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CAN A PERSONAL RESIDENCE BE AN ACTIVITY ENGAGED IN FOR THE PRODUCTION OF INCOME?

Bolaris v. Commissioner,
776 F.2d 1428 (9th Cir. 1985)

I. INTRODUCTION

The taxation of income is governed by the massive web of law called the Internal Revenue Code (Code). The complexity of the Code arises from the countless cross-references and interrelations between different sections, not from the individual sections in and of themselves. Under the Code, the income taxation scheme of any item centers primarily around its classification as a certain type of use.[1]

A taxpayer's personal residence has traditionally been classified as "personal use"[2] property. In a recent case, *Bolaris v. Commissioner,*[3] the Ninth Circuit Court of Appeals altered the status of a personal residence, allowing it to have chameleon like characteristics. In doing so, the court took a seemingly settled area of law and added further confusion to the already complex Code scheme.

The court considered whether a taxpayer could defer recognition of the gain on the sale of a personal residence and also take deductions which were attributable to the property being held for the production of income. The real issue in the case was whether a personal residence could qualify coextensively as production of income property. The Commissioner of Internal Revenue and the Tax Court had earlier decided that the taxpayer could not both defer the gain and take the deductions. The Ninth Circuit reversed the Tax Court and allowed both deferral and deductions.

This comment will focus on the Ninth Circuit's opinion in *Bolaris,* beginning with an examination of the law preceeding the *Bolaris* case. After an examination of the facts and opinion of the case is made, the analysis section will study the opinion and consider the impact of the decision. The analysis concludes that the Ninth Circuit Court erred in allowing the taxpayers' residence to qualify coextensively as a residence and production of income property.

1. *See infra* notes 4, 6-9 and accompanying text.
2. *See infra* note 8 and accompanying text.
3. 776 F.2d 1428 (9th Cir. 1985).

II. History

The Internal Revenue Code contemplates three classes of expenditures: (1) those paid or incurred in a trade or business; (2) those paid or incurred in a profit-making or production of income context; and (3) those paid or incurred essentially for a personal purpose.[4] Corresponding to these three classes of expenditures are three different uses of property. The first type, trade or business, are deductible under section[5] 162, which covers all trade or business expenses.[6] The second type, production of income use, are deductible under section 212, which covers deductions for expenses for the production of income.[7] The third type, personal use,[8] are deductible under section 183[9] or 280A,[10] which covers activities not engaged in for profit. Congress, in section 183, clearly established the three area classification, by defining activities not engaged in for profit as any activity other than one for which deductions under section 162 or 212 are allowable.[11]

Under the Code, income is taxed from "whatever source derived."[12] On the other hand, deductions are a matter of legislative grace;[13] only

4. Levin, *A Home Is Not Where the Deductions Are*, 11 J. REAL EST. TAX'N No. 4, 377, 382 (1984).

5. All section references are to the Internal Revenue Code of 1954 as amended.

6. Section 162(a) provides in pertinent part:

"There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business."

7. Section 212 provides in pertinent part:

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

(1) for the production or collection of income;

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

8. *See Levin, supra* note 4, at 382.

9. Section 183 provides in pertinent part:

(a) General rule.—In the case of an activity engaged in by an individual . . . if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

. . . .

(c) Activity not engaged in for profit defined.—For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

10. An either/or distinction between §§ 183 and 280A is intended by Congress as to residences. Section 280A(f)(3) states that if § 280A applies, § 183 shall not.

11. In fact, the factors indicating that property is being held for the production of income tend to indicate the absence of use as a personal residence. Maule, *Rental of Prinicipal Residence Before Sale: Retaining 1034 Treatment & Rental Deductions*, 55 J. TAX'N 8, 10 (1981). *See* Dickens, *Temporary Rentals of a Former Residence After* Bolaris*: Can Sections 212 and 1034 Co-exist?*, 62 TAXES No. 10, 685, 696 (1984) ("One's personal residence [must] be classified as property which is not engaged in for profit, thus invoking Section 183.").

12. Section 61.

13. *See* New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934) ("Whether and to what

expenses specified in an identifiable statutory provision are deductible. Under Code sections 161 and 211, certain itemized deductions are specifically provided for, but all are subject to Part IX,[14] which lists non-deductible items. Sections 261[15] and 262[16] of Part IX state that there shall be no deductions allowed for personal, living, or family expenses.[17] Therefore, unless a specific code section provides otherwise, no deductions may be taken for personal expenses.

