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Blowing Hot and Cold at the Same Time: Section 1034 Rollover and Rental Deductions on Rental and Sale of Principal Residence

BLOWING HOT AND COLD AT THE SAME TIME: SECTION 1034 ROLLOVER AND RENTAL DEDUCTIONS ON RENTAL AND SALE OF PRINCIPAL RESIDENCE

Congress enacted section 1034 of the Internal Revenue Code (IRC) to protect a taxpayer's investment in his home.[1] Section 1034 provides for the nonrecognition[2] of any gain realized[3] from the sale of a taxpayer's principal residence[4] that the taxpayer applies to the purchase of a new principal residence

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1. I.R.C. § 1034 (West 1984); *see* H.R. REP. No. 586, 82d Cong., 1st Sess. 28, *reprinted in* 1951-2 C.B. 357, 377 [hereinafter cited as H.R. REP. No. 586]; S. REP. No. 781 (Part 2), 82d Cong., 1st Sess. 36, *reprinted in* 1951-2 C.B. 458, 482-83 [hereinafter cited as S. REP. No. 781]. Congress passed § 1034 of the Internal Revenue Code (IRC) to relieve the hardships on taxpayers who move or change residences and sell their old residences at a gain. *See* H.R. REP. No. 586, *supra*, at 377; S. REP. No. 781, *supra*, at 482. Congress determined that taking the gain a taxpayer realizes when he sells his residence may be especially burdensome when the taxpayer must move because of a change in employment or an increase in the size of the taxpayer's family. *See* H. R. REP. No. 586, *supra*, at 377; S. REP. No. 781, *supra*, at 482. Consequently, Congress passed IRC § 1034 which allows a taxpayer to defer recognition of gain realized from the sale of a taxpayer's principal residence provided the taxpayer applies the gain to the purchase of a new principal residence within two years.

2. *See* I.R.C. § 1034(a) (West 1984) (taxpayer does not recognize gain realized from sale of principal residence to extent taxpayer applies gain to purchase of new principal residence). Section 1034 provides that a taxpayer must include as income gain realized from the sale of the taxpayer's old principal residence only to the extent that the adjusted sales price of the old principal residence exceeds the purchase price of the new principal residence. *Id.; see* Occhipinti, 28 TAX CT. MEM. DEC. (CCH) 978, 983 (1969) (IRS required recognition of gain realized from sale of taxpayer's old principal residence because total gain realized was less than amount by which adjusted sales price of old residence exceeded purchase price of new residence). The adjusted sales price of a residence is the value of the money or property that the taxpayer received for the residence less any expenses the taxpayer incurred while preparing the residence for sale. *See* I.R.C. § 1034(b) (West 1984); *see also* Cramer v. Commissioner, 55 T.C. 1125, 1132 (1971) (taxpayer could deduct costs of painting and repairing residence before sale from amount taxpayer received from sale of residence to determine adjusted sales price or residence). Any gain realized from the sale of a taxpayer's principal residence that does not fall within § 1034's nonrecognition provision is capital gain that the taxpayer must report as income. *See* I.R.C. § 61(a)(3) (West 1984) (taxpayer's gross income includes gain taxpayer made from dealings in property); *Id.* § 1202 (taxpayer may deduct from gross income 60% of taxpayer's net capital gain); *infra* note 3 (determination of gain realized from sale of property); *infra* note 6 (rollover of nonrecognized gain into basis of new principal residence).

3. *See* I.R.C. § 1001(a) (West 1984). When a taxpayer sells or exchanges property, the gain realized from the sale or exchange of the property is the amount realized from the sale or exchange minus the adjusted basis for the property. *Id.* The amount realized from the sale or exchange of property is the total value of the money or property which the taxpayer receives in the sale or exchange. *Id.* § 1001(b). The adjusted basis for the property is the basis of the property less adjustments provided under § 1016. *See id.* § 1012 (basis of property is cost of property to taxpayer); *id.* § 1016 (items taxpayer must subtract from basis in determining adjusted basis for property).

