Robert W. Aagaard & Margery B. Aagaard, Petitioners v. Commissioner of Internal Revenue, Respondent, 56 T. C. 191 (1971)

Gain from the sale of a principal residence can be deferred under section 1034, but only the portion allocable to the residential use is eligible for deferral, and the taxpayer must comply with specific timing and usage requirements.

Summary

In Aagaard v. Commissioner, the Tax Court addressed multiple tax issues related to the Aagaards' real estate transactions and stock investment. The court ruled that the gain on the sale of a four-unit apartment building on Camden Road, where the Aagaards resided in one unit, could be deferred under section 1034 to the extent allocable to the residential unit. However, the gain from the rental portion had to be recognized as the exchange did not meet section 1031's like-kind requirements. The gain from selling another property on Petra Place was fully recognized, as it was sold within one year of another residence sale, and 60% was classified as short-term capital gain. The court also limited the Aagaards' real estate tax deduction for their new residence and denied a deduction for allegedly worthless stock due to insufficient evidence.

Facts

Robert and Margery Aagaard owned and sold several properties in Madison, Wisconsin. In 1964, they exchanged a four-unit apartment building on Camden Road, where they lived in one unit, for a rental property on Pauline Street. They also sold an eight-unit apartment building on Petra Place, where they resided in one unit, and purchased a new residence on Chippewa Drive. The Aagaards claimed full deferral of gains under section 1034 for both sales. They also deducted real estate taxes on the Chippewa Drive property and sought a loss deduction for allegedly worthless stock in Mill Fab, Inc.

Procedural History

The Commissioner of Internal Revenue issued a notice of deficiency for the tax years 1964 and 1965, challenging the Aagaards' deferral of gains, their real estate tax deductions, and the stock loss deduction. The Aagaards petitioned the United States Tax Court, which held that only the gain attributable to the residential portion of the Camden Road property could be deferred under section 1034, the gain from the Petra Place sale had to be recognized in full, the real estate tax deduction was limited, and the stock loss was not deductible due to lack of evidence of worthlessness.

Issue(s)

1. Whether the gain realized on the exchange of the Camden Road property can be deferred in its entirety under section 1031 or only the portion allocable to the

residential unit under section 1034?
2. Whether the gain realized on the sale of the Petra Place property can be deferred under section 1034?
3. Whether the Aagaards are entitled to deduct the full amount of 1964 real property taxes on the Chippewa Drive property?
4. Whether the Aagaards' investment in Mill Fab, Inc. , stock became worthless in 1965?

Holding

1. No, because the exchange included non-like-kind property (cash and mortgage assumption), only the gain allocable to the residential unit can be deferred under section 1034, and the remainder must be recognized under section 1031(b).
2. No, because the Petra Place property was sold within one year of another residence sale, and the gain must be recognized under section 1034(d).
3. No, because under section 164(d), only the portion of taxes allocable to the period after the purchase date is deductible.
4. No, because the Aagaards failed to provide sufficient evidence that the stock was worthless in 1965.

Court's Reasoning

The court applied section 1034 to defer the gain on the Camden Road property only to the extent allocable to the residential unit, following the regulation's requirement for allocation in mixed-use properties. The court rejected the Aagaards' claim for full deferral under section 1031 due to the receipt of cash and mortgage assumption, which disqualified the transaction from being solely like-kind. For the Petra Place property, the court applied section 1034(d) to require full recognition of the gain because another residence was sold within one year. The court also applied section 164(d) to limit the real estate tax deduction to the period after the purchase date. Regarding the Mill Fab stock, the court found insufficient evidence of worthlessness and denied the deduction, emphasizing the need for clear proof of total loss.

Practical Implications

This decision clarifies the application of section 1034 for deferring gains on residence sales, particularly in mixed-use properties, requiring allocation of gains based on residential and non-residential use. It underscores the importance of adhering to the one-year timing rule for multiple residence sales and the necessity of like-kind exchanges under section 1031. Practitioners must advise clients on the proration of real estate taxes under section 164(d) when purchasing property mid-year. The ruling also highlights the evidentiary burden for claiming stock worthlessness, affecting how taxpayers and their advisors approach such deductions. Subsequent cases have cited Aagaard for its principles on gain deferral and tax deductions.