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**INCOME TAX—Listing Abandoned Residence for Sale
and Not for Rent Considered Sufficient To
Convert to “Property Held for the
Production of Income”—
Hulet P. Smith***

Since 1941, Hulet Smith and his wife had lived in a large house in Arcadia, California, where Smith had been actively engaged in a real estate loan business. In 1959, Smith decided to retire and move to Pebble Beach, a distance of about 400 miles from Arcadia. He purchased a parcel of land in Pebble Beach and built a large expensive home, with the avowed intention of making this his permanent personal residence. In 1961, after severing all business and social connections in the vicinity of their old residence, Smith and his wife moved into their new home, taking virtually all of their furnishings with them.¹ At the same time Smith placed the Arcadia residence on the market for sale, having decided not to offer it for rent, because the rental income would have been insufficient to justify retention of the property, and because rental would have obstructed sale.² Smith and his wife filed joint returns for the years 1962 and 1963, claiming as deductions depreciation and expenditures for maintenance and repair of the Arcadia property. The Commissioner of Internal Revenue disallowed these deductions and ordered a deficiency assessment. The Tax Court, acting on the petition of Smith, *held*, in a memorandum opinion, that throughout 1962 and 1963 the Arcadia property was “held for the production of income” under sections 167(a)(2) and 212(2) of the 1954 Internal Revenue Code (Code),³ and thus that petitioner was entitled to deduct depreciation

* 1967 P-H Tax Ct. Mem. ¶ 67,028 [hereinafter cited as principal case].

1. Most of the permanent floor carpeting and even a truckload of plants and flowers were removed from the old residence to be installed in the new Pebble Beach home. Only window drapes and part of the carpeting were left behind.

2. The premises would have had to have been leased for at least two years in order to induce a tenant to make the expenditures necessary to render the house habitable, and, in any case, rental would have made the showing of the house to prospective purchasers more difficult.

3. INT. REV. CODE OF 1954, § 167 provides, in part:
Sec. 167. DEPRECIATION.

(a) GENERAL RULE. There shall be allowed as a depreciation deduction a

and maintenance expenditures in both years.⁴ If a former residence is permanently abandoned and placed on the market for sale only, such property may be sufficiently converted to "property held for the production of income" to qualify for depreciation and maintenance expense deductions arising after such conversion.

Sections 167(a)(2) and 212(2) of the 1954 Code, under which the deductions in the principal case for depreciation and maintenance expenses were allowed, are almost identical to their predecessors, sections 23(1)(2) and 23(a)(2),⁵ which were added to the 1939 Code as amendments by the Revenue Act of 1942⁶ to allow the taxpayer to deduct for the depreciation and the ordinary and necessary maintenance expenses of property "held for the production of income" but not used in a "trade or business."⁷ Under these sections,⁸ property is considered to be "held for the production of income" even if the only anticipated income is that which would accrue on the disposition of the property, and even though there is no guarantee that the property will be sold at a profit or otherwise be productive of income.⁹

reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

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

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

Sec. 212. EXPENSES FOR THE PRODUCTION OF INCOME.

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

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

.....

4. Principal case ¶ 67,165, at 67-165.

5. *George W. Mitchell*, 47 T.C. 120 (1966); *Frederich H. Prince Trust*, 35 T.C. 974 (1961).

6. Revenue Act of 1942, § 121, 56 Stat. 819.

7. The congressional purpose in amending § 23 of the 1939 Code is summarized as follows:

The existing law allows the taxpayer to deduct expenses incurred in connection with a trade or business. Due partly to the inadequacy of the statute and partly to court decisions, nontrade or nonbusiness expenses are not deductible, although nontrade or nonbusiness income is fully subject to tax. The bill corrects this inequity by allowing all of the ordinary and necessary expenses paid or incurred for the production or collection of income, or for management, conservation or maintenance of property held for the production of income. Thus, whether or not the expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income or in connection with property held for the production of income, it is allowable.

H.R. REP. NO. 2333, 77th Cong., 1st Sess. 46 (1942); see S. REP. NO. 1631, 77th Cong., 2d Sess. (1942). See also *Treas. Reg. § 1.212-1(b)* (1957).