4. *See* Jacobs v. United states, 65-1 U.S. Tax Cas. (CCH) ¶ 9120, at 94,571 (D. Minn. 1964). The court in *Jacobs v. United States* stated that a principal residence under § 1034 is the main residence where a taxpayer actually resides. *Id.; see* Stolk v. Commissioner, 40 T.C. 345, 351 (1963) (courts should apply ordinary meaning to terms "use," "principal" and "residence"

within two years of the date of sale of the old residence.[5] The IRC terms section 1034's nonrecognition of the gain realized from the sale of a taxpayer's principal residence as a "rollover" because section 1034 enables a taxpayer to continue his investment by applying the gain to the purchase of a new principal residence.[6] Although taxpayers who use residential property as a principal residence may claim section 1034 rollover of the gain realized from the sale of the property, taxpayers who use residential property in an activity for the production of income may claim deductions for expenses resulting from the activity.[7] Courts and the Internal Revenue Service (IRS) generally view rental of residential property as use of the residence for the production of income.[8] Deductions associated with the rental of a residence typically include

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in § 1034). For a residence to qualify as a taxpayer's principal residence under § 1034, a taxpayer must use the residence habitually as his principal residence. *See* Friedman v. Commissioner, 43 TAX CT. MEM. DEC. (CCH) 1009, 1013 (1982) (court held residence that taxpayer occupied during summer months of year was summer residence and not taxpayer's principal residence); *infra* notes 21-28 and accompanying text (determination of principal residence status under § 1034).

5. I.R.C. § 1034 (West 1984).

6. *Id.* A taxpayer "rolls-over" the gain realized from the sale of his old principal residence by subtracting the amount of the nonrecognized gain from the basis of the new principal residence. *Id.* § 1034(e); Treas. Reg. § 1.1034-1(e) (1956). Should a taxpayer later sell his new residence at a gain, the § 1034 reduction in the basis of the new residence will reflect the unrecognized gain from the old residence when the taxpayer computes and pays taxes on the gain realized from the sale of the new residence. *See* I.R.C. § 1016(7) (West 1984) (taxpayer shall deduct from basis of residence any gain not recognized under § 1034 for sale of taxpayer's previous residence).

7. *See* I.R.C. § 212 (West 1984) (taxpayer may deduct ordinary and necessary expenses attributable to management, conservation, or maintenance of property which taxpayer holds for production of income); *see, e.g.*, Jones v. United States, 279 F. Supp. 772, 778-79 (D. Del. 1968) (taxpayer may deduct as ordinary and necessary expense cost of maintaining access road to rental property); Hartford v. United States, 265 F. Supp. 86, 90 (W.D. Wis. 1967) (taxpayer may deduct as ordinary and necessary expenses legal fees and insurance premiums for rental property); Nelson v. Commissioner, 47 TAX CT. MEM. DEC. (P-H) ¶ 78,287, at 78-1191 (1978) (taxpayer may deduct as ordinary and necessary expenses costs of advertising and maintenance for condominium that taxpayer held for production of income); Ree v. Commissioner, 32 TAX CT. MEM. DEC. (P-H) ¶ 63,125, at 63-665 (1963) (court allowed taxpayer deductions for cost of repairs, electricity, and insurance as ordinary and necessary expenses for rental property); Tschupp v. Commissioner, 32 TAX CT. MEM. DEC. (P-H) ¶ 63,098 at 63-528 (1963) (court allowed taxpayer deduction for expenses of janitorial service that taxpayer's sons performed on rental property); Thornbrough v. Commissioner, 11 TAX CT. MEM. DEC. (CCH) 227, 227-28 (1952) (taxpayer may deduct sewer tax paid on property as ordinary and necessary expense of operating rental property). Taxpayers, however, may not claim as ordinary and necessary expenses the cost of making capital improvements to property. *See* I.R.C. § 263(a) (West 1984) (taxpayer may not deduct cost of new buildings or permanent improvements that taxpayer made to increase value of property); *see also* Wacker v. Commissioner, 49 TAX CT. MEM. DEC. (P-H) ¶ 80,324, at 80-1474 (1980) (court denied taxpayer deduction for cost of survey on income-producing property because survey was capital expenditure rather than ordinary and necessary expense); Perkins v. Commissioner, 11 TAX CT. MEM. DEC. (CCH) 532, 534-35 (1952) (court denied taxpayer deduction for cost of improvements taxpayer made to prepare upper floor of residence for renting because improvements were capital expenditures rather than ordinary and necessary expenses).

