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THE MIXED USE OF A PERSONAL RESIDENCE: INTEGRATION OF CONFLICTING HOLDING PURPOSES UNDER I.R.C. SECTIONS 121, 280A, AND 1031

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ABSTRACT

In light of the fact that the majority of Americans consider their personal residence one of their most important investments, as well as the rapid changes in technology allowing an increasing number of Americans to work from their personal residence, this article reconsiders the non-applicability of Internal Revenue Code ("I.R.C.") section 1031 to a residence occupied by the taxpayer. I.R.C. section 1031 provides that gain or loss will not be recognized if property held for a business or an investment purpose is exchanged for property of like kind to be held as business or investment property. For this nonrecognition provision to apply, the property relinquished and the property received cannot be held for personal use at the time of the exchange. This article provides an overview of the current state of federal income tax law as it relates to personal residences. It then considers the application of I.R.C. section 1031 to property that is held as a personal residence at the time of the exchange, or was held in the past or would be held in the future as a personal residence. The interrelationship of I.R.C. section 1031 with other sections of the I.R.C. that exclude gain on the sale of a principal residence and control the tax treatment of home offices and vacation homes will also be explored. Finally, the article illustrates that while the rules limiting deductions for personal-use properties should remain in force, nonrecognition treatment under I.R.C. section 1031 should be extended to personal residences.

I. INTRODUCTION

For most Americans, their home is their primary and most cherished investment asset. The recent economic struggles have caused many Americans to rethink home ownership, and have caused lawmakers to consider new ways to stimulate investment in the real estate market. At the same time, an exponential growth in technology has allowed American workers to conduct business from any location. As a result of this technology, more and more Americans are establishing and carrying on businesses in their homes or otherwise generating income from the use of their homes. Underlying these rapid and important changes is the ever-looming question of whether the law is keeping up. This article explores that question in a practical setting - the federal income tax law with respect to personal residences.

Traditional tax policy has been premised on the government's goal of facilitating business and investment. As such, the availability of many tax benefits, such as nonrecognition and deductions, depends on whether or not certain property is used for trade, business, or investment. Conversely, a taxpayer's personal use of a property has historically precluded application of these tax benefits. As workers increasingly use their homes for both business and personal use, the inapplicability of the like-kind exchange provision to personal residences seems unwarranted. This provision allows for the nonrecognition of gain only if the property involved in the exchange is trade, business, or investment property.

This article explores the tax treatment of personal residences, with a focus on the nonrecognition and exclusion of gain on the exchange of such residences, as well as the deductibility of expenses during the mixed use of such residences. The purpose of the article is two-fold; first, it is intended to be a tool for students and practitioners desiring to learn more about the current state of the federal tax law as it relates to the exchange and mixed use of personal residences; second, it illustrates the growing liberalization of the tax treatment of exchanges of real property, ultimately arguing for full applicability of Internal Revenue Code ("I.R.C.") section 1031 nonrecognition treatment for the exchange of personal residences.

To begin, Part II explains the federal income tax treatment of the disposition of personal residences. Part III then introduces the rationale and mechanics of I.R.C. section 1031, which provides nonrecognition of gain or loss on the exchange of property if certain requirements are met. Next, Part IV discusses the exclusion of gain on the sale of personal residences pursuant to I.R.C. section 121, including the interplay of the exclusion with nonrecognition of gain under I.R.C. section 1031. Part V examines specific rules regarding the deductibility of expenses related to personal residences used in part as home offices and vacation homes. Finally, Part VI concludes that the exchange of personal use real property should be allowed nonrecognition under I.R.C. section 1031 since such treatment is consistent with that section's rationale and interpretation, as well as the statutory backdrop related to personal residences.

II. GAIN AND LOSS ON THE DISPOSITION OF PERSONAL RESIDENCES

With regard to the disposition of personal residences, several sections of the I.R.C.[1] provide for the treatment of any resulting gain or loss. Generally, "gains derived from dealings in property" are included in the gross income of the taxpayer.[2] On the sale of a personal residence, the gain realized by the taxpayer is not the total sales price, but the amount by which the sales price exceeds the cost of the residence.[3] Gain is computed as the difference between the amount realized[4] on the disposition and the adjusted basis[5] of the personal residence.[6] This tax-free recovery of investment is one of the basic premises of federal income tax law.[7] Typically, a personal residence is a capital asset,[8] and therefore, any gain from the sale or exchange of a personal residence held for more than one year is taxed at a preferential rate.[9] If the taxpayer sells the residence for less than

[1] All references to the Internal Revenue Code are to the 1986 Internal Revenue Code [hereinafter I.R.C.], 26 United States Code, as amended.

[2] I.R.C. § 61(a)(3) (2006).

[3] I.R.C. § 1001(a) (2006).

[4] The term "amount realized" is defined as the sum of the money plus the fair market value of property other than money received. I.R.C. § 1001(b) (2006). Whether recourse or nonrecourse debt, debt relief is included in amount realized. Crane v. Comm'r, 331 U.S. 1 (1947); Tufts v. Comm'r, 461 U.S. 300, 308 (1983); Treas. Reg. § 1.1001-2 (2013).

[5] The "adjusted basis" is defined as the original basis of the property, e.g., cost, with adjustments over the period the taxpayer holds the property (e.g., basis is increased for capital improvements and decreased for depreciation deductions taken). I.R.C. § 1001(a); I.R.C. § 1011(a) (2006); I.R.C. § 1012(a) (2006 & Supp. V 2011); I.R.C. § 1016(a) (2006 & Supp. V 2011). Whether recourse or nonrecourse debt, debt incurred in the acquisition of property is included in the cost basis of the property acquired. *Crane*, 331 U.S. at 6.

[6] I.R.C. § 1001(a).

[7] BORIS I. BITTKER, MARTIN J. MCMAHON, JR., & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 3.04 (3d ed. 2002).

[8] *See* I.R.C. § 1221 (2006) (defining the term "capital asset").

[9] *See* I.R.C. § 1(h) (2006) (providing for a preferential rate of tax on net capital gains); I.R.C. § 1222(11) (2006) (defining the term "net capital gains" as net long-term capital gains over net short-term capital losses); I.R.C. § 1222(3) (defining the

its cost, a loss is realized to the extent of unrecovered investment.[10] Loss is the difference between the adjusted basis of the property and the amount realized.[11]

If gain or loss is *realized* on the disposition of property,[12] except as otherwise provided in the I.R.C., gain or loss is *recognized*.[13] There are several exceptions to this rule. As discussed below, on the exchange of property held as business or investment assets, I.R.C. section 1031 provides for the nonrecognition of realized gain or loss.[14] However, through the mechanism of an exchange basis, I.R.C. section 1031 merely defers the recognition of the gain or loss until the ultimate sale of the property received in the exchange.[15] If the requirements of I.R.C. section 121 are met, the taxpayer is allowed to permanently exclude a limited amount of gain on the sale of a principal residence.[16]

If a loss is realized and recognized on the disposition of property, I.R.C. section 165 determines whether a loss deduction is allowable.[17] A deduction is allowed to the extent the loss is sustained during the taxable year and not compensated for by insurance.[18] For individuals, loss deductions are allowed for losses incurred in a trade or business and transactions entered into for profit.[19] However, with regard to personal use property, loss deductions are limited to losses incurred "from fire, storm, shipwreck, or other casualty, or from theft."[20] As a result, an individual may not deduct a loss incurred on the sale of a

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term "long-term capital gain" as gain from the sale or exchange of a capital asset held for more than one year).

[10] I.R.C. § 1001(a).

[11] *Id.* Loss is computed as the difference between adjusted basis and amount realized on the disposition of property. *Id.*

[12] The requirement of realization, which is implicit in I.R.C. § 1001(a), is founded on administrative convenience. Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 559 (1991). *See generally* BITTKER, ET. AL., *supra* note 7, ¶ 28.01 (examining the realization requirement).

[13] I.R.C. § 1001(c).

[14] I.R.C. §1031(a) (2006). *See infra* Part III. A. – B. (providing a detailed examination of I.R.C. § 1031).

[15] I.R.C. § 1031(d). *See infra* Part III. A. – B. (providing a detailed examination of I.R.C. § 1031).

[16] I.R.C. §§ 121(a), (b) (2006 & Supp. V 2012). *See infra* Part IV. (providing a detailed examination of I.R.C. § 121).

[17] I.R.C. § 165 (2006 & Supp. V 2012). The basis for determining loss is the adjusted basis provided in I.R.C. § 1011(a). I.R.C. § 165(b).

[18] I.R.C.§ 165(a).

[19] I.R.C. § 165(c)(1)-(2).

[20] I.R.C. § 165(c)(3); Treas. Reg. § 1.165-7(a)(1) (1960) (explaining that any loss arising from theft is treated as sustained during the taxable year in which the taxpayer discovers the loss); I.R.C. § 165(e); Treas. Reg. § 1.165-8(a)(2) (1960).

personal residence. Generally, no deduction is allowed for personal, family, or living expenses because personal expenses represent personal consumption.[21]

However, it is possible for a taxpayer to convert a personal residence into non-personal use property if the residence is rented or otherwise adapted for income-producing purposes.[22] In general, the taxpayer must actually rent the residence, not merely list the residence for sale or rent, to successfully convert a residence from personal use to income-producing purposes.[23] If the property is successfully converted, the adjusted basis used to determine the amount of the loss is the lesser of the adjusted basis of the residence, or the value of the residence at the time of conversion, as adjusted for subsequent depreciation deductions taken.[24] Thus, the loss deduction is limited to the portion of the loss incurred while the property was used for income-producing purposes.

> **Example:** Taxpayer purchased a residence for $500,000 and used the residence as her personal residence for ten years. Due to a change in employment, Taxpayer abandoned the residence and immediately offered the residence for sale or rent. Taxpayer successfully rented the residence for three years prior to the sale of the residence for $300,000. At the time of conversion, the residence had a value of $400,000. During the three years Taxpayer rented the residence, Taxpayer took depreciation deductions of $40,000. For the purposes of computing the loss on the sale of the residence, the basis of the residence is the lesser of the cost of the residence ($500,000), or the

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[21] I.R.C. § 262(a) (West Supp. 2011); MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 21.03[1] (2d ed. 2012).

[22] Treas. Reg. § 1.165-9(b)(1) (1960); Horrmann v. Comm'r, 17 T.C. 903, 907-08 (1951).

[23] Treas. Reg. § 1.165-9(b)(1); *See Horrmann*, 17 T.C. at 907-08 (finding that the taxpayer, who held an abandoned personal residence for sale or rent, but never rented prior to sale, satisfied I.R.C. § 167(a)(2) (depreciation deduction) and I.R.C. § 212(2) (deduction of expenses) but did not satisfy I.R.C. § 165(c)(2) (deduction of losses), as the residence was not "rented or otherwise appropriated to income-producing purposes" as required by Treasury Regulation 1.165-9(b)(1)); Cowles v. Comm'r, 29 T.C.M. (CCH) 884 (1970) (finding that the mere holding of the personal residence for sale or rent was not a "transaction entered into for profit" as required by I.R.C. § 165(c)(2)). *Cf.* Newcombe v. Comm'r, 54 T.C. 1298 (1970) (finding that the taxpayer did not hold property "for production of income" under I.R.C. § 167(a)(2) or I.R.C. § 212(2) as the taxpayer moved out and immediately offered the personal residence for sale but not for rent).

[24] Treas. Reg. § 1.165-9(b)(2).

> value of the residence at the time of conversion ($400,000). Thus, the amount of the loss is the adjusted basis of $360,000 ($400,000 value minus $40,000 depreciation deductions) minus the amount realized of $300,000, resulting in a $60,000 deductible loss.

Although losses from the sale or exchange of personal use property are not deductible, losses resulting from the casualty or theft of personal use property are deductible.[25] The term "casualty" has been described as follows:

> The courts have consistently upheld the Internal Revenue Service position that an 'other casualty' is limited to casualties analogous to fire, storm, or shipwreck. The Service position has been that a casualty is the complete or partial destruction of property resulting from an identifiable event of a sudden, unexpected, and unusual nature.[26]

In the case of a casualty loss sustained with regard to personal use property, the amount of the loss deduction is limited to the lesser of (1) the reduction in the value of the property immediately before and after the casualty and (2) the adjusted basis of the property.[27] Furthermore, personal casualty and theft losses are subject to a nondeductible floor of $100 and are allowable as a deduction for the taxable year only to the extent of personal casualty gains,[28] plus so much of the excess personal casualty losses[29] as exceeds ten percent of the taxpayer's adjusted gross income.[30]

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[25] I.R.C. § 165(c)(3).

[26] Rev. Rul. 72-592, 1972-2 C.B. 101.

[27] Treas. Reg. § 1.165-7(b) (1960) (explaining that if the property used in a trade or business or a transaction entered into for profit is totally destroyed by the casualty, and if the value of the property immediately before the casualty is less than the basis, the amount of the adjusted basis will be treated as the amount of the loss deduction); *id.*; *see also* Treas. Reg. § 1.165-8(c) (1960) (providing a similar rule for determining the amount of the loss deduction arising from theft).

[28] I.R.C. § 165(h)(1). Personal casualty gains are defined as gains arising from the casualty or theft of personal use property. I.R.C. § 165(h)(3)(A).

[29] I.R.C. § 165(h)(2)(A). Personal casualty losses are defined as losses arising from the casualty or theft of personal use property minus the $100 floor for each casualty or theft. I.R.C. § 165(h)(3)(B).

[30] I.R.C. § 165(h)(2)(A). If personal casualty losses incurred in the taxable year exceed personal casualty gain, for the purposes of computing adjusted gross income, the deduction of personal casualty losses will be allowed only to the extent of personal casualty gains. I.R.C. § 165(h)(5). *See* I.R.C. § 62 (2006) (defining the term "adjusted gross income").

> **Example:** Taxpayer's car was totally destroyed in an accident. The car was purchased for $50,000 and had a value of $20,000 immediately before the accident. Taxpayer received $10,000 in insurance proceeds. The car was used exclusively for personal purposes. Assume Taxpayer had no personal casualty gains and adjusted gross income of $100,000. The amount of Taxpayer's casualty loss is $20,000 (lesser of reduction in value ($30,000), and basis ($50,000) minus insurance proceeds ($10,000)). The amount of Taxpayer's casualty loss deduction is $9,900 (casualty loss ($20,000) minus $100 floor minus 10% of adjusted gross income ($10,000)).

III. APPLICABILITY OF I.R.C. SECTION 1031 TO EXCHANGE OF PERSONAL RESIDENCES

A. Rationale and General Explanation of I.R.C. section 1031

To be included in the determination of taxable income, gain or loss on the disposition of property must be both realized and recognized.[31] Like a sale, an exchange of property for property differing materially in either kind or extent is a realization event.[32] Realized gain or loss is recognized unless the transaction falls within one of the many nonrecognition provisions contained in the I.R.C.[33] Nonrecognition provisions do not forgive the taxation of realized gains or permanently disallow realized losses, but merely defer recognition of gains and losses until the disposition of the acquired property in a taxable exchange.[34] I.R.C. section 1031 is a mandatory provision that results in the nonrecognition of gain or loss on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged for property of like kind to be held for trade or business or investment purposes.[35]

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[31] I.R.C. § 1001(c) (2006).

[32] Cottage Sav. Ass'n v. Comm'r., 499 U.S. 554, 566 (1991); Treas. Reg. § 1.1001-1(a) (1957).

[33] I.R.C. § 1001(c).

[34] BITTKER, ET. AL., *supra* note 7, ¶ 30.01[1]. The underlying assumption of the sections in the Internal Revenue Code that provide for nonrecognition of realized gain or loss is that the property received is substantially a continuation of the investment in the property relinquished still unliquidated. Treas. Reg. § 1.1002-1(c) (1957).

[35] I.R.C. § 1031(a)(1) (2006).

I.R.C. section 1031 is an exception to the general rule that the entire amount of realized gain or loss is recognized by the taxpayer.[36] In 1921, Congress made exchanges of like-kind property nontaxable with the enactment of the predecessor to I.R.C. section 1031.[37] In 1934, Congress considered and rejected the repeal of the predecessor to I.R.C. section 1031, expressing the congressional justification for non-recognition as follows:

> The law has provided for 12 years that gain or loss is recognized on exchanges of property having a fair market value, such as stock, bonds, and negotiable instruments; on exchanges of property held primarily for sale; or on exchanges of one kind of property for another kind of property; but not on other exchanges of property solely for property of like kind. In other words, profit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money; or in the case of stock in trade; or in case the taxpayer exchanges property comprising his original investment for a different kind of property; but if the taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind having a fair market value.
>
> The Treasury Department states that its experience indicates that this provision does not in fact result in tax avoidance. If all exchanges were made taxable, it would be necessary to evaluate the property received in exchange in thousands of horse trades and similar barter transactions each year, and for the time being, at least, claims for theoretical losses would probably exceed any profits which could be established. The committee does not believe that the net revenue which

[36] I.R.C. § 1031; I.R.C. § 1001(c). The general rule is recognition of realized gain or loss; therefore, the sections of the Internal Revenue Code providing exceptions to the general rule of the recognition must be strictly construed and not "extended either beyond the words or underlying assumptions and purposes of the exception." Treas. Reg. § 1.1002-1(a), (c) (1957).

[37] Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 227, 230 (1921).

> could thereby be collected, particularly in these years, would justify the additional administrative expense. Consequently, the exchange provisions have not been changed.[38]

If the requirements of I.R.C. section 1031(a)(1) are satisfied and the exchange is of solely like-kind property, gain or loss realized in the exchange is not recognized.[39] If, in addition to like-kind property, money or non-like-kind property ("boot") is also received in the exchange, realized gain, if any, is recognized to the extent of boot received.[40] Nevertheless, if loss is realized, the realized loss is not recognized even though boot is received.[41] Although the basis of property acquired in an exchange is typically the value of the property received,[42] under I.R.C. section 1031, the mechanism for deferral of realized, but unrecognized, gain or loss is the assignment of an "exchange basis"[43] to the replacement property.[44] To preserve the unrecognized gain or loss, the basis in the property received is equal to

[38] H.R. REP. NO. 73-704, at 13 (1934). The rationale for retaining I.R.C. § 1031 has subsequently been viewed by courts as providing a statement of the congressional purpose underlying the section. J. Martin Burke & Michael K. Friel, *To Hold or Not to Hold: Magneson, Bolker, and the Continuity of Investment Under I.R.C. Section 1031*, 20 U.S.F. L. REV. 177, 178 (1986). *See* Jordan Marsh Co. v. Comm'r, 269 F.2d 453, 456 (2d Cir. 1959) (summarizing the congressional intent underlying I.R.C. § 1031 as primarily a concern "with the inequity, in the case of an exchange, of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment" and only secondarily a concern "for the difficulty of the administrative task of making the valuations necessary to compute gains and losses"). *But see* Century Elec. Co. v. Comm'r, 192 F.2d 155, 159 (8th Cir. 1951) ("In this section Congress was not defining the words 'sales' and 'exchanges.' It was concerned with the administrative problem involved in the computation of gain or loss in transactions of the character with which the section deals.").

