

## CPE PROGRAM

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### Category: Taxation Lesson 93-08

With divorces occurring in unprecedented numbers, it is vital for the Certified Public Accountant to be aware of the problems and opportunities that arise when a residence has to be sold as a result of a marital split-up. The following learning objectives will be met.

- ♦ The CPA will be able to advise a client on the tax ramifications of divorce and the sale of residential property.
- ♦ Practitioners will be familiar with the relevant IRS Regulations and Tax Court rulings.
- ♦ The CPA will have the knowledge necessary to determine principal residence, an important concept in tax liability.
- ♦ CPAs will understand the application and consequences of Sections 1034, 121 and 162 of the Internal Revenue Code.

### Course Highlights

- ♦ Cases deciding the principal residence issues of occupancy, absence and divorce.
- ♦ IRS Responses
- ♦ Proposed Legislative Changes

### About the Author

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**Recommended CPE Credit: One**  
**Course Prerequisites: None**

## “This Old House” Divorce, Tax Law and Real Property

There are few more heart-wrenching, emotional and financially draining experiences in life than divorce. When a marriage ends, there are many moral, ethical, legal and tax issues which arise incident to divorce. Most people, no matter how “friendly” or agreeable the separation, are not prepared to cope with it, and certainly are not in a position to deal with the details of the finances and taxes that are usually part of the dissolution. It is vital for the certified public accountant to be aware of the many pitfalls that are inherent in the tax aspects of a divorce. It usually falls on the CPA's shoulders to advise the attorney and the client to find the proper paths. The considerations include the amount of child support, whether alimony must be paid and how to divide the marital property.

It cannot be emphasized too strongly that the practicing CPA must be knowledgeable in the area of divorce in order to properly serve his or her clients and their attorneys.

The so-called federal income tax marriage penalty can cause some married persons to pay more tax than two unmarried persons who file as single. Bitker, *Federal Taxation of Income, Estates and Gifts*, Warren, Gorham & Lamont, ¶ 39.3 states: “Because married persons who file separate returns must use the special rate schedule prescribed by IRC §1(d), rather than the rates imposed by IRC §1(c) on unmarried persons, the 1969 reform imposes a ‘marriage penalty’ on persons with relatively equal amounts

of income who get married and continue to have the same amount of income thereafter.”

A penalty can exist even after the marriage ends. One example of this post-marriage penalty is the possible inability of a divorced or separated spouse to qualify for the tax-free rollover provisions which allow most taxpayers to sell their principal residence and replace it tax free with a residence of equal or greater cost.

When deciding how to divide the family property, the couple must first agree on what is marital property. That will depend on such factors as: was the property the result of wage earnings or was the property a result of inheritance. Division may present problems in the case of a “later” marriage in which substantial property was owned prior to the marriage. A worst case scenario may occur if one of the spouses owned a residence prior to the marriage, but the mortgage was paid out of earnings during the marriage.

These issues can be further complicated if the spouses live in different states during the divorce, or if during the marriage they lived in one state that followed community property laws and in another state that did not recognize community property. As a matter of fact, even states which observe community property laws have substantially different rules to define separate and community property income. When it comes to division of property in these matters, to paraphrase the words of General Sherman, divorce can be hell.

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Even when the parties decide how much child support and alimony must be paid, and agree on the length of these payments, they must take into consideration the tax basis of the property involved. Thus, though one spouse receives \$150,000 fair market value stock and the other receives a house worth \$135,000 (net of mortgage), the division of property may not be equal. This results as a consequence of income taxes — the basis of the property continues to be the cost of the property. Therefore, in most cases, the basis will differ from the fair market value. It is vital, for that reason, when dividing the marriage property, consideration be given not only to the fair market value of marital property but to the tax basis of the property as well.

What ultimately happens to the family home? Three possibilities exist.

First, it can be sold while the couple is still living in the house and each spouse can take his or her share of the proceeds and reinvest in a new home. Under this scenario the favorable tax treatment for the rollover of gain on the sale of a principal residence may be available to each spouse.

Secondly, where the family residence is the sole asset of the marriage, it is often stipulated that the spouse who retains custody of the children keeps the house until the children have reached majority. At that time the house is sold and the proceeds divided between the former couple. In this situation, the spouse who remains in the residence will receive the benefit of the tax free rollover provisions. It is unlikely that the spouse who vacated the property will receive the favorable rollover treatment, but as will be demonstrated by this module, that spouse can try to make that provision applicable.

Thirdly, where either party moves out and the house is sold as soon as is practicable, the spouse who retained possession of the house should be able to claim the tax free rollover benefits. This module will examine whether the spouse who moves out can also claim tax free rollover if he or she reinvests the proceeds of the sale of the former residence within the required 24 months.

Although the basis for this module relates to the results of divorce, and most case law involves divorces, it will also review the applicable case law in situations in which the home is purchased either by roommates or by an unmarried couple, since the same tax issues arise when one of the co-owners moves out prior to the sale of the residence, but still wants to claim tax free rollover status on the eventual sale of the property.

This module examines whether the Internal Revenue Code creates several marriage penalties in the case of a spouse who moves out of the principal residence as part of a divorce or separation while the couple is in the process of selling the family residence.

## Fact Pattern:

The fact pattern used to examine this tax issue involves a divorce. Similar problems would occur in the case of two friends (who are either an unmarried couple or just friends) who purchase a residence together. The facts used are as follows:

1. A couple in the process of getting a divorce or legal separation, puts their family residence up for sale in order to raise sufficient cash to allow each spouse to purchase his or her own residence.
2. Based on a divorce decree, separate maintenance order, or the fact that the couple can no longer live together, one of the spouses, "S<sup>1</sup>", moves out of the house with no intention to return and rents an apartment until the family residence is sold. A different result will occur if the couple shares the house until it is sold since it will continue to be used by both spouses as their principal residence.
3. S<sup>1</sup> has no intention to move back into the former marital residence no matter how long it takes to sell the family residence.
4. The couple hopes to sell the property as soon as possible, but the drop in housing prices and the sluggish resale market make it extremely difficult to sell the home at a "reasonable" price.
5. The house is continually listed for sale and it is not rented out while it is offered for sale, because S<sup>2</sup> remains in the house until the house is sold. An interesting side issue is how the couple deals with the economic ramifications of the fact that S<sup>2</sup> continues to live in the family residence rent free while S<sup>1</sup> must pay rent. Assuming that the couple lives in a community property state, or one that treats the spouses as each owning one-half of the marital property, should S<sup>2</sup> be paying half of the rent? Moreover, does S<sup>1</sup> continue to pay half of the mortgage, taxes and upkeep on the house? This module will not attempt to deal with any of the tax issues raised by any payments between the husband and wife pursuant to trying to equalize the effect of these payments or the effect of §1041 relating to the tax effect of transfers between spouses during marriage and pursuant to a divorce.
6. Between one and three years after S<sup>1</sup> moves out, the family home is sold.

