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Federal Income Taxation: Nonrecognition of Gain on Sale of Residence

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raised whether the court should classify gift cases under the Fraudulent Conveyancing Act or under the Bulk Sales Act. Clearly, a Plaintiff would use the latter where possible.

As a matter of policy, it is the writer's opinion the court has arrived at a sound conclusion, and in as much as the Wisconsin Bulk Sale Statute[28] contains the word "transfer", the Wisconsin Court should follow the principal case and include gratuitous transfers in its statutory construction.

DOROTHY PROPSOM

Federal Income Taxation—Nonrecognition of Gain on Sale of Residence—Petitioner, a specialist in foreign economics, was sent to Europe by the U.S. State Department. While there he rented his house in Maryland. He returned to this country and took a job in Washington. He tried to evict the tenant but was forestalled by Federal rent regulations. Being in need of housing, he sold the house, subject to the lease, and bought another house, which cost more than the proceeds from the sale of the old one. The purchaser of the old house was not able to obtain possession for six months. Petitioner did not declare the gain on the sale as income, believing this sale fell under Section 112(n) of the Internal Revenue Code of 1939. The Commissioner assessed a deficiency on the ground that the old house was not petitioner's residence, since it was rented out at the time of the sale. *Held:* Judgment for petitioner; the statute was designed to aid cases such as this and does not require actual occupation of the house at the time of the sale. The decision is limited strictly to the facts of the case. *Ralph L. Trisko,* 29 T.C. No. 59 (1957).

Pervading many of the nonrecognition sections of the Code is the idea that where there is an exchange of property of a like kind, the taxpayer's holdings have not substantially changed and he should not be taxed on any gain from the exchange because his economic situation has not been changed.[1] While most of the nonrecognition sections apply to exchanges only, Section 112(n) of the 1939 Code (renum-

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[28] WIS. STAT. §241.18 (1955). "The sale, transfer, or assignment, in bulk, otherwise than in the ordinary course of trade, and in the regular prosecution of the business of the seller, transferor or assignor, of any part, or the whole, of any stock of goods, wares and merchandise, or of the fixtures pertaining to the same, or of such goods, wares and merchandise and fixtures, including such sales, transfers and assignments made in consideration of an existing indebtedness, shall be conclusively presumed to be fraudulent and void. . . ."

[1] Thus in Century Electric Co. v. Commissioner, 192 F.2d 155, 159 (8th Cir. 1951), in discussing section 112, the general nonrecognition section in the 1939 Code, the Court stated:

> "Subsection 112(b)(1) and 112(e) indicate the controlling policy and purpose of the section, that is, the nonrecognition of gain or loss in transactions where neither is readily measured in terms of money, where in theory the taxpayer may have realized gain or loss but where in fact his economic situation is the same after as it was before the transaction."

bered Section 1034 in the 1954 Code) applies to sales as well as exchanges. However, basically, the transaction involved under Section 112(n) is an exchange, since the taxpayer, at the close of the entire transaction, still is in possession of a residence, just as he was before the transaction. Thus the result accomplished is comparable to the exchange of investment property for other investment property[2] or common stock for common stock.[3] Before 1951 this result in the change of residences was ignored and a taxpayer in such a situation was taxed at capital gains rates on any gain from the sale of the old residence. This obviously could work a hardship on a taxpayer who was forced to move because of a change of employment or for other reasons. Congress, recognizing this hardship,[4] amended the Code in 1951 so as to postpone recognition of gain from the sale of a taxpayer's principal residence when the proceeds are reinvested in another residence within a limited time period.[5] This brings this area in line with the other nonrecognition sections. The subsection itself indicates that the exchange must be a sale of property used as a principal residence and a purchase of property to be so used. In other words, there must be an "exchange" of property of a like kind.

