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Like-Kind Exchanges of Personal-Use Residences

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The law governing section 1031 exchanges of personal-use residences ranges from very explicit, in the case of principal residences, to very vague, in the case of mixed-use second homes. The law excludes from section 1031 nonrecognition exchanges of property used solely for personal use. The IRS has provided guidance regarding exchanges of mixed-use principal residences and has provided an all-or-nothing safe harbor with limited applicability for exchanges of mixed-use second homes. To complete the body of law governing exchanges of personal-use residences, this article suggests that the IRS should provide broader guidance for exchanges of mixed-use second homes.

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I. Introduction

Recent government activity has drawn attention to exchanges of vacation and second homes (hereinafter referred to collectively as second homes) that owners report under section 1031. The IRS, and many practitioners, believe that many such transactions do not qualify for section 1031 nonrecognition. Owners who outgrow a beach home, for example, might sell it for a nice gain and reinvest the proceeds in a home in the mountains. Reading section 1031 liberally, they could take the position that they held the beach home for business use or investment and acquired the mountain home to hold for business use or investment, thus satisfying the section 1031 use requirement. Some of those owners gave little thought to whether the sole use of the home during their ownership was personal, while other owners may have nominally leased the home to third parties in an attempt to satisfy the use requirement. Other owners clearly have held second homes for dual personal and rental purposes. Although the exchange of the property may qualify for section 1031 nonrecognition, existing authority has provided little guidance on the issue.

In Rev. Proc. 2008-16, the IRS provides a safe harbor for exchanges of second homes. The question addressed in the revenue procedure is under what circumstances ''a dwelling unit qualifies as property held for productive use in a trade or business or for investment for purposes of section 1031 of the Internal Revenue Code.''[1] The revenue procedure answers that question for a narrow class of exchanges. As a result, exchanges of second homes that do not come within the limited scope of the procedure depend on other section 1031 authority and theory. A fairly significant body of law addresses section 1031's application to exchanges of other types of personal-use residential property. The recent focus on exchanges of second homes provides a timely opportunity to discuss the broader topic of exchanges of personal-use residences and to consider Rev. Proc. 2008-16. The preeminent section 1031 question in every exchange of personal-use property is whether the property satisfies the use requirement.

II. The Use Requirement

The use requirement is one of three requirements an exchanger must satisfy to receive section 1031 nonrecognition.[2] To satisfy the use requirement, the exchanger

[1]Rev. Proc. 2008-16, 2008-10 IRB 547, section 1, *Doc 2008-3363*, *2008 TNT 33-12*.

[2]Recall that in addition to the use requirement, section 1031 includes the exchange requirement and the like-kind property requirement. *See* section 1031(a)(1). Because the use requirement

(Footnote continued on next page.)

must hold the relinquished property for productive use in a trade or business or for investment and acquire the replacement to hold for productive use in a trade or business or for investment.[3] Thus, for purposes of section 1031, a taxpayer who acquires property with the intent to sell that property or transfer it by gift does not satisfy the use requirement, even if selling or otherwise transferring the property is not part of the taxpayer's ordinary course of business.[4] This requirement raises four specific issues: (1) What constitutes business use or investment property? (2) When must an exchanger possess the requisite intent? (3) Must an exchanger hold property for a specific period of time to satisfy the use requirement? (4) Must an exchanger hold the relinquished and replacement property for the same purpose?

A. Business-Use and Investment Property

Case law helps establish the definition of business-use property and investment property by identifying property that does not qualify for section 1031 exchange treatment. In particular, court holdings show that property that is acquired for resale,[5] to be given as a gift,[6] or transferred to a charity[7] does not satisfy the qualified use requirement. Nonetheless, case law leaves some questions unanswered.

1. Business-use property. Section 1031 cases generally do not address whether property is business-use property. Section 1031(a)(1) refers to productive use in a trade or business, language similar to that used elsewhere in the code.[8] While language in other code sections generally does not specifically refer to the ''productive use'' of property, it does refer to use in a trade or business.[9] Nonetheless, taxpayers should be able to look to interpretations of these other provisions to gain an idea of the section 1031 definition of business-use property generally.

If the section 1031 reference to productive use has significance, the standard in section 1031(a)(1) is higher than the standard in other sections of the code. Although the code refers to productive use, a taxpayer who can establish that property is used in a trade or business should be able to show that the property was used productively.[10] If property is not used productively, perhaps the activity for which it is used is not a trade or business (perhaps the activity is a hobby, as discussed below). A trade or business is an activity engaged in for profit and would have no use for property that is not used productively.

A taxpayer is engaged in a trade or business if it is involved in the activity with continuity and regularity and the taxpayer's primary purpose for engaging in the activity is for income or profit.[11] A trade or business is distinguished from investment activities and activities engaged in for pleasure (hobbies) instead of profit.[12] Property used in the pursuit of a hobby would not qualify as business-use property. The regulations list several factors that may indicate whether the activity is

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is the preeminent issue in personal-use residence exchanges, this article limits its analysis to the use requirement. Portions of this section of the article on the use requirement are taken from Bradley T. Borden, ''Tax-Free Like-Kind Exchanges'' (Civic Research Institute 2008).

[3]Section 1031(a)(2)(A) specifically excludes ''stock in trade or other property held primarily for sale'' from qualifying for section 1031 treatment. This concept differs from the more narrow concept found in section 1221(a)(1), which excludes ''property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business'' from the definition of capital asset. *See* Borden, *supra* note 2, at para. 3.5[1][a] (discussing the disqualification of dealer property). *See also id*. at para. 7.2-7.3 (discussing the use requirement in the context of proximate business transactions, including exchanges followed by contributions to a separate tax entity, exchanges followed by distributions from a tax entity, contributions followed by exchanges, and distributions followed by exchanges).

[4]*See Black v. Commissioner*, 35 T.C. 90 (1960).

[5]*See Regals Realty Co. v. Commissioner*, 127 F.2d 931 (2d Cir. 1942) (holding that the resolution of a corporation's board of directors to sell replacement property two weeks after the corporation acquired it was evidence that the corporation acquired the property with the intent to resell it, not hold it for productive use in a trade or business or for investment).

[6]*See Click v. Commissioner*, 78 T.C. 225 (1982) (holding that the taxpayer did not intend to hold replacement properties for productive use in a trade or business or for investment where she allowed her adult children to move into residential replacement properties immediately on acquisition, allowed them to live in the houses rent free, allowed them to make improvements to the properties, and transferred titles to the properties to her children seven months after her acquisition).

[7]*See Lindsley v. Commissioner*, 47 T.C.M. (CCH) 540 (1983) (holding that a taxpayer's decision to transfer replacement property to a charity before the acquisition of the replacement property and the subsequent transfer demonstrated that the taxpayer did not acquire the property with the intent to hold it for productive use in a trade or business or for investment).