# ACCOUNTING TODAY

7. Thereafter, both spouses purchase replacement homes costing at least one-half the adjusted sales price of the marital property.

This module will focus on the issue whether S<sup>1</sup> qualifies for the tax free rollover of gain realized on the sale of the family home. It will examine whether the spouse also qualifies for the related one time exclusion of \$125,000 (\$62,500 for married filing separately) on the sale of a residence if the spouse is 55 years of age at the time of the sale.

## The Law: §1034:

Section 1034 of the Internal Revenue Code of 1986, as amended (the "Code") states in pertinent part:

§ 1034. Rollover of gain on sale of principal residence

(a) **Nonrecognition of gain.**—If property (...old residence") used by the taxpayer as his principal residence is sold by him and, within a period beginning 2 years before the date of such sale and ending 2 years after such date, property (...new residence") is purchased and used by the taxpayer as his principal residence, gain (if any) from such sale shall be recognized only to the extent that the taxpayer's adjusted sales price (...) of the old residence exceeds the taxpayer's cost of purchasing the new residence. (Emphasis added)

Section 1034(g) further provides that a "taxpayer and his (or her) spouse" can consent to have the provisions of Section 1034 applied even if only one of them owns either the new or the old residence. However, that election can be made "only if the old residence and the new residence are each used by the taxpayer and his spouse as their principal residence."

Thus, in order for the taxpayer to qualify under Section 1034, the old residence must be "used by the taxpayer (S<sup>1</sup>) as his (or her) principal residence." Unfortunately, the Code does not define either the term "used" or the term "principal residence." Regulation Section 1.1034-1(c)(3) provides very little guidance except to state that only if the former family residence continues to be the taxpayer's principal residence can the taxpayer defer gain on the sale. It is clear that S<sup>2</sup>, who continues to live in the family residence, qualifies under section 1034 since this is the spouse's only residence and therefore the principal residence. Accordingly, this module is limited to the applicability of Section 1034 to the spouse who vacates the family residence.

Reg. §1.1034-1(c)(3) states in pertinent part:

(3) *Property used by the taxpayer as his principal residence.* (i) *Whether or not property is used by the taxpayer as his residence, and whether or not property is used by the taxpayer as his principal residence (...), depends upon all the facts and circumstances in each case, including the good faith of the taxpayer. The mere fact that property*

*is, or has been, rented is not determinative that such property is not used by the taxpayer as his principal residence.*

The Congressional Committee Reports to the predecessor of Section 1034 are of little help in defining "use of the principal residence" except that they state that each case depends on the facts and circumstance, including the bona fides of the taxpayer.

## The Law: §121:

Section 121 of the Code, which provides for the one time election to exclude \$125,000 of gain (\$62,500 for married filing separately) on the sale of a principal residence states in part:

§ 121. One-time exclusion of gain from sale of principal residence by individual who has attained age 55.

(a) **General rule.** At the election of the taxpayer, gross income does not include gain from the sale or exchange of property if

(1) the taxpayer has attained the age of 55 before the date of such sale or exchange, and

(2) during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as his principal residence for periods aggregating 3 years or more. (Emphasis added)

Unfortunately, Reg. § 1.121-3(a) simply states that "the term 'principal residence' has the same meaning as in Section 1034 (relating to sale or exchange of residence) and the regulations thereunder ..."

Thus, when the family residence is finally sold, and S<sup>1</sup> claims the benefit of both Sections 1034 and 121, the IRS will be able to deny the benefit of both Sections if it can prove that the residence is not the taxpayers' "principal residence." This assumes that the taxpayer qualifies for all of the other requirements under the respective Code Sections and that the only issue is whether the residence is a "principal residence".

## Issue:

The issue to be determined is whether S<sup>1</sup>, who voluntarily moved out of the family residence, can continue to claim that the residence is his or her principal residence, even though S<sup>1</sup> lived in rented quarters until the house was sold. Thus, the sole question is whether the family residence continues to be used by S<sup>1</sup> as his or her principal residence for purposes of Sections 1034 and 121. If the home is not a principal residence, and if it had been rented out prior to sale rather than used by one of the spouses, the taxpayer should qualify to depreciate the lower of the fair market value or tax basis of the house.

## Analysis:

Publication 523, published by the Internal Revenue Service, entitled *Tax Information on Selling*

# ACCOUNTING TODAY

*Your Home*, describes to taxpayers the law relating to the deferral of tax under Section 1034. Although the Code states that gain will not be recognized on the sale of a taxpayer's "principal" residence, the Publication states that gain must be postponed if "...you buy a new main home ..." Postponement of gain under §1034(a) is mandatory. It is not an elective provision.

Thus, if the taxpayer purchases and sells a principal residence within a 24 month period, realized gain will be recognized only to the extent that the adjusted sales price of the old residence exceeds the cost of purchasing the new residence. It is interesting that Publication 523 does not use the term principal residence but instead refers to the qualified residence as the main home.

Publication 523 states that usually, your main home is the home in which you live. If you have more than one home and live in both homes, your main home is the one you live in most of the time.

If you own a home, but live in another house which you rent, the IRS states that the rented home is your main home. "But, if a house you own is your main home, you can temporarily rent it out before its sale without changing its character as your main home."

If, as the IRS has stated, a taxpayer can temporarily rent out his or her main home (principal residence) and continue to qualify for the deferral of gain under Section 1034, how long can this temporary rental status exist until it is no longer temporary? The publication does not address this issue.