[39] I.R.C. § 1031(a)(1).

[40] I.R.C. § 1031(d).

[41] I.R.C. § 1031(c).

[42] Phila. Park Amusement Co. v. United States, 126 F. Supp. 184, 188 (Ct. Cl. 1954).

[43] I.R.C. § 7701(a)(44) (2006). The term "substituted basis property" is defined as property that is "transferred basis property" or "exchanged basis property." I.R.C. § 7701(a)(42). The term "transferred basis property" is defined as property having a basis determined in whole or in part by reference to the basis of the property in the hands of the transferor. I.R.C. § 7701(a)(43). The term "exchanged basis property" is defined as property having a basis determined in whole or in part by reference to the basis of other property previously held by the holder of the property. I.R.C. § 7701(a)(43).

[44] I.R.C. § 1031(d).

the basis in the property transferred, with adjustments for money received and recognized gain or loss.[45]

> **Example:** Taxpayer exchanges land that she farmed for many years for an apartment building that she intends to hold as investment property. The farmland has a basis of $200,000 and a value of $1,000,000, and the apartment building has a value of $1,000,000. As Taxpayer received solely like-kind property, Taxpayer will not recognize the $800,000 gain ($1,000,000 value of the apartment building minus the $200,000 basis of the farm) realized on the exchange. Taxpayer's basis in the apartment building is $200,000. However, if the value of the apartment building is $900,000, Taxpayer therefore receives an additional $100,000 cash (boot). Taxpayer will recognize $100,000 of the $800,000 of gain realized on the exchange. The Taxpayer's basis in the apartment building is $200,000 ($200,000 basis of the farmland minus $100,000 cash plus $100,000 gain recognized).

B. Requirements of I.R.C. section 1031

The mechanics of I.R.C. section 1031 have been the subject of a great deal of scrutiny by the courts, the Treasury Department, and taxpayers. I.R.C. section 1031 applies to any transaction in which property held for productive use in a trade or business or for investment is exchanged for property of like kind to be held for productive use in a trade or business, or for investment.[46] I.R.C. section 1031(a)(1) requires: (1) an "exchange" of property (2) the properties exchanged to be of "like kind," and (3) the holding purpose of the property relinquished and the property received to be for use in a trade or business or for investment.[47]

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[45] *Id.* Generally, the basis of the property received is the same as the basis of the property relinquished decreased by the amount of money received, increased by the amount of gain, and decreased by the amount of loss recognized on the exchange. *Id.* *See* I.R.C. § 1223(1) (2006) (discussing tacking the holding period of the property relinquished onto the holding period of the property received for the purposes of the characterization of capital gains and capital losses).

[46] I.R.C. § 1031(a)(1). Property held primarily for sale, stock, securities, evidences of indebtedness, partnership interests, certificate of trust, and choses in action are excluded from the application of I.R.C. section 1031. I.R.C. § 1031(a)(2).

[47] I.R.C. § 1031(a)(1).

1. *Exchange*

The Treasury regulations define an exchange as "a reciprocal transfer of property, as distinguished from a transfer of property for money consideration only."[48] Courts describe a sale and an exchange as follows: "[a] 'sale' is a transfer of property for a price in money or its equivalent. 'Exchange' means the giving of one thing for another."[49] The requirement of an exchange is not satisfied unless the transfers are reciprocal and mutually dependent.[50] The presence of cash to adjust for the difference in the value of the properties exchanged will not prevent the transaction from being considered a like-kind exchange.[51] However, I.R.C. section 1031 has no application to a sale of property for cash even if the proceeds are reinvested in property of like kind,[52] and even if both the sale and reinvestment occur on the same day.[53] Nevertheless, if the transaction is, in substance, an exchange rather than a sale and purchase, the transaction will be treated as an exchange under I.R.C. section 1031.[54]

Although the language of I.R.C. section 1031(a)(1) contemplates the exchange of like-kind property between two parties, most transactions are more complex, involving multiple parties.[55] With

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[48] Treas. Reg. § 1.1002-1(d) (1960).

[49] Bloomington Coca-Cola Bottling Co. v. Comm'r., 189 F.2d 14, 16 (7th Cir. 1951).

[50] Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652, 657 (5th Cir. 1968); Treas. Reg. § 1.1002-1(d).

[51] *Bloomington Coca-Cola Bottling Co.*, 189 F.2d at 16.

[52] Swaim v. United States, 651 F.2d 1066, 1070-71 (5th Cir. 1981) (holding that the transaction was not an exchange but a sale and purchase as the receipt, and unrestricted use, of cash negated any contractual interdependence).

[53] Carlton v. United States, 385 F.2d 238 (5th Cir. 1967). In *Carlton*, the court stated, "[i]n the instant case, while elaborate plans were laid to exchange property, the substance of the transaction was that the appellants received cash for the deed to their ranch property and not another parcel of land. The very essence of an exchange is the transfer of property between owners, while the mark of a sale is the receipt of cash for property. . . . The fact that they [appellants] did use it to pay for the Fernandez properties does not alter the fact that their use of the money was unfettered and unrestrained. *Carlton*, 385 F.2d at 242-43.

[54] Treas. Reg. § 1.1031(k)-1(f)(1) (1960); *see Redwing Carriers, Inc.*, 399 F.2d at 652 (holding that the sale of old trucks by the parent corporation and the purchase of new trucks by the subsidiary corporation "at or about" the same time was substantively an exchange); Rev. Rul. 61-119, 1961-1 C.B. 395 (finding that, with the application of the substance over form and step transaction doctrines, the sale of old equipment and the purchase of new equipment from the same dealer were reciprocal and mutually dependent, and therefore, were an exchange of property).

[55] *See* Robert H. Voelker, *The Exchange Requirement in Multiparty and Nonsimultaneous Exchanges: A Critical Analysis and Statutory Solution*, 37 SW. L.J.

numerous variations, a multiple-party exchange involves the acquisition of the replacement property for cash by a party facilitating the exchange, who then transfers the replacement property in exchange for the relinquished property to the exchange party seeking nonrecognition.[56] Generally, multiple-party exchanges qualify for nonrecognition as long as the exchange party intends to and does receive like-kind property.[57] The actual, or constructive, receipt of cash as consideration for the relinquished property by the exchange party will prevent I.R.C. section 1031 from applying to the transaction.[58] With regard to a multiple-party exchange, the actual or constructive receipt of cash by the agent of the exchange party will also prevent I.R.C. section 1031 from applying to the transaction.[59]

Originally, cases and rulings sanctioned two-party or multiple-party exchanges involving the *simultaneous* exchange of real property.[60] However, *deferred* exchanges of like-kind property received judicial approval in *Starker v. United States*.[61] In *Starker*, the taxpayer transferred real property to Crown Zellerbach, a publicly held corporation, for an "exchange balance" of $1.5 million.[62] Within a five-year period, Crown Zellerbach was to use the exchange balance to acquire replacement real property as identified by the taxpayer, or pay any outstanding balance in cash.[63] The court held that the transaction qualified under I.R.C. section 1031 on a showing that the taxpayer

645, 652 (1983). *See also* PAUL R. MCDANIEL, MARTIN J. MCMAHON, JR., DANIEL L. SIMMONS, & GREGG D. POLSKY, FEDERAL INCOME TAXATION 935 (6th ed. 2008).

[56] *Id.* at 652. Title to the replacement property may be deeded directly to the exchange party. Treas. Reg. § 1.1031(k)-1(g)(4)(iv)-(v). *See* Biggs v. Comm'r, 632 F.2d 1171, 1177 (5th Cir. 1980) (holding that the intermediary is not required to take legal title to the replacement property); Rev. Rul. 90-34, 1990-1 C.B. 154 (finding that the failure of the facilitating party to acquire legal title to the replacement property does not disqualify the exchange from I.R.C. § 1031).

[57] *See* Voelker, *supra* note 55, at 561; Alderson v. Comm'r, 317 F.2d 790, 795 (9th Cir. 1963) (explaining that nonrecognition will result even though the original agreement provided for a sale of the relinquished property and a cash option if the replacement property could not be located). *See* Rev. Rul. 57-244, 1957-1 C.B. 247 (holding that a "round-robin" transaction in which A transfers to B, B transfers to C, and C transfers to A property of like kind constitutes an exchange under I.R.C. § 1031 for all three parties).

[58] *See Carlton*, 385 F.2d at 242; Rev. Rul. 77-297, 1977-2 C.B. 304; Treas. Reg. § 1.1031(k)-1(f)(1).

[59] *See* Treas. Reg. § 1.1031(b)-2 (1994) (providing safe harbors for the use of qualified intermediaries in simultaneous exchanges).

[60] BITTKER, ET. AL., *supra* note 7, 30.02[4][b].

[61] *See* Starker v. United States, 602 F.2d 1341, 1352-53 (9th Cir. 1979).

[62] *Id.* at 1342-43.

[63] *Id.*

preferred replacement property to cash and only like-kind property was ultimately received.[64]

> Against this background, the government offers the explanation that a contract right to land is a 'chose in action,' and thus personal property instead of real property. This is true, but the short answer to this statement is that title to real property, like a contract right to purchase real property, is nothing more than a bundle of potential causes of action: for trespass, to quite title, for interference with quiet enjoyment, and so on. The bundle of rights associated with ownership is obviously not excluded from section 1031; a contractual right to assume the rights of ownership should not, we believe, be treated any different than the ownership rights themselves. Even if the contract right includes the possibility of the taxpayer receiving something other than ownership of like-kind property, we hold that it is still of a like kind with ownership for tax purposes when the taxpayer prefers property to cash before and throughout the executory period, and only like-kind property is ultimately received.[65]

In 1984, Congress responded to *Starker* by enacting I.R.C. section 1031(a)(3),[66] which limits the time period for the identification and receipt of the replacement property in a deferred exchange.[67] For the exchange to qualify, the replacement property must be identified within forty-five days of the date on which the relinquished property was transferred (identification period),[68] and the replacement property

[64] *Id.* at 1355.

[65] *Id.*

[66] Deficit Reduction Act of 1984, Pub. L. No. 98-369, 90 Stat. 494 (1984).

[67] I.R.C. § 1031(a)(3) (2006); Treas. Reg. § 1.1031(k)-1 (2012). *See* Treas. Reg. § 1.1031(k)-1 (defining the term "deferred exchange" as follows: "[f]or the purposes of section 1031 and this section, a deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the 'relinquished property') and subsequently receives property to be held for either productive use in a trade or business or for investment (the 'replacement property')"). I.R.C. § 1031(a)(3) has no application to "reverse-Starker exchanges," i.e., exchanges where the replacement property is transferred, or "parked," prior to the transfer of the relinquished property. Rev. Proc. 2000-37, 2000-2 C.B. 308, 309. *See* Rev. Proc. 2000-37, 2000-2 C.B. at 308 (providing a safe harbor under which the Internal Revenue Service will not challenge certain aspects of a reverse-Starker exchange).

[68] I.R.C. § 1031(a)(3)(A); Treas. Reg. § 1.1031(k)-1(b), (c). The exchange party may identify three replacement properties of any value (3-property rule); any number

must be received not later than 180 days after the date of the transfer of relinquished property or, if earlier, the due date, including extensions, for the tax return for the taxable year in which relinquished property was transferred (exchange period).[69] Again, the taxpayer may not be in actual or constructive receipt of cash.[70] The Treasury Regulations provide several safe harbors that allow the exchange party to secure or guarantee the receipt of the replacement property without the actual or constructive receipt of cash: (1) security or guarantee arrangements; (2) qualified escrow accounts and qualified trusts; and (3) qualified intermediaries.[71]

Although not restricted to exchanges of real property, the case law that sanctioned multiple-party exchanges, both simultaneous and deferred, involved exchanges of real property. As a consequence, Congress amended the I.R.C., and the Treasury Department amended the Treasury Regulations, to facilitate the use of I.R.C. section 1031 in the multiple-party exchanges of real property. Practically, the current difference between a sale and purchase of real property and the simultaneous or deferred exchange of real property is limited to the technicality of whether cash is actually or constructively received by the exchange party or deposited with an independent entity that carries out the instructions of the exchange party. As stated by one commentator:

> Although Congress originally was motivated by the liquidity burdens and valuation uncertainties that would result from treating the exchange of like-kind properties as a taxable event, those justifications did not survive the advent of deferred, multiparty exchanges. Because section 1031 now permits taxpayers to defer the recognition of gain from dispositions of property for cash provided they subsequently invest the cash proceeds in property of like kind (pursuant to a regulatory regime that simply suspends constructive

of replacement properties that, in the aggregate, do not exceed twice the value of the property relinquished (200-percent rule); and any replacement property identified before the end of the identification period and received before the end of the exchange period if 95 percent of the value of the identified property is received before the end of the exchange period (95-percent rule). Any replacement property received by the exchange party before the end of the identification period qualifies. Treas. Reg. § 1.1031(k)-1(c)(4).

[69] I.R.C. § 1031(a)(3)(B); Treas. Reg. § 1.1031(k)-1(b), (d).

[70] Treas. Reg. § 1.1031(k)-1(a), (f); Starker v. United States, 602 F.2d 1341, 1352 (9th Cir. 1979).

[71] Treas. Reg. § 1.1031(k)-1(g). An interest or growth factor will not result in a determination that the exchange party is in actual or constructive receipt of cash. *Id.*

> receipt principles), concerns regarding access to liquid resources to finance the tax liability or the accurate measurement of realized gain ring hollow.[72]

2. Like-Kind Property

As used in I.R.C. section 1031(a), the term "like kind" refers to the "nature or character of the property and not to its grade or quality.[73] One kind or class of property may not . . . be exchanged for property of a different kind or class."[74] The Treasury Regulations establish a very broad definition of like kind with regard to real property by stating that the fact that real property is improved or unimproved relates only to the grade or quality of the property and not to its kind or class.[75] The examples in the Treasury Regulations include the exchange of city real property for a ranch or farm, and the exchange of a thirty-year leasehold in real property for a fee interest in real property.[76] By contrast, the examples involving the exchange of personal property are much narrower in scope; a truck for a new truck and a passenger automobile for a new passenger automobile.[77] In classifying property as real or personal property, the Internal Revenue Service will consider all facts and circumstances, including state law and federal tax law classifications.[78]

The broad interpretation of the term "like kind" in the Treasury Regulations with regard to real property is reflected in cases and revenue rulings. For example, an exchange of a mineral interest in

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[72] Brant J. Hellwig, *The Holding Intent Requirement for Property Transferred in a Section 1031 Exchange*, 45 REAL PROP. TR. & EST. L.J. 635, 638-39 (2011).

[73] Treas. Reg. § 1.1031(a)-1(b) (1960).

[74] *Id.*

[75] *Id.*

[76] Treas. Reg. § 1.1031(a)-1(c). Real property located in the United States is not like kind with real property located outside the United States. I.R.C. § 1031(h)(1) (2006).

[77] Treas. Reg. § 1.1031(a)-1(c). Personal property used predominantly within the United States is not like kind with property used predominantly outside the United States. I.R.C. § 1031(h)(2). The exchange of personal property for real property does not qualify as a like kind exchange. Rev. Rul. 72-151, 1972-1 C.B. 225. Depreciable tangible personal property in the same General Asset Class or the same Product Class are considered properties of like kind. Treas. Reg. § 1.1031(a)-2(b)(1)-(3). An exchange of intangible personal property or nondepreciable personal property must satisfy the like kind requirement based upon all of the facts and circumstances. Treas. Reg. § 1.1031(a)-2(c).

[78] I.R.S. Gen. Couns. Mem. 201238027 (Apr. 17, 2012). *See* Kelly E. Alton & Louis S. Weller, *Does State Law Really Determine Whether Real Property is Real Estate for Section 1031 Purposes?*, 32 REAL EST. TAX'N. 30 (2004) (discussing the weight given to state law in classifying real property as like kind).

unimproved country land was held to be like kind to an interest in an improved city lot.[79]

> For the regulation and the interpretation under it, leave in no doubt that no gain or loss is realized by one, other than a dealer, from an exchange of real estate for other real estate, and that the distinction intended and made by the statute is the broad one between classes and characters of properties, for instance, between real and personal property. It was not intended to draw any distinction between parcels of real property however dissimilar they may be in location, in attributes and in capacities for profitable use.[80]

Regardless of how dissimilar,[81] if the properties constitute an interest in real property, generally, cases and revenue rulings found the property to be of like kind.[82] Examples include: a long-term leasehold interest in a building used in part by the corporate taxpayer for its retail operations, and in part subleased as office space for an identical leasehold in the retail portion of the building;[83] undivided interests in three parcels held as tenants in common for undivided interests in one parcel;[84] fee interest in golf course property for property subject to ninety-nine-year condominium leases;[85] operating gold mines, including realty, for operating coal mines subject to supply contracts;[86] and perpetual water rights for a fee interest in real property.[87] All facts and circumstances must be considered, including state law and federal law classifications; nevertheless, state law classification of

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[79] Comm'r v. Crichton, 122 F.2d 181 (5th Cir. 1941).

[80] *Id.* at 182.

[81] *Id.*

[82] J. MARTIN BURKE & MICHAEL K. FRIEL, TAXATION OF INDIVIDUAL INCOME 926 (10th ed. 2012).

[83] Rev. Rul. 76-301, 1976-2 C.B. 241.

[84] Rev. Rul. 73-476, 1973-2 C.B. 301.

[85] Koch v. Comm'r, 71 T.C. 54, 54-56 (1978).

[86] Peabody Natural Res. Co. v. Comm'r, 126 T.C. 261, 261-62 (2006). Although under New Mexico law the supply contracts were contracts to sell personal property, the supply contracts were servitudes on the real property, and therefore, were real property under the laws of New Mexico. *Peabody Natural Res. Co.*, 126 T.C. at 268-71.

[87] Rev. Rul. 55-749, 1955-2 C.B. 295. However, a right to a limited amount or duration of water for a fee interest in real property is not of like kind. Rev. Rul. 55-749, 1955-2 C.B. 295.

property as real property is not determinative as to whether the property is like kind under I.R.C. section 1031.[88]

In *Peabody Natural Resources Co. v. Commissioner*,[89] the Tax Court stated the factors necessary in finding real property to be of like kind.