[8]*See, e.g.*, section 162(a) (allowing a deduction for the ordinary and necessary expenses incurred in carrying on a trade or business); section 167(a)(1) (allowing a depreciation deduction for specified property used in a trade or business); section 1221(a)(2) (excluding from the definition of capital asset property used in a trade or business); section 1231(b)(1) (defining property used in a trade or business as property subject to the depreciation allowance in section 167); and section 1033(h)(2) (defining property ''similar or related in service or use'' for purposes of section 1033(a) to include property held for productive use in a trade or business and property held for productive use in a trade or business or investment converted as a result of a presidentially declared disaster).

[9]*See* Borden, *supra* note 2, at para. 3.3[a][i], n. 136 (identifying only section 1033 as another code provision that refers to ''productive use'').

[10]*But see Sears Oil Co. v. Commissioner*, 359 F.2d 191 (2d Cir. 1966); *Carter-Colton Cigar Co. v. Commissioner*, 9 T.C. 219 (1947) (holding that the term ''used in'' in sections 167 and 1231 does not require that the property be actively and continuously employed).

[11]*Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987) (allowing a professional gambler to deduct some gambling expenses).

[12]*See* section 212 (allowing deductions for investment activities); Borden, *supra* note 2, at para. 303[2][a][ii] (discussing investment property in the section 1031 context); and section 183(b) (disallowing deductions for activities not engaged in for profit).

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engaged in for profit and not pleasure.[13] If a taxpayer can establish that an activity is a trade or business, any property used productively in that trade or business should be business-use property for section 1031 purposes.

Rental property will often be business-use property for purposes of section 162 and is commonly the subject of section 1031 exchanges. Several judicial decisions provide that renting real property is a trade or business if the owner provides management services.[14] Rental property that is not business-use property should qualify as section 1031 investment property.

2. Investment property. As with business-use property, the code, regulations, and case law do not specifically provide a section 1031 definition of investment property. In discussing the definition of like-kind property, the regulations state: ''Unproductive 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.''[15] The reference to holding property, as a person other than a dealer, for future realization hearkens to the definition of capital asset, which is important for taxpayers wishing to obtain favorable long-term capital gain treatment.[16] The definition of capital asset includes personal-use property, which section 1031 excludes,[17] so the definition of capital asset is too broad to define investment property for section 1031 purposes. A capital asset that is not personal-use property would, however, appear to satisfy the section 1031 definition of investment property.[18]

Section 1031 investment property should also include ''property held for the production of income,'' which is referred to elsewhere in the code.[19] Courts have interpreted such property to include rental real estate if the owner triple-net-leases the property and does not have to renegotiate the terms of the rental agreements very often.[20]

3. Personal-use property. The definition of property held for productive use in a trade or business or for investment does not include personal-use property.[21] Thus, a principal residence and other personal-use property will not qualify for section 1031 nonrecognition.[22]

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[13] *See* reg. section 1.183-2(b) (listing the following nine factors: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisers; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that the assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses on the activity; (7) the amount of occasional profits, if any, the taxpayer earns; (8) the financial status of the taxpayer; and (9) elements of personal pleasure or recreation); Boris I. Bittker, Martin J. McMahon Jr., and Lawrence A. Zelenak, *Federal Taxation of Individuals*, para. 13.09 (Warren, Gorham & Lamont of RIA, 3d Ed. 2002).

[14] *See, e.g.*, *Pinchot v. Commissioner*, 113 F.2d 718, 719 (2d Cir. 1940) (''What was done was more than the investment and re-investment of funds in real estate. It was the management of the real estate itself for profit. . . . It necessarily involved alterations and repairs commensurate with the value and number of buildings cared for and such transactions as were necessary to constitute a recognized form of business. The management of real estate on such a scale for income producing purposes required regular and continuous activity of the kind which is commonly concerned with the employment of labor; the purchase of materials; the making of contracts; and many other things which come within the definition of business.''); *Cecil v. Commissioner*, 100 F.2d 896 (4th Cir. 1939); *Gorod v. Commissioner*, 42 T.C.M. (CCH) 1569 (1981) (holding that a person who advertised rental property and kept it in rental condition, but could not rent the property, held the property for production of income and could deduct costs under section 212); *Francis v. Commissioner*, 36 T.C.M. 704 (1977) (holding that the property owner was in the trade or business of operating a rental apartment complex); and *Hazard v. Commissioner*, 7 T.C. 372 (1946) (holding that the property owner held rental property for use in a trade or business, even though business activity appears to have been minimal).

[15] Reg. section 1.1031(a)-1(b) (as amended in 1991).

[16] *See* section 1221(a)(1) (defining capital asset to exclude ''stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business''); section 1(h)(1)(C) (providing a favorable tax rate for net capital gain); and section 1222(11) (defining net capital gain as the excess of net long-term capital gain over the net short-term capital loss).

[17] *See* Borden, *supra* note 2, at para. 3.3[2][a].

[18] *But see Margolis v. Commissioner*, 337 F.2d 1001, 1004 (9th Cir. 1964). (''If the purpose of the acquisition and holding and the only manner in which benefit was to be realized from the property acquired was ultimate sale at a profit, its acquisition and holding by a dealer such as taxpayer must be considered to have been for sale to customers in the ordinary course of business.'')

[19] *See, e.g.*, section 167(a)(2) (allowing depreciation deductions for the cost of property held for the production of income); section 212(2) (allowing deductions for all the ordinary and necessary expenses paid or incurred ''for the management, conservation, or maintenance of property held for the production of income''); and *Margolis v. Commissioner*, 337 F.2d 1001, 1004 (9th Cir. 1964) (''On the other hand, income-producing property (or property potentially of that character) held not for purpose of sale but in order that gain may be realized from the income produced by it, is properly regarded as investment'').

[20] *See, e.g.*, *Grier v. United States*, 218 F.2d 603 (2d Cir. 1955) (holding that leasing property for a long period to a single tenant with minimal effort by the lessor is not a trade or business). A triple-net lease is a lease that requires the lessee to manage the property and cover all of the property's expenses. *Neill v. Commissioner*, 46 B.T.A. 197, 198 (1942) (''The mere ownership of property from which income is drawn does not constitute the carrying on of a business within the purview of [section 162]'') (*citing McCoach v. Minehill & Schuykill Haven R.R. Co.*, 228 U.S. 295 (1913); *Stafford Owners, Inc. v. United States*, 68 Ct. Cl. 478 (1930)).

[21] *See, e.g.*, *Starker v. United States*, 602 F.2d 1341, 1350-1351 (9th Cir. 1979) (''It has long been the rule that use of property solely as a personal residence is antithetical to its being held for investment. . . . A similar rule must obtain in construing the term 'held for investment' in section 1031''); *Click v. Commissioner*, 78 T.C. 225 (1982) (holding that an exchange for property used immediately by exchanger's adult children as residences did not qualify for section 1031 nonrecognition).

[22] *See Starker*, 602 F.2d at 1350-1351.

