South Carolina Law Review

Volume 6 | Issue 3 Article 6

Spring 3-1-1954

When Residence Deemed "Income-Producing" Property

Robert J. Thomas

NOTES

FEDERAL INCOME TAXATION – WHEN RESIDENCE DEEMED "INCOME-PRODUCING" PROPERTY

When a taxpayer abandons his residence as such, the character of the property thereafter has a particular significance in regard to the owner's income taxes. That this is so is illustrated by two examples: First, if the residence takes on the character of "income-producing" property, and the property is subsequently sold at a loss, the taxpayer will find that he is entitled to a deduction for the loss sustained on the sale (limited, however, in that the basis of the property is computed with reference to its value at the time of its change in character if such value happens to be less than the cost of the property.)[1] Secondly, if it can be said that the residence has been converted into "property held for the production of income," the taxpayer is entitled to deductions for depreciation[2] and maintenance expenses[3] thereof. The material questions in either case are always whether or not a change in character has taken place, and if so, when?

The discussion to follow deals with the following set of circumstances: The taxpayer abandoned his old residence and listed it with a real estate broker "for rent" or "for rent or sale." Efforts to rent the property were unsuccessful, and the property was eventually sold at a price less than its value at the time of its abandonment. Is the taxpayer entitled to take deductions for depreciation and maintenance expenses of the property for the interim before it was sold? Is he entitled to deduct the loss on the sale? The answer turns on the character assumed by the property at the time it was abandoned and listed.

In the set of circumstances set out above, it happens that the depreciation and maintenance expenses are deductible whereas the loss is not.[4] This is a confusing point in our federal income tax law. It seems that in determining whether or not a change in character has taken place, separate thought patterns are followed in cases involving the deductibility of a loss and cases involving the deductibility of depreciation and maintenance expenses. The property is said to be

1. U. S. TREAS. REG. 118, § 39.23(e)-1(e) (1953).
2. IRC § 23(a)(2).
3. IRC § 23(l)(2).
4. William C. Horrmann, 17 T. C. 903 (1951); Mary Laughlin Robinson, 2 T. C. 305 (1943).

"property held for the production of income," thus making it possible to deduct depreciation and maintenance expenses, yet it is not regarded as "income-producing" property, and a loss is therefore not deductible.

It is the purpose of this discussion to explain in some way the reasons underlying the different treatment of these two types of deductions. To reduce verbiage, the cases dealing with the deductibility of a loss under the circumstances set out above will be referred to as the *loss* cases. Those dealing with the deductibility of depreciation and maintenance expenses will be referred to as the *expense* cases.

The Loss Cases

The authority for deducting maintenance expenses and depreciation is derived from the Internal Revenue Code itself as amended in 1942,[5] while the authority for determining whether or not a loss is deductible stems from the language used in the Regulations.[6] Although the Regulations do not have the same weight as statutory enactment, this particular regulation has come to have peculiar force and effect in a manner somewhat as follows:

Prior to 1928, a taxpayer could not deduct a loss resulting from the sale of residence property unless the property was purchased or constructed with a view to its subsequent sale at a profit. Thus, if a taxpayer purchased or constructed residence property with the intention of occupying it as his home, it was immaterial that he later leased the property commercially; he was not allowed to deduct a loss resulting from a subsequent sale of the property. The Supreme Court, however, in *Heiner v. Tindle*,[7] held that the abandonment of a residence and the subsequent leasing of the property was equivalent to purchasing or constructing commercial property with an original purpose to lease it. Hence, a loss on the subsequent sale of such is deductible by the same authority that allows a loss on the sale of property acquired with an original purpose of producing income, (but the basis of the property must be computed with reference to its value at the time of its change in character, if that value is less than cost.[8]) Pursuant to this decision, the Treasury Department revised its Regulations to the effect that although a loss on the sale

5. MAINTENANCE EXPENSES: IRC § 23(a)(2); DEPRECIATION: IRC § 23(l)(2).
6. U. S. TREAS. REG. 118, § 39.23(e)-1(e) (1953).
7. 276 U. S. 582, 48 S. Ct. 326, 72 L.Ed. 714, 6 AFTR 7366, 1 USTC ¶ 299, T.D. 4212, VII-2 C.B. 272 (1928).
8. *Id.*

of residence property is not deductible where it is so used by the taxpayer up to the time of its sale, if the property is rented or otherwise *appropriated to income-producing* purposes prior to its sale, then a loss is deductible, but it must not exceed the excess of the value of the property at the time it was so appropriated.[9] (Italics added.)