Taxpayers should not confuse Section 1041 and Sections 1034 and 121. Section 1041, which in certain cases recharacterizes transfers between spouses as gifts probably does not affect the determination of "principal residence" under Sections 1034 or 121. It may however affect the tax treatment of purported rent paid by S<sup>1</sup> to S<sup>2</sup> as rent on the family house prior to the sale, if payment of rent is considered a transfer of property. This is because Section 1041(a) states that:

*"No gain or loss shall be recognized on a transfer of property from an individual to (...)*

*(1) a spouse, or*

*(2) a former spouse, but only if the transfer is incident to the divorce."*

Whether a taxpayer can benefit from Sections 1034 and 121 depends on whether the taxpayer uses the home as his or her principal residence. This in turn depends on the facts and circumstances of each case and the intent of the taxpayer.

Since these facts vary substantially, no single factor or line of reasoning has been used in the cases. Instead, several different lines of legal analysis have emerged which focus on the particular facts of the case.

This module will discuss the facts and holdings of most of the cases deciding the principal residence issue using the following topics:

♦ Actual Occupancy Required - More than One Home

♦ Exceptions to Actual Occupancy - Temporary Rental

♦ Absent Too Long or Just Plain Absent

♦ Renting the Property Prior to Sale

♦ Divorce Decree

After discussing the cases, the module will address the following topics:

♦ IRS Response - the Revenue Rulings

♦ Proposed Legislative Change

♦ Summary and Conclusion

## Actual Occupancy Required - More than One Home:

Publication 523 states that where a taxpayer has more than one home, his/her main home is the one he/she lives in most of the time. It also says that if you own one home and live in another which you rent, the rented home is your principal residence. Taxpayers have often taken the position that they do not necessarily have to live in a home in order for it to qualify as their principal residence. This may be supported by the Committee Reports that indicate that one of the factors used to determine a principal residence is the taxpayer's intent. Even the regulations state that whether or not property is used by the taxpayer as his principal residence depends on all the facts and circumstances, including the good faith of the taxpayer.

In **Michael Friedman** 43 TCM 1009 (1982) the taxpayer owned a house in Nassau County, New York and also rented an apartment in New York City. The taxpayer argued that the sale of the Nassau County house was a sale of a principal residence because they lived in it more than one-half the year and they always intended their home to be there. The Court held that the apartment was the taxpayer's principal residence because the taxpayer's business office was there, his children went to school in the City and the phone records indicated that the family lived in the apartment at least nine months out of each year. Thus, in **Friedman**, the subjective intent was not supported by the facts and Section 1034 did not apply.

The **Ernst & Young Tax Guide** 1992, Ernst & Young, John Wiley & Sons, Inc. at page 233 states:

*To determine which is your principal residence, the IRS considers the following: where you vote, the address you use on your tax returns, the address you claim to be your residence in other financial dealings, where your children go to school, where you work, where your car is registered, and where you belong to social and religious groups.*

In **Payne E. L. Thomas** 92 T.C. 206 (1989) the taxpayers had four residences, one in Illinois and three in Florida. The taxpayers actually lived in Illinois for short periods of time. At other times the taxpayers lived in Florida but made frequent trips to Illi-

nois, always staying in the residence there. The Court concluded that Illinois was always the taxpayers' residence. The next question was whether it was their principal residence. The Court stated that in deciding multiple residence cases, it must take into account several factors with each factor having a different degree of relevance in each case. The relevant fact in this case appears to be the intent of the taxpayer and the length of time spent at each residence. The Court listed three factors in this case:

- ♦ The amount of time spent at each residence.
- ♦ Whether one residence was abandoned with no intent to return.
- ♦ Whether a temporary rental was necessitated by an adverse real estate market.

The second and third factors will be discussed under the topics "Absent Too Long or Just Plain Absent" and "Renting the Property Prior to Sale" respectively.

The Court determined that over the relevant four year period the taxpayer had lived in the Illinois home half the time and had spent the other half of the time in the three Florida homes 11, 5, and 7 months respectively. This suggested to the court that of the four residences, the Illinois residence was their principal residence. In addition to the time spent in each home, the Court pointed out that the taxpayers' business was in Illinois, they filed tax returns there as full-time residents for three of the years, they voted there, attended church there and had an Illinois driver's license.

The Court rejected the IRS argument that the taxpayer must provide objective facts to prove that their intent was to make Illinois their home, stating that nothing in the regulations require proof of intent by objective facts alone. Rather, the regulations provide that one must weigh all the facts and circumstances, including the good faith of the taxpayer. "We have weighed the evidence as to both the objective and subjective facts in the instant case. ... We hold for petitioner (taxpayer) on this issue." Thus, a taxpayer who lives in more than one residence should gather as much evidence as possible in support of the asserted principal residence. Although not analogous, a helpful area for determining the relevant factors which prove which residence is the principal residence appears to be the state tax cases on who is a resident and who is a part year resident. The current federal tax definition under Section 7701(b)(3) relating to the definition of resident aliens is of no guidance because it provides for a mathematical test of presence in the United States based on the number of days of presence over a three year period rather than a facts and circumstances test of where the taxpayer maintains his or her principal residence.

Another case involving multiple residences is **Stolk v. Commissioner** 40 T.C. 345, aff'd per curiam 326 F.2d 760 (2d Cir, 1964), 64-1 USTC ¶9228 in which the taxpayer owned a home in upstate New York for nine years prior to moving to a rented

apartment in New York City. He continued to spend his weekends at the suburban residence. Three years later, the taxpayer rented a larger apartment in New York City and listed the suburban residence for sale. Within two days of listing the property for sale and prior to placing the furniture in storage, the taxpayer received a very attractive offer of purchase, which he did not accept.

One or two months later, the taxpayer placed virtually all of his household property in storage, moved out of the house "with the definite intention of not living there again." At the time, he intended to sell the suburban house and purchase a new suburban residence. In July, 1955 the suburban house was sold and in September, a replacement property was purchased in Esmont, Virginia, 427 miles from New York City.

The Tax Court had to determine whether the original suburban residence continued to be used as the taxpayer's principal residence after he and his wife moved to New York City. Unlike Thomas, where the taxpayer continued to use both houses, here, the IRS asserted that the taxpayer abandoned the suburban residence. The taxpayer claimed that the suburban residence continued to be his principal residence because it had been so beginning in 1941 and because "he regarded the city apartment as a temporary residence pending his acquisition of property to replace the (suburban) property."