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B. Intent at the Time of Exchange

Whether property is business-use or investment property is measured at the time of the exchange.[23] An exchanger always intends to dispose of the relinquished property at the time of the exchange.[24] The purpose for which the exchanger held property before deciding to exchange it does reflect the exchanger's intent for relinquished property.[25] Courts have held in non-section 1031 contexts that property owners may change the purpose for which they hold property. Converting property from personal-use to business-use or investment property generally requires that the taxpayer rent the property or otherwise convert it to business-use or investment property.[26]

Following the acquisition of replacement property, a taxpayer may decide to dispose of the property or convert it to personal use. Such a sale or conversion may not adversely affect the section 1031 treatment of the exchange.[27] If an exchanger transfers or converts replacement property shortly after an exchange, it must be able to demonstrate that it made the decision to transfer or convert the property after the exchange was completed. The Tax Court has held that an exchanger demonstrated a subsequent intent to transfer property by showing that he did not talk to his accountant about the tax consequences of making the gift until after the exchange.[28]

A technique some exchangers used to convert gain deferred to gain exclusion was to acquire a residence, hold it for productive use in a trade or business (that is, rent it out), and then move into it. After living in the residence for two years, or long enough to obtain the needed gain exclusion, the exchanger would sell the property and exclude gain under section 121(a). Congress enacted legislation to help close this loophole. Now, section 121 does not apply to property acquired in a section 1031 exchange until five years after the acquisition of the property.[29]

C. No Holding Period Requirement

Unlike other provisions of the code,[30] section 1031 does not impose a holding period requirement. Thus, a taxpayer may acquire replacement property and dispose of it shortly after the acquisition without destroying the nonrecognition of the exchange.[31] A transfer immediately following an exchange may nonetheless be evidence that the exchanger did not intend to hold the property for productive use in a trade or business or for investment.[32] In such a situation, a taxpayer must be able to demonstrate that its intent changed following the exchange. Market conditions or the taxpayer's circumstances may change, or other business events may occur immediately following a transaction that would compel the exchanger to dispose of recently acquired replacement property. An example would be a taxpayer's relocation for employment following the acquisition of rental replacement property. Instead of retaining the property, the taxpayer may decide to dispose of it to avoid the problems of managing it after the relocation.

A taxpayer's long holding period before an exchange does not necessarily demonstrate the taxpayer's investment intent at the time of the exchange. For example, the Tax Court has held that a taxpayer who held property for 11 years before an exchange did not hold the property for

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[23] *See Magneson v. Commissioner*, 753 F.2d 1490, 1493 (9th Cir. 1985) (''To qualify for nonrecognition treatment under section 1031(a), the taxpayer must, at the time the exchange is consummated, intend to hold the property acquired for investment''); *Regals Realty Co. v. Commissioner*, 127 F.2d 931 (2d Cir. 1942) (holding that a taxpayer who transferred property immediately following an exchange did not intend to hold it for productive use in a trade or business or for investment at the time of the exchange).

[24] *See Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir. 1985) (holding that an exchange of property immediately after it was acquired from a corporation in a tax-free distribution qualified for section 1031 nonrecognition); *Coupe v. Commissioner*, 52 T.C. 394, 405 (1969). (''It is now well settled that when a taxpayer who is holding property for productive use in a trade or business enters into an agreement to sell the property for cash, but before there is substantial implementation of the transaction, arranges to exchange the property for other property of like kind, he receives the nonrecognition benefits of section 1031. *Coastal Terminals v. United States*, 310 F.2d 333 ([4th Cir.] 1963); James Alderson, 38 T.C. 215 (1962), *rev'd on other grounds* 317 F.2d 790 ([9th Cir.] 1963); *Carlton v. United States*, 385 F.2d 238 ([5th Cir.] 1967).'')

[25] *See, e.g., Neal T. Baker Enters., Inc. v. Commissioner*, 76 T.C.M. (CCH) 301 (1998) (holding that an exchanger who held property on its books for 11 years as inventory did not hold the property for productive use in a trade or business or for investment); Borden, *supra* note 2 at para. 303[2][c] (discussing the lack of importance of a holding period).

[26] *See, e.g., Cowles v. Commissioner*, 29 T.C.M. (CCH) 884 (1970) (holding that ''mere offers to sell or rent are insufficient to provide the necessary foundation for the deduction of a loss incurred in a 'transaction entered into for profit,' as required by section 165(c)(2)''); *Newcombe v. Commissioner*, 54 T.C. 1298 (1970) (holding that placing a former residence on the market for sale does not convert it to property held for production of income); and *Hazard v. Commissioner*, 7 T.C. 372 (1946) (holding that a taxpayer who rented out his former residence held it for use in a trade or business after renting it out).

[27] *See, e.g., Wagensen v. Commissioner*, 74 T.C. 653 (1980) (holding that the taxpayer satisfied the use requirement even though he transferred property by gift nine months after acquiring through an exchange); *Land Dynamics v. Commissioner*, 37 T.C.M. (CCH) 1119 (1978) (''[A] subsequent sale is not conclusive on the question of the primary purpose in acquiring

(Footnote continued in next column.)

and holding real estate.'') (quoting *Mun. Bond Corp. v. Commissioner*, 382 F.2d 184, 188 (8th Cir. 1967)).

[28] *Wagensen*, 74 T.C. at 659.

[29] *See* section 121(d)(10). *See also* Borden, *supra* note 2, at para. 9.2 (discussing exchanges of property used as a principal residence and for productive use in a trade or business and therefore qualifying for both section 121 gain exclusion and section 1031 gain deferral).

[30] *See, e.g.*, section 121 (providing a gain exclusion for property owned by the taxpayer for two years); section 1222(3) (defining long-term capital gain as gain from the sale of a capital asset held for more than one year).

[31] *See, e.g., Wagensen*, 74 T.C. 653.

[32] *See, e.g., Regals Realty Co. v. Commissioner*, 127 F.2d 931 (2d Cir. 1942) (holding that the decision to transfer replacement property within two weeks after the exchange showed the taxpayer's lack of intent to hold the property for productive use in a trade or business or for investment).

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productive use in a trade or business or for investment.[33] In that case, the taxpayer, a real estate developer, accounted for the property as work in progress on its books, even though it had made no significant effort to improve it during the 11 years preceding the exchange.[34] Having reviewed the use requirement, the analysis now considers how it applies to personal-use residences.

III. Exchanges of Residential Property

Rev. Proc. 2008-16 is one of several authorities that address exchanges of personal-use residences. Before the publication of Rev. Proc. 2008-16, the IRS and courts had considered section 1031's application to exchanges of property used solely as a principal residence and mixed-use property used concurrently as a principal residence and for business purposes. Rev. Proc. 2008-16 adds to the body of law regarding exchanges of residential property by considering section 1031's application to second homes.

A. Exchanges of Principal Residences

In Rev. Rul. 1959-229, the IRS ruled that section 1031 does not apply to exchanges of principal residences and that old section 1034 governed those transactions.[35] Twenty years later, the Ninth Circuit in *Starker v. United States* held that "it has long been the rule that use of property solely as a personal residence is antithetical to its being held for investment."[36] In *Click v. Commissioner*, the court held that residential property acquired for personal use by the taxpayer's children did not qualify for section 1031 nonrecognition.[37] Thus, section 1031 does not apply to exchanges of principal residences.

