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## Loss Deduction on the Sale of an Abandoned Residence: Case-Law Thinking in Statutory Interpretation

Cover Page Footnote

Member of New York Bar.

LOSS DEDUCTION ON THE SALE OF AN ABANDONED RESIDENCE:  
CASE-LAW THINKING IN STATUTORY INTERPRETATION

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INTRODUCTION

Goodhart, familiar with both English and American legal procedure, has written that the case system requires a learned bar on which the bench can rely, and that the English courts, more fortunate in their practising bar than the American courts, assume that their sole duty is to decide the issue on the arguments of counsel.<sup>1</sup> Since the complexity of the tax law is commonplace,<sup>2</sup> judges sitting in tax cases are especially entitled to a highly-trained bar,<sup>3</sup> but the Tax Court has instead been compelled to complain that it cannot always do the work of counsel.<sup>4</sup>

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1. "The case system . . . requires a learned bar on which the bench can rely. Judicial work becomes overwhelming if the judge must depend on his own research for the relevant authorities. In England, with a practicing bar limited to a few hundred barristers of ability and experience, the courts are free to assume that their sole duty is to determine the issue on the arguments advanced by counsel. . . . In America there are as many able lawyers as there are in England, but there is also a far larger number of less competent ones. Unfortunately, it is of frequent occurrence that the cases which are of the greatest importance to law as a science are argued by lawyers of the second class. In deciding the cases the courts too often must rely upon themselves." Goodhart, *Case Law in England and America*, 15 *Corn. L.Q.* 173, 192 (1930).

2. "[F]or the first time in the history of the federal income tax we are becoming really aware of its anatomical structure, so to speak. Once we isolate and identify the fundamental technical premises underlying the tax treatment of business and family arrangements, we are then in a position to evaluate the soundness of those premises and to agree upon the changes required." Surrey and Warren, *The Income Tax Project of the American Law Institute*, 66 *Harv. L. Rev.* 761, 768 (1953).

3. ". . . a judge rarely performs his functions adequately unless the case before him is adequately presented." Brandeis, *Business—A Profession* 362 (1933 ed.)

"The ability and attainments of counsel will be reflected in the work of the Court, so that the complete understanding of what falls from the bench involves some consideration of the adequacy of presentation at the bar." Fairman, *Mr. Justice Miller and the Supreme Court 1862-1890* 111 (1939).

4. See: *Estate of William A. Hager*, P-H 1946 TC Mem. Dec. ¶ 46,226 (1946) in which Judge Murdock said that, as the case was argued, the issue was whether property irrevocably transferred in trust prior to the Joint Resolution of March 3, 1931, with the control of income retained for the life of the grantor, was includible in the gross estate of the grantor, but that counsel for both sides had overlooked the Supreme Court decision in *Hassett v. Welch*, 303 U.S. 303 (1938) and U.S. Treas. Reg. 105, § 81.19 (1942), which specifically excluded such transfer from a decedent's gross estate.

"He [counsel] may not safely rely upon the Tax Court to dig out and develop a case for him. That is not the function of the Court, and it does not have the time or the facilities to do the work of counsel." *Producers Crop. Impr. Assn.*, 7 T.C. 562, 565 (1946).

"We conclude this opinion by pointing out what should be obvious. When counsel

The task of ascertaining the effect of sections of the tax statute upon each other, when the statute has been amended, is the task of counsel and of text-writers, not of the court.<sup>5</sup> The decisions on whether a loss on the sale of an abandoned residence held for rent or sale is deductible under the Revenue Act of 1942 illustrate the feebleness of that kind of aid furnished by counsel<sup>6</sup> and the textwriters.<sup>7</sup> The cases hold that the loss is not deductible, and yet it clearly is.<sup>8</sup>