> To decide whether an exchange is like kind within the meaning of section 1031(a), we must compare the exchanged properties to ascertain whether the nature and character of the transferred rights in and to the respective properties are substantially alike. We conclude that the real property interest status under New Mexico law of the TEPCO and WEF supply contracts is not determinative of whether those supply contracts constitute like-kind property as opposed to boot under section 1031. In making this comparison, consideration is to be given to the respective interests in physical properties, the nature of the title conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from their grade or quality.[90]

With the exception of interests restricted to the life of an individual, or a specified quantity or dollar value of production, cases and revenue rulings seemingly treat all property found to be real property under state law as a single class of property even though the exchange results in a dramatic change in the investment status of the taxpayer.[91] One commentator remarked: "[s]ection 1031(a)(1) imposes a host of conditions for the exchange of properties to benefit from nonrecognition treatment. The most prominent condition is that the exchanged properties be of like kind, a standard that is remarkably liberal as applied to reality."[92]

3. Holding Purpose

[88] I.R.S. Gen. Couns. Mem., *supra* note 78. *See* Louis S. Weller, *IRS Muddies the Like-Kind Waters in Guidance Considering State Law Classification*, 118 J. TAX'N 13 (Jan. 2013) (criticizing the approach taken in CCA 201238027 and offering an alternative approach in the interest of "sound tax administration and common sense").

[89] *Peabody Natural Resources Co.*, 126 T.C. at 261.

[90] *Id.* at 273.

[91] BITTKER, ET. AL., *supra* note 7, ¶ 30.02[2][b].

[92] Hellwig, *supra* note 72, at 639.

The rationale underlying I.R.C. section 1031 is that gain or loss should not be recognized if the property received in a like-kind exchange is essentially a continuation of the investment in the trade or business or investment asset relinquished.[93] As a result, for an exchange to qualify for nonrecognition, the property *transferred* must have been "held" by the taxpayer for productive use in a trade or business or for investment, and the like-kind property *received* must be "held" either for productive use in a trade or business or for investment.[94] Excluded from the like-kind provisions are stock-in-trade or property held primarily for sale by the taxpayer.[95] The statute does not further define the holding purpose requirement, and the Treasury Regulations merely state, "[u]nproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale."[96]

Two factors are relevant to the determination of whether the requisite holding purpose is met: (1) the taxpayer's subjective intent, and (2) the length of time that the taxpayer used, or will use, the property for trade or business or investment purposes.[97] First, whether property received satisfies the statutory holding intent requirement is determined based on the subjective intent[98] of the taxpayer *at the time of the exchange*.[99] The subjective intent of the taxpayer is a facts and circumstances determination,[100] and the taxpayer has the burden of

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[93] *See supra* Part III. A. (stating the rationale underlying the like-kind exchange provisions).

[94] I.R.C. § 1031(a)(1) (2006). *See also* Treas. Reg. § 1.1031(a)-1(a) (1960) (explaining property held for productive use in a trade or business may be exchanged for like-kind property to be held for investment, and vice versa).

[95] I.R.C. § 1031(a)(2)(A). *See* Neal T. Baker Enters., Inc. v. Comm'r, 76 T.C.M. 301, *7 (1998) (stating that the exception under I.R.C. § 1031(a)(1)(A) for property "held primarily for sale" is broader than the exception to the definition of "capital asset" under I.R.C. § 1221(a)(1), as the latter requires that the property be "held by the taxpayer primarily for sale to customers in the ordinary courses of his trade or business"); Neal T. Baker Enters., Inc., 76 T.C.M at *21 (finding that a corporate taxpayer that purchased undeveloped property, which it then subdivided and improved, acquired the property for development and, therefore, held the property primarily for sale).

[96] Treas. Reg. § 1.1031(a)-1(b) (1960).

[97] Burke & Friel, *supra* note 38, at 181.

[98] *Id.* at 181-82.

[99] Click v. Comm'r, 78 T.C. 225, 231 (1982). *But see* Rev. Rul. 57-244, 1957-1 C.B. 247 (finding that I.R.C. § 1031 applied to an exchange even though the relinquished undeveloped land was initially acquired by the taxpayers for the purpose of constructing personal residences and held for that purpose for only a short period of time before being retained for investment purposes).

[100] *See* Bradley T. Borden & Alex Hamrick, *Like-Kind Exchanges of Personal-Use Residences*, 119 TAX NOTES 1256 (June 23, 2008).

proof[101] as to the primary intent for holding the properties.[102] The purchase of property with the intent of relinquishing the property in an exchange [103] or the immediate sale of property received in an exchange [104] does not satisfy the requirement that the property relinquished or received in a like-kind exchange be held for the productive use in a trade or business or for investment.

Second, although the requirement that properties be held for productive use in a trade or business or for investment suggests that the taxpayer must hold the properties for some appreciable period of time with the requisite purpose, the statute does not impose a formal holding period.[105] Nevertheless, the length of time the property is held for productive use in business or for investment is significant as a factor probative to the intent of the taxpayer.[106] The Internal Revenue Service has stated that renting the replacement property for at least two years after the exchange satisfies the statutory intent requirement, provided no other significant factors contradict the investment intent.[107]

Whether property received in an exchange is held for productive use in a trade or business or for investment is based upon the intention

[101] *Click*, 78 T.C. at 231 (citing Regals Realty Co. v. Comm'r, 43 B.T.A. 194, 208 (1940)).

[102] *Id.*

[103] Barker v. United States, 668 F. Supp. 1199 (1987); Rev. Rul. 75-291, 1975-2 C.B. 332; Rev. Rul. 77-297, 1977-2 C.B. 304.

[104] *Regals Realty Co.*, 43 B.T.A. at 194; Rev. Rul. 75-292, 1975-2 C.B. 333.

[105] Hellwig, *supra* note 72, at 674. *But see* Bolker v. Comm'r, 760 F.2d 1039, 1041 (9th Cir. 1985) (focusing not on the intent to "keep" for the requisite purposes, but on the intent not to liquidate or to use for personal purposes). In 1989, Congress considered amending I.R.C. § 1031(a)(1) to require property to be held one year prior to an exchange in order to qualify for nonrecognition treatment; however, the final form of the legislation did not contain the one-year holding period requirement. Hellwig, *supra* note 72, at 635, n.42. The only holding period requirement imposed by I.R.C. § 1031 is the requirement that taxpayers in a related–party exchange each hold the replacement property for two years after the exchange in order to avoid gain recognition in the original exchange. I.R.C. § 1031(f) (2006).

[106] Burke & Friel, *supra* note 38, at 190.

[107] I.R.S. Priv. Ltr. Rul. 8429039 (Apr. 17, 1984). S*ee* Burke & Friel, *supra* note 38, at 181 ("[A] short holding period may provide strong proof of a lack of intent to hold the property for the required purposes of section 1031."); Hellwig, *supra* note 72, at 643 (stating that the requisite holding purpose for at least one year prior to the exchange will satisfy the holding purpose requirement); Stefan F. Tucker, *The Like Kind Exchange: A Current Review*, William & Mary Law School Scholarship Repository, Aug. 21, 2003, at 4, *available at* http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=1133&context=tax (recommending that the relinquished property be held two years before the exchange with the requisite holding purpose).

of the taxpayer at the time of the exchange.[108] Nevertheless, the holding purpose requirement of I.R.C. section 1031(a)(1) may be satisfied even though, at the time of the exchange, the taxpayer intended to gratuitously transfer the replacement property at a future date. In *Wagensen v. Commissioner*,[109] the Tax Court held that the exchange of a ranch for a ranch and cash qualified for nonrecognition treatment despite the fact that the taxpayer intended to eventually transfer the ranch received in the exchange to his children, and did transfer the replacement ranch to his children ten months after the exchange.[110]

Holding that the exchange qualified under I.R.C. section 1031, the Tax Court in *Wagensen* noted, "[o]ne of the primary purposes for allowing the deferral of gain in a like-kind exchange is to avoid imposing a tax upon a taxpayer who, while changing his form of ownership, is continuing the nature of his investment."[111] The Tax Court found that the taxpayer increased his ownership in ranch property as a result of the exchange and continued to search for additional ranch properties after the exchange.[112] The taxpayer did not initiate discussions with his accountants about the gift until after the exchange, and the ranch property acquired in the exchange was used in the taxpayer's ranching business during the period between the exchange and the gift.[113] Although the taxpayer had discussed with his wife the possibility of transferring their ranch property to their children prior to the exchange, at no time prior to the announcement of the gift did the children have any indication that the gift would be made.[114] Finding that the taxpayer had no concrete plans to transfer the property to his children at the time of the exchange, the Tax Court held the exchange qualified under I.R.C. section 1031.[115] Further, the Tax Court noted that, if the taxpayer had gifted the relinquished property to his children prior to the exchange and the children then entered into the exchange, the exchange by the children would have qualified under I.R.C. section 1031 and, therefore, to hold otherwise would elevate form over substance.[116]

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[108] *Click*, 78 T.C. at 231.
[109] Wagensen v. Comm'r, 74 T.C. 653 (1980).
[110] *Id.* at 655-60.
[111] *Id.* at 658 (citing Jordan Marsh Co. v. Comm'r, 269 F.2d 453, 455 (2d Cir. 1959)).
[112] *Id.* at 659.
[113] *Id.*
[114] *Id.* at 656.
[115] *Id.* at 660.
[116] *Id.*

However, in *Click v. Commissioner*,[117] the Tax Court held that the exchange by the taxpayer of investment farmland for two residences, a note, and cash, did not qualify for nonrecognition treatment under I.R.C. section 1031.[118] In *Click*, seven months after the exchange, the taxpayer gifted the residences to her children who moved into them immediately after the exchange.[119] The Tax Court noted that a taxpayer's intent to hold the property for investment must be determined at the time of the exchange and that the substance, rather than the form, of the transaction must be examined.[120] Distinguishing the facts of *Wagensen*, the Tax Court stated that a general desire to make a gift prior to the time of exchange is not inconsistent with the intent to hold the replacement property for productive use in a trade or business, or for investment.[121] However, in *Click*, the court found that the children themselves located the residences, the taxpayer was working on her estate plan when the idea for an exchange was formed, and the children insured and made improvements upon the residences.[122] As a result, the Tax Court found that the taxpayer did not have the requisite intent at the time of the exchange to hold the residences received in the exchange as investment property.[123]

Nevertheless, in two cases the Ninth Circuit Court of Appeals held that an exchange qualified under I.R.C. section 1031, despite the fact that ownership was only transitory.[124] In *Magneson v. Commissioner*,[125] pursuant to a prearranged plan, the taxpayers exchanged real property and, on the same day, contributed the real property received to a partnership in exchange for a ten percent general partnership interest.[126] The contribution of replacement property to the partnership qualified for nonrecognition treatment under I.R.C. section 721.[127] The partnership intended to hold the contributed property for investment, and the assets of the partnership

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[117] *Click*, 78 T.C. at 225.

[118] *Id.* at 228-34. Similarly, if the intent at the time of the exchange is to make a charitable contribution of the property received, the exchange will not qualify for nonrecognition treatment under I.R.C. § 1031. Lindsley v. Comm'r, 47 T.C.M. (CCH) 540, 543 (1983).

[119] *Click*, 78 T.C. at 226-30.

[120] *Id.* at 231.

[121] *Id.* at 232.

[122] *Id.* at 233.

[123] *Id.* at 234.

[124] Magneson v. Comm'r, 753 F.2d 1490 (9th Cir. 1985).

[125] *Id. See generally* Burke & Friel, *supra* note 38, at 181 (providing an analysis of the statutory holding intent requirement and criticizing the *Magneson* and *Bolker* decisions).

[126] *Magneson*, 753 F.2d at 1492.

[127] *Id.*

consisted predominantly of property of like kind to the property contributed by the taxpayers.[128] The Ninth Circuit Court of Appeals held that the initial like-kind exchange qualified for nonrecognition under I.R.C. section 1031, as the contribution to the partnership was a mere change in the form of the taxpayers' investment, and not a liquidation of the taxpayers' investment.[129]

In *Bolker v. Commissioner*,[130] the taxpayer, the sole shareholder of a corporation, received real property in the liquidation of the corporation pursuant to former I.R.C. section 333, which provided for nonrecognition of gain in a one-month liquidation.[131] On the day of the corporate liquidation, the taxpayer contracted to exchange the real property received, and the exchange took place three months after the liquidation.[132] Again, the Ninth Circuit Court of Appeals concluded that the taxpayer acquired the relinquished property without the intent to liquidate or use for personal purposes; therefore, the taxpayer held the property relinquished for productive use in a trade or business or for investment.[133] Thus, the intent to exchange for like-kind property satisfied the holding requirement of I.R.C. section 1031(a)(1).[134] The court clarified its reasoning as follows:

> The Commissioner's position, in contrast, would require us to read an unexpressed additional requirement into the statute: that the taxpayer have, previous to forming the first intent to exchange one piece of property for a second parcel, an intent to keep the first piece of property indefinitely. We decline to

[128] *Id.*

[129] *Id. Contra* Rev. Rul. 75-292, 1975-2 C.B. 333 (holding that the statutory holding purpose was not satisfied because, immediately after the like-kind exchange and pursuant to a prearranged plan, the taxpayer transferred the property received in the exchange to a corporation in a transaction that qualified for nonrecognition under I.R.C. § 351).

[130] Bolker v. Comm'r, 760 F.2d 1039 (9th Cir. 1985). *See generally* Burke & Friel, *supra* note 38, at 181 (providing an analysis of the statutory holding intent requirement and criticizing the *Magneson* and *Bolker* decisions).

[131] I.R.C. § 333 *repealed by* the Tax Reform Act of 1986, § 631(e)(3), 100 Stat. 2,085.

[132] *Bolker*, 760 F.2d at 1041.

[133] *Id.* at 1045.

[134] *Id. See also* Maloney v. Comm'r, 93 T.C. 89 (1989) (holding that the statutory holding purpose was satisfied even though the taxpayer intended to distribute the replacement property in nontaxable liquidation of the corporation pursuant to former I.R.C. § 333). *Contra* Rev. Rul. 77-337, 1977-2 C.B. 305 (holding that the statutory holding purpose was not satisfied because, immediately after the nontaxable liquidation under former I.R.C. § 333, the taxpayer relinquished the property received upon the liquidation in a like-kind exchange).

> do so. Rather, we hold that if a taxpayer owns property which he does not intend to liquidate or to use for personal pursuits, he is "holding" that property "for productive use in trade or business or for investment" within the meaning of section 1031(a)(1). Under this formulation, the intent to exchange property for like-kind property satisfies the holding requirement, it is *not* an intent to liquidate the investment or to use for personal pursuits.[135]

C. Exchange of Personal Residences—Recent Tax Court Cases

It is well established that that the statutory holding requirement of I.R.C. section 1031(a)(1) is not satisfied if the property relinquished or acquired in an exchange is held solely for personal use.[136] "It has long been the rule that use of property solely as a personal residence is antithetical to its being held for investment."[137] In several recent cases, the Tax Court considered whether the requirement that the properties be held for productive use in a trade or business or for investment is met if the property was used as a personal residence either at the time of the exchange or immediately after the exchange. These cases illustrate the fact-intensive and burdensome process that courts and taxpayers must engage in when determining whether the holding purpose requirement is met for the application of I.R.C. section 1031. In *Moore v. Commissioner*,[138] the Tax Court held that the property relinquished and the property received in the exchange did not constitute properties held for investment as required by I.R.C. section 1031(a)(1) because the primary intent of the taxpayers in holding the properties was personal use.[139] In *Moore*, the issue of whether the anticipated appreciation in value of a second, or vacation, home is sufficient to establish investment intent was directly addressed by the courts for the first time.[140] Taxpayers disposed of a residence and acquired a residence pursuant to a series of transactions structured

[135] *Bolker*, 760 F.2d at 1045 (citations omitted).
[136] Starker v. United States, 602 F.2d 1341, 1350-51 (9th Cir. 1979); Rev. Rul. 59-229, 1959-2 C.B. 528; Rev. Proc. 2005-14, 2005-7 I.R.B. 528..
[137] *Starker*, 602 F.2d at 1351.
[138] Moore v. Comm'r, 2007 T.C.M. (CCH) 1275 (2007).
[139] *Id.* at *12-13.
[140] Ari Meltzer, *Solving the Personal Use/Investment Dilemma for Like-Kind Exchanges:* Moore v. Commissioner, 63 TAX LAW. 267, 267 (2009). *See* Borden & Hamrick, *supra* note 100, at 1260 (stating that the taxpayer's nonrecognition position was aggressive given the law on exchanges of personal-use residences existing at the time of the exchange).

to qualify as a deferred exchange[141] under I.R.C. section 1031.[142] Finding that the taxpayers used both properties frequently and exclusively for recreational purposes and never rented or attempted to rent either property, the Tax Court held that the mere expectation that a vacation home would increase in value is not enough to show the property was held primarily with investment intent.[143] The court also noted that the exclusive use of property as a residence by the owner contradicts any claim that the property is held for investment.[144]

Consistent with prior case law, the Tax Court stated that, for the properties to be held for investment, the purpose or intent of the taxpayers at the time of exchange is determinative.[145] The court accepted that one of the motives of the taxpayers in acquiring and holding the vacation homes was the prospect of appreciation resulting in profit on eventual sale; nevertheless, the court held that an investment motive must be the primary purpose of the taxpayer in holding the properties:[146]

> Petitioners argument, if carried to its logical extreme, is that the existence of any investment motive in holding a personal residence, no matter how minor a factor in the overall decision to acquire and hold (or simply to hold) property before its inclusion in an exchange of properties, will render it "property held for investment" with any gain on the exchange eligible for nonrecognition treatment under section 1031. Petitioners are mistaken.[147]

Other than the expectation that the properties would appreciate in value,[148] in *Moore*, the Tax Court found no evidence that the taxpayers held the properties for production of income, but found convincing evidence that the taxpayers and their family used the properties as

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[141] *Moore*, 2007 T.C.M. (CCH) 1275 (2007).

[142] *Id.* at 3.

[143] *Id*. at 10-11.

[144] *Id*. at 9 (citing Starker v. United States, 602 F.2d 1341, 1350-51 (9th Cir. 1999)). *Contra* Meltzer, *supra* note 140, at 276-78 (stating that the court in *Moore* improperly relied on the *Starker* decision to support its holding that property used primarily for personal use is per se inconsistent with property held for investment).

[145] *Moore*, 2007 T.C.M. (CCH) at 9.