B. Exchanges of Mixed-Use Residential Property

In Rev. Proc. 2005-14, the IRS said that it will apply both sections 121 and 1031 to mixed-use property exchanges.[38] The revenue procedure provides three rules for computing gain on the exchange of mixed-use property.[39] First, the revenue procedure requires the property owner to apply section 121 before applying section 1031.[40] Second, although section 121 does not apply to gain attributable to depreciation deductions taken after May 6, 1997, section 1031 may apply.[41] Third, boot received by the property owner affects the property owner's gain recognized only to the extent it exceeds the gain section 121 excludes.[42]

In computing the basis of replacement property, owners treat any gain excluded under section 121 as gain recognized, which increases the property's basis.[43] The revenue procedure thus provides a simple explanation of the rules, but provides somewhat complicated examples to demonstrate their application. The manner in which the IRS will simultaneously apply the rules depends to a large extent on whether the residence and business-use property were part of a single edifice and whether the use was concurrent.

1. Business-use property separate from residence. As a general rule, if a principal residence and business-use property are physically separated, the IRS will treat an exchange of that property for other mixed-use property as two different exchanges. For example, assume that Trent owns TCI Estate, a piece of property with a house and a guesthouse.[44] Trent uses the house as a principal residence and the guesthouse as a business office. Trent allocates the basis of TCI Estate two-thirds to the house and one-third to the guesthouse. Trent paid $210,000 for TCI Estate and has taken $30,000 of depreciation deductions for the guesthouse.

Trent exchanges TCI Estate for Residence and Business Office. The fair market value of Residence is $240,000, and the FMV of Business Office is $120,000. The revenue procedure treats the transaction as two separate exchanges: the exchange of the TCI house for Residence and the exchange of the TCI guesthouse for Business Office.

a. Exchange of residences. On the exchange of residences, Trent will be deemed to receive Residence for the house on TCI Estate. His amount realized will be the FMV of Residence or $240,000. Two-thirds of the basis in the TCI Estate is $140,000 ($210,000 x 2/3). Thus, Trent will realize $100,000 of gain on the exchange of the TCI house.

Under Rev. Proc. 2005-14, Trent will recognize none of that $100,000 of gain because the amount is less than the section 121 $250,000 exclusion limit. Because Rev. Proc.

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[33] *See Margolis v. Commissioner*, 337 F.2d 1001, 1004 (9th Cir. 1964) ("Where one is engaged in the business of buying and selling real estate on as broad a basis as was taxpayer, the fact that property was acquired with the intention of holding it for a substantial period of time before sale, is not sufficient to constitute an investment"); *Stockton Harbor Indus. Co. v. Commissioner*, 216 F.2d 638, 655 (9th Cir. 1954) ("The fact that the final sale did not occur for many years afterwards . . . does not invalidate the conclusion of the Tax Court that the property was held for sale to customers in the ordinary course of trade"); and *Neal T. Baker Enters., Inc. v. Commissioner*, 76 T.C.M. (CCH) 301 (1998); *Land Dynamics v. Commissioner*, 37 T.C.M. (CCH) 1119 (1978). ("However the fact that land was held for many years does not establish an intention to hold the property for investment rather than sale.")

[34] The taxpayer's activity was limited to taking steps to record a plat and to lock in lower city development fees.

[35] Section 1034 is the predecessor to current section 121. Both sections address tax treatment involving the disposition of taxpayer principal residences.

[36] *Starker v. United States*, 602 F.2d 1341, 1350 (9th Cir. 1979).

[37] *See* 78 T.C. 225 (1982).

[38] *See* Borden, *supra* note 2, at para. 9.2 (discussing mixed-use property exchanges in detail).

[39] *See* Rev. Proc. 2005-14, section 4.01. Portions of this section of the article come from Borden, *supra* note 2, para. 9.2.

[40] *See* Rev. Proc. 2005-14, section 4.02(1).

[41] *See* Rev. Proc. 2005-14, section 4.02(2) *citing* code section 121(d)(6) for the inapplicability of section 121 to gain attributable to depreciation deductions.

[42] *See* Rev. Proc. 2005-14, section 4.02(3).

[43] *See* Rev. Proc. 2005-14, section 4.03 *citing* code section 1031(d) for rules regarding the computation of basis in property received in an exchange. *See* Borden, *supra* note 2, at para. 2.4 (discussing the section 1031(d) basis rules).

[44] This is a version of the example in Rev. Proc. 2005-14, section 5, Example 2.

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Amount Realized	
FMV of Residence	$240,000
Cash	$0
Amount realized	$240,000
Adjusted Basis	
Basis of relinquished house (2/3 of $210,000)	$140,000
Depreciation	$0
Adjusted basis	($140,000)
Gain	
Gain realized	$100,000

2005-14 treats the exchange of the house and the guesthouse as two different transactions, the section 121 exclusion applies only to the gain realized on the exchange of the TCI house. Trent would take a basis in Residence of $240,000, its FMV.[45]

Section 121 exclusion $100,000

Basis in replacement residence $240,000 (FMV)

b. Exchange of business-use property. The portion of the exchange involving the TCI guesthouse and Business Office will not qualify for section 121 exclusion because Trent did not use the guesthouse as a principal residence. Thus, Trent will have to recognize gain on that transaction unless it qualifies for section 1031 nonrecognition.

In exchange for the TCI guesthouse, Trent received Business Office worth $120,000, which will be his amount realized on this part of the transaction. His cost basis in the guesthouse portion of TCI Estate is $70,000 ($210,000 x 1/3). He has taken $30,000 of depreciation on that property, so his adjusted basis in the guesthouse portion of TCI Estate is $40,000. Thus, Trent will realize $80,000 of gain on the exchange of the guesthouse portion of TCI Estate.

Amount Realized	
FMV of Business Office	$120,000
Cash	$0
Amount realized	$120,000
Guesthouse Adjusted Basis	
Basis of relinquished office (1/3 of $210,000)	$70,000
Depreciation	($30,000)
Adjusted basis	($40,000)
Gain	
Gain realized	$80,000

Because Rev. Proc. 2005-14 separates this transaction from the disposition of the principal residence, Trent will defer this gain under section 1031. Trent will take a section 1301(d) exchanged basis in Business Office. Because Trent did not recognize gain or loss on the exchange and did not receive boot, he will not adjust the basis. Further, he will not adjust the exchanged basis to account for the section 121 exclusion because Rev. Proc. 2005-14 treats the section 121 transaction as a separate transaction.