Since the general rule is that no deductions are allowed for personal expenses, any expenses for maintenance, insurance, and utilities on a personal residence should not be deductible.[18] However, many cases have arisen where taxpayers have claimed deductions for these types of expenses while their residence was being rented out before its sale.

Rental of a Residence

The difficult question arising in these rental cases is whether and when a personal residence loses its character as such and is converted into property held for the production of income.[19] The regulations under section 212 contemplate such conversion. Regulation section 1.212-1 provides for the deduction of ordinary and reasonable expenses incurred in connection with the management, conservation or maintenance of property held as rental property, even though such property was formerly held by the taxpayer for use as a home.[20]

In *Horrmann v. Commissioner*,[21] the taxpayer moved out of his former principal residence and listed it for sale. It was not sold for three years, but in the interim, it was held for both lease and sale. The court

extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor [sic] can any particular deduction be allowed.").

14. Subtitle A, Ch. 1B, Part IX includes §§ 261-280. *See also* Treas. Reg. § 1.212-1(e) (1954) ("A deduction under Section 212 is subject to the restrictions and limitations in part IX" (§ 261 and following)).

15. Section 261 provides: "In computing taxable income no deduction shall in any case be allowed in respect of the items specified in this part."

16. Section 262 provides: "Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."

17. Hereafter referred to as personal expenses. Treas. Reg. § 1.262-1(c) (1954) refers to certain personal expenses that may be deductible even though not incurred in a business or profit-oriented transaction. Pertinent to this comment are interest, taxes, and losses.

18. Treas. Reg. § 1.262-1(b)(2), (3).

19. This comment concentrates its discussion only upon § 212, property for the production of income [hereafter referred to as § 212 property] and will not consider § 162 trade or business property unless relevant. Much of the litigation has been over the interpretation of Treas. Reg. § 1.1034(3)(i), stating "[t]he mere fact that property is, or has been, rented is not determinative that such property is not used by the taxpayer as his principal residence."

20. Treas. Reg. § 1.212-1(h) (1942).

21. 17 T.C. 903 (1951).

found it was held for the production of income because the property was being held for rental, and therefore, allowed a rent loss deduction.

Similiarly, in *McAuley v. Commissioner*,[22] the court also allowed the deduction of expenses incurred where the property was held for rent by the taxpayer. The court stated, "[t]he bona fide placement of property on the rental market has been held to be a sufficient holding of the property for production of income to justify the deduction of expenses paid by a taxpayer in connection with the holding of the property."[23]

Thus, in *Horrmann* and *McAuley*, the rental or holding for rental of a former residence was enough to qualify the property for deductions for the production of income. However, a number of cases have arisen where the rental of a former residence did not qualify the property for deductions for the production of income. These cases are generally distinguishable from the *Horrmann* type cases because the taxpayers wished to qualify for section 1034 treatment[24] and therefore wanted to have their property characterized as a residence.

In *Clapham v. Commissioner*,[25] the taxpayers vacated their old residence when they moved to another city. The court did not find that rental of the property converted it to section 212 property. Rather, the court found the rental temporary and necessitated by the exigencies of the real estate market, and therefore the property did not lose its status as a residence.

The issue of conversion by temporary rental was discussed in Priv. Ltr. Rul. 81-32-017.[26] The ruling made a distinction between the pure fair rental situation and the situation where the taxpayer does not intend to convert the residence to rental property. The point to be drawn from the ruling is that a temporary rental of a principal residence alone does not necessarily change the residence into property held for the production of income.

Section 165

When property held for the production of income (section 212) is sold for a loss, this loss may qualify for recognition under section 165.[27]

22. 35 T.C.M. (CCH) 1236 (1976).
23. *Id.* at 1241.
24. Discussion of Section 1034 is presented *infra* notes 36-38 and accompanying text.
25. 63 T.C. 505 (1975).
26. Priv. Ltr. Rul. 81-32-017 (April 30, 1981).
27. Section 165 provides in pertinent part:

(a) General rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

. . . .

The mere status as section 212 property, however, does not mean automatic qualification for section 165 treatment. The conditions for deducting a loss from a sale under section 165 are more stringent than the section 212 requirement for deducting certain expenses.[28] Section 165 has a transactional requirement, that the losses must be incurred in a transaction "entered into for profit," versus the section 212 standard of "held for the production of income."