The Court determined that there was insufficient evidence to conclude that the taxpayer had tried to sell the residence for the entire two years. However, even if the taxpayer had continually attempted to sell the property, the Tax Court stated:

*... (T)hese explanations do not negate the fact that the (suburban) property was not used and was abandoned as a residence two years before it was sold. The provisions of Section 1034(a) do not provide and the legislative history thereof does not indicate that the stated relief will be allowable if there is a reasonable cause for not using the old property as a principal residence.*

It is not clear what relevance should be attached to the fact that at the time this case arose, Section 1034 required a taxpayer to sell the old residence and purchase a new residence within one year. It may not have made a difference in this case because the taxpayer's rejection of an attractive offer made several years prior to the sale seemed to indicate to the court that the house would not be sold until a replacement was found. At that time, the taxpayer had not lived in the suburban house for almost five years and the house had been physically vacated for almost two years.

In deciding that the taxpayer had abandoned the suburban residence and therefore failed to qualify under Section 1034, the Tax Court defined a residence as an abode with the intention of remaining in that abode. Since the Court found that the taxpayer moved out with no intention of ever returning, that constituted an abandonment of the subur-

# ACCOUNTING TODAY

ban property as a residence.

Even if the Court had determined that the suburban residence continued to be the principal residence, the Court in dicta found that the new residence which was used only on weekends did not become the new principal residence. Instead, the New York City apartment, where the taxpayer's job was located and where he voted, became (or continued to be) the principal residence. It is interesting that four Tax Court Judges dissented. They believed that in the absence of Congressional expression, the statute should be read liberally. Since there is no restriction on the word "used," they felt that the Court should not have imposed one. They felt that as a matter of a finding of fact, that the mere placing of all of petitioner's property in storage for two years did not constitute abandonment of the residence. This was indicated by the fact that all of the furniture was placed in storage rather than integrated into the New York City residence. Thus, these judges felt that the New York City apartment was a temporary residence.

Taxpayers faced with facts similar to Stolk and Friedman tried to claim that the second home was intended as their principal residence. In **Paul J. McDowell** 40 TCM 301 (1980) the taxpayers owned a home close to work in Fitchburg, Massachusetts and another 120 miles away in Cape Cod. While still working in the Fitchburg area, they sold the Cape Cod home and purchased a replacement home in Cape Cod. They argued that Section 1034 applied because they had decided to retire to Cape Cod and thus it was their principal residence even though they had not yet retired. The Court stated that since they had not retired prior to the sale and since they sold the retirement home rather than their principal residence, Section 1034 did not apply. The Court stated that *"it flies in the face of reason to think that persons owning a residence in the same city in which they are regularly employed would maintain their principal residence in another house owned by them 120 miles away."*

As requested by the IRS in Thomas, the subjective intent of the taxpayer will be given little weight if the intent is not supported by the facts. For the taxpayers to have prevailed, they should have moved into the Cape Cod home as their full time (retirement) residence prior to its sale. Alternatively, they could have sold the Fitchburg home and then retired to a new home on Cape Cod. The problem with this alternative is that they would either have to keep the original Cape Cod home or pay tax on the proceeds of its sale.

Under the first alternative, moving to the original retirement home prior to its sale, they could have accomplished the tax-free rollover of the Cape Cod gain. But, they would have had to commute to work over 120 miles for a long enough time to establish the old Cape Cod home as their principal residence. Ultimately, however, they would have to pay tax on the gain from the sale of the Fitchburg residence.

The net effect is that no matter how the sale of the houses is accomplished, if two houses are sold, one of them will result in gain. In Revenue Ruling 66-114, 1966-1 C.B. 181, the IRS has stated that the opposite is also true. If two houses are purchased to replace one, only one residence qualifies as the principal residence. Thus, if a principal residence is sold for an adjusted sales price of \$150,000, in order to defer the gain, one principal residence must be purchased for at least \$150,000. Any other homes purchased at the same time would not be included for purposes of Section 1034.

## Exception to Actual Occupancy - Temporary Rental

Can the taxpayer move out without abandoning the property? In **Ralph L. Trisko** 29 T.C. 515 (1957), acq., 1959-1 C.B. 5 the taxpayer temporarily rented his home when he was assigned to work abroad. At all times he intended to return to that home. When he returned home and tried to regain possession, he was denied use of the property on account of Rent Control Regulations imposed by the federal government. Thus, he was compelled to purchase a new residence. The old home was sold within the statutory time limit.

The only question was whether the old home continued to be the taxpayer's principal residence, even though it had been rented and the taxpayer did not actually return to the residence upon returning to the United States. The Court stated:

*We have no doubt but that the situation presented by the instant case is of the general type which Congress considered entitled to the relief provided by Section 112(n). The narrow question is whether petitioner is precluded from such relief by reason of the words "used ... as his principal residence" appearing in the statute.*

(For purposes of understanding the prior quote, it helps to know that Section 112(n) of the Internal Revenue Code of 1939 is almost identical to Section 1034 of the Internal Revenue Code of 1986, as amended with respect to the use of the term "used by the taxpayer as his principal residence." The same is true of Regulation 111, Sec 29.112 (n)-1.)

That Congress did not intend that the relief afforded by this statute should be confined solely to cases where the old home is actually lived in by the taxpayer as a home at the time of sale is indicated by that part of the Committee Reports which reads as follows:

*Whether or not property is used by the taxpayer as his residence, and whether or not property is used by the taxpayer as his principal residence (in the case of a taxpayer using more than one place of residence), depends upon all of the facts and circumstances in each individual case, including the bona fides of the taxpayer. The term "residence" is used in contradistinction to property used in trade or business and property held for the pro-*



duction of income. Nevertheless, the mere fact that the taxpayer temporarily rents out either the old or the new residence may not, in light of all the facts and circumstances in the case, prevent the gain from being recognized. For example, if the taxpayer purchases his new residence before he sells his old residence, the fact that he rents out the new residence during the period before he vacates the old residence will not prevent the application of this subsection. (citations omitted) ...

In our opinion, "all of the facts and circumstances" in the instant case, "including the bona fides of the taxpayer," indicates to our satisfaction that the property sold by the taxpayer was used by him as a residence "in contradistinction to property used in trade or business ..." in spite of the fact that "the taxpayer temporarily rent[ed] out ... the old ... residence."