8. *See* Bolaris v. Commissioner, 81 T.C. 840, 849 (1983) (rental of former residence at fair market value suggests rental was activity for profit); Treas. Reg. § 1.212-(h) (1967) (taxpayer may deduct ordinary and necessary expenses arising from rental of property even though property was taxpayer's former residence). Although actual rental of property constitutes conversion of

expenses for insurance and maintenance of the property under section 212,[9] and for depreciation of the property under sections 167[10] and 168.[11] While a taxpayer may claim certain expense and depreciation deductions for residential property that the taxpayer uses for the production of income, section 262 prohibits the taxpayer from claiming these deductions for property that the taxpayer uses as his personal residence.[12] Consequently, taxpayers who rent their residences while trying to sell may make the seemingly inconsistent claims that the residence is not only the taxpayer's principal residence in order to claim section 1034 rollover, but also income-producing property for the purpose of

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the property into property that the taxpayer holds for the production of income, courts have held that merely offering the property for rent or sale also can convert residential property into property that the taxpayer holds for the production of income. *See* Briley v. United States, 189 F. Supp. 510, 515 (N.D. Ohio 1961) (taxpayer converted his former residence into property held for production of income by offering residence for rent or sale even though taxpayer never rented residence), *rev'd on other grounds*, 298 F.2d 161 (6th Cir. 1962); Sherlock v. Commissioner, 31 TAX CT. MEM. DEC. (CCH) 383, 385-86 (1972) (taxpayer converted his former residence into property held for production of income by offering property for rent or sale); Horrmann v. Commissioner, 17 T.C. 903, 907-08 (1951) (taxpayer converted residence into property held for production of income by offering property for rent even though taxpayers received no rental income); Robinson v. Commissioner, 2 T.C. 305, 307-08 (1943) (residence that taxpayers abandoned and offered for rent or sale was income-producing property even though taxpayers received no income from property).

A taxpayer, however, must make a good faith effort to rent the property before the mere offering of property for rent or sale acts to convert the property to property the taxpayer holds for the production of income. *See* Sherlock v. Commissioner, 31 TAX CT. MEM. DEC. (CCH) 383, 385-86 (1972) (taxpayer's offer to rent residential property must be bona fide offer to establish conversion of residence into property taxpayer holds for production of income). In contrast, a taxpayer who rents at below a reasonable rental value or below the fair market rental value of the property may not establish successfully that he holds the property for the production of income. *See* Jasionowski v. Commissioner, 66 T.C. 312, 323-24 (1976) (taxpayer who rented property at well below fair market value to help taxpayer's friend could not claim rental deduction); Nicath Realty Co. v. Commissioner, 35 TAX CT. MEM. DEC. (P-H) ¶ 66,246, at 66-1415 (1966) (court held taxpayer who rented residence to relatives at below fair market value could not claim rental deductions). *See generally* Byrne, *Conversion of A Personal Residence to a Business or Investment Use For Tax Purposes*, 8 RUT.-CAM. 393 (1977) (conversion of personal residence into property held for production of income).

9. *See* I.R.C. § 212 (West 1984) (taxpayer may deduct ordinary and necessary expenses attributable to management, conservation, or maintenance of property that taxpayer holds for production of income); *supra* note 7 (cases allowing taxpayers deductions for ordinary and necessary expenses attributable to rental property).

10. *See* I.R.C. § 167 (West 1984) (taxpayers may claim straight line depreciation deduction for reasonable exhaustion, and wear and tear of property that taxpayer used in trade or business or held for production of income).

11. *See id.* § 168 (accelerated cost recovery system for determining depreciation for property that taxpayer began using in trade or business or holding for production of income after January 1, 1981).

