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## SELECTED TAX ISSUES CONCERNING THE SALE OF A PRINCIPAL RESIDENCE

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Many times taxpayers change their personal residence as a result of job changes, job transfers, or a desire to move to another location. Problems often arise when the taxpayer attempts to sell his old home and finds that he is unable to sell it because of a soft real estate market in the area or the unavailability of mortgage financing or high interest rates. The purpose of this article is to examine the feasibility of renting a personal residence during these periods of economic depression while at the same time retaining the nonrecognition of gain treatment for Federal income tax purposes upon the eventual sale of the residence.

To alleviate the cash flow problems of making two house payments, many taxpayers decide to rent their principal residence until it can be sold. For Federal income tax purposes, this series of events creates two questions/problems from the standpoint of the taxpayer (seller-renter):

1. Will the former personal residence be considered abandoned by vacating it before its sale? Do rental activities from the time the former residence is vacated until its sale convert such property into "property held for the production of income"? Depending upon the answers to these two questions, the former residence could be deemed as property held for investment rather than as a personal residence the effect of which would preclude the nonrecognition of any gain on its sale (Code Section 1034 treatment).
2. To what extent may the related rental expenses be deducted from the rental income collected during this interim period? Are the deductibility of rental expenses and Code Section 1034 nonrecognition of gain treatment on the sale of a principal residence mutually exclusive?

### **Code Section 1034 and Code Section 121, in General**

When a taxpayer sells his home, a loss (if realized on the sale) is generally not deductible because the property is personal use property and a gain (if

realized on the sale) is generally taxable as a capital gain. However, Code Section 1034 provides for the nonrecognition of any gain realized on the sale of a taxpayer's principal residence, if within a certain time period he invests (by purchasing or building) in a new principal residence an amount at least as large as the adjusted sales price of the old residence. For this section to be applicable, "the home sold and the home acquired must be the 'principal residence' " ([3], p. A-3) of the taxpayer. "Principal residence" is ordinarily defined as the home you actually live in. The new residence must be acquired no earlier than two years before or no later than two years after the sale of the old residence [4].

In addition to the relief provided by Code Section 1034, Code Section 121 allows a taxpayer to exclude from gross income up to \$125,000 (\$62,500 for a married person filing separately) of the gain on the sale of a personal residence if he or she has reached age 55 on or before the date of sale. For this Code Section to be applicable, the residence must have been owned and used by the taxpayer as his principal residence for at least three years out of the last five years ending with the date of sale. This exclusion must be elected by the taxpayer and may be used only once by a taxpayer.

It should be noted that the Tax Reform Act of 1986 [6], while categorized as the most extensive overhaul of our tax system in history, did not affect the basic tax structure in regards to a sale of a principal residence. Consequently, the tax law in this area remains unchanged.

### **Code Section 1034 and the "Actual Physical Occupancy" Rule**

Because the old principal residence must be sold either two years before or after the acquisition of the new principal residence in order to take advantage of Code Section 1034, certain tax problems arise when the old home cannot be sold. Such a home is often rented or left vacant between the time the taxpayer occupied it and the date of its eventual sale. Does this preclude the taxpayer from the tax savings offered by Code Section 1034 because the taxpayer did not physically occupy the premises as his principal residence on the date of the sale? The legislative history of the statute indicates that the taxpayer does not have to physically occupy his old residence within two years of the date of its sale and purchase of a new principal residence. The requirement of "actual physical occupancy" of the old residence within two years of the date of its sale does not require the taxpayer to occupy his former home until the date he sells it. However, it does require the taxpayer to purchase and occupy his new principal residence within two years of the date that he vacated his former principal residence. Failure to sell one's home within two years before or after the acquisition and physical occupancy of a new principal residence would preclude the taxpayer from applying Code Section 1034 resulting in the recognition and taxing of any gain on the eventual sale of the former principal residence [7].

There are two exceptions to this “physical occupancy” rule. One exception to this rule involves the taxpayer who vacates his residence *with the intention of returning* but later changes his plans and sells the residence. In *Trisko v. Commissioner* [8], the taxpayer vacated his home because of a temporary work assignment abroad. While abroad, he leased the house. When he returned to the States, he attempted to occupy his home as his principal residence but could not due to rent controls and a lease obligation. The taxpayer then purchased a new home and sold his old home subject to the lease. The Tax Court permitted nonrecognition of the gain resulting from the sale of the former home under Code Section 1034 even though the taxpayer had not physically occupied the premises in several years. Internal Revenue Ruling 59-72 states that the taxpayer will be entitled to apply Code Section 1034, even though the former residence was rented prior to its sale, if the facts and circumstances indicate that the property sold by taxpayer was his principal residence.

The second exception to the “physical occupancy” rule involves a delay in selling the vacated premises due to a soft real estate market. There is still some uncertainty in the law in this area. However, in *Clapham v. Commissioner* [2], the Tax Court allowed Code Section 1034 treatment on the sale of a former residence although the taxpayer did not physically occupy the residence within the statutory period as of the date of the sale and had no intention of reoccupying this home as his principal residence. In this case, the taxpayer’s job location was changed and he had no intention of returning to occupy this home. The taxpayer had vacated his former residence for a period of nearly three years. Because of the real estate market, he was unable to sell his home and, therefore, agreed to lease it (with an option to purchase) for one year. When the lease term was up, the tenants vacated the home without exercising the option to purchase. The house was again listed for sale, but with no success, and the house was leased again for several months. Within approximately a year from the date the former residence was sold, the taxpayer purchased a new home at his new job location. The court held that the sale qualified for Code Section 1034 treatment and

... viewed the rentals as necessitated by the exigencies of the real estate market and merely ancillary to the sales effort. The Tax Court, citing the Ways and Means Committee Report under the Revenue Act of 1951 regarded the situation of a change in residence due to change of employment as a type of involuntary conversion to which Congress intended to extend relief, and stated that interpreting the statute as inapplicable when a poor real estate market or unavailability of mortgage funds required leasing ‘for a temporary period concurrent with and ancillary to sales efforts’ would be inconsistent with the statute’s remedial purpose ([3], pp. A-6 – A-7).