8. The criteria for determining whether or not property is "held for the production of income" are the same under sections 167 and 212, and thus, if the holding of property satisfies one section, the other section will also be satisfied. *George W. Mitchell*, 47 T.C. 120 (1966); *Eleanor Saltonstall, rev'd on other grounds*, 148 F.2d 396 (1945); *Mary Laughlin Robinson*, 2 T.C. 305 (1943).

9. *Treas. Reg. § 1.212-1(b)* (1957).

Although in enacting sections 167 and 212 Congress thus intended to allow the taking of nonbusiness deductions, section 262 remains as a bar to deductions of personal, living, or family expenses.¹⁰ Expenses incurred prior to or in connection with the sale of a personal residence appear to be within this category and consequently would not ordinarily be deductible.¹¹ In any particular case, then, it is crucial to determine whether the personal residence has been converted into property "held for the production of income," so as to permit deductions for depreciation and maintenance expenses.¹² By its decision in the principal case, the Tax Court has apparently abolished a traditional prerequisite for the conversion of residential property into income producing property: a bona fide offer to rent the abandoned residence. As a result, a taxpayer may now be able to establish conversion merely by abandoning his former residence and holding it for sale. Thus, the principal case has created a new test for conversion, which, it is submitted, cannot be supported by the three cases upon which the court relied.

*Mary Laughlin Robinson*¹³ is a landmark decision which has often been cited for the proposition that the taxpayer-owner must make efforts to rent an abandoned residence in order to qualify for deductions for maintenance expenses and depreciation.¹⁴ In *Robin-*

10. INT. REV. CODE OF 1954, § 262 provides:

Sec. 262. PERSONAL, LIVING, AND FAMILY EXPENSES.

Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

11. Treas. Reg. § 1.262-1(b) (1965) gives examples of personal, living, and family expenses. Among these are expenses of maintaining a household and losses sustained by the taxpayer on the sale or other disposition of property held for personal, living and family purposes.

12. This problem should be distinguished from that arising under § 165(c) of the Code allowing a deduction for losses incurred in "any transaction entered into for profit, though not connected with a trade or business." In order to take such a deduction upon sale of property formerly used as a personal residence, there must have been an actual rental of the property and not merely an offering for rent. *See, e.g.,* Heiner v. Tindle, 276 U.S. 582 (1928) (allowing the loss deduction where there had been actual rental); William C. Horrmann, 17 T.C. 903 (1951); Allen L. Grammer, 12 T.C. 34 (1949) (disallowing the deduction when not rented but merely listed for rent). A deduction was also denied, for the same reason in *Phipps v. Helvering*, 124 F.2d 292 (1941); *Morgan v. Commissioner*, 76 F.2d 390 (1935); *Howard Oats*, 37 B.T.A. 571 (1938). However, when the property was never used for personal purposes, actual rental (showing a transaction entered into for profit) will not be required. *See* *George W. Carnick*, 9 T.C. 756 (1947); *Estell G. Marx*, 5 T.C. 173 (1945).

13. 2 T.C. 305 (1943).

14. *See also* *Charles F. Neave*, 17 T.C. 1237 (1952), where, although property was periodically rented, it was not offered for rent continually during the period offered for sale. The Court held that no conversion to income producing purposes had occurred merely because property was offered for sale, and that temporary rental for a few months was not determinative. In *William C. Horrmann*, 17 T.C. 903 (1951), deductions were allowed where the abandoned property was offered for both sale or rent. The Tax Court in *Clarence B. Jones*, 22 T.C. 407 (1954), allowed deductions on a converted summer residence, but only after offered for rent or sale (stating that an offer for sale was not enough), but allowing deductions for the winter season

son, the taxpayer offered her former residence for rent or sale and made diligent efforts to find either prospective tenants or purchasers. On its facts, then, the case held only that where a taxpayer abandons residential property and attempts to rent as well as to sell, he will meet the requirements for conversion, although the court did note in dictum that "production of income can include gain from the disposition of property." Thus, the court in the principal case was unwarranted in reading *Robinson* to support the proposition that abandonment coupled only with an offer to sell is sufficient for conversion.

