17 T.C. 865 (1951)

A loss on the sale of residential property is generally not deductible, even if the original intent was to make a profit, if the property was used solely as a personal residence at the time of sale; furthermore, claiming a loss after converting residential property to rental property requires proving the fair market value at the time of conversion.

Summary

Wilkes purchased property in 1928 intending to profit from a planned development. He lived there until 1944, then rented it briefly before selling it at a loss in 1945. Wilkes argued the loss was deductible because of his original profit motive. The Tax Court denied the deduction, holding that the property's prolonged use as a personal residence superseded any original profit motive. Moreover, Wilkes failed to establish the fair market value of the property when he purportedly converted it to rental property, a necessary element for claiming a deductible loss after such a conversion. This case illustrates the importance of demonstrating a continuous profit-seeking motive and provides clarity on deducting losses related to personal residences.

Facts

1. In 1928, Wilkes purchased property ("Jacksonwald") near Reading, Pennsylvania, for $13,000, purportedly intending to profit from a planned residential development.
2. Wilkes and his family immediately occupied Jacksonwald as their primary residence.
3. Over the next 16 years, Wilkes made substantial improvements to the property, expanding it to accommodate his growing family.
4. From 1928 to 1944, Wilkes made no attempt to rent or sell the property, except for an 18-month period when he lived elsewhere and the property remained unoccupied.
5. In 1944, Wilkes moved to Washington, D.C., and briefly rented Jacksonwald before listing it for sale.
6. In 1945, Wilkes sold Jacksonwald for $15,000 and claimed a loss of $6,795.76 on his tax return, arguing that his original intent was to make a profit.

Procedural History

1. The Commissioner of Internal Revenue disallowed Wilkes' claimed loss deduction.
2. Wilkes petitioned the Tax Court for a redetermination of the deficiency.

Issue(s)

1. Whether Wilkes sustained a deductible loss under Section 23(e) of the Internal Revenue Code on the sale of Jacksonwald in 1945, considering his claim that the property was initially purchased for profit.
2. Assuming a conversion from residential to rental property occurred, whether

Wilkes provided sufficient evidence of the property's fair market value at the time of conversion to determine the amount of loss, if any, sustained on the sale.

Holding

1. No, because Wilkes primarily used the property as his personal residence for 16 years, negating any original profit motive at the time of sale.
2. No, because Wilkes failed to establish the fair market value of the property at the time of the alleged conversion from residential to rental use.

Court's Reasoning

1. The court emphasized that while an initial intent to profit could classify a transaction as one entered into for profit under Section 23(e)(2), the subsequent use of the property can alter that character. Here, the court found that Wilkes' prolonged use of Jacksonwald as his personal residence outweighed any original profit motive. "The mere assertion of one's intention in entering into a given transaction is of little or no evidentiary value unless the subsequent conduct in dealing with respect thereto is consistent with such asserted intention."
2. The court noted that even if Wilkes had successfully demonstrated a conversion to rental property, he failed to provide evidence of the property's fair market value at the time of conversion. Citing *Heiner v. Tindle, 276 U.S. 582*, the court reiterated that establishing fair market value at the time of conversion is a prerequisite for determining the deductible loss. Without this evidence, the court could not ascertain whether a loss occurred after the conversion.
3. The court further reasoned that the purchase of residential property, its immediate occupancy, and continued use as a personal residence raise a strong presumption that the property was acquired for such purpose and that the evidence presented was not persuasive enough to rebut this presumption. The court also noted that it was likely that the loss occurred prior to the conversion date.

Practical Implications

1. This case underscores the importance of documenting and maintaining evidence of a continuous profit-seeking motive when dealing with real estate that is also used as a personal residence. Taxpayers must demonstrate that the intent to profit remains the primary driver behind the ownership and disposition of the property.
2. When converting a personal residence to rental property, it is crucial to obtain a professional appraisal to establish the fair market value at the time of conversion. This valuation is essential for accurately calculating any potential deductible loss upon the eventual sale of the property.
3. The *Wilkes* ruling serves as a reminder that the IRS and the courts will closely scrutinize transactions involving personal residences, particularly when taxpayers attempt to deduct losses based on an initial profit motive that may have been superseded by personal use. Taxpayers should be prepared to provide clear and convincing evidence to support their claims.

4. Later cases cite *Wilkes* for the principle that a property's character can change over time, and that prolonged personal use can negate an earlier intention to profit. This principle is frequently applied in disputes over the deductibility of losses on the sale of real estate.