Trisko appears to be based on the fact that the taxpayer had not abandoned the residence because he intended to return and therefore the residence continued to be "used as his principal residence." A similar taxpayer victory occurred in **Arthur R. Barry** 30 TCM 757 (1971). Mr. Barry was a career Army officer beginning in 1940. The Barry home in Annapolis was purchased in 1955. He lived there until 1960, always intending that this home would be his retirement home. From 1960 to 1962, he and his family were stationed in Germany. From 1962 to 1965 he was stationed in Denver. During this period, his home was leased on a year to year lease. In 1965, the taxpayer left the army, was hired for a civilian job in Denver and began building a house in Colorado. The Annapolis home was listed for sale in order to raise funds to construct the home in Colorado. Six years had passed from the time the taxpayer moved out of the Maryland home until it was finally sold. The Tax Court based its decision on Trisko and held that the Maryland home continued to be the taxpayer's principal residence because:

- ♦ the taxpayer always considered the Maryland home to be his principal residence since he always intended to return there,
- ♦ the home was rented solely to provide for its proper maintenance,
- ♦ no significant profit was made on the rental, and
- ♦ the home was not offered for sale anytime prior to actual change of principal residence to Colorado.

It is uncertain how much weight should be given to the fact that this was the taxpayer's only home during a 26 year military career or the Court's statement that the taxpayer's case is made even stronger by the fact that he was living in government-provided housing during the five years he was away from his home. The Court states: "Clearly, petitioner could not have abandoned his ... home and adopted any of these temporary military quarters as a new principal residence when his retirement from the military was to occur in the very near future." Does that mean the Court thinks that 5 years is the near future for Section 1034?

Other cases have held that the taxpayer is not required to return to the former residence, so long as the taxpayer intended to sell the residence as soon as possible after moving out. The most favorable facts for many taxpayers is found in **Robert G. Clapham** 63 T.C. 505 (1975). There, the taxpayer was employed in San Francisco by a company that was opening an office in Los Angeles. In anticipation of the move, the taxpayers placed their home on the market in May, 1966. Three months later they moved to Altadena, California, leaving their Mill Valley property vacant in order to sell the property as soon as possible.

In the spring of 1967, financial circumstances forced the taxpayers to lease the Mill Valley house. One year later, the tenant moved out and the property was placed on the market and left vacant. In the fall of 1968, the house was rented for financial reasons. In September, 1968 they purchased a home in the Los Angeles area. In December, the Mill Valley home was vacated. In June, 1969 the house was sold.

Does Section 1034 apply to the sale of the residence which occurred almost three years after they moved to Los Angeles? Hadn't the Claphams abandoned their Mill Valley home?

The Court first states that a taxpayer is not required to reoccupy the former residence when it is sold for it to qualify as the principal residence. The residence may even be temporarily rented prior to its sale. The Court cites **Robert W. Aagaard** 56 T.C. 191 (1971) for the propositions that the intention to return is not always one of the relevant facts and circumstances to be considered and therefore temporary rental of the old or new residence will not necessarily prevent the application of Section 1034. The Court held that Section 1034 applied even though the taxpayers abandoned their old residence because they intended to sell their house as soon as possible. The Court concluded that there is nothing in the legislative history to indicate that Section 1034 is inapplicable:

...when a poor real estate market or the unavailability of mortgage money requires an individual to lease his old premises for a temporary period concurrent with and ancillary to sales efforts. To hold otherwise would make relief dependent on the vicissitudes of the real estate and money markets.

The Court then dismissed any issue involving the rental of the property by determining that the taxpayers' dominant motive was to sell the property at the earliest possible date rather than to hold the property for the realization of rental income. Thus, the house qualified under Section 1034 as used as a principal residence even though the taxpayers had moved out, with no intention of returning and had rented the house for a short period of time prior to selling the residence three years later.

In August, 1992 a very interesting case was decided that was very similar to Clapham. In **Dorothy Louise Green** 1992 T.C. Memo 48,394, 1992-439, the taxpayer paid \$12,000 down and her boyfriend paid

\$4,000 down for the purchase of a home in Los Angeles in 1975. Following a dispute in 1979, the taxpayer moved to Baltimore. She subsequently reconciled with her boyfriend but was unable to secure a reassignment of her job to Los Angeles. From 1980 to 1982 she made trips to Los Angeles ranging from 2 weeks to 2 months. She even made all mortgage and tax payments because her boyfriend refused to do so.

The taxpayer moved all of her belongings out of the home in 1982 and several months later, the boyfriend married and moved his wife into the home. Although the boyfriend agreed to sell the home, when a buyer was found several months later, he refused to sell it. In 1983, the Superior Court ordered the boyfriend to make all trust deed payments, which the taxpayer treated as rent. Finally, in 1986, the Court ordered the sale of the home. She claimed that the Los Angeles home remained her principal residence and claimed both the exclusion under Section 121 and deferral under Section 1034.

The IRS asserted that neither Section applied and the Tax Court determined that Section 121 did not apply, but that Section 1034 did apply. The Court stated that moving to Baltimore did not change her principal residence, because it was only temporary. The Court distinguished it from earlier cases such as *Stolk* because in those cases the taxpayer had abandoned the residence. Here, when the taxpayer removed her belongings, she intended to sell the property immediately. She could not do so only because her ex-boyfriend refused to sell. Even the IRS conceded that the taxpayer sold the residence as soon as she could.

The IRS argued however, that the rental losses and depreciation claimed by the taxpayer indicated that the taxpayer no longer considered this her residence, but rather it became investment property. The Tax Court noted that this was not rental property in the conventional sense. In fact, as soon as her boyfriend refused to sell, she immediately brought suit in Court to force the sale, thus indicating that rental was not her primary motivation. The Tax Court therefore concluded that the Los Angeles home continued to be the taxpayer's principal residence and Section 1034 was therefore available to the taxpayer.

What is harder to understand is the Court's reasoning on why Section 121 was not applicable. After stating that principal residence has the same meaning for purposes of Section 121 and 1034, it jumped to the conclusion that since the taxpayer was not 55 when she moved out of the home in 1982, she did not qualify for the exclusion. This seems to have totally disregarded Section 121 which only requires that the taxpayer has attained the age of 55 before the date of the sale or exchange of the home. It is unclear why the Court looked at the date the house was first listed rather than when it was sold. The question this decision raises is whether homeowners should wait to list their homes until they are 55

in order to qualify for the exclusion.