12. *See id.* § 262 (taxpayers may not claim deductions for personal, living or family expenses unless IRC provides otherwise); *see, e.g.*, Ullman v. United States, 33 AFTR (P-H) 1672, 1673-74 (S.D.N.Y. 1944) (court denied taxpayer maintenance and depreciation deductions for residential property when court found taxpayer used residence as home rather than for production of income); Gross v. United States, 51 AFTR 2d (P-H) ¶ 83-488, at 83-990 (C.D. Cal. 1982) (court denied taxpayer deduction for lawn maintenance of taxpayer's personal residence); Sheldon v. Commis-

claiming maintenance and depreciation under sections 212, and 167 or 168.[13] The factors which indicate that a residence is a taxpayer's principal residence, primarily occupancy of the residence by the taxpayer, suggest that the taxpayer is using the property personally and therefore not holding the property for the production of income.[14] The IRS contends that residential property can be either the taxpayer's principal residence or property which the taxpayer holds for the production of income, but not both at the same time.[15] Accordingly, the IRS maintains that a taxpayer who qualifies for section 1034 rollover on the gain realized from the sale of his former residence may not also claim deductions for maintenance and depreciation if he rented the residence prior to its sale.[16]

When Congress enacted section 1034, Congress intended that a temporary rental of a taxpayer's principal residence prior to sale should not render the rollover provisions of section 1034 automatically inapplicable to any gain realized from the sale.[17] Congress stated that although the term "principal residence" in section 1034 seemingly would exclude property held for the production of income, a taxpayer who temporarily rents his old principal residence prior to sale nevertheless may qualify for the section 1034 rollover provided the residence qualifies as the taxpayer's principal residence under section 1034.[18]

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sioner, 20 TAX CT. MEM. DEC. (CCH) 241, 244 (1961) (court denied taxpayer expenses incurred in changing rental property into personal residence because such expenses were personal living expenses); Ford v. Commissioner, 29 T.C. 499, 504 (1957) (taxpayer could not claim maintenance deductions for property which taxpayer occupied and held for rent simultaneously). Deductions for personal or family living expenses that the IRC allows are primarily interest payments, medical expenses, or payments for state and local taxes. *See* I.R.C. §§ 163, 164, 213 (West 1984).

13. *See* Bolaris v. Commissioner, 81 T.C. 840, 843-48 (1983) (taxpayer claimed residence was not only taxpayer's principal residence under § 1034 but also property taxpayer held for production of income under §§ 212 and 167).

14. *See* Maule, *Rental of Principal Residence Before Sale: Retaining 1034 Treatment & Rental Deductions*, 55 J. TAX'N 8, 10 (1981) (factors such as occupancy and personal use that indicate property is taxpayer's principal residence tend to show that taxpayer did not hold residence for production of income).

15. *See* Bolaris v. Commissioners, 81 T.C. 840, 848 (1983) (IRS argued that taxpayer did not hold property for production of income if property was taxpayer's principal residence); Private Letter Ruling No. 8132017 (April 30, 1981) (IRS denied taxpayer deductions attributable to rental of residence prior to sale when § 1034 applied to gain realized from sale); *see supra* notes 69-70 and accompanying text (IRS' argument in *Bolaris* that § 183 applies to limit presale rental expense deductions if § 1034 applies to sale of residence).

16. *See* Bolaris v. Commissioner, 81 T.C. 840, 848 (1983) (IRS contended that § 183 applied to limit deductions for presale rental of residence when § 1034 applied to gain realized from sale of residence).

17. *See* H.R. REP. No. 586, *supra* note 1, at 377, 436; S. REP. No. 781, *supra* note 1, at 483. Congress stated in the legislative history to § 1034 that a taxpayer could rent temporarily either the old residence before sale or the new residence before occupancy and still qualify for § 1034 treatment. H.R. REP. No. 586, *supra* note 1, at 377; S. REP. No. 781, *supra* note 1, at 483; *see* Treas. Reg. § 1.1034-1(c)(3) (1956) (that taxpayer has rented residence is not determinative of principal residence status under § 1034). *But see infra* note 18 and accompanying text (term "principal residence" in § 1034 ordinarily excludes property taxpayer holds for production of income).

18. *See* H.R. REP. No. 586, *supra* note 1, at 436; S. REP. No. 781, *supra* note 1, at 566.