Personal use property can be converted to property qualifying for a deduction under section 165. Regulation section 1.165-9(h) states that a loss may be deducted for a taxpayer's personal residence, which prior to its sale is rented or otherwise appropriated to income producing purposes.[29] It is not clear exactly what causes conversion, but merely listing property for sale or rental has been held not "appropriated to income producing purposes."[30]

In *Rechnitzer v. Commissioner*,[31] the taxpayer was allowed to deduct a loss on the sale of his residence. The taxpayer listed the prior residence for sale, but after unsuccessful efforts to sell, rented the property to a tenant. The issue before the court was whether the taxpayer was entitled to a section 165 loss deduction.[32] The court, interpreting Treas. Reg. § 1.165-9, held that a loss was deductible if the residential property was converted to rental property. The conversion requirement was satisfied by meeting two conditions. First the rental transaction must be profit inspired, and second the rental of the property must preclude reoccupancy of the premises by the owner.[33] The court allowed a loss deduction after finding these conditions met.[34]

(c) Limitation on losses of individuals.—In the case of an individual, the deduction under subsection (a) shall be limited to—

. . . .

(2) losses incurred in any transaction entered into for profit; and

(3) . . . losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

28. Fowler, Bolaris: *Does Qualification for Section 1034 Foreclose a Rent Loss Deduction?*, REV. TAX'N INDIVIDUALS 226, 234 (1985); *See also* McAuley v. Commissioner, 35 T.C.M. (CCH) 1236, 1241 n.8 (1976) ("[S]uch a distinction [between §§ 212 and 165] has long been established in the decided cases.").

29. Treas. Reg. § 1.165-9(h) (1954).

30. *McAuley*, 35 T.C.M. (CCH) at 1241; *see also* Rumsey v. Commissioner, 82 F.2d 158 (2d cir.), *cert. denied*, 299 U.S. 552 (1935).

31. 26 T.C.M. (CCH) 298 (1967).

32. *Id.* at 301.

33. *Id.* at 302.

34. *Id.* at 304; *see* Heiner v. Tindle, 276 U.S. 582, 584 (1928), where the Supreme Court held that where property originally acquired for residential purposes is subsequently devoted exclusively to the production of taxable income, a transaction is entered into for profit at the date of the change in use from which a deductible loss may result.

In *Sweet v. United States*,[35] the district court considered whether a loss was deductible on the sale of a former residence. The taxpayers entered into an exclusive real estate listing agreement for sale of the residence. After it became obvious that the property was not going to sell, the taxpayers decided to rent it to ease the financial burden of holding the house. On these facts, the court found the property was converted to income producing purposes and allowed a loss on the subsequent sale. Thus, a loss could be deductible on the sale of a former residence, but only once it is converted from personal residence status.

Section 1034

Gains or losses on a sale of a residence would be recognized under section 1001, if it were not for sections 1034 and 165. Under section 1034,[36] a taxpayer is allowed to "rollover" the gain on the sale of a principal residence[37] if the statutory requirements are met. The main requirement is that the property must be used by the taxpayer as his principal residence. The reasoning behind nonrecognition is that most individuals need the proceeds from the sale of the former residence, undiminished by a tax, in order to purchase a new house of equivalent value.[38]

A loss on the sale of a personal residence is not deductible as long as the residence is still personal use property. In order for individuals to deduct a loss, the loss must meet the requirements of section 165.[39] The sale of a personal residence does not satisfy the section 165 requirement of a fire, storm, shipwreck or other casualty. Moreover, Treas. Reg. § 1.165-9 expressly states that a loss sustained on the sale of a taxpayer's personal residence is not deductible under section 165.[40] Although a tax-

35. 68-2 U.S. Tax. Cas. (CCH) ¶ 9656 (N.D. Cal. 1968).

36. Section 1034 provides in pertinent part:

(a) Nonrecognition of gain.—If property used by the taxpayer as his principal residence is sold by him and, within a period beginning 2 years before the date of such sale and ending 2 years after such date, property is purchased and used by the taxpayer as his principal residence, gain from such sale shall be recognized only to the extent that the taxpayer's adjusted sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence.

37. The determination of whether or not property is used by the taxpayer as his principal residence depends upon all the facts and circumstances in each case, including the good faith of the taxpayer. Treas. Reg. § 1.1034-1(3)(i).

38. Clapham v. Commissioner, 63 T.C. 505, 511 (1975). *See* Davies v. Commissioner, 54 T.C. 170, 175 (1970), stating that very often the "gain" upon sale is an inflationary one, and mere replacement of the residence will require using all the proceeds from the old house. *See also* H.R. REP. No. 586, to accompany H.R. 4473 (Pub. L. No. 183), 82d Cong., 1st Sess., at 27 (1951) (the purpose is to eliminate a hardship).