The Clapham and Green cases are very similar to the hypothetical facts in this module. The IRS may try to counter them with several of the cases listed below because in Clapham, the taxpayer moved because of a job transfer and in Green the taxpayer attempted to move back in and to sell the house immediately, whereas in the hypothetical example, the move is personal. However, S<sup>1</sup> should argue that Clapham and Green stand for the proposition that rental of the residence due to an adverse real estate market or the inability to sell which is beyond the control of the taxpayer, does not change the character of the house as a principal residence and does not turn the house into a primarily rental property.

## Absent Too Long or Just Plain Absent?

Unfortunately for S<sup>1</sup>, although Green, Clapham, Aagaard and Barry were successful in convincing the Court that their homes remained their principal residence even after they moved out, taxpayers such as the Stolks have not been as fortunate. Many cases have determined that taxpayers who have moved out of their residence for too long a period of time have abandoned their principal residence. In *Ann K. Demeter* 30 TCM 863 (1971) the taxpayers purchased a residence in Mill Valley, California in 1950. In 1952 it was converted to rental property and rental property in San Francisco was used as their residence for almost 14 years. In June, 1966, the taxpayers began remodelling the Mill Valley home and without even listing the property, it was sold in December. The taxpayers claimed that Section 1034 precluded any gain being recognized because of the intent to reoccupy their residence. The Court did not find any facts that indicated the intent to resume their residence and thus the gain was fully taxable.

A much closer case that seems hard to reconcile with Clapham which was decided seven years earlier is *Richard T. Houlette* 48 T.C. 350 (1967) in which the taxpayers owned a home in Portland, Oregon. Due to a transfer to Alaska in July, 1955, they attempted to sell their home in Portland. Since they could only sell the house at a loss, the taxpayers rented the house for two years and added a one year extension to the lease. At the end of the additional one year lease, the Houlettes again unsuccessfully attempted to sell the house. The taxpayers were then transferred to Astoria, Oregon. The Portland house was continually leased on one year leases and at the end of each lease, the taxpayers unsuccessfully attempted to sell the house.

In 1960, the Houlettes were transferred to Wisconsin and they purchased a new house. Eight months later, on May 1, 1961, they sold the Portland house. The taxpayers reported the gain as the sale of a principal residence under Section 1034. The IRS examination stated that the Portland house did not qualify as the sale of a "personal residence."



The Court discussed whether the taxpayer was required to actually occupy the residence which was sold to qualify under Section 1034. Trying to distinguish the present case from Trisko, the Court states:

*... We likewise believe that the facts and circumstances must be exceptional and unusual to permit the conclusion that a principal residence is being used by the taxpayer at the time of sale if he is not in possession thereof and occupying same (sic) at the time. Our decision in Trisko was expressly limited to the particular facts of that case.*

The Court then states that each case is based on its own facts. Trisko was distinguished because there, actual (re)occupancy, "which is usually required," was impossible due to the rent control laws. However, the Court was convinced that the taxpayer intended to and would have reoccupied his former house if he had not been prevented from doing so. Here, the Court concluded that based on the fact that the taxpayer continued to re-lease the property every time the lease expired, that he did not intend to reoccupy the house.

The Court then discussed Stolk's holding that vacating one's residence with the intent of not returning is incompatible with the requirement that the property be used by the taxpayer as his principal residence. The Court placed a very heavy emphasis on actual use. In Stolk, the taxpayer's actions amounted to an abandonment of the residence for purposes of Section 1034. The same conclusion of abandonment was applied to the Houlettes:

*We think the listing for sale, combined with nonoccupancy over a period of years, should properly give rise to a presumption of abandonment.*

*There is no shred of evidence that petitioner ever contemplated or intended to reoccupy or use his Portland house as his residence again.*

Is the difference between Houlette, Clapham and Green the fact that the taxpayer decided not to sell because they would have suffered a loss in Houlette as compared to the Claphams and Ms. Green who could not sell either because the real estate market was depressed or because the boyfriend would not permit a sale of the home? Or was the difference the fact that the Houlettes did not sell the home until almost 6 years after they moved out whereas the Claphams and Ms. Green sold their residence after only two and four years. As the Clapham Court stated: "Stolk and Houlette do not establish a rule of law, but merely identify facts and circumstances deemed relevant in those cases."

## Renting the Property Prior to Sale

In *Bolaris V. Commissioner* 776 F.2d 1428 (9th Cir. 1985), 1985-2 USTC ¶ 9822, aff'g, rev'r and rem'g 81 T.C. 840, the taxpayers attempted to sell their prior residence after they had completed construction on a new residence. They attempted to sell the property for 90 days. When that proved unsuccessful, they rented the property on a month to month

lease to "lessen the burden of carrying the property." The house was finally sold just over one year from the time it was originally listed and approximately nine months after they moved to the new residence.

The real issue (and one of first impression) was whether the taxpayers could claim the benefit of Section 1034 while also claiming depreciation, thus temporarily treating the property as held for investment. The Tax Court permitted the taxpayers to defer the gain on the sale of the home under Section 1034, but did not permit them to claim depreciation.

Although the IRS did not challenge the applicability of Section 1034, the Tax Court held that Section 1034 applied because "they intended and always wanted to sell the old residence as soon as they received a reasonable offer. ... They had no expectation or intention of making a profit from the rental..." The Appeals Court upheld the applicability of Section 1034 even though it permitted depreciation and even though it found that Bolaris had permanently abandoned the old home. The Ninth Circuit held that there was nothing inconsistent with allowing the taxpayer to depreciate a home as part of a transaction entered into for profit, while at the same time finding that the home qualified as the taxpayer's principal residence under Section 1034.

Thus, Bolaris is consistent with the other cases that appear to stand for the proposition that once the taxpayer moves into a new home, a reasonable time will be given to sell the old home even if the old home is rented while it is listed for sale.

