# Is the Loss on the Sale of an Inherited Residence Deductible?

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One of the most frequent questions I'm asked to answer is whether a client who inherits a decedent's residence may deduct a loss on its subsequent sale.

## Introduction

Suppose that a decedent held his or her principal residence in a revocable trust or as community property, and that upon death, ownership of the residence passes to a spouse or some other relative. Since the basis of the residence is its fair market value on date of death,[1] if it is sold soon after the decedent's death, the sale will usually result in a loss due to the fact that the sales price, minus selling expenses (e.g., real estate commissions, title insurance, transfer taxes) is less than the basis.

The issue discussed in this article is whether the loss is deductible, and if so, is it deductible as a capital loss or an ordinary loss? The answers to these questions largely depend upon the use of the residence after the decedent's death.

## Case Law and IRS's Position

For over 60 years, the IRS's position on this issue was that since the residence was used by the decedent before death as a personal residence, any loss on its sale after death must therefore be a personal and nondeductible loss. According to the IRS, a loss would only be allowable if the residence was converted to some sort of income-producing activity after the decedent's death.

There have been several court cases that have demonstrated that the decedent's use of the residence is irrelevant, and that what is important is the intended and actual use of the residence after the decedent's death. The cases uniformly hold that the sale of a decedent's residence after his or her death results in a capital loss. The only exceptions to this rule are:

1. If the residence is devoted to personal use after the decedent's death, then its subsequent sale results in a nondeductible personal loss; and
2. If the residence is offered for rent after the decedent's death, then its subsequent sale results in an ordinary loss under IRC §1231(a).[2]

Apparently, the first case to address this issue was *Marx v. Commissioner*, 5 T.C. 173 (1945). In this case, the decedent's surviving spouse inherited a yacht, which she put in storage for nearly a year until it was sold. The sale resulted in a loss. She had no intended or actual personal use of the yacht after her husband's death. The Tax Court ruled that she was entitled to deduct the loss because her intent was to sell the property for a profit. The court said:

> *The fact that property is acquired by inheritance is, by itself, neutral. It shows nothing constructive to aid in disposing of the issue. It is not like cases where property has been used for residential or other personal purposes * * * where a change of intention must hence affirmatively appear. * * * But neither does it in and of itself demonstrate a motive connected with gain or profit, as might, for example, the purchase of investment property. * * * The record contains nothing to counteract or negative the uniform, continuous, and apparently bona fide efforts of petitioner to turn the property to a profit which would justify any conclusion but that this was at all times her exclusive purpose.*

In the same year, in *Campbell v. Commissioner*, 5 T.C. 272 (1945), the Tax Court ruled that a taxpayer who had inherited a one-half interest in his father's principal residence (his sister inherited the other half) could deduct the loss on its sale because neither he nor his sister had any personal use of the residence after their father's death. The residence was listed with a real estate agent for either sale or rent, but it was never rented, and it proved impossible to sell until seven years after the father's death. Since the property was offered for rent by a realtor, the court allowed the loss allocable to the building as an ordinary loss (property used in a business) and the loss allocable to the land as a capital loss (this was the law at the time).[3]

Two years later, in *Carnrick v. Commissioner*, 7 T.C. 756 (1947), the Tax Court considered a similar situation. In this case, the taxpayer's mother died in 1933, whereupon her residence was transferred to a trust. The taxpayer and his sister lived in the residence until 1937 when his sister died, at which time he moved out. In 1939, he reached age 21 and received the residence from the trust. He tried to rent or sell the residence, listing it with several real estate brokers. He sold the residence in 1941 at a loss. The Tax Court allowed the loss allocable to the building as an ordinary loss (property used in a business) and the loss allocable to the land as a capital loss (again, this was the law at the time).

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In *Estate of Assmann v. Commissioner*, 16 T.C. 632 (1951), the Tax Court again considered a similar situation. In this case, the taxpayer's husband died in 1936, whereupon she moved out and began living with her daughter. The residence was listed with a realtor, but never rented or offered for rent. Instead, the building was demolished seven months later, and the vacant land was subsequently sold at a loss in 1948. The IRS argued that the loss was allowable as a capital loss, while the taxpayer argued for an ordinary loss. The court agreed with the IRS since the property had never been offered for rent or used in a business.