39. *See supra* note 27.

40. Treas. Reg. § 1.165-9(a). *See also* Treas. Reg. § 1.262-1(b)(4), which states that losses sus-

payer must recognize or defer gains, losses on the sale of a personal residence are not deductible, unless the property is converted from personal use status.

III. FACTS OF THE *BOLARIS* CASE

The *Bolaris* case arose after the Commissioner of Internal Revenue determined a deficiency in the petitioners, Stephen and Valerie Bolaris', federal income taxes for the years 1977 and 1978. The taxpayers purchased a home in San Jose, California in August, 1975, which was used as their personal residence until they moved to a new residence in October, 1977.[41] After initial efforts to sell the house were unsuccessful, the taxpayers decided to rent the house while continuing to look for prospective purchasers.[42] The decision to rent was based on financial circumstances, mainly the burden of satisfying obligations on both the new and former residences.[43] After deciding that it might be easier to sell the house without a present month-to-month tenant, they asked the tenant to leave.

Six weeks after the tenant vacated the residence, the taxpayers received an offer to purchase the home. The taxpayers accepted the offer, but agreed to rent the prior residence to the purchasers until the financing difficulties of the purchasers were settled and the purchase was consumated.[44] Both of the rentals were at the home's fair rental value, in arm's length transactions.

On the taxpayers' 1977 and 1978 tax returns, interest, taxes, insurance, depreciation and other miscellaneous expenses attributable to the house were deducted.[45] The IRS disallowed all expenses other than the interest and taxes. These expenses were deductible under sections 163 and 164 regardless of the status of the property. The other deductions were disallowed because the rentals were held not entered into for the

tained by a taxpayer upon the sale or other disposition of property held for personal, living and family purposes are not deductible. For cases holding loss on sale of residence is nondeductible *e.g.*, Christensen v. Commissioner, 47 T.C.M. (CCH) 1558, 1559 (1984); *McAuley*, 35 T.C.M. (CCH) at 1241.

41. Bolaris v. Commissioner, 776 F.2d 1428, 1429 (9th Cir. 1985). Efforts to sell the house began in July 1977 with a 90 day exclusive listing with a realtor.

42. The petitioners had already moved into their new residence with no intent to return to the old residence.

43. Bolaris v. Commissioner, 81 T.C. 840, 842 (1983). The trial court found that the Bolarises had no expectation or intention of making a profit from the rental, but rather rented it to lessen the burden of carrying the property.

44. 776 F.2d at 1429.

45. *Id.* at 1430. The amounts were $2909.22 and $7444.28 in 1977 and 1978 respectively.

production of income.[46] Additionally, the IRS contended that if the taxpayers were entitled to defer the gain on the sale of their old residence under section 1034, they were not entitled to deduct depreciation or rental expenses.[47]

The Tax Court first considered whether the taxpayers were entitled to section 1034 treatment on their residence even though they rented it out before its sale. The court quoted the legislative history of section 1034:

> The term "residence" 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 light of all the *facts and circumstances* in the case, prevent the gain from being recognized.[48]

The court found that the rentals were dictated by financial circumstances and that the primary motive of the taxpayers was to sell the prior residence rather than to hold it for the production of income. Thus, the rentals were temporary as contemplated by the legislative history of section 1034 and deferral of the gain was allowed.[49]

The Tax Court next considered whether the taxpayers could claim depreciation and rental expense deductions pursuant to section 212. The court found the nature of the taxpayers' rental activity demonstrated that it was not engaged in with the objective of making a profit.[50] Accordingly, the court disallowed the taxpayers' deductions for depreciation, insurance, and miscellaneous expenses relating to the rental of the old residence.[51]

IV. NINTH CIRCUIT OPINION OF THE *BOLARIS* CASE

The first issue considered by the Ninth Circuit was whether the taxpayers were entitled to defer recognition of the gain on the sale of their old home under section 1034.[52] The court reviewed the Tax Court's reasons for allowing the nonrecognition and quoted the same legislative his-

46. *Id.* The deductions were disallowed specifically upon a determination that they were attributable to an activity not engaged in for profit under § 183. 81 T.C. at 844.

47. *See* §§ 167 and 212.

48. 81 T.C. at 846 (quoting H.R. REP. No. 586, 82d Cong., 1st Sess., at 109) (emphasis added by court).

49. 81 T.C. at 847. The court also relied upon Clapham v. Commissioner, 63 T.C. 505 (1975).