1031 deferral $80,000

Basis in Office Building $40,000

2. Multiple uses of a single building. If a property owner uses a single piece of property as a principal residence and for business purposes, Rev. Proc. 2005-14 will apply to any gain realized on the exchange of such property. The revenue procedure provides several examples of exchanges of a single building used for dual purposes. The following example illustrates the IRS's treatment of an exchange of a single piece of mixed-use property for a single piece of mixed-use property. The treatment varies to some extent if the exchanger also receives boot.[46]

Tara owns House, a single-family house. Tara uses two-thirds of House as a principal residence and one-third as a business office.[47] Tara paid $210,000 for House and has claimed $30,000 of depreciation deductions for the portion she uses as a business office. Tara exchanges House for two properties: Residence worth $240,000 and Business Office worth $120,000. The revenue procedure bifurcates the transaction into two integrated exchanges.

Section 121 applies to the portion of the transaction treated as an exchange of residences. For that portion of the transaction, Tara is treated as receiving Residence for two-thirds of House. Her adjusted basis in two-thirds of House is $140,000 ($210,000 x 2/3). In exchange for that portion of House, she receives Residence, which is worth $240,000. Thus, Tara realizes $100,000 of gain on the exchange.

Amount Realized	
FMV of Residence	$240,000
Cash	$0
Amount realized	$240,000
Adjusted Basis	
Basis in residential portion (2/3 of $210,000)	($140,000)
Gain	
Gain realized on residential portion	$100,000

The revenue procedure treats Tara as receiving Business Office in exchange for one-third of House. Tara's cost basis in that one-third portion of House is $70,000 ($210,000 x 1/3), and that amount is adjusted by the $30,000 of depreciation deductions she has taken. Tara therefore has a $40,000 adjusted basis in the one-third portion of House. In exchange for that property, she will receive Business Office worth $120,000. Therefore, she will realize $80,000 of gain on the exchange.

Under Rev. Proc. 2005-14, Tara will apply section 121 to all of the gain realized, but she cannot apply it to any

[45]*See* Borden, *supra* note 2, at para. 2.4 (discussing basis computation in property exchanges).

[46]*See* Rev. Proc. 2005-14, section 5, Example 4; Borden, *supra* note 2, at para. 9.2[4][c].

[47]This is a version of the example in Rev. Proc. 2005-14, section 5, Example 3.

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Amount Realized	
FMV of Business Office	$120,000
Cash	$0
Amount realized	$120,000
Adjusted Basis	
Basis in office portion (1/3 of $210,000)	$70,000
Depreciation	($30,000)
Adjusted basis	($40,000)
Gain	
Gain realized on office portion	$80,000

portion of the gain attributable to depreciation deductions. Total gain realized is $180,000 ($100,000 from the residential portion of House and $80,000 from the business-use portion of House). Of that amount of gain realized, $30,000 is attributable to depreciation. Therefore, section 121 can apply only to $150,000 of the gain realized. Tara will take a basis in Residence equal to its FMV.

Section 121 exclusion $150,000

Basis in Residence $240,000

Section 1031 will apply to the $30,000 of gain attributable to depreciation, so Tara will defer that amount of gain realized. Tara's basis in Business Office will equal her $40,000 exchanged basis plus the section 121 exclusion of gain from the exchange of the business-use portion of House. Thus, she will take a $90,000 basis in House.

Section 1031 Deferral	
Deferred gain	$30,000
Basis in Business Office	
Exchanged basis	$40,000
Section 121 exclusion	$50,000
Basis	$90,000

Increasing the basis of House by the amount of the section 121 exclusion preserves the exclusion. If Tara were to immediately dispose of Business Office for $90,000, she would recognize only $30,000 of gain, the amount section 1031 deferred.

3. Residential property converted to rental property. The IRS allows taxpayers who convert residential property to rental property to apply sections 121 and 1031 to the extent they apply. For example, Tapioca, an unmarried individual, owns and uses House as a principal residence long enough to satisfy the section 121 ownership and use requirements.[48] Tapioca then converts the house to rental property and rents it for two years, claiming $20,000 in depreciation. Tapioca exchanges the house for $10,000 of cash and Town House worth $460,000. At the time of the exchange, Tapioca had an adjusted basis in House of $190,000. Tapioca realizes $280,000 of gain on the transaction.

Amount Realized	
FMV of Town House	$460,000
Cash	$10,000
Amount realized	$470,000
Adjusted Basis	
Basis in converted property	$210,000
Depreciation after conversion	$20,000
Adjusted basis	($190,000)
Gain	
Gain realized	$280,000

Because Tapioca had used House for two years during the five-year period preceding the transfer, the gain from the sale of House qualifies for section 121 exclusion. Because Tapioca was leasing House at the time she sold it and acquired like-kind property to use in a trade or business, the gain also qualifies for section 1031 nonrecognition. Section 121 excludes the gain up to the $250,000 limit, including the amount of boot Tapioca receives, but does not exclude any amount of gain attributable to depreciation deductions. Section 1031 defers gain not excluded by section 121, including the amount attributable to depreciation deductions.

Section 121 exclusion $250,000

(covers the $10,000 cash received)

Section 1031 deferral $30,000

(includes the $20,000 of depreciation)

Tapioca would use the section 1031(d) basis rules modified by Rev. Proc. 2005-14 to compute her basis in Town House. Thus, her basis in Town House would be House's exchanged basis, increased by excluded gain, and decreased by the cash she received.

Basis in Replacement Property	
Exchanged basis	$190,000
Excluded gain	$250,000
Cash received	($10,000)
Basis	$430,000

By adding the excluded gain to Tapioca's basis in Town House, Rev. Proc. 2005-14 preserves the section 121 exclusion. If Tapioca were to sell Town House immediately following the exchange, she would recognize $30,000 ($460,000 FMV of Town House minus Town House's $430,000 adjusted basis). If Tapioca had not added the $250,000 of excluded gain to her basis in Town House, on her subsequent disposition of the property, she would recognize $280,000 ($460,000 FMV of Town House minus Town House's hypothetical lower basis of $180,000). That result would be incorrect because it would have failed to exclude the section 121 gain. Thus, the basis rule in Rev. Proc. 2005-14 helps ensure the correct result.

Rev. Proc. 2005-14 is illuminating because it recognizes taxpayers' dual use of property. Although the IRS has not yet moved in that direction, it should recognize dual use of second homes.

[48]This is a version of the example in Rev. Proc. 2005-14, section 5, Example 1.

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C. Exchanges of Second Homes

A second home is any residential property the owner uses other than property that comes within the section 121 definition of principal residence. Second homes can include vacation homes the owners use only for short vacations and properties the owners stay in frequently, such as weekend homes or homes used regularly for extended periods.[49] *Moore v. Commissioner* directly addressed whether second homes satisfy the section 1031 use requirement.[50] In *Moore*, the taxpayers held a residential property exclusively for personal use as a weekend residence during the summer. The taxpayers never rented out the property or offered it for rent. They exchanged their original property for another residential property (the replacement second home) that was closer to their new principal residence. The taxpayers held the replacement second home exclusively for personal use and never rented it out or held it out for rent. The taxpayers claimed the exchange of the relinquished second home for the replacement second home qualified for section 1031 nonrecognition. The IRS challenged that position, arguing that neither the relinquished second home nor the replacement second home satisfied the section 1031 use requirement.