[146] *Id.*

[147] *Id.*

[148] *Id.* at 3 (after suffering a loss as a result of a theft by their financial advisor, the taxpayers purchased the first vacation home at the suggestion of a family member as the properties on that lake had increased in value and were expected to continue to increase in value).

vacation retreats.[149] The properties were identified as second residences to the lender and were never held out for rent or primarily for sale at a profit.[150] After the taxpayers changed their principal residence, thereby making the vacation home inconvenient for personal use, the condition of the vacation home was allowed to deteriorate until it was ultimately exchanged for a more accessible replacement vacation home.[151] The replacement vacation home, which was closer to the taxpayers' new principal residence, was not disposed of until required due to the need for liquidity, incidental to their divorce.[152] Although substantial improvements were made to both properties, the improvements were consistent with enjoying the properties as vacation homes.[153] Finally, with regard to the vacation homes, the taxpayers did not claim any tax deductions for maintenance expenses or depreciation, and claimed deductions for home mortgage interest rather than investment interest.[154]

In *Goolsby v. Commissioner*,[155] the Tax Court held that the taxpayers could not defer recognition of the entire gain realized upon the exchange of real property since the taxpayers could not prove their intent at the time of the exchange[156] was to hold one of the replacement properties for productive use in a trade or business or for investment.[157] In order for an exchange to qualify under I.R.C. section 1031, the burden of proof is on the taxpayer to prove that the requisite holding intent existed at the time of the exchange[158] and that such intent was the primary motive for holding the exchanged properties.[159] The court noted that the use of property solely as a personal residence

[149] *Id.* at 26.

[150] *Id.* The Tax Court, in *Moore*, also relied on cases deciding whether expenses incurred with respect to a personal residence are deductible under I.R.C. § 212(2), expenses incurred for the production of income, stating that listing property for immediate sale at, or shortly after, its abandonment as a residence will ordinarily be strong evidence that a taxpayer did not hold the property for appreciation in value after the conversion from personal use. *Id*. at 24-25 (citing Newcombe v. Commissioner, 54 T.C. 1298, 1302 (1970)).

[151] *Id.* at 11.

[152] *Id.* at 26.

[153] *Id.* at 27.

[154] *Id.* at 28.

[155] Goolsby v. Comm'r, 99 T.C.M. (CCH) 1249 (2010).

[156] A taxpayer's intent to hold a property for productive use in a trade or business or for investment is a question of fact that must be determined at the time of the exchange. *Id*. at 8.

[157] *Goolsby*, 99 T.C.M. (CCH) at 10.

[158] *Id.* at 9.

[159] *Id*.

is contrary to holding the property for use in a trade or business or for investment.[160]

Goolsby constituted a deferred exchange, involving the exchange of a single-family residence held as investment property for two properties: a four-unit residential building and a single-family residence.[161] Two months after the exchange, the taxpayers moved into the single-family residence.[162] The Tax Court was not persuaded that the taxpayers intended to hold the replacement residence as investment property based on the following facts:[163] the acquisition of the residence was made contingent on the sale of their personal residence;[164] advice was sought as to the tax consequences of occupying the residence if renters could not be found;[165] preparations were immediately begun to finish the basement of the residence;[166] and, around the time of the exchange, the taxpayers' personal residence was sold and the taxpayers began living with relatives.[167] Significantly, prior to the exchange, the taxpayers failed to research rental opportunities or whether the covenant of the homeowners association would allow rental of the replacement residence, and, after the exchange, the taxpayers' attempts to rent the replacement residence were minimal, consisting only of the placement of a single advertisement in a neighborhood newspaper.[168] Thus, the court concluded that the taxpayers failed to meet their burden of proving that at the time of the exchange their primary purpose in holding the replacement residence was for investment or for productive use in a trade or business.[169]

Conversely, in *Reesink v. Commissioner*,[170] the Tax Court held that the single-family residence acquired by the taxpayers in a like-kind exchange was held for productive use in a trade or business or for investment even though the single-family residence was used as a personal residence eight months after the exchange.[171] The taxpayers transferred a fifty percent interest in an apartment building for a

[160] *Id*.
[161] *Id*. at 4.
[162] *Id*. at 10. The Tax Court found that the taxpayers did not temporarily move into the single-family residence two months after the exchange until the tenants could be found. *Id*.
[163] *Id*.
[164] *Id*.
[165] *Id*.
[166] *Id*.
[167] *Id*. at 12.
[168] *Id*. at 11.
[169] *Id*.
[170] Reesink v. Comm'r, 103 T.C.M. (CCH) 1647 (2012).
[171] *Id*. at 19.

single-family residence in a deferred exchange.[172] Concluding that the single-family residence was held for investment at the time of the exchange, the Tax Court distinguished the facts and circumstances from those in *Goolsby*.[173]

The taxpayers in *Reesink* posted flyers throughout the town, showed the replacement residence to potential tenants, and waited almost eight months before moving into the replacement residence.[174] Unlike the taxpayers in *Goolsby*, the taxpayers did not decide to sell their personal residence until six months after acquiring the replacement residence.[175] Although the taxpayers showed the replacement residence to potential tenants, the taxpayers would not reduce their monthly rental price as requested in order to secure a lease.[176] The court found that the taxpayers were reasonable in their belief that the single-family residence should be rented for a rental amount sufficient to cover the cost associated with the property and, therefore, were reasonable in not reducing the rental price despite the loss of potential tenants.[177] The Tax Court also noted that the taxpayers introduced credible testimony from several witnesses that the taxpayers did not intend to live in the replacement residence at the time of the exchange.[178]

In *Adams v. Commissioner*,[179] the Tax Court also held that the acquisition by the taxpayers of a single-family residence was for the requisite holding purpose within the meaning of I.R.C. section 1031(a)(1).[180] *Adams* involved a deferred exchange in which the taxpayers disposed of a San Francisco residence that was used as rental property for approximately twenty-five years, and received a five-bedroom residence located in Eureka, California.[181] In

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[172] *Id.* at 5-7. The husband held a fifty percent ownership interest in the apartment building with his brother. *Id*. at 3-4.

[173] *Id*. at 16-19.

[174] *Id.* at 16.

[175] *Id.*

[176] *Id.* at 8.

[177] *Id.* at 18.

[178] *Id.* *See* Yates v. Comm'r, 105 T.C.M. (CCH) 1205 (2013) (holding that the taxpayers' testimony and a provision in the sales contract were not sufficient to establish that the replacement property was to be used as a "bed and breakfast" and the failure of the taxpayers to submit any evidence regarding efforts to transform the property into a business enterprise establishes that no business motive existed, and the use of the property "as their personal residence, beginning a mere four days following the close of the sale, creates a clear presumption of nonbusiness intent, exceeding that of the taxpayers in either *Goolsby* or *Reesink*").

[179] Adams v. Comm'r, 105 T.C.M. (CCH) 1029 (2013).

[180] *Id.* at 19.

[181] *Id.* at 7.

determining whether the taxpayer intended to hold the property acquired in the exchange for investment, the court considered the intent of the taxpayers at the time of the exchange[182] and the conduct of the taxpayers before and after the exchange to inform the determination of the intent of the taxpayers.[183] A real estate broker suggested to the taxpayers an exchange of the residences in order to reduce the potential income tax liability resulting from the intended sale of the San Francisco residence.[184]

The taxpayers' son, who had extensive homebuilding and home renovation experience, lived in Eureka with his large family,[185] and he and his family immediately moved into and began renovating the replacement residence,[186] which was old, dilapidated, moldy, and required extensive work to be livable.[187] In lieu of monetary rent, the son and his family worked an aggregate sixty hours of work a week on the replacement residence for the first three months after the exchange,[188] with such services being worth $3,600.[189] The taxpayers' son and his family then began paying monetary rent of $1,200 a month, which was a few hundred dollars less than similar houses rented in the neighborhood.[190] Even though the taxpayers chose the replacement residence because their son and his family lived in Eureka and the house suited the son's large family, the court found that the taxpayers did not intend to charge their son below-market rent.[191] The Tax Court determined that the monthly rent of $1,200 was a fair rental because the son and his family assumed substantial responsibilities for renovating, maintaining, and repairing the replacement residence.[192]

IV. EXCLUSION OF GAIN ON THE DISPOSITION OF A PRINCIPAL RESIDENCE UNDER I.R.C. SECTION 121

A. Mechanics of I.R.C. section 121

182 *Id.* at 19 (citing Click v. Comm'r, 78 T.C. 225, 231 (1982)).
183 *Id*.
184 *Id.* at 4.
185 *Id.* at 5.
186 *Id.*
187 *Id.*
188 *Id.*
189 *Id.* at 6.
190 *Id.*
191 *Id*. at 19-20.
192 *Id.* at 20.

The I.R.C. does contain tax preferences that specifically apply to personal residences. Generally, I.R.C. section 121 allows a taxpayer to exclude up to $250,000 of the gain on the sale or exchange of a principal residence.[193] This provision relieves a perceived hardship, facilitates the replacement of a principal residence, and also allows taxpayers a tax-free source of consumption.[194] To qualify for the exclusion, the taxpayer must have owned and used the residence as a principal residence for a period aggregating two years of the five-year period preceding the sale or exchange.[195] Gain from the sale or exchange of a principal residence may be excluded only if the taxpayer has not claimed an exclusion within the preceding two-year period.[196]

To qualify for the exclusion under I.R.C. section 121, the taxpayer must have *owned* and *used* the residence as a principal residence for a period aggregating two of the five years prior to the sale or exchange.[197] The term "residence" is broadly interpreted to include a house boat, house trailer, and stock in a cooperative housing unit, but does not include personal property that is not a fixture under local law.[198] A residence can include surrounding acreage, if the surrounding acreage is not used for business or profit.[199] To satisfy the two-year use requirement, occupancy is required; however,

[193] I.R.C. § 121(a), (b)(1) (2006).

[194] MCDANIEL, MCMAHON, JR., SIMMONS & POLSKY, *supra* note 55, at 233.

[195] I.R.C. § 121(a).

[196] I.R.C. § 121(b)(3).

[197] I.R.C. § 121(a); Treas. Reg. § 1.121-1(a), -1(c)(1) (as amended in 2002). The requirements of ownership and use can be satisfied during nonconcurrent periods. Treas. Reg. § 1.121-1(c)(1) (as amended in 2002). *See generally* I.R.C. § 121(d)(2) (allowing an unmarried individual to include the period a deceased spouse owned and used the residence); I.R.C. § 121(d)(3)(A) (allowing an individual, who receives a residence pursuant to I.R.C. § 1041 (transfers during marriage or incident to a divorce), to include the period the transferor owned and used the residence); I.R.C. § 121(d)(3)(B) (allowing an individual, whose former spouse is granted use of the residence under a divorce or separation instrument (as defined in I.R.C. § 71(b)(2)), to include the period the former spouse used the residence); I.R.C. § 121(d)(7) (allowing an individual, who is physically or mentally incapable of self-care, to include any period during the five-year period the individual is in a licensed health care facility if such individual owned and used the residence for one year); I.R.C. § 121(d)(9), (12) (suspending the five-year period for up to ten years for extended duty as a member of the uniformed service, the intelligence community, or the Peace Corps).

[198] Treas. Reg. § 1.121-1(b)(1) (as amended in 2002).

[199] Treas. Reg. § 1.121-1(e)(1) (as amended in 2002) (explaining that only the portion of the gain attributed to the residential use is excludable under I.R.C. § 121). *See also* Lokan v. Comm'r, 39 T.C.M. (CCH) 168 (1979) (holding that the acres used in the taxpayer's business of farming was not included as part of the principal residence).

temporary absences, such as for vacations or other seasonal absences, are counted as periods of use even if the residence is rented.[200] Thus, as long as the residence is used as a principal residence for an aggregate two-year period within the five-year period preceding the sale or exchange, the residence can be used as rental property at the time of sale or exchange.[201]

Further, the residence must have been used as the *principal* residence of the taxpayer for an aggregate period of two years during the preceding five-year period.[202] If a taxpayer owns more than one residence, whether a residence is used as the taxpayer's principal residence is determined by examining all of the facts and circumstances.[203] If the taxpayer alternates between two residences, the property that the taxpayer uses the majority of the time during the year will ordinarily be considered the taxpayer's principal residence.[204] Other relevant factors in determining which residence is the taxpayer's principal residence include: place of employment; principal abode of family members; address listed on tax returns, driver's license, and automobile and voter registration; mailing address for bills and correspondence; location of banks; and location of religious organizations and recreational clubs.[205]

If the taxpayer meets the ownership and use requirements and has not excluded gain under I.R.C. section 121 within the preceding two years, the taxpayer may exclude from gross income a maximum of a $250,000 gain on the sale or exchange of the taxpayer's principal residence.[206] If the principal residence is owned by two or more taxpayers, each taxpayer may exclude from gross income up to $250,000 gain attributable to the taxpayer's interest in the residence.[207] Married taxpayers, whether filing jointly or not, may each exclude up to $250,000 gain on the sale or exchange of jointly owned or community property.[208] Nevertheless, if only one spouse

[200] Treas. Reg. § 1.121-1(c)(2) (as amended in 2002). *See also* Gates v. Comm'r, 135 T.C. 1 (2010) (holding that the taxpayer's principal residence did not meet the use requirement as the taxpayer did not occupy the residence after demolition and reconstruction).

[201] Treas. Reg. § 1.121-1(c)(4), Ex. 1 (as amended in 2002).

[202] I.R.C. § 121(a) (2006).

[203] Treas. Reg. § 1.121-1(b)(2) (as amended in 2002).

[204] *Id*.

[205] *Id*. *See also* Guinan v. U.S., 91 A.F.T.R.2d 2003-2174 (D. Ariz. 2003) (applying the majority-of-the-time test and other relevant factors in determining which of taxpayer's residences was the taxpayer's principal residence).

[206] I.R.C. § 121(b)(1).

[207] Treas. Reg. § 1-121-2(a)(2) (as amended in 2002).

[208] I.R.C. § 121 (b)(2)(B); MCDANIEL, MCMAHON, JR., SIMMONS, & POLSKY, *supra* note 55, at 228.

owns the residence but both spouses use the residence as a principal residence for the requisite period, an exclusion of gain up to $500,000 is permitted on a joint return.[209]

> **Example:** A married couple holds title to a residence as joint tenants or community property. The couple owned and used the residence as a principal residence for a period aggregating two years during the five-year period prior to sale. If the gain on the sale of the principal residence is $800,000, the couple will only include $300,000 in income ($800,000 minus $500,000 ($250,000 exclusion amount x 2)). If title is held in the name of only one spouse and the couple files a joint return, again, the couple will only include $300,000 in income ($800,000 minus $500,000 exclusion amount).

Gain allocable to periods of nonqualified use of the residence is not excludable from gross income under I.R.C. section 121.[210] The term "period of nonqualified use" means any period, after January 1, 2009, during which the residence is not used as the principal residence of the taxpayer or the taxpayer's spouse or former spouse.[211] The exceptions include any portion of the five-year period preceding the date of the sale or exchange after the last date the property was used as a principal residence.[212] The gain allocable to the period of nonqualified use is determined by the ratio which the aggregate periods of nonqualified use during the taxpayer's ownership of the residence bears to the period the taxpayer owned the property.[213]

[209] I.R.C. § 121(b)(2)(A); Treas. Reg. § 1.121-2(a)(3) (as amended in 2002). The non-owner spouse cannot have used the exclusion under I.R.C. § 121 within the two years prior to the sale or exchange. I.R.C. § 121(b)(2)(A)(iii); Treas. Reg. § 1.121-2(a)(3) (as amended in 2002). An unmarried individual may exclude $500,000 of gain if the sale or exchange occurs not more than two years after the death of the individual's spouse and the requirements of I.R.C. § 121(b)(2)(A) were met immediately before such death. I.R.C. § 121(b)(4).

[210] I.R.C. § 121(b)(4)[5](A),(B) (due to an error in the official code, (4)[5] will be used to refer to the second section (4) in the I.R.C. § 121(b) cites).

[211] I.R.C. § 121(b)(4)[5](C)(i).

[212] I.R.C. § 121(b)(4)[5](C)(ii)(I). The exceptions also include any period, not exceeding ten years, the taxpayer or the taxpayer's spouse is serving on qualified official extended duty as a member of the armed forces, as a Foreign service officer, or as an employee of the intelligence community, or any period of temporary absence because of a change in employment, health condition, or other unforeseen circumstance. I.R.C. § 121(b)(4)[5](C)(ii)(II), (III).

[213] I.R.C. § 121(b)(4)[5](C). To the extent the taxpayer was allowed depreciation deductions during the rental period, the gain allocable to the depreciation is not excluded from income. I.R.C. § 121(d)(6). The nonqualified use provision is applied after I.R.C. § 121(d)(6), and the allocation of gain to the period

> **Example:** Taxpayer, an unmarried individual, owned a residence from January 1, 2006, to December 31, 2013, which she sold for $200,000 gain. The residence was used as rental property from January 1, 2006 until December 31, 2010, and used as a principal residence from January 1, 2010, until its sale on December 31, 2013. Taxpayer has two years of nonqualified use (January 1, 2009 until December 31, 2010) and eight years of ownership. Of the $200,000 gain that would otherwise have been excluded from income, Taxpayer will include $50,000 ($250,000 x 25% (2 years of nonqualified use ÷ 8 years of ownership)).

The exclusion of gain by a taxpayer under I.R.C. section 121 is allowed only once in a two-year period.[214] Even though the taxpayer fails to meet the two-year ownership and use requirements or the once in two-years limitation, some or all of the gain may be excluded if the sale or exchange of the principal residence occurs by reason of an unforeseen circumstance.[215] A facts and circumstances determination is made as to whether the primary reason for the sale or exchange was a change in employment, health, or other unforeseen circumstance.[216] The Treasury Regulations provide several safe harbors in establishing the taxpayer's primary reason for the sale or exchange: (1) a distance safe harbor by reason of change in employment; (2) a physician's recommendation safe harbor by reason of a change in health; and (3) a specific event safe harbor by reason of unforeseen circumstances.[217] If the exception to the "once every two-years" requirement applies, the amount of gain excludable is a fraction of the maximum exclusion amount of $250,000, or $500,000 in the case of a joint return.[218] The maximum exclusion amount is multiplied by a fraction: the numerator of which is the shorter of (1) the aggregate periods within the

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of nonqualified use is made without regard to I.R.C. § 121(d)(6). I.R.C. § 121 (b)(4)[5](D).

[214] I.R.C. § 121(b)(3)(A); Treas. Reg. § 1.121-2(b) (as amended in 2002). A taxpayer may elect not to have I.R.C. § 121 apply to the sale or exchange of a principal residence. I.R.C. § 121(f).