In the *Trisko* case the important question is whether or not there was a substantial change in the nature of the asset held before and after the transaction. If there was not, then the case definitely falls under the basic theory of all the nonrecognition sections and there can be no quarrel with the Tax Court decision. The Tax Court recognizes this basic theory, when, in discussing the purpose of Section 112(n), it states:

> "If all the proceeds of such a sale (of the old residence) were used in the purchase of the new home, the transaction was to be considered in effect as a nontaxable exchange of the old home for the new."[6]

[2] INT. REV. CODE OF 1954, §1031.
[3] INT. REV. CODE OF 1954, §1036.
[4] H.R. REP. No. 586, 82d Congress, 1st Sess. (1951), 1951-2 CUM. BULL. 357, at p. 377.
[5] Int. Rev. Code of 1939.
Sec. 112. RECOGNITION OF GAIN OR LOSS.
(n) Gain From Sale or Exchange of Residence.—
(1) Nonrecognition of Gain.—If property (hereinafter in this subsection called "old residence") used by the taxpayer as his principal residence is sold by him and within a period beginning one year prior to the date of such sale and ending one year after such date, property (hereinafter in this subsection called "new residence") is purchased and used by the taxpayer as his principal residence, gain (if any) from such sale shall be recognized only to the extent that the taxpayer's selling price of the old residence exceeds the taxpayer's cost of purchasing the new residence.
Int. Rev. Code of 1939, Sec. 112(n), added by Sec. 318 (a), Revenue Act of 1951, as amended, Public Law 567, Sec. 1, (1952). The Int. Rev. Code of 1954 changed the number of this subsection to Section 1034 as well as making other changes not material to this discussion.
[6] Ralph L. Trisko, 29 T.C. No. 59 (1957).

The Court readily concedes that this is a "hardship" case of the type to which Congress[7] intended to afford relief. However, to come under this subsection, the exchange must be of residences and conceding the hardship does not necessarily mean that the transaction falls under the subsection. To be non-taxable the exchange must be of property of a like kind.

The obvious question must be whether the renting of the house so changed the character of the asset as to take it out of the residence category which the section in question covers. If the house was removed from this category, there was not an "exchange" of assets of a like kind and the transaction was not within either the letter or the spirit of the nonrecognition sections. The Tax Court found that the mere renting out of the house while the petitioner was overseas did not change the residential character of the asset. To support this the Court cites the House[8] and Senate[9] Committee Reports as well as the Treasury Regulations[10] on the section. The latter provides the following test to determine if the asset has changed character:

> "Whether or not property is used by the taxpayer as his residence . . . depends upon all the facts and circumstances in each individual case, including the bona fides of the taxpayer."

The Tax Court was satisfied that all the facts and circumstances of the case, including the bona fides of the taxpayer, justified a finding that the taxpayer used the property as a residence; that this was not changed by renting the house; and, that the residence retained the character needed to fit under the subsection.

The question of renting as changing the character of the asset was referred to in the reports of both the Senate[11] and House[12] Committees and in the Regulations. The example used to illustrate the point that the taxpayer does not have to be actually occupying the old residence at the time of sale is that the taxpayer may rent the old residence after purchasing the new while he tries to sell the old.[13] While this example is not on all fours with the Trisko fact situation, the rule which is illustrated does lend support to the petitioner's contention.

Upon the above authority the Tax Court determined that the

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[7] H.R. Rep. No. 586, 82nd Congress, 1st Sess. (1951), 1951-2 Cum. Bull. 357, at p. 377.

[8] *Ibid.*

[9] S. Rep. No. 781 (Supp.), 82d Cong., 1st Sess. 318 (1951), 1951-2 Cum. Bull. 458, at p. 566.

[10] U.S. Treas. Reg. 111, Sec. 29.112(n)-1(b) (1953).
The present regulation on this subject, Reg. 1.1034, is only slightly changed from 29.112(n).

[11] S. Rep. No. 781 (Supp.), 82d Cong., 1st Sess. 318 (1951), 1951-2 Cum. Bull. 458, at p. 566.

[12] H. Rep. No. 586, 82nd Congress, 1st Sess. (1951), 1951-2 Cum. Bull. 357, at p. 377.

[13] *Joint Committee Staff Summary of Provisions of Revenue Act of 1951*, 1951-2 Cum. Bull. 287, at p. 309.

house had not lost its character as petitioner's principal residence and, therefore, there was no substantial change in the assets involved in the transaction. Applying the aforesaid basic theory of nonrecognition, this case was definitely one for application of Section 112(n).