A number of cases followed in which the property was never actually rented though efforts had been made to do so. The Courts, using the test laid down in the new regulations, held that the property cannot be deemed to have been "appropriated to income-producing purposes" unless it was in fact rented or some other more positive act of appropriation had taken place. The mere listing "for rent" or "for rent or sale" was insufficient to constitute an "appropriation" in the sense employed in the regulations.[10]

These cases consistently referred to the language of the regulations thus giving it "Court sanction." In addition, Congress continued to reinact the same law without change year after year. Thus, this regulation also required "statutory sanction".[11]

The Expense Cases

Prior to 1942, deductions for depreciation were allowable only on business property. Property which produced income but which was not a part of the taxpayer's regular trade or business could not be depreciated. The same was true as to maintenance expenses. Thus, if the taxpayer derived income from non-business property, his income therefrom was fully taxable, yet he was not allowed to claim deductions or depreciation and maintenance expenses. Why? Be-

9. U. S. TREAS. REG. 118, § 39.23(e)-1(e) (1953).

10. The leading cases are: Phipps v. Helvering, 124 F. 2d 292, 139 A.L.R. 809, 28 AFTR 635, 41-2 USTC ¶ 9787 (D.C. Cir. 1941); Gevirtz v. Commissioner, 123 F. 2d 707, 28 AFTR 402, 41-2 USTC ¶ 9760 (2d Cir. 1941); Schmidlapp v. Commissioner, 96 F. 2d 680, 118 A.L.R. 297, 21 AFTR 175, 38-1 USTC ¶ 9285 (3d Cir. 1938); Rumsey v. Commissioner, 82 F. 2d 158, 17 AFTR 557, 36-1 USTC ¶ 9157 (2d Cir. 1936), *cert.* denied, 299 U. S. 552, 57 S. Ct. 14, 81 L.Ed. 406 (1936); Morgan v. Commissioner, 76 F. 2d 390, 15 AFTR 1130, 35-1 USTC ¶ 9243 (5th Cir. (1935)), *cert.* denied, 296 U. S. 601, 56 S. Ct. 117, 80 L.Ed. 426 (1935). These cases and others decided by the Board of Tax Appeals are discussed in an annotation at 139 A.L.R. 815. For more recent cases of the Tax Court level, see Rowena S. Barnum, 19 T.C. 401 (1952); E. R. Fenimore Johnson, 19 T.C. 93 (1952); William C. Horrmann, 17 T.C. 903 (1951); Allen L. Grammer, 12 T.C. 34 (1949); Rea E. Warner, 1947 (P.-H.) Memo. Dec. ¶ 47,144, 6 TCM 582 (memo. op.), CCH Dec. 15,822 (m) (1947), affmd. *per curiam,* 167 F. 2d 633, 36 AFTR 973, 48-1 USTC ¶ 9250 (2d Cir. 1948).

11. Allen L. Grammer, 12 T.C. 34 (1949).

cause Congress had not authorized such deductions. Simply, there was an *absence* of authority *permitting* them.[12]

Congress supplied this authority in the Revenue Act of 1942.[13] By that Act, it was provided that a taxpayer may claim deductions for both depreciation and maintenance expenses on "property held for the production of income".

This similarity in language with the regulations so often cited by the Courts in disposing of *loss* cases would seem to indicate that the "property" referred to in the regulations and the "property" referred to in the new legislation would be the same type of property. Certainly, at first blush, it would seem that "income-producing property" and "property held for the production of income" are one and the same thing. If so, it would follow that depreciation and maintenance expenses would be deductible only where the property is of such character that a loss would also be deductible if the property were sold at a loss. But this question remained to be passed on by the Court.