Later that same year, the Tax Court issued its opinion in *Crawford v. Commissioner*, 16 T.C. 678 (1951). In this case, upon the death of her husband in 1936, the taxpayer inherited a 5/7 interest in their residence, a large estate that included a three-story house, two-story garage and club house, a tool house and two servants' houses. The other 2/7 interest was held by her husband's brother, which she purchased after he died in 1941. She moved out of the residence in 1937, and after purchasing the remaining 2/7 interest, she tried to rent or sell the property with the assistance of her attorney and real estate brokers. The property proved to be too large to either rent or sell. In 1944, some of the buildings were demolished or given away, and in 1947, the property was sold at a loss. Since she had attempted to rent the property, the court allowed her to deduct the loss as an ordinary loss.

In *Estate of Miller v. Commissioner,* T.C. Memo. 1967-44, the taxpayer inherited a vacation home in Florida upon the death of her husband in 1959. She immediately listed the property for sale. Neither she nor any member of her family used the vacation home personally after her husband's death. After changing real estate brokers three times, the property was sold in 1963 at a loss. The IRS denied the loss on the grounds that it was a personal loss, but the court allowed the loss as a capital loss, saying, "the tax status of the property became neutral at the moment of death and the use the devisee thereafter made of the property determined its future tax status."

Similarly, in *Watkins v. Commissioner*, T.C. Memo. 1973-167, upon the death of his wife in 1965 the taxpayer inherited their residence. He continued to live there for four months after her death, whereupon he remarried and moved out. The taxpayer's children temporarily moved into the residence upon their mother's death, but moved out five months later. The taxpayer never offered the residence for rent, and sold it (at a loss) 12 months after his wife's death. The taxpayer testified that he never intended to make the residence his personal residence after his wife's death and his lawyer, who administered his wife's estate, corroborated his intent. Based on his testimony, the court ruled that the loss was deductible as a capital loss.

Without citing any of the foregoing cases, in Significant Service Center Advice 1998-012, the IRS ruled that an estate may deduct the loss on the sale of the decedent's personal residence only if it can prove that the property was converted to income-producing property.

This continued to be the IRS's position on this issue until it issued Publication 559, *Survivors, Executors, and Administrators*, for preparing 2005 returns. That version of the publication (and every year's version since) states:

**Sale of decedent's residence.** *If the estate is the legal owner of a decedent's residence and the personal representative sells it in the course of administration, the tax treatment of gain or loss depends on how the estate holds or uses the former residence. For example, if, as the personal representative, you intend to realize the value of the house through sale, the residence is a capital asset held for investment and gain or loss is capital gain or loss (which may be deductible). This is the case even though it was the decedent's personal residence and even if you did not rent it out. If, however, the house is not held for business or investment use (for example, if you intend to permit a beneficiary to live in the residence rent-free and then distribute it to the beneficiary to live in), and you later decide to sell the residence without first converting it to business or investment use, any gain is capital gain, but a loss is not deductible.*

## Summary and Conclusions

There are three possible uses of a decedent's principal residence between the time that he or she dies and the time that the residence is sold, and these uses generally determine the treatment of a subsequent sale of the residence at a loss:

1. The residence is vacant, not offered for rent – the loss is deductible as a capital loss;
2. The residence is used by the surviving spouse or family members as a personal residence – the loss is a nondeductible, personal loss; and
3. The residence is offered for rent or converted to some other business use – the loss is deductible as an ordinary loss.

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[1] *IRC §1014(a).*

[2] *IRC §1231(a) allows an ordinary loss for property used in the taxpayer's business.*

[3] *For years before 1942, a loss on property used in a business was split. The loss on the depreciable property was deductible as an ordinary loss, and the loss on the nondepreciable property was deductible as a capital loss. This split was eliminated by section 151(a) of the Revenue Act of 1942, which amended IRC §117(a)(1). See Senate Finance Committee Report No. 1631 (77th Cong. 2d Sess.), p. 119.*