The Tax Court agreed with the IRS. The court considered the following factors: (1) the taxpayers did not rent or attempt to rent either the relinquished or replacement properties; (2) the taxpayers personally used relinquished and replacement properties frequently and exclusively; (3) the taxpayers significantly improved the properties and kept personal items (such as satellite TV systems and VHS recorders) in the homes for their personal use and benefit; (4) the taxpayers identified the properties as second residences to the lender; (5) the taxpayers did not maintain the relinquished second home after they ceased using it; and (6) the taxpayers did not treat the relinquished or replacement second homes on their tax returns as investment property.

Moore is significant because the court specifically reviewed various qualitative factors to determine whether a second home can satisfy the section 1031 use requirement. Even though *Moore* appears to be the first case to consider whether a second home can satisfy the section 1031 use requirement,[51] the holding is limited to its facts. Most commentators would agree that the taxpayers' nonrecognition position was very aggressive, given the law on exchanges of personal-use residences existing at the time of the exchange. The facts expose a potentially prevalent abuse of section 1031, and the limited scope of the case leaves questions unanswered.

Following *Moore*, the Treasury Inspector General for Tax Administration issued a report identifying section 1031 exchanges of personal-use residences as an area of potential taxpayer abuse.[52] The TIGTA report recommended the IRS act to stop taxpayers who "improperly claim deferral of capital gains tax by selling nonqualifying second and vacation homes through 'tax-free' exchanges."[53] The TIGTA report cites alleged planning strategies "pitched" to taxpayers. The alleged schemes include attempts to rent vacation homes and selling rental homes too quickly following acquisition or improvements by the taxpayer.[54] The TIGTA report concluded that the lack of clear guidance on second homes led to opportunities for promoters to exploit and abuse naïve or overaggressive property owners.

The IRS issued Rev. Proc. 2008-16 shortly after the publication of the TIGTA report. The revenue procedure provides a safe harbor for determining whether some personal-use residences satisfy the use requirement.[55] To come within the safe harbor, a personal-use residence must satisfy qualifying use standards. The qualifying use standards include holding period requirements, rental requirements, and personal-use limitations. The qualifying use standards apply independently to relinquished and replacement property. Thus, the revenue procedure applies if either the relinquished or replacement property is a personal-use residence. For example, an exchanger may transfer a house that satisfies the qualifying use standards for raw land, if the transaction otherwise satisfies the section 1031 requirements.

For relinquished property to satisfy the qualifying use standards under the safe harbor, the exchanger must have owned the relinquished property for the 24 months immediately preceding the exchange.[56] The qualifying use standards break the 24-month period into two consecutive 12-month periods. During each of those 12-month periods, the exchanger must have rented the relinquished property at fair rental to another person or persons for at least 14 days.[57] Finally, the qualifying use standards prohibit the exchanger from using the relinquished property for personal purposes during either

[49]*See* reg. section 1.121-1(b)(2) (discussing the definition of principal residence and listing factors to consider to characterize one of multiple personal-use properties as principal residence).

[50]*Moore v. Commissioner*, T.C. Memo. 2007-134.

[51]*But see* Borden, "Tax-Free Swaps: Using Section 1031 Like-Kind Exchanges to Preserve Investment Net Worth" 275-277 (2007) (discussing the possible adoption of section 280A for testing whether second homes satisfy the use requirement).

[52]TIGTA, *Like-Kind Exchanges Require Oversight to Ensure Taxpayer Compliance*, 2007-30-172 (Sept. 17, 2007), *available at* http://ustreas.gov/tigta/auditreports/2007reports/200730172fr.pdf.

[53]*Id.* at 6 (observing that the absence of clarification on the issue of exchanges of second homes leaves unrebutted the sales pitch of like-kind exchange promoters who suggest that exchanges of any second home may qualify for section 1031 nonrecognition).

[54]*Id*.

[55]2008-10 IRB 547, section 1. The IRS refers to the residences as "dwelling unit[s]" in the revenue procedure and defines dwelling unit as "real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including sleeping space, bathroom and cooking facilities." *See id.* section 3.01.

[56]*See id.* at section 4.02(1)(a).

[57]*See id.* at section 4.02(1)(b)(i). The revenue procedure provides that "whether a dwelling unit is rented at a fair rental is determined based on all of the facts and circumstances that exist when the rental agreement is entered into. All rights and obligations of the parties to the rental agreement are taken into account." *Id.* at section 4.04.

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12-month period for more than the greater of 14 days or 10 percent of the number of days the exchanger rented the property during the corresponding 12-month period.[58]

For replacement property to satisfy the qualifying use standards, the exchanger must own the replacement property for the 24 months immediately preceding the exchange.[59] Again, the qualifying use standards break that 24-month period into two consecutive 12-month periods. During each of those 12-month periods, the exchanger must rent the replacement property to another person or persons for at least 14 days, at fair rental.[60] Finally, the qualifying use standards prohibit the exchanger from using the replacement property during either 12-month period for more than the greater of 14 days or 10 percent of the number of days the exchanger rents the property at fair rental during the corresponding 12-month period.[61] An exchanger who anticipates that the replacement property will satisfy the qualifying use standards may report the exchange as a section 1031 nonrecognition transaction. If, following the exchange, the property does not satisfy the qualifying use standards, the revenue procedure suggests the exchanger must file an amended return, and not report the transaction under section 1031.[62] This reporting requirement is inconsistent with the safe harbor nature of the revenue procedure. An exchange that does not come within the safe harbor may nonetheless qualify for section 1031 nonrecognition, in which case the exchanger should report the transaction under section 1031 and not amend the earlier return.

The safe harbor in the revenue procedure modifies the section 280A limitation on deductions of costs related to property used for personal purposes. Recall that section 280A(d) provides that a taxpayer uses a residence for personal purposes during a tax year only if the personal use exceeds the greater of 14 days or 10 percent of the number of days during such year the taxpayer rents the property at FMV. Section 280A restricts personal use, but does not impose a minimum rental period as the IRS does in Rev. Proc. 2008-16. Apparently the modified limitation is in response to the TIGTA report, which recognizes that some taxpayers rent or attempt to rent second homes immediately before an exchange to convert them to property that satisfies the use requirement.[63] This type of deathbed conversion (that is, conversion before the passing of property) does not satisfy the Rev. Proc. 2008-16 safe harbor.

To come within the safe harbor, an exchanger must rent out personal-use property for at least 14 days during each of the two years immediately preceding the exchange. This prevents deathbed conversions by requiring exchangers to rent property for at least 14 days during the period that is more than 12 months before the exchange. Similarly, for replacement property to come within the safe harbor, the exchanger must rent it for at least 14 days during each of the two years immediately following the exchange. Thus, an exchanger who acquires property and only rents it for the two weeks immediately following an exchange does not satisfy the safe harbor requirements.