#### DISCUSSION

Before the Revenue Act of 1942 treatment of abandoned residences fell into three categories: (1) if the abandoned residence was rented before sale, depreciation and maintenance expenses were allowable on the ground that the property was used in a trade or business, and a loss on the sale was allowable under 23(e)(1) as a loss incurred in a trade or business;<sup>9</sup> (2) if the residence was inherited, but not used as a residence after inheritance, depreciation and maintenance expenses were not allowable, since the property

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fails to do the initial research and brief the issues presented to the Court, to put it mildly an undesirable situation arises. It is unfair to the Court, it is unfair to counsel's clients, and it is unfair to the thousands of other taxpayers waiting to have their cases heard. If the Court is required to do the initial research (the burden of which rests on counsel) as well as its own independent research in cases as involved as this one an impossible situation will arise." *Morrisdale Coal Mining Co.*, 19 T.C. 203, 229 (1952).

"It is not the function of the Tax Court to dig out and develop a taxpayer's case." *W. A. Prater*, P-H 1953 TC Mem. Dec. ¶ 53,262 (1952).

5. Learned Hand, *Thomas Walter Swan*, 57 Yale L.J. 167, 169 (1947): "In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession; cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. . . . Again and again I have found myself utterly bewildered by the involution of phrase with phrase and of term with term . . ." This is the language of a judge whom Judge Frank, of the same bench, has called, and none will say him nay, the greatest living American judge. *Frank, Words and Music*, 47 Col. L. Rev. 1267 (1947).

6. *Rea E. Warner v. Commissioner*, 167 F.2d 633 (2d Cir. 1948); *Allen L. Grammer et al.*, 12 T.C. 34 (1949); *William C. Horrmann et al.*, 17 T.C. 903 (1951); *E. R. Fenimore Johnson*, 19 T.C. 93 (1952).

7. *Surrey and Warren*, *Federal Income Taxation* 253, 260 (1953 ed.); *Shaw, Sale or Other Disposition of Residential Property*, *Proceedings of the Tax Institute of University of Southern California*, *Major Tax Problems of 1951*; *Kriegh, Problems in Disposition of Residence Property*, *Proceedings of New York University, Eleventh Annual Institute on Federal Taxation* (1953); 5 *Mertens, Law of Federal Income Taxation* § 28.78 (1953 Rev. ed.); *Rabkin and Johnson, Income, Gift and Estate Taxation* § 43.09 (1951).

8. Any argument that this discussion is academic is invalid, since, the cases, having been decided in ignorance of the fact that section 23(e)(2) was in effect amended by the enactment of sections 23(l)(2) and 23(a)(2), are not binding, even under the strictest adherence to the doctrine of *stare decisis*. See note 20 *infra*.

9. *Fackler v. Commissioner*, 45 B.T.A. 708, *aff'd*, 133 F.2d 509 (6th Cir. 1943).

was not used in a trade or business, but a loss on the sale was allowable under 23(e)(2) as a loss in a transaction entered into for profit;<sup>10</sup> (3) if the residence was abandoned by the taxpayer, depreciation and maintenance expenses were not allowable, since not connected with a trade or business, and no loss on the sale was allowable, since there was no appropriation to income-producing purposes until the property was rented or remodeled for business purposes.<sup>11</sup>

As to (3) above Judge Vinson<sup>12</sup> (later Chief Justice of the United States) writing the opinion for a unanimous bench, said in *Phipps v. Helvering*<sup>13</sup> in 1941 that sections 23(e)(1) and 23(e)(2) must be read in connection with section 24(a)(1), which disallows deductions for personal, living, or family expenses. He then stated why the loss on the sale of an abandoned residence was not deductible:<sup>14</sup>

"The critical showing at the outset is not into what deductible subsection the loss is to be placed, but that it [the residence] has been removed from the nondeductible personal, living, or family expense classification. Whether the property has been removed from this nondeductible classification is the very essence of the appropriated-for-a-business-use test."