A second case cited by the Tax Court in attempting to find precedent for its holding in the principal case is *George W. Mitchell*,¹⁵ in which petitioners and two other joint venturers purchased non-residential property at an auction, held it without advertising it for sale or rent, and claimed a depreciation deduction. The court allowed the deduction, finding an intent to hold the property for income producing purposes, and citing *Robinson* for the proposition that "income" includes "gain from the disposition of property." In the principal case, however, the Tax Court failed to mention that in *Mitchell* the taxpayers had never used the property as a personal residence; they had purchased the property solely for investment purposes. Thus, the question of conversion from personal use to income producing purposes was not in issue, and the *Mitchell* decision would seem to offer little support for the result reached in the principal case.

Briley v. United States,¹⁶ the third case cited, is, like *Robinson*, a case in which the property in question, after having been abandoned as a residence, was offered by the taxpayer for either sale or rent. The issue here, however, was not whether there had been a

though not put up for rent during the winter on proof that the house was not suited for winter residence. A recent case citing *Robinson* (see note 13 *supra*) is Paul F. Stutz, 1965 P-H Tax Ct. Mem. ¶ 65,166, in which abandoned residential property was offered for rent until March 23, 1960, and after that held for sale only. Maintenance and depreciation deductions were allowed only for the period to March 23 and not thereafter. Deductions were allowed in *Helene Irwin Fagan*, 1950 P-H Tax Ct. Mem. ¶ 50,017 and *Anna C. Newberry*, 1945 P-H Tax Ct. Mem. ¶ 45,077, even though there was no offer to rent in either case. In neither case, however, was the property used as a residence. Cases denying deductions because of failure to make a bona fide offer of rent include: *Frederich H. Prince Trust*, 35 T.C. 974 (1961) and *Eugene H. Walet, Jr.*, 31 T.C. 461 (1958), *aff'd per curiam*, 272 F.2d 694 (5th Cir. 1959) (both of which involved rent free occupancy); *Ebb James Ford, Jr.*, 29 T.C. 499 (1957) (taxpayer lived on the property while offering for rent); and *Warren Leslie, Sr.*, 6 T.C. 488 (1946) (which included a rigorous dissent to the effect that proof of property being no longer suitable for residential use should be sufficient to establish conversion to income producing purposes). Other cases denying deductions include: *James Parks Bradley*, 30 T.C. 701 (1958); *John M. Coulter*, 1950 P-H Tax Ct. Mem. ¶ 50,077; *Charles S. Guggenheimer*, 1943 P-H Tax Ct. Mem. ¶ 43,432.

15. 47 T.C. 120 (1966).

16. 189 F. Supp. 510 (N.D. Ohio 1960).

conversion, but whether the rental offer had been bona fide. The government contention that there had been no bona fide offering for rent was rejected by the court, and the deductions were allowed.

Thus, there seems to be no case authority for the Tax Court's holding in the principal case. Neither is there authority in the Treasury Regulations. Although Treasury Regulation section 1.212-1(b) states, as did *Robinson*, that "income" includes gain from the disposition of property, Treasury Regulation section 1.212-1(h) provides:

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

Relying upon the first sentence of this regulation, it might be arguable that once a taxpayer abandons his residence, he no longer holds it "for use as a residence," and thus the prohibition against the listed deductions is not applicable. Such an interpretation, however, would render superfluous the second sentence which specifically allows deductions with respect to a former residence held as "rental property." By implication, then, the regulations require a rental offer to convert a former residence to income producing property.¹⁷

Since the rental offer requirement was not derived directly from the statute, but was adopted by the courts and by the Internal Revenue Service, the courts are competent to change the requirement according to their interpretation of the statute.¹⁸ Moreover, there may be some policy justification for eliminating a rental offer as a *sine qua non* for conversion. If a taxpayer purchases residential property as an investment, never living in it, he is entitled to deductions for maintenance expenses and depreciation. When he sells the property, he will be taxed on his profits, measured by the excess of the selling price over the adjusted basis.¹⁹ Similarly, if a taxpayer

17. See note 8 *supra*.

18. It should be emphasized, however, that a taxpayer is entitled to a deduction only if he comes under the terms of a statute allowing such a deduction. Moreover, the burden of proof lies on the taxpayer. See, e.g., *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934):

The power to tax income . . . is plain and extends to the gross income. Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed. . . . Obviously, therefore, a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms.