At the time the 1942 Act was passed, the case of *Robinson v. Commissioner*[14] was under review by the Third Circuit. Taxpayer had abandoned his residence and had had it listed "for rent or sale," but was never successful in his efforts to rent the house. The Court affirmed the holding below that deductions for depreciation and maintenance expenses were not deductible as *business* expenses because the property had never been appropriated to a *business* use. Leave was granted, however, for the Tax Court to reconsider the case with regard to the applicability of the recent legislation, to wit: whether or not the deductions were proper as related to "property held for the production of income". On the second hearing,[15] the Tax Court concluded that the new law was applicable, and that the taxpayer was entitled to the deductions claimed. The abandonment of the residence and the undertaking to rent it, changed the character of the property to "property held for the production of income," although the property was never in fact rented. The Court acknowledged that the character of the property had not changed in regard to taking a loss deduction on a sale of it were it thereafter sold at a loss, but justified its finding by reference to the intention of Congress in enacting the new law. It was said that it was the intention of Congress to benefit the taxpayer by allowing deductions where re-

12. Robinson v. Commissioner, 134 F. 2d 168, 30 AFTR 1047, 43-1 USTC ¶ 9279 (3d Cir. 1943).
13. § 121, REV. ACT OF 1942.
14. 134 F. 2d 168, 30 AFTR 1047, 43-1 USTC ¶ 9279 (3d Cir. 1943).
15. Mary Laughlin Robinson, 2 T.C. 305 (1943).

lated to property which constituted a potential source of taxable income. "The statute does not require that the property be actually used for production of income, that is, be actually rented, but only held for that purpose . . . ."[16]

Rea E. Warner[17] raised the question as to whether these two positions were not inconsistent, i. e. Is it not inconsistent to allow deductions for depreciation and maintenance expenses on the theory that the property is held for the production of income yet disallow a loss upon the theory that the property is not income-producing property? The Court said that such action is not inconsistent, citing the *Robinson*[18] case. The Court, in disallowing a loss, referred to the language of the Code rather than that of the Regulations used as the test in prior *loss* decisions. The Code employs the language, ". . . in any transaction entered into for profit".[19] It seems the Court was trying to avoid the confusion caused by the similarity between the language of the Regulations and that of the new amendment.

In *William C. Horrmann,*[20] there was a noticeable avoidance of the language of the Regulations pertaining to losses. There, petitioners sold their abandoned home at a loss after several unsuccessful attempts to rent it. The Court allowed deductions for depreciation and maintenance expenses during the period of idleness, but disallowed the loss. Pointing to the difference in the language of the applicable *Code* sections, the Court said, ". . . that distinction in language may result in allowing a deduction in one case and not allowing a deduction of another type. At least the cases have distinguished between the two statutory provisions."[21]

Since the *Horrmann* decision, there seems to be no question but what the law in these respects is well settled. In *E. R. Fenimore Johnson,*[22] the Court, in disallowing a loss, devoted only a few lines to say, "The fact that the petitioners have been allowed to deduct depreciation of the premises since 1940 is of no significance. Depreciation is properly allowable where property is merely held for the production of income even though in the taxable year it has

16. *Id.* at 309.
17. 1947 (P.H.) TC Memo. Dec. ¶ 47,144, 6 TCM 582 (memo. op.), CCH Dec. 15,822(m) (1947), affmd. *per curiam,* 167 F. 2d 633, 36 AFTR 973, 48-1 USTC ¶ 9250 (2d Cir. 1948).
18. Note 15, *supra.*
19. IRC § 23(e)(2).
20. 17 T.C. 903 (1951).
21. *Id.* at 909.
22. 19 T.C. 93 (1952).

produced no income and is held for sale," citing the *Robinson* and *Horrmann* cases.[23]

CONCLUSION

Even if not too sound in logic, the rules as they exist today certainly have their support in authority. It may have been that if the first *loss* case had been decided after 1942, the Court would have allowed the deduction for the sake of consistency, but as it happened, in 1942, these cases had become too well settled to admit any change in policy.

It does not seem necessary to decide whether these holdings are consistent or inconsistent. The question is hardly worth arguing. But even if the rules are inconsistent, it does not follow that the result is bad law. Since it appeared to the Court that Congress meant to benefit the taxpayer by the provision allowing the new type of deductions, and since there was nothing to indicate that Congress meant to change the rule as had been long applied to cases involving losses, the Court could not have put the two types of deductions on the same basis without violating what it inferred to be the intention of Congress.

ROBT. J. THOMAS.

23. *Id.* at 98.