The reason the Board of Tax Appeals allowed losses under (2) on the sale of an inherited residence was that, not having been occupied by the taxpayer as a

10. In *Robert W. Williams, Ex'r*, 1 B.T.A. 1101 (1925) the Board of Tax Appeals allowed the taxpayer a loss on the sale of a residence she had inherited from her deceased husband and immediately offered for rent or sale. In *Robert H. Montgomery*, 37 B.T.A. 232 (1938), the taxpayer argued that he was entitled to deduct depreciation and maintenance expenses on the property given him by his wife which he had immediately offered for rent or sale. He considered the Williams opinion controlling. The Board distinguished the Williams case, saying that the test for determining whether the loss on the sale was deductible was whether it was sustained in a transaction entered into for profit, but that deductions for depreciation and maintenance expenses were allowed only if incurred in a trade or business. The taxpayer tried the issue for another taxable year in the Court of Claims, but that court followed the Board. *Robert H. Montgomery v. United States*, 23 F. Supp. 130 (Ct. Cl. 1938).

11. *Morgan v. Commissioner*, 76 F.2d 390 (5th Cir. 1935); *Rumsey v. Commissioner*, 82 F.2d 158 (2d Cir. 1936); *Schmidlapp v. Commissioner*, 96 F.2d 680 (2d Cir. 1938); *Phipps v. Helvering*, 124 F.2d 292 (D.C. Cir. 1941); *Gevirtz v. Commissioner*, 123 F.2d 707 (2d Cir. 1941). In the Morgan and Rumsey cases the Fifth and Second Circuit Courts observed that the taxpayer could have resumed residential uses at will, that it was not as if he had remodeled the building for business purposes or rented it. But in the Schmidlapp case the Second Circuit Court observed that, if the matter were new, putting the property in the hands of a broker might be regarded as itself the inception of a transaction entered into for profit, but that the Rumsey case was the other way.

12. He was chairman of a subcommittee of the Committee on Ways and Means which considered revenue legislation and won wide renown in the House of Representatives as a tax expert. *N.Y. Times*, Sept. 8, 1953.

13. 124 F.2d 292 (D.C. Cir. 1941).

14. 124 F.2d 292, 294 (D.C. Cir. 1941). "Very rarely the actual words in which a famous judge formulated a rule are treated almost as equivalent to a section of a statute." Lawson, *The Rational Strength of English Law* 16 (1951).

residence after inheritance, the property never had to be removed from the personal classification.

The test that Judge Vinson laid down applied to cases decided before the enactment of the Revenue Act of 1942. That Act, however, added sections 23(1)(2) to allow depreciation and 23(a)(2) to allow maintenance expenses on property held for the production of income. The Tax Court has interpreted these sections as allowing deductions for depreciation and maintenance expenses on an abandoned residence held for rent or for rent or sale.<sup>15</sup> It refuses, however, to allow deductions for a loss on those residences, on the ground that 23(e)(2), which allows deductions for losses in transactions entered into for profit, was not amended.<sup>16</sup> Thus, when a taxpayer abandons a residence and offers it for rent or for rent or sale he deducts depreciation and maintenance expenses, and yet when he sells the residence he is not allowed a deduction for a loss on the sale.

This anomalous result is not directed by the Code. Once the Code was amended to permit deductions for depreciation and maintenance expenses on an abandoned residence held for rent or for rent or sale the property was taken out of the non-deductible personal classification and brought within the sweep of section 23(e)(2), for the profit motive has been established.<sup>17</sup> But in none of the cases in which a loss on the sale has been sought, has it been pointed out to the court that no amendment to 23(e)(2) was necessary.<sup>18</sup> Instead, it has been accepted that the earlier cases still retained vitality. In fact, in the *Warner*<sup>19</sup> case, the one case to go up on appeal, the taxpayer in his brief told the Second Circuit that its decisions in 1936 and 1938 in the *Rumsey* and *Schmidlapp* cases correctly stated the law. The argument was advanced, however, that the taxpayer in the *Warner* case had so clearly abandoned the residence without intent to return that the loss deduction should be allowed. The Second Circuit, however, affirmed on the authority of the *Rumsey* and *Schmidlapp* cases. Nevertheless, if deductions for depreciation and maintenance expenses are allowable, the *Warner* decision is not precedent in the Second Circuit, since the effect of sections 23(1)(2) and 23(a)(2) on 23(e)(2) were not presented to the court.<sup>20</sup>