In *Clapham v. Commissioner* [1], “the Court rejected the Commissioner’s [the Internal Revenue Service’s] argument, stating that rather than establishing a rule of law that a taxpayer must actually be occupying or intending to return to his old residence, . . . [the question of] ‘whether or not property is the principal residence of the taxpayer depends on all the facts and circumstances in each individual case.’ ”

### **Deductibility of Rental Expenses Related to Former Residence**

If a taxpayer vacates his old residence and leases it until the date of its sale, he is faced with taxable rent income which he collects from the tenant. Will rental expenses be permitted to offset this taxable rental income for Federal income tax purposes?

In *Bolaris v. Commissioner* [1], the Internal Revenue Service and the Tax Court both held that a “personal residence” could not also be “property held for the production of income” (i.e., rental property) which, in essence, prohibited the deductibility of rental expenses in these situations. They view these designations of property as being mutually exclusive. In the *Bolaris* case, the Bolarises attempted to sell their old home from July, 1977 until they sold it in August, 1978. In October, 1977, they vacated their old home and moved into their new principal residence. After first unsuccessfully listing their home for sale for 90 days, they rented it on a month-to-month basis at a fair rental value. Because the Bolarises thought the old home would show better if it were vacant, they asked the tenants to move after eight months. Six weeks later, the Bolarises received their first offer to buy their old home which they accepted. Due to financing difficulties, the Bolarises agreed to rent the home to the buyers until they obtained financing. About one month later, the buyers purchased the home. The Bolarises appealed the rulings of both the Internal Revenue Service and the Tax Court to the Ninth Circuit Court of Appeals. After analyzing the legislative history of the appropriate statutes and applying their interpretation of such to the facts of the *Bolaris* case, the Ninth Circuit Court found several key factors in favor of the Bolarises which they felt were essential in order for them to deduct rental expenses for Federal income tax purposes.

1. There were both offers to rent and offers to sell and the home was actually rented at its fair market value;
2. The home had been abandoned permanently by the Bolarises when they moved to their new residence; and
3. The home was not used for personal recreation. “The (C)ourt stated that ‘(i)t is completely understandable that petitioners (the Bolarises) desired to turn this potential expense eater (the old residence) into an income-producing asset during (the) waiting period (prior to sale)’ ”[1].

As a result, it reversed the Tax Court's decision and in summary, the Bolarises were allowed to defer recognition of the gain on the sale of their old residence and were also entitled to deduct all expenses which were applicable to the rental activities of the old residence.

Although this decision is binding in the Ninth Circuit, the IRS may attempt to challenge this interpretation of legislative history. If the IRS refuses to acquiesce to the Ninth Circuit's decision, they probably will continue to challenge those situations in which a taxpayer claims a residence as qualifying as a principal residence within the context of Code Section 1034 while at the same time holding it for the production of income.

### Summary

In attempting to maximize the tax position upon the sale of a former principal residence, taxpayers strive to defer any gain that is realized on such a sale. If a home is sold within the two-year statutory period from the date the taxpayer vacates the premises and it continues to qualify as his principal residence on the date of sale, Code Section 1034 will be applied to defer recognition of any gain on the sale. If a loss is realized, such loss will be disallowed. If the residence were converted into income-producing property prior to its sale, then the loss may become deductible for Federal income tax purposes [5]. Profits or losses from rental activities that were incurred during the interim period will not prohibit Code Section 1034 treatment on a qualifying sale of the former residence.

If a former residence is sold after the two-year statutory period, then Section 1034 treatment of the gain realized will be disallowed and the gain, therefore, will be recognized for Federal income tax purposes unless the taxpayer meets one of the following exceptions:

1. Premises vacated with intent to return
2. Exigencies in the real estate market

If a loss is realized and if the taxpayer meets either of the two exceptions noted above, then the loss will not be recognized for Federal income tax purposes. Because this area of taxation is very complex, it is imperative that individuals who are considering the sale or rental of their principal residence be aware of the ramifications in order to achieve the desired result.

### References

1. *Bolaris v. Commissioner*, 81 T.C. 840 (1983).
2. *Clapham v. Commissioner*, 63 T.C. 505 (1975).
3. Handler, R. Arnold. *Sale or Exchange of Residence*. 179-3rd T.M., Washington, DC: Bureau of National Affairs, Inc. (1985).

4. *Internal Revenue Code*, Section 1034(a).
5. *Rechnitzer v. Commissioner*, 26 T.C.M. (CCH) 298 (1967).
6. *Tax Reform Act of 1986*, Pub. L. No. 99-514, 100 Stat. 2085 (1986).
7. *Treasury Regulations*, Section 1.1034-1(c)(1) (1960).
8. *Trisko v. Commissioner*, 29 T.C. 515 (1957), acq. 1959-1 C.B. 5.