[215] I.R.C. § 121(c)(2)(B).

[216] I.R.C. § 121(c)(2)(B); See Treas. Reg. § 1.121-3(b) (as amended in 2002) (listing relevant factors to be considered in a fact and circumstances determination).

[217] Treas. Reg. § 1.121-3(c)-(e) (as amended in 2002). The facts and circumstance determination and the safe harbors are applied with regard to a "qualified individual," which includes individuals in addition to the taxpayer. Treas. Reg. § 1.121-3(f) (as amended in 2002).

[218] I.R.C. § 121 (c)(1); Treas. Reg. § 1.121-3(g) (as amended in 2002).

preceding five-year period that the taxpayer owned and used the residence as a principal residence, or (2) the period from the most recent sale or exchange to which the exclusion applied, and the denominator of which is two years.[219]

> **Example:** Taxpayer, an unmarried individual, purchased a home on January 1, 2012, which she used as her principal residence. Twelve months later, she sells her principal residence for health reasons as recommended by a physician, realizing a $350,000 gain. Taxpayer has not excluded gain under I.R.C. section 121 within the prior two years. On the sale of her principal residence, Taxpayer may exclude up to $125,000 gain ($250,000 x 50% (12 months ÷ 24 months)). As a result, Taxpayer will include in income $225,000 gain ($350,000 gain minus $125,000 exclusion amount) from the sale of her principal residence.

If the principal residence was used in part for business purposes, either as a rental or a home office under I.R.C. section 280A,[220] I.R.C. section 121 may apply to the sale or exchange of the residence if the ownership and use requirements are met.[221] The Treasury Regulations require an allocation of gain if the residential use and nonresidential use of the property are not within the same dwelling unit, with only the gain allocable to the residential portion of the property excluded under I.R.C. section 121.[222] The allocation of gain is not necessary if the residential and nonresidential use is within the same dwelling unit.[223] Nevertheless, any gain attributable to depreciation deductions taken, and not appreciation in value, is not excludable from gross income under I.R.C. section 121.[224]

> **Example:** Prior to sale, Taxpayer, an unmarried individual, owned a residence for five years. For the

[219] I.R.C. § 121 (c)(1); Treas. Reg. § 1.121-3(g) (as amended in 2002).
[220] *See* discussion *infra* Part V. (examining the tax treatment of a residence that is used in part for the production of income under I.R.C. § 280A).
[221] Treas. Reg. § 1.121-1(e) (as amended in 2002).
[222] *Id.* Allocation based on the square footage of the residential and nonresidential portions of the dwelling unit is an appropriate method of allocating basis and amount realized. Poague v. United States, 947 F.2d 942 (4th Cir. 1991).
[223] Treas. Reg. § 1.121-1(e)(1) (as amended in 2002).
[224] I.R.C. § 121(d)(6); Treas. Reg. § 1.121-1(d), (e)(1) (as amended in 2002). I.R.C. § 121 does not apply to gain that does not exceed the depreciation adjustments taken after May 6, 1997. I.R.C. § 121(d)(6)); Treas. Reg. § 1.121-1(d) (as amended in 2002).

> first three years of ownership, Taxpayer used the residence as a principal residence and, for the last two years of ownership, Taxpayer used the dwelling unit as rental property. During the latter period, Taxpayer took $20,000 of depreciation deductions with respect to the property. Taxpayer's gain on the sale of the residence is $200,000. Only $180,000 ($200,000 gain realized minus $20,000 depreciation taken) of gain may be excluded from income under I.R.C. section 121.

I.R.C. section 121 provides a mechanism for combining the exclusion of gain with the nonrecognition of gain pursuant to I.R.C. section 1033.[225] Generally, under I.R.C. section 1033, at the election of the taxpayer, gain realized on the involuntary conversion of property into money is recognized only to the extent the amount realized on the conversion exceeds the cost of replacement property.[226] An involuntary conversion of property includes "destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof."[227] In order to defer gain under I.R.C. section 1033, the replacement property must be "similar or related in service or use" to the converted property.[228] The basis of the replacement property is calculated as the cost of the replacement property reduced by the amount of gain not recognized on the involuntary conversion.[229]

In applying I.R.C. section 1033 to the involuntary conversion of a principal residence, I.R.C. section 121 treats the involuntary conversion as a sale.[230] The amount realized from the involuntary conversion for the purpose of applying I.R.C. section 1033 is reduced by the amount of gain excluded under I.R.C. section 121.[231] The computation to apply the involuntary conversion rules under I.R.C. section 1033 is as follows: (1) the amount of gain excluded under I.R.C. section 121 reduces the amount of the gain realized for the purposes of I.R.C. section 1033; (2) for purposes of determining the amount of realized gain that may be deferred under I.R.C. section

[225] I.R.C. § 121(d)(5).

[226] I.R.C. § 1033(a)(2)(A).

[227] I.R.C. § 1033(a). Generally, I.R.C. § 1033 requires that the converted property be replaced within a two-year period beginning with the date of the disposition of the converted property. I.R.C. § 1033(a)(2)(B)(2006).

[228] I.R.C. § 1033(a). *See* Rev. Rul. 64-237, 1964-2 C.B. 319 (describing the "similar or related in service or use" standard as applied to owner-users of property and investor-lessors of property).

[229] I.R.C. § 1033(b)(2).

[230] I.R.C. § 121(d)(5)(A).

[231] I.R.C. § 121(d)(5)(B).

1033, the I.R.C. section 121 exclusion is applied first against amounts received that are not reinvested in property similar or related in service or use; and finally, (3) the gain excluded under I.R.C. section 121 is added in the calculation of the taxpayer's basis in the replacement property.[232]

> **Example:** Taxpayer's residence is destroyed by fire in January of the current year. The residence had a basis of $200,000. Taxpayer, a single individual, had owned and used the house as her principal residence for ten years prior to the fire. Taxpayer's insurance company pays her $800,000 for the destruction of the residence. On the involuntary conversion, Taxpayer realized $600,000 gain ($800,000 amount realized minus $200,000 basis). By the end of the current year, Taxpayer used $700,000 of the insurance proceeds to construct a new principal residence on the same property. For the purposes of I.R.C. section 121, the destruction of the residence is treated as a sale; therefore, Taxpayer may exclude $250,000 of the realized gain from her income. For the purposes of I.R.C. section 1033, Taxpayer's amount realized is $550,000 ($800,000 amount realized reduced by the $250,000 exclusion amount) and realized gain is $350,000 ($550,000 amount realized minus $200,000 basis). As Taxpayer invested an amount equal to or greater than the amount realized of $550,000 in the construction of the new principal residence, Taxpayer may elect to defer recognition of the $350,000 realized gain under I.R.C. section 1033. Taxpayer's basis in the new principal residence is $350,000 ($700,000 cost of the new principal residence minus the $350,000 unrecognized gain).

B. Revenue Procedure 2005-14—Integration of I.R.C. sections 121 and 1031

Congress enacted I.R.C. section 121(d)(10)[233] because it was concerned that taxpayers might exchange real property held for

[232] *Id.*; Treas. Reg. § 1.121-4(d) (as amended in 2002); Rev. Proc. 2005-14 § 2.09, 2005-1 C.B. 528. The taxpayer will be treated as owning and using the new residence as her principal residence for the periods she owned and used the converted residence as her principal residence. I.R.C. § 121(d)(5)(C).

[233] H.R. REP. NO. 108-548(I), at 80 (2004).

production of income for residential rental property, and then convert the received residential rental property into a principal residence, ultimately excluding the gain on a later sale of the principal residence pursuant to I.R.C. section 121 that was earlier deferred pursuant to I.R.C. section 1031.[234] Under this provision, the taxpayer may not exclude gain under I.R.C. section 121 if the principal residence was acquired in a like-kind exchange within the five-year period preceding the date of the sale or exchange.[235] By effectively increasing the minimum holding period for property acquired in a like-kind exchange, Congress reduced the potential tax shelter created by combining the non-recognition section with the exclusion section.[236]

Conversely, a taxpayer who has used a residence both for personal and business purposes, either consecutively or concurrently, and who disposes of the property in a like-kind exchange, may exclude gain under I.R.C. section 121 and defer recognition of the balance of the gain under I.R.C. section 1031**.** Revenue Procedure 2005-14[237] provides guidance on the application of I.R.C. sections 121 and 1031 to a single exchange of property that meets the requirements for both gain exclusion and non-recognition.[238] For Revenue Procedure 2005-14 to apply, the taxpayer must exchange property that qualifies as the taxpayer's principal residence under I.R.C. section 121 and also satisfies the statutory holding purpose of I.R.C. section 1031(a)(1), requiring both the relinquished property and the replacement property be held for productive use in a trade or business or for investment.[239]

Similar to the integration of I.R.C. sections 121 and 1033,[240] I.R.C. section 121 is applied before I.R.C. section 1031.[241] For the computation of gain, the rules are as follows: (1) the amount of gain excluded under I.R.C. section 121 reduces the amount of gain realized for the purposes of I.R.C. section 1031; (2) under I.R.C. section 121(d)(6), the I.R.C. section 121 exclusion does not apply to gain

[234] American Jobs Creation Act of 2004, Pub. L. No. 108-357, §840, 118 Stat. 1418 (2004), *amended by* Tax Corrections Act of 2005 Pub. L. No. 109-135, §403, 119 Stat. 2577 (2005).

[235] I.R.C. § 121(d)(10). This section applies to the taxpayer who received the residence in the like-kind exchange or to any person whose basis is determined by reference to such taxpayer's basis.

[236] H.R. REP. NO. 108-548, at 298-99 (2004).

[237] Rev. Proc. 2005-14, 2005-7 I.R.B. 528, 532 (Revenue Procedure 2005-14 became effective January 27, 2005).

[238] *Id.* at 528-29.

[239] *Id.*

[240] *See supra* text accompanying notes 225-32 (examining the application of I.R.C. § 121 and I.R.C. § 1033 to the involuntary conversion of a principal residence).

[241] Rev. Proc. 2005-14, 2005-7 I.R.B. 528, 529.

attributable to depreciation deductions taken, after May 6, 1997, with respect to the business use of the residence, however, such gain may be deferred under I.R.C. section 1031; and (3) in applying I.R.C. section 1031, gain realized in exchange is recognized only to the extent the boot received exceeds the amount of the gain excluded under I.R.C. section 121.[242] In determining the basis of the property received, any gain excluded under I.R.C. section 121 is treated as gain recognized and, therefore, is added to the taxpayer's basis of the property received in the exchange.[243]

Revenue Procedure 2005-14 includes six examples that illustrate the application of the above computational rules.[244] All of the examples assume that the taxpayer is an unmarried individual and has met the statutory requirements of I.R.C. sections 121 and 1031.[245] The examples are summarized as follows:

> **Example #1:** Taxpayer purchased a residence for $210,000 that Taxpayer used as a principal residence for the first four years of ownership and then rented to tenants for the final two years of ownership. Taxpayer claimed depreciation deductions of $20,000 for the period of business use. Taxpayer exchanges the residence for $10,000 cash (boot) and a townhouse with a value of $460,000 that Taxpayer intends to rent to tenants. On the exchange, Taxpayer realizes $280,000 gain ($470,000 amount realized ($460,000 value of townhouse plus $10,000 cash) minus $190,000 adjusted basis ($210,000 cost minus $20,000 depreciation deductions)). Of the $280,000 gain realized, Taxpayer may exclude $250,000 under I.R.C. section 121 before applying the nonrecognition rules of I.R.C. section 1031. Under I.R.C. section 1031, Taxpayer may defer the remaining $30,000 of realized gain, including the $20,000 gain attributable to depreciation taken. Although Taxpayer received $10,000 cash, Taxpayer does not recognize $10,000 of the realized gain as the boot received does not exceed the amount of the gain excluded under I.R.C. section 121. Under I.R.C. section 1031, Taxpayer's basis in the townhouse is $430,000 ($190,000 adjusted basis in the relinquished

[242] *Id.*
[243] *Id.*
[244] *Id.* at 529-30.
[245] *Id.*

property plus $250,000 gain excluded minus $10,000 cash received).[246]

Example #2: Taxpayer purchased property for $210,000, consisting of a residence and a guesthouse. For the five-year period that Taxpayer owned the property, Taxpayer used the residence as a principal residence and the guesthouse as an office in Taxpayer's business. Based on the square footage of the respective parts of the property, Taxpayer allocated two-thirds of the basis of the property to the residence and one-third of the basis of the property to the guesthouse. Taxpayer claimed depreciation deductions of $30,000 for the business use of the guesthouse. Taxpayer exchanges the property for a dwelling unit that Taxpayer intends to use as a personal residence and a property that Taxpayer intends to use as an office in Taxpayer's business. The total value of the replacement properties is $360,000. The value of the replacement residence is $240,000 and the value of the replacement business property is $120,000, which is equal to the value of the guesthouse. Taxpayer realizes a gain of $180,000 on the exchange. Under I.R.C. section 121, Taxpayer may exclude $100,000 of the realized gain attributable to the residential portion of the relinquished property ($240,000 amount realized ($360,000 total amount realized x 2/3) minus $140,000 basis ($210,000 total basis x 2/3)). However, none of the realized gain attributable to the exchange of the guesthouse is excludable under I.R.C. section 121 as the guesthouse is a separate structure that does not meet the requirements of I.R.C. section 121. Nevertheless, because the value of the replacement business property is equal to the value of the guesthouse and Taxpayer receives no boot, Taxpayer may defer the remaining realized gain of $80,000 ($120,000 amount realized ($360,000 total amount realized x 1/3) minus $40,000 adjusted basis (($210,000 total basis x 1/3) minus $30,000 depreciation deductions). Taxpayer's basis in the replacement residential property is $240,000, which is the value of the replacement residential property at the time of the exchange. Because no portion of the

[246] *Id.* at 530.

realized gain attributed to the guesthouse is excluded under I.R.C. section 121, and Taxpayer receives no boot and recognizes no gain in the exchange, Taxpayer's basis in the replacement business property is $40,000, which is Taxpayer's adjusted basis of the guesthouse at the time of the exchange.[247]

Example #3: Taxpayer purchased property for $210,000, consisting of a single dwelling unit. For the five-year period that Taxpayer owned the property, based on the square footage of the respective parts of the dwelling unit, Taxpayer used the dwelling unit two-thirds as Taxpayer's principal residence and one-third as a home office in Taxpayer's business. Taxpayer claimed depreciation deductions of $30,000 for the business use of the dwelling unit. The Taxpayer exchanges the dwelling unit for a property that Taxpayer intends to use as a personal residence and a property that Taxpayer intends to use as an office in Taxpayer's business. The total value of the replacement properties is $360,000. The value of the replacement residence is $240,000 and the value of the replacement business property is $120,000, which is equal to the value of the business portion of the dwelling unit. Taxpayer realizes gain of $180,000 on the exchange. Under I.R.C. section 121, Taxpayer may exclude $100,000 of the realized gain attributable to the residential portion of the dwelling unit ($240,000 amount realized ($360,000 total amount realized x 2/3) minus $140,000 basis ($210,000 total basis x 2/3)). The remaining realized gain of $80,000 ($120,000 amount realized ($360,000 total amount realized x 1/3) minus $40,000 adjusted basis (($210,000 total basis x 1/3) minus $30,000 depreciation deductions) is attributable to the business portion of the dwelling unit. As to the remaining $80,000 of realized gain, I.R.C. section 121 applies before the nonrecognition rules of I.R.C. section 1031. Under I.R.C. section 121, Taxpayer may exclude $50,000 of the realized gain attributable to the business portion of the dwelling unit because the residential use and nonresidential use are within the same structure. Under I.R.C. section 121,

247 *Id.*

Taxpayer may not exclude the remaining $30,000 gain attributable to depreciation deductions, but may defer the $30,000 gain under I.R.C. section 1031. Taxpayer's basis in the replacement residential property is $240,000, which is the value of the replacement residential property at the time of the exchange. Taxpayer's basis in the replacement business property is $90,000 ($40,000 adjusted basis in the business portion of the dwelling unit plus $50,000 gain excluded).[248]

Example #4: The facts are the same as Example #3 except that Taxpayer receives $10,000 cash (boot) and replacement business property with a value of $110,000 in exchange for the business portion of the dwelling unit, with a value of $120,000. Taxpayer realizes gain of $180,000 on the exchange. Under I.R.C. section 121, Taxpayer may exclude $100,000 of the realized gain attributable to the residential portion of the dwelling unit ($240,000 amount realized ($360,000 total amount realized x 2/3) minus $140,000 basis ($210,000 total basis x 2/3)). The remaining realized gain of $80,000 ($120,000 amount realized ($360,000 total amount realized x 1/3) minus $40,000 adjusted basis (($210,000 total basis x 1/3) minus $30,000 depreciation deductions) is attributable to the business portion of the dwelling unit. As to the remaining $80,000 of realized gain, I.R.C. section 121 applies before the nonrecognition rules of I.R.C. section 1031. Under I.R.C. section 121, Taxpayer may exclude $50,000 of the realized gain attributable to the business portion of the dwelling unit because the residential use and nonresidential use are within the same structure. Taxpayer may not exclude the remaining $30,000 gain attributable to depreciation deductions under I.R.C. section 121, but may defer the $30,000 gain under I.R.C. section 1031. Although Taxpayer received $10,000 of cash, Taxpayer does not recognize $10,000 of the realized gain, as the boot received does not exceed the amount of the gain excluded under I.R.C. section 121. Taxpayer's basis in the replacement residential property is $240,000, which is the value of

[248] *Id.* at 530-31.

the replacement residential property at the time of the exchange. Taxpayer's basis in the replacement business property is $80,000 ($40,000 basis in the business portion of the dwelling unit plus $50,000 gain excluded minus $10,000 cash).[249]

Example #5: The facts are the same as Example #3 except that the total value of the replacement properties is $540,000. The value of the replacement residence is $360,000, and the value of the replacement business property is $180,000. Taxpayer realizes gain of $360,000 on the exchange. Under I.R.C. section 121, Taxpayer may exclude $220,000 of the realized gain attributable to the residential portion of the dwelling unit ($360,000 amount realized ($540,000 total amount realized x 2/3) minus $140,000 basis ($210,000 total basis x 2/3)). The remaining realized gain of $140,000 ($180,000 amount realized ($540,000 total amount realized x 1/3) minus $40,000 adjusted basis (($210,000 total basis x 1/3) minus $30,000 depreciation deductions) is attributable to the business portion of the dwelling unit. As to the remaining $140,000 of realized gain, I.R.C. section 121 applies before the nonrecognition rules of I.R.C. section 1031. Under I.R.C. section 121, Taxpayer may exclude $30,000 of the realized gain attributable to the business portion of the dwelling unit, at which point Taxpayer excluded the maximum exclusion amount of $250,000 ($220,000 plus $30,000). Under I.R.C. section 1031, Taxpayer may defer the remaining realized gain of $110,000 ($140,000 realized gain minus $30,000 gain excluded), including the $30,000 gain attributable to depreciation deductions. Taxpayer's basis in the replacement residential property is $360,000, which is the value of the replacement residential property at the time of the exchange. Taxpayer's basis in the replacement business property is $70,000 ($40,000 basis in the business portion of the dwelling unit plus $30,000 gain excluded).[250]

Example #6: The facts are the same as Example #3 except that the total value of the replacement properties

[249] *Id.* at 531.
[250] *Id.* at 531-32.