15. *Mary Laughlin Robinson*, 2 T.C. 305 (1943), reviewed by the court, after remand by the Third Circuit Court, 134 F.2d 168 (3d Cir. 1943) to determine the effect of the 1942 Act; *William C. Horrmann et al.*, 17 T.C. 903 (1951). Cf. "Where the taxpayer's home has been vacated and listed for rent or sale, it seems that no depreciation is deductible while the property is unoccupied." Engel, *Ownership Operation of Real Estate*, Proceedings of New York University, Seventh Annual Institute on Federal Taxation 333 (1949).

16. *Rea E. Warner v. Commissioner*, 167 F.2d 633 (2d Cir. 1948).

17. "The curiosity of the scientist is usually directed toward seeking an understanding of things or relationships which he notices have no satisfactory explanation. . . . That strong desire scientists usually have to seek underlying principles in masses of data not obviously related may be regarded as an adult form of sublimation of curiosity." Beveridge, *The Art of Scientific Investigation* 61 (1950).

18. "History is not the accumulation of facts but the relation of them." Strachey, *Portraits in Miniature* 160 (1931).

19. 167 F.2d 633 (2d Cir. 1948).

20. Even the House of Lords, which considers itself bound by its own decisions,

Professor Surrey, Dean Warren, and the other textwriters have swallowed these aberrant decisions.<sup>21</sup> Unlike other fields of law, in federal taxation the critical function is absent far too often. Surrey and Warren discuss the *Horrmann*<sup>22</sup> case, in which the taxpayer abandoned his residence and attempted to rent or sell it, selling the property at a loss after three years. They write that the Tax Court held that the efforts to rent or sell did not initiate "a transaction entered into for profit," so that the loss was not allowable under section 23(e)(2), but did result in causing the property to be "held for the production of income," so that depreciation was allowable under section 23(1)(2) and maintenance expenses under section 23(a)(2). A few pages earlier they had said that the allowance of losses sustained in the pursuit of gain is similar to the allowance under section 23(a)(2) of expenses incurred in the production of income, but that the Tax Court had held in the *Horrmann* case that "held for the production of income" is broader than "transaction entered into for profit."<sup>23</sup> They continue that "the difference in the description of the profit-seeking activity prevents the two sections from being exactly coterminous, though they cover substantially the same area." It is interesting that it does not seem to have occurred to them, or any of the other textwriters, to wonder how once deductions are allowed for depreciation and maintenance expense on the "profit-seeking activity" of holding property for the production of income, the activity can be anything other than the initiation of a transaction entered into for profit.<sup>24</sup> Of course, as we have shown, it cannot be.<sup>25</sup>

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considers that a decision given in ignorance of a controlling statute is not binding upon it, the decision being considered as being on a question of fact, not of law. "In *London Street Tramways Co. v. London County Council* [1898] A.C. 375, 380, when discussing the question whether the House of Lords was bound by its own prior judgments, the Earl of Halsbury, L.C., said: 'It is said that this House might have omitted to notice an Act of Parliament or might have acted upon an Act of Parliament which was afterwards found to have been repealed. It seems to me that the answer to that ingenious suggestion is a very manifest one—namely, that that would be a mistake of fact. If the House were under the impression that there was an Act when there was not such an Act as was suggested, of course they would not be bound, when the fact was ascertained that there was not such an Act or that the Act had been repealed, to proceed upon the hypothesis that the Act existed.'" Goodhart, *Determining the Ratio Decidendi of a Case*, 40 *Yale L.J.* 161, 173 (1930).

21. *Supra* note 7.

22. 17 T.C. 903 (1951).