50. The factors listed were the temporary and ancillary rentals in regard to the sales efforts, renting on a monthly basis, and requesting the first tenant to vacate to facilitate sales efforts. 81 T.C. at 849.

51. *Id.* at 850. Deductions were allowed for interest and taxes. If a larger amount of rental income had been received by the petitioners, other deductions up to the amount of gross income would be deductible pursuant to I.R.C. § 183 (1982).

52. Bolaris v. Commissioner, 776 F.2d 1428, 1431 (9th Cir. 1985).

tory of section 1034.[53] The court agreed that the rental of the home before its sale did not preclude the nonrecognition of the gain realized on the sale.[54] Therefore, the court affirmed the Tax Court's decision permitting the deferred recognition.[55]

The next and primary issue considered by the court was whether the Tax Court was correct in denying the deductions for depreciation and other rental expenses under sections 167 and 212 respectively. The crucial question was whether a taxpayer holding a residence qualifying for nonrecognition of gain could also hold the residence for the production of income. The court found that the IRS's focus on the portion of legislative history stating that "residence is used in contradistinction to . . . property held for the production of income," was too narrow and that it must be read in light of the remainder of legislative history and the historical background of sections 167, 212 and 1034.[56]

In particular, the court focused on the portion of the history which stated, "the mere fact that the taxpayer temporarily rents out either the old or the new residence may not, in light of all the facts and circumstances in the case, prevent the gain from being not recognized."[57] The court read this so as to allow a former residence to qualify for nonrecognition treatment even if the residence was temporarily rented *and* to qualify it as being held for the production of income.[58]

The IRS claimed that permitting both deductions and nonrecognition resulted in an improper "windfall" to taxpayers. The court retorted with a three part justification. First, not all rentals of former residences would qualify for rental expense deduction.[59] Second, if any windfall did exist, it was limited by the two year time limit within which the old residence must be sold under section 1034.[60] Third, Congress could have prevented the deduction of rental expenses under section 1034 by so providing, but it chose not to do so.[61]

The final issue addressed by the court was whether the taxpayers

53. *See supra* text accompanying note 48.

54. *Bolaris*, 776 F.2d at 1431.

55. *Id.* at 1432. The court discussed a pre-section 1034 case, Robinson v. Commissioner, 2 T.C. 305, 307 (1943), which held that an abandoned residence which was listed for rent or sale qualified as property held for the production of income. The court stated that Congress was presumably aware of the case at the time of the adoption of section 1034.

56. *Bolaris*, 776 F.2d at 1432.

57. *Id.*

58. *Id.*

59. *Id.* The court explained that rentals for less than the fair market value would probably not qualify.

60. *Id.* *See supra* note 38.

61. *Id.* The court said that it refused to imply such a provision.

were entitled to the deductions in this case. The court stated that the standard for deductibility under sections 167 and 212 was whether the individual engaged in the activity with the predominant purpose and intention to make a profit.[62] The court quoted a recent Tax Court case[63] listing five factors to be considered in determining whether an individual has converted his residence to property held for the production of income. The court adopted the following five factors:

> (1) the length of time the house was occupied by the individual as his residence before placing it on the market for sale; (2) whether the individual premanently [sic] abandoned all further personal use of the house; (3) the character of the property (recreational or otherwise); (4) offers to rent; and (5) offers to sell.[64]

The court focused primarily on the abandonment, character and offers to sell, in finding that the taxpayers possessed the requisite profit motive. The existence of both offers to rent and to sell impressed the court, especially the rental at fair market value.[65] Next, the court stressed the fact that the taxpayers permanently abandoned the old home when they moved, and were legally unentitled to return since the home was rented almost continually after they left.[66] The final significant[67] factor was that the old home had no element of personal recreation. The court cited Treas. Reg. § 1.183-2[68] stating, "a profit motivation may be indicated where an activity lacks any appeal other than profit."[69] Thus, the court found the facts indicated a profit motive and allowed the deductions. The court concluded that the Tax Court erred by denying the deductions, and reversed.[70]

V. Concurring and Dissenting Opinion of Judge Reinhardt

Judge Reinhardt concurred with the majority on the affirmation of the deferred recognition of the gain under section 1034.[71] He stated that

62. *Id.* The court stated that the burden of proving the existence of such factors was on the petitioner.

63. *See* Grant v. Commissioner, 84 T.C. 809 (1985).

64. *Bolaris*, 776 F.2d at 1433 (quoting *Grant*, 84 T.C. at 825).