> is $750,000. The value of the replacement residence is $500,000, and the value of the replacement business property is $250,000. Taxpayer realizes gain of $570,000 on the exchange. Under I.R.C. section 121, Taxpayer may exclude $250,000 of the $360,000 realized gain attributable to the residential portion of the dwelling unit ($500,000 amount realized ($750,000 total amount realized x 2/3) minus $140,000 basis ($210,000 total basis x 2/3)). The realized gain of $110,000 ($360,000 realized gain minus $250,000 exclusion amount) in excess of the maximum exclusion amount of $250,000 is included in Taxpayer's income. The remaining realized gain of $210,000 ($250,000 amount realized ($750,000 total amount realized x 1/3) minus $40,000 adjusted basis (($210,000 total basis x 1/3) minus $30,000 depreciation deductions) is attributed to the business portion of the dwelling unit. Under I.R.C. section 1031, Taxpayer may defer the remaining realized gain of $210,000 attributable to the business portion of the dwelling unit, including the $30,000 gain attributable to depreciation deductions. Taxpayer's basis in the replacement residential property is $500,000, which is the value of the replacement residential property at the time of the exchange. Taxpayer's basis in the replacement business property is $40,000, which is equal to Taxpayer's basis in the business portion of the dwelling unit at the time of the exchange.[251]

V. DEDUCTION LIMITATIONS UNDER I.R.C. SECTIONS 280A AND 183

A. General Explanation of I.R.C. sections 280A and 183

Concerned that taxpayers were converting nondeductible personal and living expenses[252] into deductible trade or business or production of income expenses by claiming home offices or acquiring second homes, Congress enacted I.R.C. section 280A in 1976.[253] Generally,

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[251] *Id.* at 532.

[252] I.R.C. § 262(a) (2006). Unless specifically provided for in the Internal Revenue Code, no deductions are allowed "for personal, living, or family expenses." *Id.*

[253] BITTKER, ET. AL., *supra* note 7, ¶ 13.10[1] (citing Staff of Joint Comm. on Tax'n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at

I.R.C. section 280A disallows or limits the deduction of expenses incurred in connection with the use of the taxpayer's residence for income producing activities.[254] Prior to 1976, the allowance of such deductions depended on whether the activity of the taxpayer was engaged in for profit as required by I.R.C. section 183.[255] Finding this standard too vague, Congress added I.R.C. section 280A, which provides objective criteria by which deductions relating to home offices and vacation homes may be evaluated.[256]

I.R.C. section 280A begins by denying all deductions with respect to a dwelling unit that was used by the taxpayer as a residence during the year.[257] Of course, I.R.C. section 280A provides an exception to this general disallowance of all deductions for expenses incurred without regard to the use of the taxpayer's residence for income producing activities,[258] including qualified residence interest,[259] real property taxes,[260] and casualty losses.[261] Important exceptions to I.R.C. section 280A also allow the taxpayer to deduct, to a limited extent, expenses incurred in connection with the use of the personal residence, in whole or in part, as a home office or as a rental property.[262]

For the purposes of I.R.C. section 280A, the use of property as a residence is defined as the personal use of the dwelling unit by the taxpayer and other individuals with an interest in the property, and the families of the taxpayer and such other individuals.[263] In terms of

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85 (Comm. Print 1987). I.R.C. § 280A applies to individuals and S corporations. I.R.C. § 280A(a) (2006).

[254] STAFF OF THE JOINT COMM. ON TAX'N, SUMMARY OF H.R. 5159 (Comm. Print 1981).

[255] *See infra* text accompanying notes 351-60 (examining the for profit requirement and deduction limitation under I.R.C. § 183).

[256] MCDANIEL, MCMAHON, JR., SIMMONS, & POLSKY, *supra* note 55, at 610. If I.R.C. § 280A(a) applies with respect to any dwelling unit for the year, I.R.C. § 183 will not apply to the dwelling unit for the year but the year will be taken into account for the purposes of the five-year presumption under I.R.C. § 183(d). I.R.C. § 280A(f)(3).

[257] I.R.C. § 280A(a).

[258] I.R.C. § 280A(b); Prop. Treas. Reg. § 1.280A-1(b), 45 Fed. Reg. 52399, 52401 (Aug. 7, 1980).

[259] I.R.C. § 163(h)(3) (2006).

[260] I.R.C. § 164(a)(1) (2006).

[261] I.R.C. § 165(c)(3) (2006).

[262] I.R.C. § 280A(c)(1), (3) (2006). Although I.R.C. § 280A is primarily concerned with deductions claimed for a home office and vacation homes, the provision also applies to dwelling units used for business entertainment and other for profit purposes. BITTKER, MCMAHON, JR., & ZELENAK, *supra* note 7, ¶ 13.10[1].

[263] I.R.C. § 280A(d)(2)(A) (2006). The family of an individual includes siblings, spouse, ancestors, and lineal descendants. I.R.C. § 267(c)(4) (2006). The

time, the use of the property as a residence by the taxpayer is defined as the use of the dwelling unit for personal purposes for more than fourteen days, or more than ten percent of the days for which the dwelling unit is rented at a fair rental, whichever is greater.[264] The term "dwelling unit" includes "a house, apartment, condominium, mobile home, boat, or similar property,"[265] "which provides basic living accommodations such as a sleeping space, toilet, and cooking facilities."[266] The term also includes unattached structures on the property such as garages, studios, and greenhouses.[267]

B. Home-Office Deduction

Employees and self-employed individuals may not deduct expenses incurred in connection with the use of a portion of their residence as a home office unless specifically allowed by I.R.C. section 280A(c)(1).[268] Deductions for the business use of a residence

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use of the dwelling unit for personal purposes includes individuals using the dwelling unit under an exchange agreement entitling the taxpayer to use another dwelling unit, whether or not a rental is charged. I.R.C. § 280A(d)(2)(B). The use of the dwelling unit for personal purposes also includes individuals using the dwelling unit, other than employees subject to I.R.C. § 119 (lodging furnished for the convenience of the employer), unless a fair rental is charged. I.R.C. § 280A(d)(2)(C). The use of the dwelling unit for the purposes of repairs and annual maintenance does not constitute personal use. I.R.C. § 280A(d)(2); Prop. Treas. Reg. § 1.280A-1(e)(4), 45 Fed. Reg. 52401, 52402 (Aug. 7, 1980). The taxpayer is not treated as using the property for personal purposes for the period the dwelling unit is rented at a fair rental to any individual who uses the dwelling unit as a principal residence. I.R.C. § 280A(d)(3)(A).

[264] I.R.C. § 280A(d)(1).

[265] I.R.C. § 280A(f)(1)(A). The term "dwelling unit" does not include a unit or any portion of a unit used exclusively as a hotel, motel, inn, or similar establishment. I.R.C. § 280A(f)(1)(B); Prop. Treas. Reg. § 1.280A-1(c)(2), 45 Fed. Reg. 52401, 52401-02 (Aug. 7, 1980). *See* Anderson v. Comm'r, T.C.M. (RIA) 2006-033 (2006) (holding a bed and breakfast, a portion of which was used for personal purposes or for both personal and business purposes, was not a "hotel," and, therefore, subject to general disallowance rule of I.R.C. § 280A(a) and the exclusive-use limitation of I.R.C. § 280A(f)(1)(B)); Prop. Treas. Reg. § 1.280A-1(c)(2), 45 Fed. Reg. 52401, 52401-02 (Aug. 7, 1980).

[266] Prop. Treas. Reg. § 1.280A-1(c)(1), 45 Fed. Reg. 52401, 52401-02 (Aug. 7, 1980).

[267] I.R.C. § 280A(f)(1)(A).

[268] I.R.C. § 280A(c). Expenses allocable to space within the dwelling unit used regularly to store inventory or product samples for a business of selling products are excepted if the dwelling unit is the sole fixed location of the retail or wholesale business. I.R.C. § 280A(c)(2). Expenses allocable to the regular-use of a portion of the dwelling unit in the taxpayer's business of providing day-care services for children or individuals who are over 65 or are physically or mentally unable to care for themselves are also excepted. I.R.C. § 280A(c)(4).

are only allowed under I.R.C. section 280A(c)(1) to the extent of any expenses "allocable to *a portion of the dwelling unit* which is used *exclusively* and *on a regular basis*" as: (1) the principal place of business of the taxpayer; (2) the place of business that is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of business; or (3) an unattached separate structure used in connection with the business of the taxpayer.[269] An employee may not take deductions for the business use of a personal residence unless the use is for the convenience of the employer.[270]

A portion of the dwelling unit means "a room or other separately defined space," although the space need not be marked by a permanent partition.[271] The space must be used exclusively for business purposes, and if the space is used exclusively for more than one business, then the business purpose of each business must qualify under I.R.C. section 280A(c)(1).[272] Furthermore, the space must be used as a business in the sense of I.R.C. section 162 and not merely a

[269] I.R.C. § 280A(c)(1). With regard to the perceived audit risk of claiming a home-office deduction, one commentator states, "Although an estimated 26 million Americans have home offices, just 3.4 million taxpayers claim home-office deductions . . . I suspect many people with home offices forgo the tax breaks because they fear the write-offs will trigger a tax audit. Get over it. The tax sharpies I've spoken to say they believe home offices no longer set off alarms at the Internal Revenue Service." Richard Eisenberg, *Secrets of Claiming a Home-Office Deduction*, FORBES (Feb. 8, 2013, 1:07 PM), http://www.forbes.com/sites/nextavenue/2013/02/08/secrets-of-claiming-a-home-office-deduction/.

[270] I.R.C. § 280A(c)(1). *See* Hamacher v. Comm'r, 94 T.C. 348, 358 (1990) (defining "convenience of the employer" as when the home office is necessary for the function of the employer's business or necessary to allow the employee to perform duties properly); Weissman v. Comm'r, 751 F.2d 512, 516-17 (2d Cir. 1984) (allowing a college professor to deduct the expenses of his home office, which he used for scholarly research and writing required as a condition of his employment, because his employer did not provide a suitable space for engaging in such employment-related activities).

[271] I.R.C. § 280A(c)(1); Prop. Treas. Reg. § 1.280A-2(g)(1), 48 Fed. Reg. 33320, 33324 (July 21, 1983). *See* Hewett v. Comm'r, T.C.M. (RIA) 96,110 (1996) (holding that I.R.C. § 280A(c)(1) was satisfied by a piano teacher using a grand piano exclusively for teaching that was located in an alcove off the living room); Sengpiehl v. Comm'r, T.C.M. (RIA) 98,023 (1998) (allowing a deduction for a lawyer, who worked exclusively from a home office, of expenses relating to the living room of the residence as the taxpayer and his wife gave credible testimony that the living room was used exclusively as a conference room for the taxpayer's legal practice and not used for personal purposes of the family).

[272] Hamacher, 94 T.C. at 357-59 (finding that no deduction of expenses was allowed for a home office because the office was used by the taxpayer as the principal place of business of a sole proprietorship and also used by the taxpayer to perform work for an employer that was found not for the convenience of the employer).

profit-seeking activity in the sense of I.R.C. section 212.[273] The requirement that the business use of the space within the residence be on a regular basis is not satisfied by occasional or incidental business use.[274] "These standards are clearly intended to disqualify residential space used by investors to study stock market quotations and keep records, by business executives to read or prepare business reports, by teachers to prepare for class and grade examinations, and by most self-employed taxpayers whose principal office is located elsewhere."[275]

The standard for determining whether the home office constitutes the *principal* place of the business of the taxpayer has generated substantial controversy.[276] Resolving the controversy, the Supreme Court held, in *Commissioner v. Soliman,*[277] that the principal place of business of the taxpayer was the "most important or significant" location of the business, as determined by two primary considerations: "(1) the relative importance of the activities performed at each business location and (2) the time spent at each location."[278] The point where goods and services are delivered is given great weight in the relative importance analysis.[279]

In *Soliman*, the taxpayer was a self-employed anesthesiologist who spent thirty to thirty-five hours per week administering anesthesia and postoperative care in three hospitals. As none of the hospitals provided office space, the taxpayer used one of the three bedrooms in his residence, exclusively and on a regular basis, as an office, where he performed a wide variety of essential tasks related to his medical practice.[280] The Supreme Court denied the taxpayer a deduction for his home office, even though it was his only office and essential to

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[273] *See* Comm'r v. Groetzinger, 480 U.S. 23, 35 (1987) (ruling that in order to be engaged in a trade or business the taxpayer must be involved in the activity with continuity and regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit); Higgins v. Comm'r, 312 U.S. 212, 218 (1941) (holding that managing investments, no matter how continuous or extended, does not constitute carrying on a business); Curphey v. Comm'r, 73 T.C. 766 (1980) (allowing the deduction of expenses relating to a home office to a dermatologist as the dermatologist's activities of managing rental properties qualified as a business).

[274] *See* Christine v. Comm'r, T.C.M. (RIA) 2010-144 (2010) (disallowing the deductions under I.R.C. § 280A(c)(1) as the author failed to provide information concerning the amount of time spent writing at home).

[275] BITTKER, ET. AL., *supra* note 7, at ¶ 13.10[2][a].

[276] I.R.C. § 280A(c)(1)(A) (2006); MCDANIEL, MCMAHON, JR., SIMMONS & POLSKY, *supra* note 55, at 617.

[277] Comm'r v. Soliman, 506 U.S. 168 (1993).

[278] *Id.* at 174.

[279] *Id.* at 175.

[280] *Id.* at 188-89 (Stevens, J., dissenting).

carrying on his medical practice.[281] Applying the "relative importance" test, the Supreme Court found that the treatment that the taxpayer provided at the hospitals constituted "the essence" of his medical practice and the point where his services were delivered to his patients.[282] As to the comparison of the time spent at each location, the fact that the taxpayer spent more time at the hospitals than at his home office supported the determination that his home office was not his principal place of business.[283] Following *Soliman*, the Treasury Department announced that it will determine the taxpayer's principal place of business by first applying the "relative-importance" test to compare the business activities of the taxpayer at each location and, if the relative-importance test does not provide a definitive answer, the "relative-time" test will be applied.[284]

In response to the harshness of *Soliman*, Congress amended I.R.C. section 280A(c)(1) in 1997.[285] Pursuant to I.R.C. section 280A(c)(1), a home office qualifies as the taxpayer's principal place of business if: (1) the home office is used by the taxpayer to conduct the administrative or management activities of the business and (2) the business does not have another fixed location at which the taxpayer conducts substantial administrative or management activities.[286] Pursuant to the House Report, the taxpayer may take the home-office deduction even though substantial non-administrative or non-management business activities are performed by the taxpayer at a fixed location outside the residence, substantial administrative or management business activities are performed for the taxpayer by others outside the residence, or the taxpayer could have used an office outside the residence to perform administrative or management business activities but chose not to do so.[287]

Even if the taxpayer satisfies the business-use requirement, the amount of the deductions allowed for the home office is severely limited.[288] First, the deductions allowed may not exceed the amount

[281] *Id.* at 178.
[282] *Id.*
[283] *Id.*
[284] Rev. Rul. 94-24, 1994-1 CB 87; *See* Popov v. Comm'r, 246 F.3d 1190 (9th Cir. 2001) (holding that the taxpayer's home office in her residence was her principal place of business, relying on the "relative time" test as the "relative importance" test did not yield a definitive answer).
[285] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 881.
[286] I.R.C. § 280A(c)(1) (2012).
[287] H.R. REP. NO. 105-148, at 242-243 (1997).
[288] I.R.C. § 280A(c)(5) (2006) (applying limitations on deductions to the use of a personal residence to regularly store inventory or samples held for use in taxpayer's retail or wholesale business; in the taxpayer's business of providing day

of income generated by the business use of the dwelling unit.[289] To determine the amount of income, the gross income generated by the business use of the dwelling unit is reduced by the expenses incurred by the business apart from the business use of the dwelling unit, e.g., expenses for secretarial support, supplies, and business telephones.[290] Second, the expenses incurred by the use of the dwelling unit must be allocated to the portion of the dwelling unit used for business purposes by any reasonable method.[291] Generally, the taxpayer will allocate expenses according to the percentage of the total floor space of the dwelling unit used for business purposes.[292]

Pursuant to I.R.C. section 280A(c)(5), the deductions with respect to the business use of the dwelling unit are subject to the overall limit of the income generated by the business use of the dwelling unit and are allowed in the following order: (1) the allocable portion of the deductions allowable without regard to any business use of the dwelling unit, e.g., qualified residence interest[293] and real estate taxes;[294] (2) to the extent of any excess income, the allocable portion of the deductions allowable by reason of the business use of the dwelling unit that do not result in an adjustment to the basis of the property, e.g., utilities, homeowner's insurance, and repair and maintenance;[295] and (3) to the extent of any excess income, the allocable portion of the deductions allowable by reason of the business use of the dwelling unit that result in an adjustment to the basis of the property, e.g., depreciation deduction.[296] Any business-related deductions not allowed within the current year by reason of the income limitation may be carried over to the subsequent year.[297]

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care services; or as a rental if the taxpayer uses the dwelling unit as a personal residence during the year).

[289] I.R.C. § 280A(c)(5)(A); Prop. Treas. Reg. § 1.280A-2(i), 45 Fed. Reg. 52399, 52404 (Aug. 7, 1980)

[290] Prop. Treas. Reg. § 1.280A-2(i)(2)(iii), 45 Fed. Reg. 52399, 52404 (Aug. 7, 1980).

[291] Prop. Treas. Reg. § 1.280A-2(i)(3), 45 Fed. Reg. 52399, 52404 (Aug. 7, 1980) (stating that expenses which are attributable exclusively to a particular portion of the dwelling unit will be allocated in full to that portion of the dwelling unit, e.g., painting and repairs).