19. INT. REV. CODE OF 1954, § 1001. The gain from the sale will be taxed at capital gains rates under § 1221, subject to the recapture provisions of § 1250, taxing at ordinary income rates a percentage of an amount equal to the allowance for depreciation taken in the year of sale.

ceases to use property as his personal residence but continues to hold it for investment purposes, then, regardless of whether the requisite elements of conversion are established, he will be taxed, when he sells, on the excess of his selling price over his adjusted basis, including the portion of such excess that accrues after abandonment. It seems unfair and discriminatory to deny the taxpayer in the latter case the opportunity to deduct for maintenance expenses and depreciation during the period after abandonment simply because he had formerly used the property as his residence and had failed to offer it for rent after abandonment. Moreover, the rental rule might discourage the holding of a former personal residence for investment purposes in situations in which it is disadvantageous to offer for rent.²⁰

It can be argued, however, that the rental offer requirement is not overly prohibitive in effect. A taxpayer is free to set the terms of his rental offer within a wide range of alternatives. He could, for example, offer to rent for successive short periods, while retaining the right to show the property to potential purchasers. Such non-restrictive provisions would generally not disqualify the offer to rent as a bona fide offer.²¹ Furthermore, under the traditional rule, the taxpayer, while making such a rental offer, may simultaneously offer to sell.²² Thus, in many cases the rental requirement may amount to little more than a formality, since if a taxpayer has in fact abandoned his residence, it will not be disadvantageous for him to offer for rent.

The above argument may prove too much, however, since it suggests that it may be too easy to comply with the rental requirement. It is doubtful that a condition so easily satisfied can ac-

20. For example, where rental will involve too much trouble for the taxpayer, or where rental may obstruct his opportunity to sell should he feel the value of his property is declining. In fact, the principal case is an instance in which the taxpayer did not offer for rent for these very reasons. See note 2 *supra*.

21. While the courts are generally willing to consider whether an offer to rent is bona fide, they have generally held against the taxpayer only where such offers or actual rental are clearly sham transactions. See, e.g., Paul F. Stutz, 1965 P-H Tax Ct. Mem. ¶ 65,166 (discussed in note 14 *supra*) where the court held that efforts to rent were more than a mere token, and there was a bona fide offer to rent. There are, however, cases reaching contrary results. See, e.g., Charles F. Neave, 17 T.C. 1237 (1952) (discussed in note 14 *supra*) (temporary renting for a few months during the summer not determinative where rental is for an unusually low amount and other circumstances do not indicate a bona fide offering for rent); Charles S. Guggenheimer, 1943 P-H Tax Ct. Mem. ¶ 43,432 (not sufficient that real estate dealers in the community were aware that the owners were willing to rent); S. Wise, 1945 P-H Tax Ct. Mem. ¶ 45,298 (minimal amounts expended for advertising (\$72.75) and putting up signs not sufficient). See also *Briley v. United States*, 189 F. Supp. 510 (N.D. Ohio 1960); text accompanying note 16 *supra*. No cases were found where the terms of an otherwise earnest offer to rent were the basis of a finding that the offer was a sham. It is probable that only where the terms indicate clearly that a mere token offering is being made, will the courts fail to recognize the offer as bona fide. Few such cases ever reach the courts, possibly because such a factual determination seems particularly well suited for settlement at the return audit stage.

22. See *Mary Laughlin Robinson*, 2 T.C. 305 (1943).

compish its intended purpose: manifestation of conversion to income producing property. Moreover, there are cases where the necessity of making a rental offer may create a real hardship to a taxpayer who should receive the tax advantages of conversion. For example, a taxpayer may abandon his residence and purchase surrounding lots for the purpose of developing and later selling the land. Here the making of an offer to rent may be neither practicable nor appropriate.²³ Thus, the application of the rental offer requirement can produce anomalous results. On the one hand, a taxpayer who ceases to use property as a residence and intends to continue to hold it as a bona fide investment, but who, for some reason, does not wish to rent, will be denied deductions for maintenance expenses and depreciation. On the other hand, a taxpayer who desires only to find a buyer for his abandoned residence can obtain the deductions merely by offering to rent on such illusory terms as those outlined in the preceding paragraph. The rental rule, then, creates an arbitrary barrier to the benefits of conversion in some cases, while presenting an ineffective barrier to the improper taking of deductions in others.