65. *Bolaris*, 776 F.2d at 1433. The court quickly grasped the statement of the Tax Court that "renting the residence at its fair market value would normally suggest that the taxpayer had the requisite profit objective." *Bolaris*, 81 T.C. at 849.

66. *Bolaris*, 776 F.2d at 1433.

67. The court found the length of time the house was occupied unhelpful. Further, the court said that an ancillary desire to sell a home is insignificant in determining a profit motive. *Id.* at 1433 n.7.

68. Treas. Reg. § 1.183-2(b)(9) (1972). This regulation lists factors relevant in determining whether an activity is engaged in for profit.

69. *Bolaris*, 776 F.2d at 1433.

70. The court remanded the case for a redetermination of the deficiencies. *Id.* at 1434.

71. *Bolaris*, 776 F.2d at 1434 (Reinhardt, C.J., concurring and dissenting).

deferred recognition is only allowed for the taxpayers' "principal residence." He then went on to state that rental expenses were allowable *only* for property held for the production of income.[72] Judge Reinhardt followed the Tax Court and found the two phrases, "principal residence" and "production of income," mutually exclusive.[73]

Judge Reinhardt felt the statutory language and judicial interpretations were clear on this point, and there was no reason for the court to look to the applicable legislative history. Nevertheless, Judge Reinhardt stated the history was also plain and unambiguous, since it stated, " 'residence' is used in contradistinction to . . . property held for the production of income."[74]

Judge Reinhardt also disagreed with the majority's interpretation of the "temporary renting" section of the legislative history.[75] He felt the majority made an unwarranted conclusion, that a principal residence could be held for the production of income, since temporary renting was permitted.[76] He supported this view by, once again, referring to the above quoted legislative history. Before concluding, Judge Reinhardt also made reference to the fact deductions are available to the taxpayers pursuant to section 183.

VI. Analysis

The Ninth Circuit Court of Appeals incorrectly reversed the Tax Court on the issue of whether a personal residence could be held coextensively as a residence, entitled to section 1034 treatment, and production of income property, entitled to section 212 treatment. The court's ruling was based upon an erroneous interpretation of section 1034 and its accompanying legislative history.

Interpretation of Section 1034

A settled principle of statutory construction is that words are to be given their ordinary meaning.[77] It is also true that the context in which a word is used and the purpose of the statute in which it is employed indi-

72. *Id.* at 1434.
73. Judge Reinhardt made reference to the "well established law" that deductions under §§ 167 and 212 are not allowable with respect to a taxpayer's residence. *Id.*
74. *Id.* at 1435 (quoting H.R. Rep. No. 586, 82d Cong., 1st Sess. 3, *reprinted in* 1951 U.S. Code Cong. & Admin. News 1781, 1896).
75. *See supra* text accompanying note 57.
76. *Bolaris*, 776 F.2d at 1435 ("On the basis of this rather benign proposition and without any particular further explanation, the majority leaps to the conclusion.").
77. Old Colony R.R. Co. v. Commissioner, 284 U.S. 552, 560 (1932).

cate its meaning.[78] Section 1034[79] clearly refers to "principal residence." The legislative history also clearly states that "residence" is used in *contradistinction* to property "held for the production of income."[80] Contradistinction means opposite qualities or by contrast.[81] Although the court stated the sentence must be read in context, it failed to do so. The court saw the "temporary rental" language and as the dissent stated, "seized on the statement . . . [and leapt] to the conclusion that a taxpayer's home can at once be *both* a residence and property held for the production of income."[82] The use of "both" or "and" language contemplates coexistence while "contradistinction" contemplates mutual exclusivity.

The purpose behind section 1034 supports the conclusion that a taxpayer's home cannot be both a principal residence and property held for production of income. Section 1034 was enacted to eliminate the hardship of having to pay a capital gain on the sale of a personal residence.[83] Property held for the production of income, when sold, is not necessarily invested into a new residence. The purpose behind section 1034 is not to help investors defer recognition of their gains. If Congress had wanted to provide nonrecognition treatment to all types of property under section 1034, it would have done so and not worded the statute in terms of a principal residence.

Conversion

After interpreting section 1034, the court considered whether the taxpayers' residence was "converted to" property held for the production of income. Conversion is the turning or changing of something from one character to another.[84] The court allowed the residence to coextensively have section 1034 and 212 characteristics. The plain meaning of "converted to" is not susceptible to an interpretation that the property has both characteristics, since conversion means to change from one character to another.