The safe harbor also uses an expanded version of the section 280A personal-use restrictions to prevent deathbed conversions. It restricts personal use in each of the two years before the exchange (in the case of relinquished property) and each of the two years following the exchange (in the case of replacement property). Thus, to come within the Rev. Proc. 2008-16 safe harbor, an exchanger can use the subject property only on a restricted basis for the 24 months before and after the exchange.

The TIGTA report also cites flipping as a significant section 1031 concern.[64] The 24-month holding requirement disqualifies flipped property from the Rev. Proc. 2008-16 safe harbor. This appears to be the first use of a fixed time period to determine whether property satisfies the use requirement. Congress proposed a 12-month holding period in 1989 legislation, but never enacted it into law.[65] To the extent that taxpayers wish an exchange to come within the Rev. Proc. 2008-16 safe harbor, they will have to satisfy the safe harbor's holding period requirements. The traditional intent-based analysis does not apply to exchanges that come within the safe harbor. The IRS cannot, however, change existing case law with a revenue procedure.

An example illustrates the application of an intent-based analysis. A taxpayer acquires a rental house as section 1031 replacement property. The taxpayer later fails to rent out the property because of deteriorating market conditions. Six months after acquiring the property, the taxpayer decides to sell and acquire an alternative investment asset or rental property in a new location

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[58]*See id.* at section 4.02(1)(b)(ii). The revenue procedure adopts a modified section 280A(d)(2) definition of personal use. *See id*. at section 4.03 (adopting the section 280A(d)(2) definition, taking into account section 280A(d)(3) but not section 280A(d)(4)).

[59]*See id.* at section 4.02(2)(a).

[60]*See id.* at section 4.02(2)(b)(i).

[61]*See id.* at section 4.02 (2)(b)(ii).

[62]*See id*. at section 4.05.

[63]*See* TIGTA report, *supra* note 53 at 7-8. (''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 rental advertisements in distant cities.'')

[64]*Id*. at 7. (''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. Some people may not understand the IRS rules governing such exchanges and may trust the advice of realtors who may not be well versed in tax law. In some instances amateurs buy and sell properties too quickly, running the risk that the IRS may deem the transaction a person's trade or business with the gains taxed as ordinary income and subject to self-employment taxes.'')

[65]H.R. Rep. No. 3150, section 11601, 100th Cong. 1st Sess (1989).

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to which the owner is moving. The taxpayer did not reside in or improve the rental house during the ownership period.

Because the taxpayer did not rent the rental house for at least 14 days in each of the two years following the exchange, the exchange will not come within the Rev. Proc. 2008-16 safe harbor. Nonetheless, the property should satisfy the use requirement. The taxpayer's intent at the time of the rental house acquisition is consistent with the use requirement, and the subsequent disposition due to changed circumstances should not jeopardize the exchange.[66] The revenue procedure's safe harbor does not create a new universal section 1031 holding period requirement. It provides guidance on particular types of personal-use residences. It also leaves unanswered several questions regarding exchanges of personal-use residences, especially exchanges of mixed-use second homes.

Lack of personal use will not qualify a property for the Rev. Proc. 2008-16 safe harbor. The revenue procedure specifically provides that the "Service will not challenge whether a dwelling unit . . . qualifies under section 1031 as property held for productive use in trade or business or for investment if the qualifying use standards . . . are met for the dwelling unit."[67] The qualifying use standard does not include a minimum personal-use exception. Thus, if a taxpayer intends to come within the safe harbor, the taxpayer must satisfy the safe harbor rental requirements even if the taxpayer has absolutely no personal use for the property. In that respect, the safe harbor is too narrow.

IV. Physical vs. Temporal Mixed-Use

One question that has persisted after the publication of Rev. Proc. 2008-16 is whether gain can be deferred, at least in part, if a taxpayer exchanges property that the taxpayer used for personal purposes for longer than the period allowed in the revenue procedure safe harbor.

In Rev. Proc. 2005-14 the IRS demonstrated that it comprehends the difference between physically differentiated mixed-use property (that is, property held for concurrent personal and business use)[68] and temporally differentiated mixed-use property (that is, property held at different times for different purposes).[69] The IRS showed that understanding for principal residences and applied sections 121 and 1031 to exchanges of that property. The IRS bifurcated those transactions when appropriate to produce the most correct tax result. The safe harbor in Rev. Proc. 2008-16 shows less sophistication, as the IRS adopts an all-or-nothing approach to second homes. The narrow scope of the Rev. Proc. 2008-16 safe harbor and its lack of sophistication may be the result of a hurried response to the TIGTA report. With more time, the IRS could produce guidance that recognizes temporally differentiated mixed-use second homes. Examples illustrate some possibilities.

Suppose Max and Ruby, a married couple, acquire Mountain Home for $120,000 as mixed-use property. They own Mountain Home for five years. During that period they use Mountain Home 200 days for personal purposes and rent it out for 1,000 days. On average, that comes to 40 days of personal use and 200 days of business use each year, or a 1:5 ratio of personal to rental use. After owning the property for those five years, Max and Ruby transfer it in exchange for Beachfront Home, which they will use approximately 40 days each year for personal use and rent out approximately 100 days each year. Beachfront Home is worth $300,000 on the date of the exchange.

Because Max and Ruby used Mountain Home for more than 10 percent of the number of days they rented the property out and will similarly use Beachfront Home, the Rev. Proc. 2008-16 safe harbor will not apply to either property. Nonetheless, the law should not preclude the application of section 1031. Max and Ruby held Mountain Home in part for business purposes, and they will also hold Beachfront Home in part for business purposes. The policy reasons that justify nonrecognition for property held exclusively for business purposes and partial nonrecognition for property held as both a principal residence and business-use property should apply equally to exchanges of property held for personal use and business use. In particular, not granting nonrecognition may discourage Max and Ruby from exchanging Mountain Home for Beachfront Home, resulting in lock-in.[70] Treating Max and Ruby differently from taxpayers who transfer a mixed-use principal residence or other business-use property also would violate equity and discourage investments in property that may include some personal use.[71] Section 1031 should apply to the exchange, at least to the extent both properties satisfy the use requirement.

Guidance in this area would have to provide standards for determining the purpose for which Max and Ruby held Mountain Home and the purpose for which they will hold Beachfront Home during periods of nonuse. A starting point of such an analysis is to consider the time during which Max and Ruby used Mountain Home for personal purposes and the time during which they rented it out. Thus, Max and Ruby used Mountain Home 200 days for personal purposes and 1,000 days for

[66]*Wagenson v. Commissioner*, 74 T.C. 653 (1980) (holding that the change of intent and transfer of replacement property within nine months after an exchange did not alter the exchanger's intent at the time of the exchange).

[67]Rev. Proc. 2008-16, section 4.01.

[68]*See supra* text accompanying notes 46-47 (describing the IRS's treatment of property held for concurrent use as a principal residence and for business purposes).