In arriving at a similar decision, the Court in *Lee D. Andrews* ¶ 81,247 P.H. Memo T.C. used a slightly different reason for its holding. In *Andrews*, the taxpayers moved into a new residence and listed the old residence for rental rather than sale. After being unable to rent the property, it was soon sold. The Court stated that when the taxpayers originally moved, they were uncertain whether they would return. This uncertainty made it permissible to retain the house. This case was therefore distinguished from *Stolk* and *Houlette* because the taxpayers had not abandoned this house, they simply had not decided what they would do with the house. Accordingly, the gain was deferred under Section 1034. What may have swayed the Court's decision, although the reasoning is hard to follow, is that the house was sold within seven months of the time the taxpayers moved out.

## Divorce Decree

In *Robert L. Young* T.C. Memo 1985-127, 49 TCM 1002 (1985) the taxpayer was divorced in October, 1975. Pursuant to the divorce decree, the taxpayer received a 25 percent interest in the family residence. The taxpayer's former wife was given a 75 percent interest and the wife and daughter were given exclusive right to reside therein. The decree further provided that the taxpayer pay the mortgage, taxes and homeowners' insurance on the resi-

dence. The house was to be sold when the daughter finished her education, which was supposed to be three years later. In fact, it ended in 1976.

Mr. Young moved out of the house in October, 1975 and rented an apartment. In April, 1976, he married and moved into his wife's home. In November, 1976, the taxpayer sold his 25 percent interest in the home to his ex-wife for which he claimed no tax was due because that same month, he and his new wife purchased a new principal residence under Section 1034. The IRS asserted a deficiency claiming that the sale to the former wife was not the sale of a principal residence.

The IRS contended that the taxpayer abandoned the residence when, pursuant to the divorce decree, his former wife and daughter were given exclusive use of the house. The taxpayer contended that he did not abandon the residence because he paid all of the costs of the residence. Moreover, he contended that he did not abandon the property because "he intended to purchase the property from his former wife when his daughter terminated her education." Finally, he claimed that his daughter's use of the residence should be attributed to him.

The Court stated that taxpayers generally must physically occupy a residence in order to qualify under Section 1034. However, it added that all cases turn on their facts and circumstances. Citing Clapham, the Court states that Section 1034 applies when a taxpayer is not in possession only if the residence is temporarily rented or if there are exceptional circumstances over which the taxpayer has no control.

The Court stated that the taxpayer ceased to qualify under Section 1034 when the divorce decree gave exclusive use of the property to his former wife and his daughter. The Court felt that at the time the new residence was purchased, his new wife's home was his residence because it had been his actual home for nearly 20 months and he did not have the right to occupy the former residence. The fact that the taxpayer continued to pay the mortgage and taxes made no difference to the Court. Nor was it willing to attribute the daughter's use of the residence to the taxpayer.

*Furthermore, a divorce, while often unpleasant and unwanted, is uniquely personal and is not the type of external, objective, circumstance that allows a taxpayer not in possession of a home to be deemed a resident therein for purposes of Section 1034(a).*

The Court was unwilling to state that the taxpayer had abandoned the residence. It simply stated that he had testified that he intended to purchase the remaining 75% of the house from his ex-wife and therefore he had not abandoned the residence. However, the Court in a footnote indicated that an intention to return to the old residence is only one of the relevant factors to be considered and in this case it was not the controlling factor. Thus, the actual date of abandonment was not relevant in determining that his new wife's home became his principal resi-

dence prior to his sale of his former residence. This decision indicates that the courts will not give great weight to such self-serving testimony where no objective facts support the taxpayer's claim that he intends to return (or repurchase) the residence.

What is the difference between Young and Green? Hopefully it has nothing to do with one of them being a divorce case and the other being unmarried individuals. The difference is probably that in Young, possession of the house was given by the divorce Court to the wife and child and the taxpayer had no right to move back in. In Green, the right to possession of the house was not given to the boyfriend. In fact, Ms. Green went to Court to have the home sold. Thus, it was sold as soon as the Court ordered the sale. Had the Youngs agreed to list the house and sell it as soon as possible, with Mrs. Young living in the house until it was sold, the taxpayer may have won.

## IRS Response - the Revenue Rulings

**Revenue Ruling 59-72**, 1959-1 C.B. 203 follows Trisko and states that where all the facts indicate that the taxpayer sold a home which had been used as the principal residence, the provisions of Section 1034 will apply to the taxpayer even though the house was temporarily rented out prior to its sale. Although the IRS acquiesced to the Trisko decision and published Rev. Rul. 59-72 which states that Trisko will be followed, it also states that the decision will only be followed in cases which are factually similar.

**Revenue Ruling 77-298**, 1977-2 C.B. 308 discussed whether a member of Congress who kept his family home and purchased a second home in Washington D.C. qualified under Section 1034 when the Washington home was sold. Prior to the sale, the Congressman and his family lived in the Washington home for eight years and the children went to school there. The IRS stated that since a taxpayer can only have one principal residence, that where two residences were owned, the property that the taxpayer occupied a majority of the time, his Washington D.C. residence, is ordinarily the principal residence.

Would the result be different in Rev. Rul. 77-298 if the member of Congress had been a Congressman who was not elected to a second term? Revenue Ruling 78-146, 1978-1 C.B. 260 involved a fact pattern arguably similar Rev. Rul. 77-298 and also to Trisko, except that the taxpayer owned two homes. The ruling involves a taxpayer living in City X who was transferred to City Y for a 2 year temporary assignment. The taxpayer purchased a home in City Y because of the lack of quality rental property. Upon returning to City X, the taxpayer sold his original home because the local school had been closed and the commute was too far for his kids. A new home was purchased in City X. The home in City Y was also sold.

The issue was which house qualified for the deferred gain under Section 1034. The ruling states

that since the taxpayer was in fact reassigned to City X at the end of the 2 year assignment and since he intended to reoccupy the old residence, the old residence continued to be the taxpayer's principal residence. This is true even though it had been leased for the 2 year period and even though a second house had been purchased and occupied during the 2 year period.

A cynic might wonder whether the Service might have come to a different conclusion had the taxable gain on the City Y house been 2x and the deferred gain on the City X house been 20x, rather than the more favorable result under the Service's facts.

It is also interesting to note that the ruling's last sentence makes it clear that the fact that the taxpayer's principal residence remained in City X should not be interpreted to mean that City X was the taxpayer's "tax home" for purposes of Section 162(a).