The Service achieved the opposite result in a similar situation in 1955. An Air Force officer rented his house when his post was changed. Upon retirement from the Air Force, having decided to live in another city, he sold the old residence, obtaining a gain thereon, and invested the proceeds in a new house in the other city. The Commissioner, in ruling that this case was not entitled to the benefit of Section 112(n) relief, held:

> ". . . the facts and circumstances in the case do not indicate the renting of the residence was a temporary arrangement entered into during a period made necessary by the purchase of a new residence. Accordingly, it is held that the provisions of section 112(n) of the Code are not applicable under the facts and circumstances herein present."[14]

The Commissioner's position in the *Trisko* case was consistent with this ruling. However, the facts of the present case may be distinguished from the Ruling on the question of the bona fides of the taxpayer.

As we have seen, a part of the test used to determine if the property has changed its character is the bona fides of the taxpayer. The Air Force officer voluntarily sold his old home and made no effort to return to it. Apparently the Commissioner took this as an indication of an intention to change the old home into investment property and as showing that the taxpayer was not seeking relief under Section 112(n) in good faith. On the other hand, Trisko made every effort to get the house back but was precluded by Federal rent regulations and had to buy a new house to have a place to live. Certainly he had no intention of changing the character of the old residence and his acts were consistent with such lack of intention.

Attacking the problem with the basic approach of all nonrecognition sections in mind, i.e., that the taxpayer has simply exchanged property and has not changed his economic situation,[15] leads to a consideration of the effect of construing the rented residence as property held for investment purposes. If the renting is given the effect of changing the character of the property, as the Commissioner contended in the Trisko case, the property becomes eligible for nonrecognition treatment under Section 1031 (a).[16] If the taxpayer is able to trade the

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[14] REV. RUL. 55-222, 1955-1 CUM. BULL. 349.
[15] See Note 1, *supra*.
[16] INT. REV. CODE OF 1954, §1031.
Exchange of Property Held for Productive Use or Investment.
(a) Nonrecognition of gain or loss from exchange solely in kind.

house for another house of like kind, i.e., held for investment purposes, no gain will be recognized from such transaction. While the property received in the exchange must be held "either for productive use in trade or business or for investment",[17] no authority has been found to indicate that such use must be of any definite duration. Conceivably the length of time needed to evict a tenant may be a sufficient holding period and then the taxpayer would have the new residence and also have avoided recognition of gain on the transaction.

The reader is cautioned to bear in mind the doctrine of *Gregory v. Helvering*,[18] where the Supreme Court stated:

> ". . . the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."

As Judge Learned Hand pointed out in the Circuit Court decision in the same case:

> ". . . it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition."[19]

The Commissioner, if he attempted to overthrow such a scheme, could also rely on the *Century Electric Co.* case where the Court said:

> "The transaction here involved may not be separated into its component parts for tax purposes. Tax consequences must depend on what actually was intended and accomplished rather than on the separate steps taken to reach the desired ends."[20]

The Commissioner and the courts might well find that this scheme accomplished an end not intended by the section in question.

RICHARD T. BECKER

Labor Law—Enforceability of Hot Cargo Clause—A shipment of doors, manufactured by the Paine Lumber Company of Oshkosh, Wisconsin and purchased from the Sand Door and Plywood Company, were delivered to a hospital construction site on which Harvsted and Jensen were general contractors. A few days later, on August 17, 1954, Fliesher, a business agent of petitioner, Local 1976, visited the site and informed Harvsted and Jensen's foreman, a member of the local, that the doors were non-union and could not be hung. The foreman then ordered the employees to stop handling the objectionable doors and work on them ceased. The general contractors were then

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No gain or loss shall be recognized if property held for productive use in trade or business or for investment . . . is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

[17] *Ibid.*

[18] Gregory v. Helvering, 293 U.S. 465 (1935), at p. 469.

[19] Helvering v. Gregory, 69 F.2d 809 (2nd Cir. 1934) at p. 819.

[20] Century Electric Co. v. Commissioner, 192 F.2d 155, 159 (8th Cir. 1951).