were holding it primarily for rent. If the loss were allowed, it would be limited to the decline in value accruing after the taxpayer had decided to hold it primarily for rent.

An alternative recommendation is that ordinary and necessary expenses for a former residence be deductible immediately after the owner has permanently moved out. If this proposal were adopted, any loss accruing after the owner of a former residence has permanently moved out should also be deductible. The arguments in favor of and against this rule are similar to those for the corresponding rule concerning ordinary and necessary expenses. A decline in value that has occurred after the taxpayer has permanently moved out is a consequence of the taxpayer’s attempt to obtain the best possible return from the property. Since the taxpayer at that time is receiving no personal benefit from the residence, the decline in value should be allowed as a deductible loss. On the other hand, gain from sale of a former residence is often not subject to tax. Allowing a taxpayer to deduct a loss realized on sale of an asset, but not requiring him to include any gain realized on its sale, seems clearly wrong. If the government is going to share in a loss by allowing it to offset income that would otherwise be subject to tax, the government should also share in any gain by including it in taxable income.

283. For criticism of this conclusion, see supra note 274.

284. For discussion of this rule under current law, see supra notes 273-74 and accompanying text.

285. See supra notes 219-29 and accompanying text (discussing the recommended test). Expenses would generally be deductible to the extent that the owner had rental income in excess of qualified residence interest and property taxes. See I.R.C. § 183(b)(2) (1982). Allowance of deductions for this reason, however, is irrelevant to allowance of a loss on sale.

286. For discussion of the rule concerning deductibility of ordinary and necessary expenses, see supra notes 230-39 and accompanying text.

VII. CONCLUSIONS AND RECOMMENDATIONS

A. Miscellaneous Statutory Provisions

This Article demonstrates the complexity of current tax law. Owning a former residence and holding it for sale or rent are rather straightforward activities. The tax consequences should not be complicated. Nevertheless, a number of specialized provisions—sections 280A, 469, 163(h), and 67—can in many cases have a substantial impact, although not one of them is directed at a former residence. It may often be a substantial burden for the tax adviser to determine what sections are relevant and then examine their technical requirements. It should not be surprising when mistakes are made. Thus, the Article furnishes additional evidence that our income tax laws need to be simplified.

The application of section 280A to a former residence is unintended. The commingling of personal and business use at which section 280A was aimed is not present when the taxpayer has permanently moved out of a residence. Similarly, section 469 which can make conversion of a personal residence to property held for the production of income a detriment, rather than an advantage, should not apply to a former residence. It is aimed at tax shelters and the use of losses from tax-motivated transactions to offset income from other sources. Ownership of a former residence that one is renting while trying to sell is rarely motivated by the type of tax planning at which section 469 is aimed.

B. Conversion of Residence to Property Held for Production of Income

Current law for determining when a former residence has been converted to property held for the production of income is unsatisfactory. Too much depends on whether there is an offer to rent the property. If the owner's primary intent is to sell the property, an...
offer to rent may not distinguish him very much from those who are offering their former residences solely for sale.\textsuperscript{298}

This Article has suggested two possible changes for determining when maintenance expenses should be deductible.\textsuperscript{299} Either would be an improvement over current law. Under the first proposed change, a residence would not be converted to property held for the production of income unless the owner were holding it primarily for rent.\textsuperscript{300} Therefore, a taxpayer who is holding a former residence primarily for sale would be allowed to deduct expenses other than qualified residence interest and property taxes only to the extent rental income exceeded those two items. Those who are offering their former residences solely for sale would no longer be treated unfairly relative to those who unsuccessfully offer their former residences for rent while trying to sell.\textsuperscript{301} On the other hand, those who do not rent their former residences may be treated unfairly in comparison to those who successfully rent theirs,\textsuperscript{302} but a successful offer to rent seems a reasonable place to draw the line. This proposal does not constitute a radical change in current law, and courts should adopt it, although they would have to overrule a significant number of cases.

The second proposal would allow any taxpayer who has permanently moved out of his residence to deduct maintenance expenses.\textsuperscript{303} If not for sections 121\textsuperscript{304} and 1034,\textsuperscript{305} this would be the correct approach, since a taxpayer who has permanently moved out of his residence receives no personal benefit from it. If adopted without any other changes to the Internal Revenue Code, however, it would allow costs incurred to maximize proceeds from sale or rent of a former residence to be deducted, even though gain from sale of a residence is often not subject to tax. Because this proposal would represent a radical change in the law, an amendment to the Internal Revenue Code would probably be necessary for its adoption.

Finally, the Article offered separate recommendations concerning depreciation.\textsuperscript{306} A deduction for depreciation with respect to a former residence should not be coterminous with a deduction for or-

\textsuperscript{298} See supra notes 206-09 and accompanying text.
\textsuperscript{299} See supra notes 219-39 and accompanying text.
\textsuperscript{300} See supra notes 219-29 and accompanying text.
\textsuperscript{301} See supra notes 208-09 and accompanying text.
\textsuperscript{302} See supra text accompanying notes 226-28.
\textsuperscript{303} See supra text accompanying notes 230-39.
\textsuperscript{304} I.R.C. § 121 (1982).
\textsuperscript{306} See supra notes 259-66 and accompanying text.
ordinary and necessary expenses. In fact, depreciation should probably not be deductible at all, regardless of the treatment of ordinary and necessary expenses, if a homeowner is holding a former residence primarily for sale; at most, it should only be deductible to the extent there is net income, computed before any allowance for depreciation. Courts should adopt this proposal whether or not either of the recommendations concerning maintenance expenses is implemented.

C. Loss on Sale

The rule for deducting a loss on sale of a former residence should correspond to the deductibility of ordinary and necessary expenses. Under current law a taxpayer who offers his former residence for rent can generally deduct ordinary and necessary expenses, but cannot deduct a loss unless he has actually rented the property. These two rules are inconsistent. If the law concerning deductions for ordinary and necessary expenses is not changed, then a loss on sale should also be deductible if the owner has offered it for rent. The deductible loss, however, would be limited to the decline in value (after adjustments for depreciation) that had accrued after the property had been offered for rent.

If either of the two suggestions offered above for revising the deductibility of ordinary and necessary expenses were adopted, there should be a corresponding change in the deductibility of a loss on sale. In both cases, however, the deductible loss would not include any decline in value that had accrued while the property was still considered a personal asset.

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307. See supra note 282 and accompanying text.
308. See supra notes 275-77 and accompanying text.
309. See supra notes 267-71 and accompanying text.