Ideally, the standard for conversion should discriminate between the following two types of cases: first, abandonment where the taxpayer wishes to sell his property immediately at the market price, but tries to obtain deductions while searching for a buyer; second, abandonment where the taxpayer wishes to hold his property as an investment, with appreciation in value being at least one of his objectives, but with no plan to sell at any particular time. Clearly, maintenance and depreciation deductions should be denied in the first case and allowed in the second case. There are, of course, cases between these extremes. For example, a taxpayer on abandoning his residence may decide that since the market price is too low, he will wait to sell until he can obtain what he considers to be a suitable price. Arguably, he is holding for appreciation in value, but his continued ownership more likely represents some disagreement as to the fair market value of the property, and as such indicates that he is simply trying to dispose of personal, rather than income, property. An even harder case may be presented by the taxpayer who wishes to sell his property for *considerably* more than the price he is offered at the time he abandons.

As a practical matter, the rental rule seems to be an admission that a case by case determination of the taxpayer's motive is too

23. Even without purchasing surrounding property, if a taxpayer subdivides his original lot for the purpose of development and sale of the property in separate parcels, this conduct may be sufficient to demonstrate legitimate conversion. This determination is obviously subjective, and the relevant factors will vary from case to case; however, it is hoped that in exceptional cases, the taxpayer who wishes to convert his abandoned residence into true investment property will be able to satisfy his burden of proof and establish conversion without having to suffer the additional burden of offering his property for rent.

difficult; thus, a formal test is substituted, under which deductions are generally allowed in all of the cases described above as long as there is a bona fide offer to rent. The principal case, on the other hand, seems to take a more liberal view in allowing deductions in all cases upon proof of actual abandonment, whether or not there has been an accompanying offer to rent. If the court is requiring something in addition to abandonment as a test for conversion, the other indicia are not adequately identified in the opinion. Such a position leads both to uncertainty as to the present criteria for conversion, and, in the principal case, to a decision which on its facts seems clearly incorrect. Smith did nothing other than abandon and continually attempt to sell his residence. His holding of the property for two years probably indicated only that his asking price was higher than anyone wished to pay. Thus, for all that appears, Smith was attempting to sell a personal, rather than an income producing, piece of property. A test for conversion requiring only abandonment thus produces an unsatisfactory result.

As between the rental rule and the rule apparently laid down in the principal case, then, the former seems preferable in that it requires something more than mere abandonment. An offering for rent at least demonstrates a non-personal, income producing use of the property, regardless of the taxpayer's motive for so offering. If the rental rule is to remain, however, two changes appear salutary. First, it should be recognized that there may be exceptional situations in which deductions should be allowed even in the absence of an offer to rent. In such cases, the taxpayer should have the burden of proving both conversion and the impossibility or substantial impracticality of rental. Second, in situations in which there has been a rental offer, a more careful inquiry should be made to insure that the offer is bona fide and is not simply a cover to give the taxpayer deductions for personal expenses while he disposes of his former residence.²⁴ The two proposals will demand some consideration of the circumstances surrounding a particular abandonment and will perhaps invite some degree of uncertainty. However, with an appropriately rigorous burden on the taxpayer to show legitimate investment purposes,²⁵ it is believed that the suggested inquiries will eliminate the manipulation of the rental offer requirement to obtain unwarranted tax benefits and will accommodate only the true investor.

24. Such an inquiry was made in Paul F. Stutz, 1965 P-H Tax Ct. Mem. ¶ 65,166; Charles F. Neave, 7 T.C. 1237 (1952); S. Wise, 1945 P-H Tax Ct. Mem. ¶ 45,298; Charles S Guggenheimer, 1943 P-H Tax Ct. Mem. ¶ 43,432. The difficulty of making such a determination, however, is well illustrated by the taxpayer who sets his rental price just slightly above what the market will allow. Of course, if the taxpayer continually rejects potential rental offers, this could be acceptable as proof that there was no bona fide offer to rent.

25. See note 23 *supra*.