[292] *Id.* (stating if the rooms in the dwelling unit are of approximately equal size, the taxpayer may also allocate expenses according to the number of rooms used for business purposes and expenses which are not related to the use of the dwelling unit for business purposes are not to be taken into account, e.g., lawn care).

[293] I.R.C. § 163(h)(3) (2006).

[294] I.R.C. § 164(a)(1) (2006).

[295] I.R.C. § 162(a) (2006).

[296] I.R.C. § 168 (2006); I.R.C. § 1016(a)(2) (2006); I.R.C. § 280A(c)(5) (2006); Prop. Treas. Reg. § 1.280A-2(i)(5), 45 Fed. Reg. 52399, 52404-05 (Aug. 7, 1980).

[297] I.R.C. § 280A(c)(5).

> **Example:** Taxpayer is a self-employed attorney who maintains an office in her residence that is used exclusively and on a regular basis in her legal practice. For the current year, her gross income from the home office is $50,000, and her expenses for secretarial support, supplies, and a business telephone are $10,000. Taxpayer's home office occupies approximately 20% of the total floor space of her residence. Annually, her home mortgage interest is $5,000 and real property taxes are $4,000. Her home expenses, i.e., utilities, homeowner's insurance, and repairs and maintenance, total $6,000. If the entire residence was used for business purposes, the depreciation deduction for the year would be $8,000. Taxpayer's home-office deductions for the year are limited to Taxpayer's net income from her business $40,000 ($50,000 gross income minus $10,000 business expenses). The income limit will first be applied against 20% of the home mortgage interest and real property taxes $1,800 (($5,000 plus $4,000) x 20%), then 20% of the cost of utilities, homeowner's insurance, and repairs and maintenance $1,200 ($6,000 x 20%), and, finally, 20% of the depreciation deduction $1,600 ($8,000 x 20%). As the income generated by the business use of the residence exceeds the deductions ($40,000 income minus $4,600 deductions ($1,800 plus $1,200 plus $1,600)), the deductions attributable to the business use of the residence are fully allowed.

C. Revenue Procedure 2013-13—Safe Harbor for Determining the Amount of Deductible Expenses Attributable to a Home Office

Revenue Procedure 2013-13[298] provides an optional safe-harbor method that taxpayers may use to determine the amount of deductible expenses attributable to the business use of a residence.[299] The safe-harbor method is an alternative to the calculation, allocation, and substantiation of allowable deductions attributable to the use of a portion of the taxpayer's residence for business purposes, which the Internal Revenue Service and the Treasury Department acknowledge

[298] Rev. Proc. 2013-13, 2013-6 I.R.B. 469, 478.
[299] *Id.*

"can be complex and burdensome."[300] Generally, if the business use by the taxpayer of the residence satisfies the "qualified business use" requirements of I.R.C. section 280A(c),[301] the taxpayer may elect[302] to determine the amount of deductible expenses by multiplying the allowable square footage of the qualified business use portion of the residence, not to exceed 300 square feet,[303] by the prescribed rate of $5 per square foot.[304] Thus, the maximum deduction under the safe-harbor method is limited to $1,500 (300 square feet x $5 rate).

If the taxpayer elects the safe-harbor method for the taxable year, the taxpayer may not deduct any actual expenses related to the business use of the residence for that year.[305] Annually, the taxpayer may elect to use the safe-harbor method or to calculate and substantiate actual expenses for the purposes of I.R.C. section 280A(c).[306] If the taxpayer uses the safe-harbor method, the taxpayer may deduct any expenses related to the residence that are allowable without regard to the business use of the residence.[307] Under the safe-harbor method, no depreciation deduction is allowed,[308] and the depreciation deduction allowable for that portion of the residence "is deemed to be zero."[309] If the taxpayer uses the safe-harbor method for the current year and calculates and substantiates expenses for any subsequent year, the taxpayer must calculate the depreciation deduction allowable for the subsequent year using the appropriate

[300] *Id.* at 479.

[301] *Id.* For the purposes of the revenue procedure, "qualified business use" of the residence means business use of the residence that satisfies the requirements of I.R.C. § 280A(c)(1) (2006) (home-office use); I.R.C. § 280A(c)(2) (2006), (storage-business use); and I.R.C. § 280A(c)(4) (2006) (day-care service use). Rev. Proc. 2013-13, 2013-6 I.R.B. 469, 479.

[302] *Id.* A taxpayer elects the safe-harbor method by using the method to compute the deduction for the qualified business use of the residence on a timely filed, original federal income tax return for the taxable year, which once made is irrevocable. *Id.*

[303] *Id.* at 480. Rev. Proc. 2013-13 provides adjustments for determining the allowable square footage for a taxpayer with a qualified business use of a home for only a part of a year or a taxpayer who changes the square footage for a qualified business use of the residence during the year. *Id.*

[304] *Id.* at 479. The Internal Revenue Service and the Treasury Department may update the prescribed rate as warranted. *Id.*

[305] *Id.*

[306] *Id.*

[307] *Id.* Examples include qualified residence interest (I.R.C. § 163(h)(3)), property taxes (I.R.C. § 164(a)(1)), and casualty losses (I.R.C. § 165(c)(3)). *Id.*

[308] *Id.* at 480. The taxpayer cannot take a cost recovery deduction under I.R.C. § 168, including the first-year depreciation bonus under I.R.C. § 168(k), or the election to expense under I.R.C. § 179. *Id.*

[309] *Id.*

optional depreciation table[310] and the year that corresponds with the subsequent year based on the placed-in-service year of the property.[311] "The amount of deduction computed using the safe-harbor method" may not exceed "the gross income derived from the qualified business use" of the residence minus any business expenses unrelated to the qualified business use of the residence.[312] Any amount of deduction in excess of the income limitation is "disallowed and may not be carried over" to any subsequent year.[313]

Revenue Procedure 2013-13 includes two examples that illustrate the application of the above computational rules.[314] The examples are summarized as follows:

> **Example #1:** Throughout 2013, Taxpayer, a sole proprietor, uses a room in his residence regularly and exclusively to meet customers in the normal course of his business of being a barber. Taxpayer placed the room in service in January 2013. Taxpayer determines that the room is 350 square feet and has a cost basis of $10,000. During 2013, Taxpayer earns $9,000 from his business and pays a total of $3,400 in business expenses as follows: supplies $1,500, advertising $800, professional fees $300, magazines/subscriptions $700, and postage $100. Taxpayer also pays a total of $17,000 in expenses related to his residence as follows: qualified residence interest $10,000, real property taxes $3,000, homeowner's insurance $1,500, utilities $2,400, and repairs $900. For 2013, Taxpayer elects the safe-harbor method and determines the amount of his deduction for the qualified business use of his residence is $1,500 (300 square feet x $5 rate). Taxpayer may deduct the $3,400 total of business expenses unrelated to the business use of his residence

[310] *See* Rev. Proc. 87-57, 1987-2 C.B. 687 (providing the optional depreciation tables for the purposes of calculating the amount of depreciation deduction for the current year); *See* Rev. Proc. 2013-13, 2013-6 I.R.B. 478 (modifying Revenue Procedure 87-57 for the purposes of Revenue Procedure 2013-13).

[311] Rev. Proc. 2013-13, 2013-6 I.R.B. 478, 480.

[312] *Id.* Examples include expenses for advertising, wages, and supplies. *Id.*

[313] *Id.* A taxpayer who uses the safe-harbor method cannot deduct in the current year any disallowed amount of deduction carried over from a prior year during which the taxpayer calculated and substantiated actual expenses but can deduct the carried over disallowed amount in the next succeeding taxable year in which the taxpayer calculates and substantiates actual expenses for the purposes of I.R.C. § 280A. *Id.*

[314] *Id.* at 481.

and the $17,000 total of deductible expenses related to his residence but unrelated to the business use of his residence. Taxpayer may not deduct any portion of the actual expenses related to the qualified business use of the residence or any depreciation for the room, which is deemed to be zero. The income limit does not reduce Taxpayer's deduction for the qualified business use of the residence because the amount of the deduction, $1,500, does not exceed the gross income derived from the qualified business use of his residence reduced by the business deductions unrelated to the business use of his residence $5,600 ($9,000 gross income minus $3,400 business deductions). If Taxpayer does not elect the safe-harbor method for 2014, but instead calculates and substantiates actual expenses for the purposes of I.R.C. section 280A(c), he must determine his depreciation deduction by multiplying the $10,000 cost basis of the room by the annual depreciation rate for 2014 in the appropriate optional depreciation table.[315]

Example #2: Throughout 2013, Taxpayer, a sole proprietor, uses a room in her residence regularly and exclusively to meet customers in the normal course of her business of being an architect. Taxpayer placed the room in service in January 2010. Taxpayer determines that the room is 300 square feet and had a cost basis of $10,000. For 2010, 2011, 2012, Taxpayer depreciates the room as nonresidential real property under the general depreciation system of I.R.C. section 168, resulting in an adjusted basis of $9,241.45 as of December 31, 2012. For 2013, Taxpayer elects the safe-harbor method; therefore, she may not deduct any depreciation for the room, which is deemed to be zero. Thus, the adjusted depreciable basis of the room as of December 31, 2013, is $9,241.45. For 2014, Taxpayer resumes calculating and substantiating actual expenses for the purposes of I.R.C. section 280A(c). Taxpayer must use the appropriate optional table for determining the depreciation deduction allowable for the room for 2014, using annual depreciation rate for year five.[316]

[315] *Id.*
[316] *Id.*

D. Vacation Homes

I.R.C. section 280A also addresses deductions claimed by taxpayers for expenses associated with the rental of their vacation homes.[317] Prior to the enactment of I.R.C. section 280A, the permissibility of such deductions depended on whether the rental activity was engaged in for profit as required by I.R.C. section 183.[318] In general, I.R.C. section 280A(e) limits the deduction of expenses incurred with respect to the rental use of a vacation home if the taxpayer uses the vacation home as a residence during the year.[319]

As with the home-office deduction,[320] the taxpayer uses a dwelling unit as a "residence" if the taxpayer uses the dwelling unit for personal purposes more than fourteen days or more than ten percent of the days the dwelling unit is rented at a fair rental, whichever is greater.[321] "Personal use" is defined as the personal use of the dwelling unit by the taxpayer or other individuals with an interest in the property, and the families of the taxpayer or such other individuals.[322] Personal use by the taxpayer includes renting the dwelling unit to a nonfamily member if the dwelling unit is not rented at a fair rental.[323] Personal use also includes renting the dwelling unit to a family member, even at a fair rental, unless the dwelling unit is the principal residence of the family member.[324] A fair rental is determined on the basis of comparable rent in the area, with the taxpayer bearing the burden of proving the fair rental value of the dwelling unit.[325] However, the use of the dwelling unit by the taxpayer for the purposes of repairs and annual maintenance is not considered personal use.[326]

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[317] I.R.C. § 280A(e)(1) (2006).

[318] *See infra* text accompanying notes 352-60 (examining the for profit requirement and deduction limitation under I.R.C. § 183).

[319] I.R.C. § 280A(e), (g).

[320] *See supra* text accompanying notes 263-67 (providing a detailed definition of the terms "residence" and "personal use" for the purposes of I.R.C. § 280A).

[321] I.R.C. § 280A(d)(1).

[322] I.R.C. § 280A(d)(2)(A). A member of the family includes siblings, spouse, ancestors, and lineal descendants. I.R.C. § 267(c)(4) (2012). *See supra* note 263 (providing a detailed definition of the term "personal use" by the taxpayer).

[323] Colbert v. Comm'r, 63 T.C.M. (CCH) 1818 (1992) (renting a dwelling unit at less than a fair rental to a low-income family is deemed personal use by the taxpayer). *See* Rev. Rul. 89-51, 1989-1 C.B. 89 (holding that the donation by the owner of a vacation home for one week to a charity fund-raising auction with the use sold to the successful bidder for a fair rental constitutes one week of personal use by the taxpayer).

[324] I.R.C. § 280A(d)(3)(A).

[325] Didonato v. Comm'r, T.C.M. (RIA) 2013-011, at 92 (2013).

[326] I.R.C. § 280A(d)(2); Prop. Treas. Reg. § 1.280A-1(e)(6), 48 Fed. Reg. 33320, 33323 (Jul. 21, 1983).

I.R.C. section 280A provides different tax treatment for the four categories of dwelling units rented by the taxpayer as follows:[327] First, if a dwelling unit is used by the taxpayer for personal purposes during the year for the number of days necessary to constitute a residence, and is rented for less than fifteen days during the year, I.R.C. section 280A(g) excludes the rent from the taxpayer's income, but also disallows all deductions attributable to the rental use of the residence. Of course, deductions allowable to the taxpayer without regard to rental use, such as qualified residence interest,[328] real property taxes,[329] and casualty losses,[330] are allowed.[331]

Second, if a dwelling unit is used by the taxpayer for personal purposes during the year for the number of days necessary to constitute a residence, and is rented for fifteen days or more during the year, the residence is subject to the allocation of expenses required by I.R.C. section 280A(e) and the overall income limit imposed by I.R.C. section 280A(c)(5). Pursuant to I.R.C. section 280A(e), the taxpayer may take deductions allowable without regard to the rental use of the residence, e.g., qualified residence interest[332] and real estate taxes.[333] However, only an allocable portion of the deductions allowable by reason of the rental use are allowed, e.g., utilities, homeowner's insurance, repair and maintenance,[334] and depreciation.[335] The amount of the expenses deductible by reason of the rental use of the residence is determined by a percentage computed by dividing the number of days the residence is rented by the total number of days the residence is used for all purposes.[336]

The income limitation of I.R.C. section 280A(c)(5) reduces the ability of the taxpayer to deduct the expenses attributable to the rental use of a vacation home if the residence is rented for fifteen days or more during the taxable year. Computing the income limitation, the gross income generated by the rental use of the residence is reduced by the expenses incurred by the rental activity apart from the rental use,

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[327] BITTKER, MCMAHON, JR., & ZELENAK, *supra* note 7, ¶ 3.10[3].

[328] I.R.C. § 163(h)(3) (2006).

[329] I.R.C. § 164(a)(1) (2006).

[330] I.R.C. § 165(c)(3) (2006).

[331] I.R.C. § 280A(b) (2006).

[332] I.R.C. § 163(h)(3) (2006).

[333] I.R.C. § 164(a)(1) (2006); I.R.C. § 280A(e)(2); Prop. Treas. Reg. § 1.280A-3(c)(3), 45 Fed. Reg. 52399, 52405 (Aug. 7, 1980).

[334] I.R.C. § 162 (2006); I.R.C. § 212(2) (2006); I.R.C. § 280A(e)(1); Prop. Treas. Reg. § 1.280A-3(c)(1), 45 Fed. Reg. 52399, 52405 (Aug. 7, 1980).

[335] I.R.C. § 168 (2006); I.R.C. § 280A(e)(1); Prop. Treas. Reg. § 1.280A-3(c)(1), 45 Fed. Reg. 52399, 52405 (Aug. 7, 1980).

[336] I.R.C. § 280A(e)(1); Prop. Treas. Reg. § 1.280A-3(c)(1), 45 Fed. Reg. 52399, 52405 (Aug. 7, 1980).

e.g., realtors' fees and advertising costs.[337] The taxpayer must then determine the expenses allocable to the rental use of the residence using the same percentage required by I.R.C. section 280A(e), namely, a percentage computed by dividing the number of days the residence is rented by the total number of days the residence is used for all purposes.[338] Pursuant to I.R.C. section 280A(c)(5), the deductions with respect to the rental use of the residence are subject to the overall limit of the income generated by the rental use of the residence and are allowed in the following order: (1) the allocable portion[339] of the deductions allowable without regard to any rental use of the residence, e.g., qualified residence interest[340] and real estate taxes;[341] (2) to the extent of any excess income, the allocable portion of the deductions allowable by reason of the rental use of the residence which do not result in an adjustment to the basis of the property, e.g., utilities, homeowner's insurance, and repair and maintenance;[342] and (3) to the extent of any excess income, the allocable portion of the deductions allowable by reason of the rental use of the dwelling unit which result in an adjustment to the basis of the property, e.g., depreciation deduction.[343] Any rental related deductions not allowed within the current year by reason of the income limitation may be carried over to the subsequent year.[344]

> **Example:** Taxpayer rents her vacation home for eighty days and uses the vacation home for personal purposes for twenty days. Taxpayer's gross income from the rental use is $100,000, and her realtors' fees and advertising costs total $10,000. Annually, her home mortgage interest is $5,000 and real property taxes are $4,000. Taxpayer's other expenses, such as

[337] I.R.C. § 162; I.R.C. § 212(2) (2006); Prop. Treas. Reg. § 1.280A-3(d)(2), 45 Fed. Reg. 52399, 52405 (Aug. 7, 1980).

[338] I.R.C. § 280A(c)(5), (e)(1); Prop. Treas. Reg. § 1.280A-3(c)(1), 45 Fed. Reg. 52399, 52405 (Aug. 7, 1980).

[339] The percentage limitation employed by the Tax Court, affirmed by the Ninth and Tenth Circuit Courts of Appeals, in allocating the mortgage interest and real estate taxes is computed by dividing the total days of rental use by the total days in the taxable year, with the rationale that mortgage interest and real property taxes are assessed on a yearly and not a daily basis. Bolton v. Comm'r, 694 F.2d 556, 564 (9th Cir. 1982); McKinney v. Comm'r, 732 F.2d 414, 416 (10th Cir. 1983).

[340] I.R.C. § 163(h)(3) (2006).

[341] I.R.C. § 164(a)(1) (2006).

[342] I.R.C. § 162; I.R.C. § 212(2).

[343] I.R.C. § 168 (2006); I.R.C. § 1016(a)(2) (2006); I.R.C. § 280A(c)(5); Prop. Treas. Reg. § 1.280A-3(d)(3), 45 Fed. Reg. 52399, 52405-06 (Aug. 7, 1980).

[344] I.R.C. § 280A(c)(5).

> the cost of heating, air conditioning, water, and electricity, total \$6,000. If her vacation home was used as a rental for the entire year, the depreciation deduction would have been \$8,000. Taxpayer's deductions related to the rental use of her vacation home for the year will be limited to her net rental income \$90,000 (\$100,000 gross income minus \$10,000 realtors' fees and advertising costs). The income limit will first be applied against 80% (80 days of rental use ÷ 100 days of total use)[345] of the home mortgage interest and property taxes \$7,200 ((\$5,000 plus \$4,000) x 80%), then 80% of the cost of utilities \$4,800 (\$6,000 x 80%), and, finally, 80% of the depreciation deduction \$6,400 (\$8,000 x 80%). As the income from the business use of the residence unit exceeds the deductions (\$90,000 minus \$18,400 (\$7,200 plus \$4,800 plus \$6,400)), the deductions attributable to the rental use of the vacation home are fully allowed.