The case law concerning whether residential property qualifies for section 212 treatment has always spoken of *conversion to* production of income property, not coextensive status. *Horrmann v. Commissioner*,[85] is

78. Stolk v. Commissioner, 40 T.C. 345, 351 (1963).
79. *See supra* note 36.
80. *See supra* text accompanying note 48.
81. WEBSTER'S NEW TWENTIETH CENTURY DICTIONARY, UNABRIDGED 397 (2d ed. 1966).
82. *Bolaris*, 776 F.2d at 1435 (Reinhardt, C.J., concurring and dissenting).
83. *See supra*, note 38 and accompanying text.
84. WEBSTER'S NEW TWENTIETH CENTURY DICTIONARY, UNABRIDGED 400 (2d ed. 1966).
85. 17 T.C. 903, 909-10 (1951). The court held that, although "conversions" qualified the property for "production of income" expense treatment, the property could not be held for the

illustrative, where the court decided whether a former residence was converted to property held for the production of income.

The language of the regulations accompanying the statutes indicates that Congress contemplated conversion and not coextensive status. Regulation section 1.212-1[86] makes a sharp distinction between a residence and property held for the production of income. Subsection (h), states no deduction is allowed for expenses on property held for use as a residence. However, deductions are allowed for rental property even though it was *formerly held* by the taxpayer as a home.[87] This implies that property may not be held as a residence and as rental property at the same time.[88] It seems clear that there is a difference between temporary rentals of a residence and actual rental property.

Regulation section 1.165-9(b)(1) has the title "Property converted from personal use."[89] Within that subsection, the language allows a loss for property "appropriated to income-producing purposes" from use as a personal residence.[90] The use of "appropriated to," "formerly held," "contradistinction" and "conversion to" language indicates Congress intended an either/or dichotomy between personal use property and business or investment use property, and not a coextensive use.[91]

The Ninth Circuit itself acquiesced to this approach taken by Congress and other courts when it used this type of language. The court quoted and adopted a list of five factors to help determine whether an

production of income where the petitioners fixed the character of the property as residential in their hands. The circumstances in *Horrmann* made it clear to the court that there was no conversion of the property. *See also* Sherlock v. Commissioner, 31 T.C.M. (CCH) 383, 385 (1972), deciding whether petitioners converted their personal residential property to property held for the production of income.

86. Treas. Reg. § 1.212-1(h) (as amended in 1975) 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 through such property was formerly held by the taxpayer for use as a home.

87. This comment expresses no opinion nor knows of any case law discussing any difference between "home" and "residence."

88. *See supra* notes 17-19 and accompanying text. *See also* Maul, *supra* note 11, at 9 (Regulation § 1.212-1(h) takes the position that no deduction would be allowed, since the old principal residence was still a residence, deductions for which are barred by I.R.C. § 262 (1982)). Subsection (e) of the regulation solidifies this point, by stating that even though an expense may be made for a purpose specified in § 212, it is not allowed where disallowed elsewhere in the Code. Treas. Reg. § 1.212-1(e) (as amended in 1975). This means that even if a personal residence could be construed as § 212 property at the same time, §§ 261 and 262 would disallow any deductions as personal expenses.

89. Treas. Reg. § 1.165-9(b)(1) (as amended in 1964).

90. *Id. See also* Regulation § 1.212-1(h) which refers to property "formerly held" as a home; *see supra* text accompanying notes 19 and 20.

91. *Levin, supra* note 4, at 382 n.24.

individual has *converted* his residence to property held for the production of income.[92] The court, however, contradicted itself by saying the property was converted to section 212 property, but remained as a personal residence. The clear import of the words do not allow such an interpretation. Thus, Congress was clear that its intent was to classify property in mutually exclusive categories rather than coextensive categories.

Inconsistent Results Under Other Code Sections

An adoption of the court's coextensive approach is theoretically inconsistent with the Code, and could be an impetus to the circumvention of section 165 by certain taxpayers. Under section 165[93] and its accompanying regulations,[94] the Code unambiguously states that losses on the *sale* of a personal residence are not deductible. However, by allowing a personal residence to qualify as section 212 property, it may also qualify under section 165[95] for a loss deduction.