It should be noted that a tax home for purposes of Section 162 is entirely different than a principal residence for purposes of Sections 121 and 1034. Section 162 provides a taxpayer with a deduction for travel away from "home". Thus, cases and rulings have had to decide the location of a taxpayer's home in order to determine when the taxpayer is away from home. Unlike a principal residence in Section 1034, for purposes of Section 162, the tax home does not focus on the intent of the taxpayer but rather it focuses on the location of the taxpayer's job.

In Revenue Ruling 83-82, 1983-1 C.B. 45 the IRS essentially stated that for purposes of Section 162, a taxpayer is away from home only if the absence is temporary. If the absence is either indefinite or permanent, the taxpayer is not away from home. Instead, the location of the indefinite or permanent city is the taxpayer's new tax home.

Although a ruling applicable to Section 162, Rev. Rul. 83-82, 1983-1 C.B. 45 may be instructive of the type of unstated reasoning that the IRS follows in determining whether a taxpayer is temporarily absent or whether the taxpayer has abandoned his/her principal residence. In Rev. Rul. 83-82 the IRS states that if the taxpayer anticipates employment at the new location for less than one year, it is temporary. Thus, they have not abandoned their tax home. If the employment is expected to last between one and two years, there is a rebuttable presumption that the move is indefinite. To rebut the presumption, the taxpayer must clearly demonstrate by objective factors that it was realistic to expect that the employment would last less than two years and that the taxpayer would return to the claimed tax home. A move of two years or more would be considered permanent, and at least for purposes of Section 162, the new home is the tax home.

Finally, it is interesting that in such a complex area where the taxpayer and the IRS agents are in such need of guidance, the Service in Revenue Procedure 87-3, 1987-1 C.B. 523 at paragraph 6, indicated that Sections 121 and 1034 are areas in which it

will not ordinarily issue advance rulings or determination letters on the issue of whether property qualifies as the taxpayer's principal residence.

## Proposed Legislative Changes

An arguably subjective test that is so complicated that the IRS will not issue advanced rulings does not create uniformity between taxpayers. It also means that the taxpayer with the best "planning" has the best chance of prevailing. Finally, it has cost both taxpayers and the government substantial litigation costs to determine what is the taxpayer's principal residence. It appears that a bright line test is needed. Although it may not be fair, the same can be said of any provision that places certainty over equity such as only allowing 24 months in which to replace a residence.

Congress attempted to solve some of the definition problems of "principal residence" in the case of divorces in the Tax Fairness and Economic Growth Act of 1992, the Family Tax Fairness Economic Growth, and Health Care Access Act of 1992 and in the Revenue Act of 1992. However, the final tax bill of 1992 that contained changes relating to divorces and Section 1034 was vetoed by President Bush.

At the present time, it is unclear what provisions, if any will be included in the tax provisions winding their way through Congress. To the extent they only deal with divorces, the provision will not affect the discussion above as it relates to unmarried couples and roommates who jointly purchase a home and subsequently are forced to move out.

The following is a proposed amendment to Sections 121 and 1034 that would be applicable to both divorced and any other co-owners.

Section 121(a)(2) is amended to read as follows:

*... used by the taxpayer as his principal residence (as defined in Section 1034) for periods aggregating 3 years or more.*

Subsection 1034(c) is amended by adding the following:

(5) Special rules for taxpayers who move out of their principal residence prior to its sale.

(A) If a taxpayer has moved out of a principal residence (whether or not there is an intent to return) for a period in excess of 24 months prior to sale, such residence will not be considered a principal residence for purposes of this title.

(B) If a taxpayer has moved out of a principal residence (whether or not there is an intent to return) for a period of more than 24 months prior to the sale of a residence and has resided in the residence following the rental for at least one year prior to the sale, the burden of proof shall be on the Secretary to prove that this is not the taxpayer's principal residence.

(C) If a taxpayer has moved out of a principal residence (whether or not there is an intent to return) and has rented that property within 24

months of sale under a lease greater than one year (including possible extensions or options), such residence will not be considered a principal residence for purposes of this title.

(D) If (i) the taxpayer has moved out of a principal residence,

(ii) places that residence for sale within six months of moving out,

(iii) does not enter into a lease (including extension or options) that exceeds one year, and

(iv) sells that home within the 24 months of moving out, then except for such circumstances as prescribed by the Secretary dealing with the purchase and sale of more than one residence within a 24 month period, that residence will be treated as the taxpayer's principal residence for purposes of this title.

## Summary and Conclusion

Section 1034 does not provide an adequate definition of "used by the taxpayer as his principal residence." The regulations, Revenue Rulings and case law are of little help except to make it very clear that each case will be decided based on the facts and circumstances. In the hypothetical situation used in this module, it appears that the taxpayer who is unable to sell the principal residence due to poor real estate (economic) conditions can continue to claim that the prior residence continues as the principal residence, even though the taxpayer is temporarily living in rental housing if the house is sold within a reasonable period of time. But what if the economy is so bad that the family house is not sold for five years? Has the house been abandoned?

The results are not as clear if the house is given to the spouse pursuant to a divorce decree which requires that the house be sold and the proceeds divided equally when the children are grown. Section 1034 may not apply if instead of moving into temporary rental property, S<sup>1</sup> remarries and moves into the new spouse's home.

Uncertainty exists in defining 'used as a principal residence' because the IRS is looking for objective facts even though the regulations and the Committee Report indicate that the test includes, at least in part, the subjective intent of the taxpayer. In cases which involve a taxpayer that owns more than one residence, the problem is compounded by the fact that the taxpayer may try to decide which home is the principal residence based on which home is sold and how much taxable income can be deferred. The taxpayer will then try to tailor the subjective and objective facts to support that decision.

What can S<sup>1</sup> do to guarantee that Section 1034 applies, aside from staying in the residence until it is sold? Probably nothing. However, taxpayers should document all objective facts that are consistent with the taxpayer victories listed above. A taxpayer with children may want to retain visitation rights on weekends and therefore claim that the home continued to be the principal residence. How-

ever, this does not appear to be a practical solution because it would entail living in the home for less than one half the year. The IRS would therefore claim that the rental home is the taxpayer's principal residence, in spite of the visitation rights.

Another alternative may be to divide the marital property so that the spouse who retains the residence retains 100% of the proceeds of sale. However, this is a better alternative where children are involved and the house will not be sold for many years than it is where both parties require the proceeds of sale in order to finance their new homes.

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