Third, if the dwelling unit is rented for fifteen days or more during the year but the dwelling unit is used by the taxpayer for personal purposes less than the number of days necessary to constitute a residence, the dwelling unit is subject to the allocation required by I.R.C. section 280A(e), but not the overall income limitation imposed by I.R.C. section 280A(c)(5). Pursuant to I.R.C. section 280A(e), the taxpayer may take deductions allowable without regard to the rental use of the dwelling unit;[346] however, only an allocable portion of the deductions allowable by reason of the rental use are allowed.[347]

Fourth, if the dwelling unit is never used for personal purposes, I.R.C. section 280A has no application to the dwelling unit.[348] Generally, the taxpayer may deduct all expenses and fully depreciate

[345] As to the mortgage interest and real property taxes, the Tax Court, Ninth Circuit, and Tenth Circuit would apply a percentage limitation of only 22% (80 days of rental use ÷ 365 total days of the year); thereby, offsetting the income generated by the rental use of the residence by a lesser amount. *See supra* note 339 (citing the cases so holding).

[346] I.R.C. § 280A(e)(2); I.R.C. § 164(a)(2); Prop. Treas. Reg. § 1.280A-3(c)(3), 45 Fed. Reg. 52399, 52405 (Aug. 7, 1980).

[347] I.R.C. § 162 (2006); I.R.C. § 212(2) (2006); I.R.C. § 280A(e)(1); Prop. Treas. Reg. § 1.280A-3(c)(1), 45 Fed. Reg. 52399, 52405 (Aug. 7, 1980). *See supra* text accompanying notes 332-44 (detailing the allocation of expenses allocable to the rental use of the residence).

[348] I.R.C. § 280A(a), (d)(1), (e)(1).

cost if the dwelling unit constitutes a business activity[349] or an investment activity.[350] Nevertheless, the deductions are subject to the rules of I.R.C. section 183 if the "activity is not engaged in for profit."[351]

Enacted in 1969,[352] I.R.C. section 183 reflected the court decisions that denied deductions on the basis that the activity carried on by the taxpayer was not a business activity, but merely a hobby.[353] I.R.C. section 183 requires a facts and circumstances determination as to whether "the taxpayer entered into [an] activity, or continued [an] activity, with the objective of making a profit."[354] The Treasury Regulations list nine relevant, nonexclusive factors to consider and weigh in determining whether an activity is engaged in for profit.[355] Courts often look to the predominant purpose of the taxpayer in applying the weighing process,[356] with greater weight given to objective facts than to the statement of the taxpayer's intent.[357] I.R.C. section 183 also contains a rebuttable presumption that the activity is engaged in for profit if the activity was profitable for three years in the preceding five-year period.[358] Similar to I.R.C. section 280A, if an

[349] I.R.C. § 162(a)(3); I.R.C. § 167(a)(1) (2006). *See* I.R.C. § 168.

[350] I.R.C. § 212(1)-(2); I.R.C. § 167(a)(2). *See* I.R.C. § 168.

[351] I.R.C. § 183(a) (2006). "An activity is not engaged in for profit" if deductions under I.R.C. § 162 (trade or business) or I.R.C. § 212 (for production of income) would not be allowable. I.R.C. § 183(b) (2006). I.R.C. § 183 applies to individuals, S corporations, estates and trusts. I.R.C. § 183(a) (2006); Treas. Reg. § 1.183-1(a) (1972). I.R.C. § 183 has also been extended to partnership activities. Brannen v. Comm'r, 78 T.C. 471, 499-500 (1982), *aff'd*, 722 F.2d 695, 706 (11th Cir. 1984).

[352] *See* 10 AM. JUR. 2D *Proof of Facts* § 165 (1976); George Carey & Thomas J. Gallagher, Jr., *Requisite Greed: The Section 183 Regulations*, 19 LOY. L. REV. 41, 41 (1973).

[353] S. REP. NO. 91-552, at 103 (1969).

[354] Treas. Reg. § 1.183-2(a) (1972).

[355] Treas. Reg. § 1.183-2(b) (1972). The relevant factors are: "(1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; (9) the elements of personal pleasure or recreation." *Id.* No one factor is determinative, nor are the nine listed factors necessarily the only factors to be considered. *Id.*

[356] BURKE & FRIEL, *supra* note 82, at 483. *But see* Faulconer v. Comm'r, 748 F.2d 890, 895-96 n. 10 (4th Cir. 1984) (failing to decide whether the taxpayer must have a "primary" or "predominate" purpose of making a profit under I.R.C. § 183).

[357] Treas. Reg. § 1.183-2(a) (1972); Dreicer v. Comm'r, 78 T.C. 642 (1982).

[358] I.R.C. § 183(d) (2006); Treas. Reg. § 1.183-1(c)(1)(ii) (1972). In the case of an activity which consists in major part of breeding, training, showing, or racing

activity is determined not to have been engaged in for profit, I.R.C. section 183 allows the taxpayer to deduct business expenses, but subject to an overall limitation of the amount of income generated by the activity.[359] I.R.C. section 183 does not provide for the carryover of any unused deductions.[360]

The complex rules of I.R.C. section 280A with respect to vacation homes have been summarized as follows:

> Thus, the statute in effect creates specific rules for four different situations: (1) If the *rental* use is less than 15 days, there is no income inclusion and no deduction (except for qualified home mortgage interest, etc.); (2) if the *rental* use is 15 days or more and personal use is greater than 14 days or 10 percent of the rental period, then expenses are prorated between rental and personal use *and* deductions are limited to the income which the property generates; (3) if the *rental* use is 15 days or more and the *personal* use is insufficient to trigger § 280A, then expenses are prorated between rental and personal use, but deductions in excess of income may be allowed; and (4) if the *rental* use is 15 days or more and there is no *personal* use, all deductions are fully allowable, subject only to limitation under § 183 if a profit-seeking motive is not present, though this situation would be unlikely.[361]

E. Revenue Procedure 2008-16—Safe Harbor for Determining Whether a Vacation Home Qualifies under I.R.C. section 1031

In *Moore v. Commissioner*, the Tax Court held that the vacation homes exchanged by the taxpayers did not constitute properties held for investment as required by I.R.C. section 1031 because the primary motive of the taxpayers for holding the properties was for personal use

horses, a rebuttable presumption that the activity was engaged in for profit if the activity was profitable for two years in the seven-year period ending with the taxable year. I.R.C. § 183(d); Treas. Reg. § 1.183-1(c)(1)(i) (1972). No inference that the activity is not engaged in for profit will arise by reason of the taxpayer not meeting the presumption under I.R.C. § 183(d). Treas. Reg. § 1.183-1(c)(1)(ii) (1972).

[359] I.R.C. § 183(b)(2); Treas. Reg. § 1.183-1(b)(1) (1972). If the taxpayer engages in several activities, each activity must be tested separately as to a profit motive. Treas. Reg. § 1.183-1(d) (1972).

[360] I.R.C. § 183(b)(2); Treas. Reg. § 1.183-1(b)(1) (1972).

[361] MCDANIEL, MCMAHON, JR., SIMMONS & POLSKY, *supra* note 55, at 621.

and not for appreciation in value.[362] Following *Moore*, the Treasury Inspector General for Tax Administration (TIGTA) issued a report recommending greater oversight of like-kind exchanges to ensure taxpayer compliance.[363] The TIGTA report also recommended that the guidance provided by the Internal Revenue Service in forms, instructions, and publications, be revised to provide consistent and adequate information to taxpayers engaging in like-kind exchanges.[364] Finally, the TIGTA report recommended that additional guidance be provided to taxpayers regarding the rules and regulations governing like-kind exchanges with respect to second and vacation homes that are not used exclusively by owners.[365]

The TIGTA report noted that the rules and regulations governing the like-kind exchange of second and vacation homes not used exclusively by owners are complex and that little exists with respect to a published position by the Internal Revenue Service on like-kind exchanges involving such properties.[366] The TIGTA report stated "in our opinion, the absence of clarification on this issue leaves unrebutted the sales pitch of like-kind exchange promoters who may encourage taxpayers to improperly claim deferral of capital gains tax by selling non-qualifying second and vacation homes through 'tax-free' exchanges."[367]

In pursuit of such clarification, Revenue Procedure 2008-16 was issued shortly after the publication of the TIGTA report.[368] Revenue Procedure 2008-16 provides a safe harbor under which the Internal Revenue Service will not challenge whether a second or vacation home qualifies as property held for productive use in a trade or business or for investment for the purposes of I.R.C. section 1031.[369]

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[362] Moore v. Comm'r, T.C.M. (RIA) 2007-134, at 13 (2007). *See supra* text accompanying notes 135-51 (discussing the facts and holding of *Moore v. Comm'r*).

[363] TREASURY INSPECTOR GEN. FOR TAX ADMIN., LIKE-KIND EXCHANGES REQUIRE OVERSIGHT TO ENSURE TAXPAYER COMPLIANCE 3 (2007), *available at* http://treas.gov/tigta/auditreports/2007reports/200730172fr.pdf. Recommendation #1 of the TIGTA report was for the Internal Revenue Service to conduct a study of "issue-related returns" to determine what data should be captured in future National Research Programs in order to ensure appropriate oversight of taxpayer compliance with the tax laws pertaining to like kind exchanges.

[364] *Id.* at 5 (discussing Recommendation #2).

[365] *Id.* at 8 (discussing Recommendation #3).

[366] *Id.* at 6.

[367] *Id.*

[368] Borden & Hamrick, *supra* note 100, at 1260.

[369] Rev. Proc. 2008-16, 2008-1 C.B. 547. For the purposes of Revenue Procedure 2008-16, the term "dwelling unit" means "real property improved with a house, apartment, condominium, or similar improvement that provides basic living

The safe harbor applies if a personal-use residence satisfies "the qualifying use standards, which include holding period requirements, rental requirements, and personal-use limitations."[370] Generally, personal use is defined as any day the dwelling unit is used by the taxpayer, any member of the taxpayer's family, or any other person if the dwelling unit is not rented at a fair rental.[371] "Whether a dwelling unit is rented at a fair rental is based on all the facts and circumstances that exist" at the time the rental agreement is executed.[372]

The "qualifying use standard" applies to the relinquished property and the replacement property independently.[373] Therefore, the safe harbor provided in Revenue Procedure 2008-16 applies to a like-kind exchange "if either the relinquished property or the replacement property is a personal-use residence."[374] The relinquished property satisfies the qualified use standard if the following requirements are met: (1) the dwelling unit is owned by the taxpayer for at least twenty-four months immediately before the exchange (qualifying use period) and (2) within the qualifying use period, in each of the two twelve-month periods immediately preceding the exchange, the taxpayer rents the dwelling unit at a fair rental for at least fourteen days and the period of personal use by the taxpayer does not exceed the greater of fourteen days or ten percent of the number of days during the twelve-month period that the dwelling unit is rented at a fair rental.[375]

Applying the safe harbor to the replacement property, the replacement property satisfies the qualified use standard if the following requirements are met: (1) the dwelling unit is owned by the taxpayer for at least twenty-four months immediately after the exchange (qualifying use period) and (2) within the qualifying use period, in each of the two twelve-month periods immediately after the

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accommodations, including sleeping space, bathroom, and cooking facilities." *Id.* at 548.

[370] Borden & Hamrick, *supra* note 100, at 1260.

[371] For the purposes of the revenue procedure, "personal use" of a dwelling unit is defined under I.R.C. § 280A(d)(2) and (3), but not I.R.C. § 280A(d)(4). Rev. Proc. 2008-16, 2008-1 C.B. 548. *See also supra* text accompanying notes 263-67 (defining "personal use" for the purposes of I.R.C. § 280A).

[372] Rev. Proc. 2008-16, 2008-1 C.B. 547, 548.

[373] Borden & Hamrick, *supra* note 100, at 1260.

[374] *Id.* For example, if a personal-use residence that satisfies the qualifying use standards is exchanged for undeveloped land, the safe harbor will apply to the relinquished property and, if the transaction otherwise satisfies the requirements of I.R.C. section 1031, the exchange will qualify for nonrecognition treatment. *Id.*

[375] Rev. Proc. 2008-16, 2008-10 I.R.B. 547, 548. The first twelve-month period immediately preceding the exchange ends on the day before the exchange takes place, and the second twelve-month period ends on the day before the first twelve-month period begins. *Id.*

exchange, the taxpayer rents the dwelling unit at a fair rental for at least fourteen days and the period of personal use by the taxpayer does not exceed the greater of fourteen days or ten percent of the number of days during the twelve-month period that the dwelling unit is rented at a fair rental.[376] If the taxpayer reports on a federal income tax return a transaction as a like-kind exchange based on the expectation that the replacement property will meet the qualified use standard and subsequently determines that the replacement property does not meet the qualified use standard, the taxpayer must file an amended return.[377]

As stated, the TIGTA report expressed a concern that the lack of clarification by the Internal Revenue Service allows promoters to encourage taxpayers to improperly claim non-recognition of gain through like-kind exchanges:[378]

> Over the last few years, the concept and reality of "flipping" property throughout many parts of the country made like-kind exchanges popular with real estate speculators.
>
> . . . While the absence of guidance may be a more effective deterrent to abuse than publication of guidance, in this case, unscrupulous or uninformed promoters are already taking advantage of the IRS' silence. For example, one promoter advised that taxpayers could sell their vacation homes using like-kind exchanges even though the homes were never rented. The promoter indicated "attempts" to rent vacation homes could qualify these properties for like-kind exchanges and attempts could consist of placing advertisements in distant cities. More taxpayers may take the advice of these promoters if the IRS fails to provide adequate guidance.[379]

Revenue Procedure 2008-16 addresses these concerns by requiring that the personal-use residence relinquished be owned and rented for at least fourteen days during each of the two years immediately before the exchange, and that the replacement personal-use residence be owned and rented for at least fourteen days during each of the two

[376] *Id.* The first twelve-month period immediately after the exchange begins on the day after the exchange takes place, and the second twelve-month period begins on the day after the first twelve-month period ends. *Id.*

[377] Id.

[378] TREASURY INSPECTOR GEN. FOR TAX ADMIN., *supra* note 363, at 6-8.

[379] *Id.* at 7-8.

years immediately after the exchange.[380] Requiring the personal-use residence to be owned for at least twenty-four months prevents the taxpayer from "flipping" the property.[381] Further, requiring the personal-use residence to be rented for at least fourteen days during each two-year period prevents a taxpayer from satisfying the qualified use standard by renting, or attempting to rent, a personal-use residence for a short period immediately before an exchange or renting, or attempting to rent, a personal-use residence for a short period immediately after the exchange.[382] The qualifying use standard also greatly restricts personal use by the taxpayer in each of the two-year periods immediately before or after the exchange.[383] Nevertheless, if the taxpayer's primary purpose at the time of acquisition is to hold the residence for investment, the exchange may satisfy the requisite holding requirement of I.R.C. section 1031, even though the qualifying use standard established in the safe harbor is not satisfied.[384]

VI. **CONCLUSION**

The federal income tax law with respect to personal residences is extremely complex and uncertain. As stated in the TIGTA report, this complexity and uncertainty has resulted in noncompliance, either intentionally or inadvertently, by taxpayers and their advisors. This noncompliance is not limited to the exchange of second homes, but also extends to the exchange of residences used as principal residences and residences held for mixed personal and business purposes. By limiting the benefits of gain deferral to the exchange of properties held for productive use in a trade or business or for investment, the current law falls short of the economic realities and expectations of American taxpayers.

Amending I.R.C. section 1031 to include the exchange of personal-use real property would simplify this area of tax law and encourage investment in the residential real estate market. Certainly, to the extent a residence is used for personal purposes, any expenses or losses attributable to personal use should not be deductible, as such

[380] Rev. Proc. 2008-16, 2008-10 I.R.B. 547, 548.

[381] Borden & Hamrick, *supra* note 100, at 1261.

[382] *Id.*

[383] *See* Rev. Proc. 2008-16, 2008-10 I.R.B. 547, 548.

[384] Borden & Hamrick, *supra* note 100, at 1261-62. *See* Meltzer, *supra* note 140, at 268 (stating that, although Revenue Procedure 2008-16 provides additional guidance on the treatment of mixed-use properties, the Internal Revenue Service failed to "seize" the opportunity to define held "for investment" as it applies to mixed-use property for the purposes of I.R.C. § 1031).

costs represent personal consumption. If the personal residence is converted from personal use, or is used in part for a business or income-producing purpose, losses on the disposition of the residence, and expenses and depreciation deductions with respect to the business or income-producing use of the residence should continue to be carefully limited under I.R.C. sections 165(c), 183, and 280A. Further, I.R.C. section 121 should continue to limit the exclusion of gain on the disposition of a principal residence to the extent the residence is used for the production of income.

However, as I.R.C. section 1031 is only a tax-deferral section, upon the ultimate disposition of the property, the gain deferred in the exchange will be recognized. If the personal-use real property is not a principal residence, the unrecognized gain would be preserved in its entirety through the mechanism of the exchange basis as required by I.R.C. section 1031. For the purposes of a loss, the basis of the acquired residence would be the value of the relinquished residence on the date of the exchange as is the case with residences converted from personal use. If the residence qualifies as a principal residence under I.R.C. section 121, the current approach of integrating I.R.C. sections 121, 1033, and 1031 can be modified to preserve any gain not excluded under I.R.C. section 121 and exclude personal-use real property from boot received under I.R.C. section 1031.

In enacting I.R.C. section 1031, Congress was primarily concerned with the inequity of forcing a taxpayer to recognize theoretical gains while the unliquidated investment of the taxpayer continued in property of like kind. Throughout the last century, the definition of the term “like kind” has been broadly interpreted as it applies to real property, resulting in a broad interpretation of what constitutes a continuation of investment as applied to real property. Cases involving the exchange of real property have also resulted in a broad interpretation of the term “exchange,” culminating in the codification of the deferred exchange. In a structure designed to avoid constructive receipt of cash, I.R.C. section 1031 now permits a taxpayer to defer gain in a deferred exchange in which cash is received by a qualified intermediary if, at the direction of the taxpayer, the cash is reinvested in property of like kind. Allowing the exchange of personal-use real property is just one step further in the liberalization of I.R.C. section 1031 as it applies to real property. Such a result would also be a step towards vertical and horizontal equity in taxation, as most taxpayers, regardless of economic level, consider their personal residence an investment asset and, often, their only investment asset.