23. Surrey and Warren, *Federal Income Taxation* 253 (1953 ed.).

24. The Surrey and Warren acceptance on page 260 of their casebook of the Tax Court memorandum opinion in *Helene Irvin Fagan*, P-H 1950 TC Mem. Dec. ¶ 50,017 (1949), should be disregarded. Of that case they say that the court allowed maintenance expenses under section 23(a)(2) on an unoccupied residence which had been listed for sale (as opposed to rent or sale). That is correct, and the court also allowed depreciation. But the *Fagan* case illustrates again the necessary dependence of the court upon counsel. The opinion shows that the judge relied on *Mary Laughlin Robinson*, 2 T.C. 304 (1943), where the property had been listed for rent or sale, and that he was not informed that under the later decision in *Warren Leslie, Sr.*, 6 T.C. 488 (1946), which had been reviewed by the full bench and was therefore binding upon him, deductions for maintenance expenses were

Absurd results, moreover, flow from a rule that depreciation is allowable on the value of property held for the production of income, but that the loss on the sale is not allowable.<sup>26</sup> Yet, judging by the opinions, in no case have these absurdities been revealed to the court, nor do the textwriters refer to them.

One absurdity is that the theory of depreciation is violated by the rule. That theory is that the loss on depreciable property instead of being taken in the year of sale should be spread over the years that the property is held, since a gradual loss is deemed to occur, excess depreciation or insufficient depreciation to be accounted for in the year of sale.<sup>27</sup> By disallowing a loss on the sale and allowing a deduction for depreciation, the court is telling the taxpayer that he *is not* entitled to recover the basis of the property and that he *is* entitled to recover the basis of the property.<sup>28</sup> This is the sort of thing that gave Pavlov's dog a neurosis.

Another absurdity is that if after holding the property for the production of income the taxpayer then rents the property he must take as a basis for depreciation its then value to determine gain or loss on the sale, since only then has he entered into a transaction. If the property was worth \$75,000 when it became property held for the production of income, depreciation is allowable on that amount (if it does not exceed cost); and if the property is never sold the taxpayer may ultimately deduct the entire amount of \$75,000 through depreciation. If, however, two years later he rents the property and its then value is \$60,000 the new basis for depreciation is \$60,000. If \$6,000 has been deducted as depreciation, what treatment is to be given the difference of \$9,000? Moreover, instead of worrying about the \$9,000, since section 113(b)(1)(B) provides in determining the basis for loss for adjustment to the

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held to be not allowable under section 23(a)(2) on property which had been listed for sale alone. Two months after the Fagan case, a memorandum decision was entered in John M. Coulter, P-H 1950 TC Mem. Dec. ¶ 50,077 (1949), in which deductions for depreciation and maintenance expenses were disallowed on property offered for sale alone on the authority of the Leslie case. In the latest case on the subject, Charles F. Neave, 17 T.C. 1237 (1952), published in the same volume of the Tax Court reports as the Horrmann case, the court again held that maintenance expenses are not allowable under section 23(a)(2) on an unoccupied residence listed for sale.

25. "Here as elsewhere, names are 'noise and smoke'; the important point is to have a clear and adequate conception of the fact signified by a name." Huxley, *Touchstone for Ethics* 69 (1947).

26. "I have in my mind cases in which the highest court seem to have floundered because they had no clear idea of some of these themes." Holmes, *Collected Legal Papers* 196 (1921).

27. U.S. Treas. Reg. 118, § 39.23(1)-1 (1953) provides that the proper allowance for depreciation of property used in the trade or business or held for the production of income "is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside plus the salvage value, will, at the end of the useful life of the depreciable property, equal the cost or other basis of the property determined in accordance with section 113."

28. Cf. William Horrmann, 17 T.C. 903 (1951), where the deduction for depreciation was allowed but the loss on the sale was disallowed.



basis for depreciation, is the lower value of the property at the time the property is rented to be decreased by the \$6,000 depreciation already taken?

