Irene H. Hazard, 7 T.C. 372 (1946)

Rental property is considered 'real property used in the trade or business of the taxpayer,' allowing for full loss deductions under Section 23(e) of the Internal Revenue Code, regardless of whether the taxpayer engages in another trade or business.

Summary

The taxpayer, Irene H. Hazard, sold property in Kansas City that had been her primary residence until she moved to Pittsburgh. After moving, she listed the property for rent or sale and successfully rented it out until its sale. The Commissioner determined the loss from the sale was a long-term capital loss subject to limitations. The Tax Court held that because the property was converted to and used as rental property, it qualified as 'real property used in the trade or business,' thus allowing the taxpayer to deduct the full loss as an ordinary loss under Section 23(e) of the Internal Revenue Code.

Facts

Prior to July 1, 1939, Irene H. Hazard owned and occupied a property in Kansas City, Missouri, as her residence.
On July 1, 1939, Hazard and her family moved to Pittsburgh, Pennsylvania.
In January 1940, Hazard listed the Kansas City property with real estate agents for rent or sale.
The property was rented early in 1940 for $75 per month and was continuously rented until it was sold on November 1, 1943.

Procedural History

The Commissioner determined that the loss sustained by Hazard from the sale of the Kansas City property was allowable only as a long-term capital loss under Section 117 of the Internal Revenue Code.
Hazard petitioned the Tax Court for a redetermination, arguing that the loss was fully deductible as an ordinary loss because the property was used in her trade or business.

Issue(s)

Whether the residential property, converted to rental property after the taxpayer moved, constitutes 'real property used in the trade or business of the taxpayer' under Section 117(a)(1) of the Internal Revenue Code, thus allowing for a full loss deduction under Section 23(e).

Holding

Yes, because the property was rented out during substantially all of the period the

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taxpayer owned it, it qualifies as ‘real property used in the trade or business of the taxpayer,’ and the loss is fully deductible under Section 23(e) of the Code.

Court’s Reasoning

The Tax Court relied on established precedent, particularly John D. Fackler, which held that residential property converted into income-producing property is considered property ‘used in the trade or business of the taxpayer,’ regardless of whether the taxpayer engages in any other trade or business. The court emphasized that prior to the Revenue Act of 1942, this rule was consistently followed. The court found that the Revenue Act of 1942 did not change this rule. Because Hazard rented the property throughout almost all the time she held it after moving, the court determined the property was not a capital asset. The court stated: “Prior to the Revenue Act of 1942 the established rule followed by this and other courts over a long period was that residential improvements on real estate converted into income-producing property are property ‘used in the trade or business of the taxpayer,’ regardless of whether or not he engaged in any other trade or business, and are therefore excluded from the definition of ‘capital assets’ as defined by section 117 (a) (1).”

Practical Implications

This case clarifies that renting out a property, even if it was previously a personal residence, can qualify it as being used in a ‘trade or business’ for tax purposes. This allows taxpayers to deduct losses from the sale of such properties as ordinary losses rather than capital losses, which are subject to limitations. Attorneys should advise clients that converting a residence to a rental property can have significant tax advantages regarding loss deductions upon sale. Later cases citing Hazard further solidify the principle that active rental activity is key to establishing ‘trade or business’ status. The level of rental activity is critical. Passive investment is not enough; there needs to be evidence the owner is actively managing the property as a business.

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