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Taxation - Federal Income Tax - Renting Out a Single Home as a Trade or Business for Purposes of Capital Loss Carry-Over

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TAXATION—FEDERAL INCOME TAX—RENTING OUT A SINGLE HOME AS A TRADE OR BUSINESS FOR PURPOSES OF CAPITAL LOSS CARRY-OVER—Taxpayer, who was not in the real estate business and who was involved in only occasional real estate transactions, inherited a house which he rented out until he sold it at a loss. He treated the transaction as a capital loss, taking advantage of the capital loss carry-over provisions of the Internal Revenue Code.[1] Deficiency assessments were levied against the taxpayer upon the theory that the loss sustained upon the sale of the house was an ordinary loss which could not be carried over to later years. Taxpayer paid the deficiency assessment and sued for a refund. The district court held that the house was not property "used in trade or business," and that the loss

[1] I.R.C. (1939), §117 (e), now I.R.C. (1954), §1212.

on the sale thereof was a capital loss which could be carried over to succeeding years.[2] On appeal, *held,* affirmed per curiam. *Grier v. United States,* (2d Cir. 1955) 218 F. (2d) 603.

When a taxpayer who owns his own home abandons it as a residence, rents it out, and later sells it at a loss, an important question arises as to whether renting constitutes his trade or business. The taxpayer who rents a house prior to selling it is always allowed to take deductions for depreciation and maintenance expenses incurred from the time he starts renting until the time he sells, regardless of whether the house is considered as property "used in trade or business."[3] But once the taxpayer sells the house the issue then becomes whether he should treat the gain or loss realized as ordinary or capital gain or loss. Sections 117 (a) (2)-(10), I.R.C. (1939),[4] define capital gains and losses as gains and losses realized from the sale or exchange of capital assets. Section 117 (a) (1) (B) of the 1939 code[5] defines the term "capital asset" to mean property held by the taxpayer, with the exception of depreciable property used in the taxpayer's trade or business. Thus, if the residence in question is considered to be property "used in trade or business," it is excluded from the capital asset category, for it is unmistakably property subject to the statutory allowance for depreciation.[6] As a consequence, if the taxpayer realizes a loss upon the sale of the property, the loss is an ordinary loss and must be taken in the year in which it is sustained.[7] If the property is not considered as "used in trade or business," the loss is a capital loss, and the deduction may be carried over under sections 117 (d) and (e), I.R.C. (1939).[8] When, however, the taxpayer realizes a gain upon the property, it will be treated as a capital gain even if the property is considered as "used in trade or business," provided the conditions of section 117 (j) of the 1939 code[9] are met.[10] Before the principal case, it was uniformly held that when a taxpayer abandoned his residence and rented it out, the residence became property "used in his trade or business" within the meaning of section 117 (a)

2 Grier v. United States, (D.C. Conn. 1954) 120 F. Supp. 395.

3 Depreciation: I.R.C. (1939), §23 (*l*), now I.R.C. (1954), §167; maintenance expenses: I.R.C. (1939), §23 (a) (1) and (2), now I.R.C. (1954), §§162 and 212; George S. Jephson, 37 B.T.A. 1117 (1938); N. Stuart Campbell, 5 T.C. 272 (1945); Leland Hazard, 7 T.C. 372 (1946); Rogers v. United States, (D.C. Conn. 1946) 69 F. Supp. 8; William H. Jamison, 8 T.C. 173 (1947); George W. Carnrick, 9 T.C. 756 (1947); Mary E. Crawford, 16 T.C. 678 (1951); John E. Good, 16 T.C. 906 (1951); William C. Horrmann, 17 T.C. 903 (1951).

4 Now I.R.C. (1954), §1222.

5 Now I.R.C. (1954), §1221 (2).

6 I.R.C. (1939), §23 (*l*), now I.R.C. (1954), §167. See also the authority cited in note 3 supra.

7 I.R.C. (1939), §23 (e), now I.R.C. (1954), §165; N. Stuart Campbell, note 3 supra; Leland Hazard, note 3 supra; George W. Carnrick, note 3 supra; John E. Good, note 3 supra.

8 Now I.R.C. (1954), §§1211 and 1212.

9 Now I.R.C. (1954), §1231.

10 Nelson A. Farry, 13 T.C. 8 (1949); McGah v. Commissioner, (9th Cir. 1954) 210 F. (2d) 769.

(1) (B).[11] The rationale of these cases was simply that when the owner of depreciable property devotes it to rental purposes, exclusively for the production of taxable income, he is engaged in a trade or business.[12] It has been stated in this connection that the fact that a person is engaged in a profession does not prevent him from being engaged in a business, or more than one business, within the meaning of the code.[13]

The court in the principal case argued that since section 23 (*l*) (2)[14] makes a separate provision for the depreciation of property held for the production of income, property so held would not fall under the exclusionary provisions of section 117 (a) (1) (B). The court then concluded that the property under consideration partook more of the nature of property held for investment than property used in a trade or business, and stated that although the property was used for the production of income it was a capital asset. This reasoning is fallacious; it proceeds on the theory that property "used in trade or business" within the meaning of section 117 (a) (1) (B) must be equated with property "used in trade or business" within the meaning of section 23 (*l*) (1).[15] In fact, there is nothing in section 117 (a) (1) (B) which intimates that section 23 (*l*) is to be used in interpreting the phrase "used in trade or business." Rather, section 117 (a) (1) (B) refers to section 23 (*l*) *as a whole,* leading to the conclusion that property "used in trade or business" within the meaning of section 117 (a) (1) (B) includes property which, within the meaning of section 23 (*l*), is either "used in trade or business" or "held for the production of income." This conclusion is supported by those cases which hold that rental properties which are held for the production of income or for investment may also be "used in trade or business."[16] It should also be noted that depreciation has been allowed on residences which the owners were renting out or attempting to rent out prior to the enactment of section 23 (*l*) (2).[17] It has even been stated that such residences are "property used in trade or business" without reference to section 23 (*l*).[18]

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11 N. Stuart Campbell, note 3 supra; Leland Hazard, note 3 supra; George W. Carnrick, note 3 supra; John E. Good, note 3 supra. The same result has obtained where the taxpayer's attempts to rent the property pending sale have been unsuccessful. Mary E. Crawford, note 3 supra. An apparently contrary result was reached in Susan P. Emery, 17 T.C. 308 (1951). However, this case involved unimproved real estate.

12 John D. Fackler, 45 B.T.A. 708 (1941), affd. Fackler v. Commissioner, (6th Cir. 1943) 133 F. (2d) 509; N. Stuart Campbell, note 3 supra; Leland Hazard, note 3 supra; George W. Carnrick, note 3 supra; John E. Good, note 3 supra.

13 John D. Fackler, note 12 supra; Leland Hazard, note 3 supra; Anders I. LaGreide, 23 T.C. 508 (1954).

14 Now I.R.C. (1954), §167 (a) (2).

15 Now I.R.C. (1954), §167 (a) (1).

16 Paul v. Commissioner, (3d Cir. 1953) 206 F. (2d) 763; McGah v. Commissioner, note 10 supra; Nelson A. Farry, note 10 supra.

17 George S. Jephson, note 3 supra.

18 Leland Hazard, note 3 supra.