If, however, the value at the time the abandoned residence becomes property held for the production of income, adjusted for depreciation, is the basis for determining gain or loss if the property is rented, all absurdities or problems caused by the allowance for depreciation are dissolved. But that can be so only if abandoning a residence and holding it for the production of income is recognized as initiating a transaction entered into for profit.<sup>29</sup>

The 1953 Surrey and Warren treatment of gain or loss on the sale of a residence as compared to its 1950 discussion shows the distortion to which tax concepts are being subjected. The 1950 edition reads:<sup>30</sup>

*Gain Aspect*

"It should be noted that the gain on the sale of a residence, even if sold *qua* residence is always taxable. The amount of the gain is determined by reference to the original cost, not adjusted for subsequent depreciation. Where a residence converted to rental property is later sold, the basis for computing gain is the original cost reduced only by depreciation subsequent to the conversion. See I.T. 2533, IX-1 Cum. Bull. 129 (1930)."

But the 1953 edition, which continues this language, inserts after the second sentence:<sup>31</sup>

"In effect, the imputed income from the occupation of the residence, to the extent it is reflected in depreciation of the residence, is subtracted from the taxpayer's cost to reduce his loss in the case of a residence converted to rental property, but is not subtracted to increase his gain."

Imputed income has nothing to do with it. The reduction in value of the residence during occupation is a personal expense, as stated in I.T. 2533, cited in the first quotation, and therefore the taxpayer is not entitled to a loss deduction for the period of occupancy, but takes as a basis for loss the value at the time the property is rented.<sup>32</sup> Taxation is difficult enough without the haze that comes from a leading casebook that drags in imputed income.<sup>33</sup>

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29. U.S. Treas. Reg. 118, § 39.23(e)-1(e) (1953) prescribes that the basis for computing loss cannot exceed the original cost of the residence, or its value at the time of conversion, whichever is lower. This rule was initially prescribed in *Heiner v. Tindle*, 276 U.S. 582 (1928).

30. Surrey and Warren, *Federal Income Taxation* 234 (1950 ed.).

31. Surrey and Warren, *Federal Income Taxation* 261 (1953 ed.).

32. "[T]he cumbersome and determinedly imposing apparatus which is so often brought into play, as if to establish some profound and penetrating insight, turns out, when reduced to simple, clear and unpretentious terms, to be a quite commonplace observation." Adams, *Speaking of Books*, N.Y. Times Book Review, Feb. 21, 1954, p. 2.

33. "One must select one's guide with care, even though the candidates for employment are decked in the regalia of the schools." Cardozo, *Growth of the Law* 131 (1924).

"It is on the legal scholar that the tremendous burden of our case law falls in his attempt to master comprehensively any large part of the field. So true is this that it must be confessed that the encyclopedic legal minds seem to be disappearing, and knowledge of the law as a system is becoming increasingly rare. Fortunately for the modern law student,

## CONCLUSION

It is clear that once depreciation and maintenance expenses on an abandoned residence held for rent or sale became allowable as deductions, the property was no longer held for personal use. A loss on the sale is therefore also allowable as a loss incurred in a transaction entered into for profit.

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the wealth of scholarship which since Langdell's time has gone into the editing of casebooks has not only made accessible to him the pure gold of legal principles, but has taught him how to mine it for himself.

“ . . . .

“The time has long since passed when judges or practicing lawyers are the mentors of the profession. It is to the law schools that the legal profession must turn for guidance. Practicing lawyers, judges, legislators, and administrators, businessmen, and labor leaders may meet at the law schools to give common counsel, but it is to the law teachers that we must ultimately turn for the continuing resynthesis of the law to meet modern needs.” Chief Justice Vanderbilt, *Men and Measures in the Law* 11, 29 (1949).

“More and more we are looking to the scholar in his study, to the jurist rather than to the judge or lawyer, for inspiration and for guidance.” Cardozo, *Growth of the Law* 11 (1924).