Bolaris v. Commissioner of Internal Revenue, 81 T.C. 840 (1983)

Temporary rental of a former residence, incident to its sale, does not automatically disqualify the sale from nonrecognition of gain under Section 1034 of the Internal Revenue Code, but deductions related to the rental period may be limited if the rental activity is not primarily engaged in for profit.

Summary

Stephen and Valerie Bolaris temporarily rented their former residence while trying to sell it after moving to a new home. They sought to defer capital gains taxes on the sale of the old residence under Section 1034 and deduct rental expenses and depreciation. The Tax Court held that the temporary rental did not disqualify them from deferring capital gains under Section 1034 because the rental was ancillary to the sale. However, the court disallowed deductions for rental expenses and depreciation exceeding rental income, finding that the rental activity was not engaged in for profit under Section 183, as their primary motive was to sell, not to generate rental income.

Facts

Petitioners, Stephen and Valerie Bolaris, purchased a home in San Jose, California, in 1975 and used it as their principal residence. In July 1977, they began constructing a new principal residence and listed their old residence for sale. When the old residence did not sell within 90 days, they rented it out on a month-to-month basis starting in October 1977 to cover expenses while continuing to seek a buyer. They moved into their new residence in October 1977 and never intended to return to the old one. They rented the old residence to two different tenants until May 1978 and then for a short period to the buyers before the final sale in August 1978. They reported rental income and claimed deductions for expenses and depreciation related to the rental activity.

Procedural History

The Commissioner of Internal Revenue disallowed deductions for depreciation, insurance, and miscellaneous expenses related to the rental of the old residence, arguing it was not property held for the production of income under Sections 167, 162, or 212, and was an activity not engaged in for profit under Section 183. The Commissioner initially challenged the application of Section 1034 but conceded on brief that it likely applied. The Tax Court reviewed the Commissioner's determination.

Issue(s)

1. Whether the temporary rental of the petitioners' former residence prior to its sale precludes the nonrecognition of gain under Section 1034 of the Internal Revenue Code.

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2. Whether the petitioners are entitled to deductions for depreciation, insurance, and miscellaneous expenses incurred in connection with renting their former residence while attempting to sell it under Sections 167, 162, or 212 of the Internal Revenue Code.

Holding

1. Yes. The temporary rental of the former residence does not preclude the nonrecognition of gain under Section 1034 because the rental was temporary and ancillary to the sale.
2. No. The petitioners are not entitled to deduct depreciation, insurance, and miscellaneous expenses in excess of rental income because the rental activity was not primarily engaged in for profit under Section 183.

Court's Reasoning

Section 1034 Issue: The court relied on *Clapham v. Commissioner*, which held that temporary rental of a former residence does not automatically disqualify it from Section 1034 treatment. The court found the Bolaris' rental was temporary and due to the exigencies of the real estate market, ancillary to sales efforts, and arose from their use of the property as a principal residence. Quoting *Clapham*, the court emphasized, "*In leasing the premises, petitioners' dominant motive was to sell the property at the earliest possible date rather than to hold the property for the realization of rental income*." The legislative history of Section 1034 also supports that temporary rentals should not necessarily disqualify nonrecognition of gain.

Deduction Issue: The court determined that to deduct expenses under Sections 162, 167, or 212, the rental activity must be undertaken with the primary intention of making a profit, citing *Jasionowski v. Commissioner*. The court agreed with the respondent that the same factors supporting Section 1034 application—temporary rental, ancillary to sale—demonstrated a lack of profit motive. The court stated, "*The very nature of petitioners' rental activity — i.e., temporary, ancillary to sales efforts, renting on a monthly basis, requesting that the first tenant vacate to facilitate sales efforts — demonstrates that it was not engaged in for the objective of making a profit*." Section 183, regarding activities not engaged in for profit, limits deductions to the extent of income from the activity, after deductions allowed regardless of profit motive (like interest and taxes). Since the Bolari's interest and taxes exceeded rental income, no further deductions were allowed.

Practical Implications

Bolaris clarifies that homeowners can temporarily rent their old residence while trying to sell it and still qualify for nonrecognition of capital gains under Section 1034. However, it also establishes a crucial distinction: while temporary rental may not negate Section 1034, it may still be considered an activity not engaged in for profit under Section 183, limiting deductible rental expenses. Attorneys advising

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clients in similar situations should emphasize the importance of demonstrating that the rental activity, even if temporary, is structured and intended to generate profit to maximize deductible expenses. Taxpayers should be prepared to show efforts to achieve profitability in their rental activities if they wish to deduct losses beyond the limitations of Section 183, despite the temporary nature of the rental incident to a sale.

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