A number of cases have allowed losses on the conversion of a personal residence to income-producing property. Two cases in particular have facts very similiar to *Bolaris.* In *Rechnitzer v. Commissioner,* the Tax Court allowed a loss deduction upon conversion to a transaction entered into for profit where the taxpayer showed: (1) the rental transaction was profit inspired; and (2) rental of the property precluded reoccupancy of the premises as a residence.[96] The district court in *Sweet v. United States,*[97] also allowed a loss on a conversion of a residence to income-producing purposes. In both prior cases, the taxpayer rented the property only after sales efforts were unsuccessful. In *Sweet,* the decision to rent was made under the identical financial circumstances as *Bolaris.*[98] In all three cases, the primary intent of the parties was to sell the residence. In *Sweet* and *Rechnitzer,* the rentals were found to be profit-oriented merely because the parties rented the property in bona fide rental transactions.[99] Additionally, in all three cases, the second requirement of *Rechnitzer,* rental precluding reoccupancy, was met merely because there were actual tenants under binding agreements.[100]

92. *See supra* text accompanying note 64 (emphasis added).
93. *See supra* note 27.
94. *See supra* note 29 and accompanying text.
95. *See supra* notes 28-30 and accompanying text.
96. 26 T.C.M. (CCH) 298, 302 (1967).
97. 68-2 U.S. Tax Cas. (CCH) ¶ 9565 (N.D. Cal. 1968).
98. *Id.* at 88,262. The Sweets stated it would be a great hardship to maintain two residences. In *Bolaris,* 81 T.C. at 842, the Bolarises stated that it was to lessen the burden of carrying the property.
99. The court in *Bolaris* found that the rentals were bona fide transactions.
100. *Bolaris,* 776 F.2d at 1433 (the Bolarises were legally unentitled to return); *Sweet,* 68-2 U.S.

The facts of the *Bolaris* case meet the standards promulgated by the *Sweet* and *Rechnitzer* courts. Thus, the Bolarises would probably be allowed a deduction under section 165 if a loss was incurred on the sale instead of the gain which was actually realized.

Since the court stated the property could be held as a residence and section 212 property, a taxpayer proving the facts necessary to meet the "transaction entered into for profit" test could deduct a loss incurred on the sale of a personal residence. This is in direct contradiction to the explicit language of Treas. Reg. § 1.165-9(a). The court, by allowing coextensive use, leaves the door open to circumvention of the rule that no loss is deductible on the sale of a personal residence.[101]

VIII. IMPACT

The first and foremost impact of this decision will be upon the taxpayers. The Ninth Circuit's pro-taxpayer decision in *Bolaris* gives the taxpayer the "best of all worlds." First, a taxpayer will be able to deduct all the rental expenses (including rental losses) without any limitation. Second, the taxpayer will be allowed to defer recognition of the gain on the sale of his "residence" even though it no longer is put to use as such. Finally, the taxpayer may be able to take advantage of a deduction of a loss on the sale of his personal residence/section 212 property.[102] Before this decision the taxpayer could only deduct expenses up to the income received and would not be allowed any loss recognition.

The question remains, what will *Bolaris* do to the body of tax law concerning personal residences and section 212 property? It is hoped that this case will not start a trend by courts in construing statutes to blantantly disregard the unambiguous and clear intent of Congress. After *Bolaris*, the Commissioner and the Tax Court are left asking the question what application do sections 183 and 165 have in restricting the activities of taxpayers in transactions effecting personal use property? The five factor test adopted by the court leaves working standards that are tenuous at best. The court itself did not even apply all five factors. The best guess is that the other circuits will come to an opposite conclusion, or Congress will step in and "clarify" things.

Tax Cas. at 88,262 (the property was rented continuously except for a two week period between tenants); *Rechnitzer*, 26 T.C.M. (CCH) at 302 (no question that the lease arrangement destroyed petitioners' ability to reoccupy).

101. The tests in *Sweet* and *Rechnitzer* are not very strenuous, and a smart taxpayer could easily make a showing of his "intent to make a profit" without much difficulty in a normal combination sale/rental transaction.

102. *See supra* note 101.

IX. Conclusion

The *Bolaris* case was the first case to consider whether a taxpayer's personal residence could coextensively be held as property for the production of income. The Ninth Circuit appeared to start out on the right track, by allowing deferral of the gain on the sale of the residence under section 1034, affirming the Tax Court. However, it was then that the Ninth Circuit went off track.

The court's interpretation of the legislative history of section 1034 stretched beyond any plausible logical interpretation. The decision allowed property to be put to two completely different uses at once. This was against the clear intent of Congress, as evidenced by the many statutory sections and regulations which contemplate an "either/or" dichotomy. The decision could and might very well lead to the circumvention of sections 165 and 1034 by certain taxpayers. Adding to the already illogical opinion was the Ninth Circuit's absence of any case law to support the position. Hopefully, as espoused earlier, another circuit will come to an opposite result or Congress will step into the area and change the result reached by the court.

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