[69]*See supra* text accompanying note 48 (describing the IRS's treatment of principal residences converted to rental property).

[70]*See generally* Daniel N. Shaviro, "An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax," 48 *Tax L. Rev*. 1 (1992) (discussing the efficiency justification for nonrecognition in general and section 1031 specifically). Lock-in occurs when a property owner prefers not to sell property because the sale will trigger a tax and reduce the exchanger's net worth.

[71]*See* Borden, "The Like-Kind Exchange Equity Conundrum," 60 *Fla. L. Rev*. (forthcoming 2008), *currently available at* http://ssrn.com/article=1005384 (discussing the equity justification for section 1031 nonrecognition).

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business purposes. That accounts for 1,200 of the 1,826 days (taking into account one leap year) Max and Ruby held the property. Guidance should explain how to account for the remaining 626 days. An all-or-nothing approach for those days seems inappropriate, because Max and Ruby would have to use some of those days to maintain and repair the property preceding and following both personal and rental use. Dividing the 626 days in proportion to actual use should be appropriate. Thus, one-sixth of the 626 days should be treated as personal-use days and the remaining five-sixths as business-use days. Guidance should therefore bifurcate the exchange into a one-sixth personal-use property exchange and a five-sixths business-use property exchange.[72]

Under the bifurcation approach, Max and Ruby would recognize $30,000 (1/6 x ($300,000 amount realized over $120,000 basis)) of gain on the transaction. They would defer five-sixths, or $150,000, of gain under section 1031. To preserve that deferred gain, Max and Ruby should take a basis in Beachfront Home equal to the $120,000 basis they had in Mountain Home plus the $30,000 of gain they recognized on the exchange or a $150,000 basis.[73] This is similar to the rule the IRS adopted in Rev. Proc. 2005-14.[74]

Max and Ruby's exchange was fairly simple because it did not involve any boot and because the ratio of business-to-personal use was the same for both the relinquished and replacement properties. Any further guidance would have to address more complicated exchanges. If Max and Ruby had acquired Beachfront Home worth $240,000 and received $60,000 of cash in the exchange, they would have to account for that boot. In Rev. Proc. 2005-14, the IRS allocated boot received first to the section 121 portion of property and then to the section 1031 portion of property in the case of transfers of mixed-use single properties.[75] That treatment allows the taxpayer to exclude gain attributed to boot. Guidance could follow the standard set in Rev. Proc. 2005-14, in which the IRS allocates boot first to the personal-use portion of a residence and any remainder to the business-use portion.[76] Under such a rule, the entire $60,000 of Max and Ruby's boot would be allocated to the exchange of the personal-use portion of the house. Consequently, they would recognize the same $30,000 of gain, and defer $150,000 of gain in the business-use portion of the property.

Existing section 1031 principles should govern exchanges of property that have different personal-use-to-business-use ratios. For example, Syesha, an exchanger, transfers $50,000 of personal property and $250,000 of real property in exchange for $100,000 of personal property and $200,000 of real property. The transferred personal property is like-kind to the personal property received, and the transferred real property is like-kind to the real property received. The section 1031 regulations would treat that transaction as an exchange of $50,000 of personal property and an exchange of $250,000 of real property for $200,000 of real property and $50,000 of boot.[77]

Section 1031 could treat exchanges of mixed-use second homes similarly. For example, assume that Max and Ruby will use Beachfront Home one-third of the time for personal purposes and two-thirds of the time for business purposes. Under those assumptions, $100,000 of Beachfront House will be personal use and $200,000 will be business use. The law should treat them as exchanging $50,000 of personal-use property for $50,000 of personal-use property and $250,000 of business-use property for $200,000 of business-use property and $50,000 of personal-use property. The $50,000 of personal-use property received in exchange for the business-use portion of Mountain Home should be boot to Max and Ruby. Max and Ruby should recognize the $30,000 of gain on the exchange of the personal-use portion of the property and gain equal to the boot received ($50,000) on the exchange of the business-use portion of the property. Thus, they would recognize $80,000 of gain and defer $100,000 of gain. They would take a basis of $200,000 in the Beachfront Home.[78]

Guidance should also consider a minimum business-use requirement and generally limit the definition of business use to renting the property. A minimum business-use requirement would eliminate unjustified claims that the taxpayers held property for investment during periods they did not personally use the property. If the sole use of the property is personal, the time during which the property goes unused is merely a reservation for personal use and should be considered as such. Even though the property may appreciate considerably (and indicate a good investment), the exclusive personal use of it should deny it the benefits of section 1031.

Thus, by combining existing rules and sound tax policy, the IRS could provide broader guidance for mixed-use second homes. If carefully considered and equitably applied, the guidance would help stop abusive exchanges of second homes and apply section 1031

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[72]This is not the first time commentary has recommended bifurcating exchanges of mixed-use property. *See, e.g.*, Borden, *supra* note 52 at 276-277. In other contexts, commentators have also considered the merits of bifurcated section 1031 exchanges. *See, e.g.*, Kelly E. Alton, Bradley T. Borden, and Alan S. Lederman, "Related-Party Like-Kind Exchanges," *Tax Notes*, Apr. 30, 2007, p. 467, *Doc 2007-7797*, *2007 TNT 84-34* (describing possible bifurcation of related-party exchanges).

[73]*See* section 1031(d) (providing that basis in replacement property equals the basis the exchanger had in relinquished property increased by any gain the exchanger recognizes on the exchange).

[74]*See* Rev. Proc. 2005-14, section 4.03.

[75]*See* Rev. Proc. 2005-14, section 4.02(1).

[76]*See* Rev. Proc. 2005-14, section 4.02.

[77]*See* reg. section 1.1031(j)-1 (describing the tax treatment of multiple-property exchanges).

[78]The basis of Beachfront Home would include Max and Ruby's $120,000 basis in Mountain Home increased by the $30,000 of gain they would recognize on the exchange of the personal-use portion of Mountain Home and the $50,000 of gain they would recognize on the exchange of the business-use portion of Mountain Home. Because Beachfront Home is worth $300,000, the $200,000 basis would preserve the $100,000 of deferred gain.

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appropriately to qualifying exchanges by setting standards that go beyond mere safe harbor status and complement existing law. The guidance would also help conscientious taxpayers plan their affairs in a manner that complies with the law. They could then accurately and consistently report exchanges of mixed-use second homes. The guidance would also help curb miscreant reporting practices because return preparers would better understand the bounds of section 1031. The guidance would therefore help promote equity by establishing reporting guidelines that all could follow.

V. Conclusion

The body of law governing exchanges of personal-use residences continues to grow. The most recent additions to that body of law, Rev. Proc. 2008-16 and *Moore v. Commissioner*, address the proper tax treatment of exchanges of second homes. They fall short, however, of providing much-needed guidance on a broader range of exchanges of mixed-use second homes. The IRS should consider publishing additional guidance that will follow more closely the pattern it established for exchange of mixed-use principal residences. That guidance would help bring order to a chaotic area of the law.

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