Whether a residence constitutes a taxpayer's principal residence for purposes of section 1034 depends on the circumstances in each case, including the good faith of the taxpayer.[19] Therefore, rental of either an old principal residence prior to sale, or of a new principal residence prior to occupancy, is not determinative necessarily of whether a residence qualifies as a taxpayer's principal residence for purposes of claiming section 1034 rollover.[20]

Determination of principal residence status under section 1034 does not require actual occupancy of the old residence by the taxpayer at the time of sale.[21] Section 1034 provides that the taxpayer must sell his old principal residence within two years of the taxpayer's purchase and use of a new principal residence.[22] Courts generally require the taxpayer to have occupied the old principal residence and to have moved into the new principal residence within the two-year period.[23] Courts are reluctant to apply section 1034 to

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Under § 1034, property that the taxpayer rents or hold for the production of income is not a taxpayer's principal residence. *See* H.R. REP. No. 586, *supra* note 1, at 436 (Congress used term "principal residence" in § 1034 in contradistinction to property that taxpayer holds for production of income). Although Congress intended that property is not a principal residence if the taxpayer holds it for the production of income, Congress stated that a taxpayer who temporarily rents his old residence prior to sale, or the new residence prior to occupancy, still may qualify for 1034 rollover. *See* H.R. REP. No. 586, *supra* note 1, at 436; S. REP. No. 781, *supra* note 1, at 566; Treas. Reg. § 1.1034-1(c)(3) (1956) (taxpayer may rent temporarily new residence during period before he vacates old residence and still qualify for § 1034 nonrecognition of gain); *see, e.g.*, Clapham v. Commissioner, 63 T.C. 505, 511-12 (1975) (court held § 1034 applied to sale of old residence even though taxpayer temporarily rented residence prior to sale); Barry v. Commissioner, 40 TAX CT. MEM. DEC. (P-H) ¶ 71,179, at 71-793 to -794 (1971) (taxpayer's temporary rental of his old principal residence before sale did not bar application of § 1034 to gain realized); Trisko v. Commissioner, 29 T.C. 515, 518-20 (1957) (taxpayer may claim § 1034 rollover on gain realized from sale of residence when taxpayer temporarily rented residence prior to sale); *infra* notes 21-28 and accompanying text (determination of principal residence status under § 1034). *But see* Stolk v. Commissioner, 40 T.C. 345, 355 (1963) (residence that taxpayer rented before sale did not qualify as taxpayer's principal residence because taxpayer abandoned residence as his principal residence).

19. Aagaard v. Commissioner, 56 T.C. 191, 202 (1971) (whether residence is taxpayer's principal residence under § 1034 depends on facts and circumstances of each case); Houlette v. Commissioner, 48 T.C. 350, 354-55 (1967) (courts must determine principal residence status under § 1034 factually on case-by-case basis); Treas. Reg. § 1.1034-1(c)(3) (1956) (courts should determine principal residence status under § 1034 by examining facts of each case and good faith of taxpayer).

20. *See* Treas. Reg. § 1.1034-1(c)(3) (1956) (fact that taxpayer rented residence is not determinative of whether residence is taxpayer's principal residence under § 1034); *supra* note 18 (courts that applied § 1034 to gain realized from sale of residences that taxpayers rented prior to sale).

21. *See* Aagaard v. Commissioner, 56 T.C. 191, 202 (1971) (court stated that taxpayer need not occupy his old residence upon its sale to qualify for § 1034 rollover); Houlette v. Commissioner, 48 T.C. 350, 354-56 (1967) (§ 1034 does not require that taxpayer actually occupy his old residence at time of sale); Trisko v. Commissioner, 29 T.C. 515, 518-19 (1957) (taxpayer may claim § 1034 rollover on gain realized from sale of residence even though taxpayer did not occupy old residence on date of sale); *see also* Treas. Reg. § 1.1034-1(c)(3) (1956) (taxpayer need not occupy old residence at time of sale to qualify for § 1034 nonrecognition of realized gain).

22. I.R.C. § 1034(a) (West 1984).

23. *See* Stolk v. Commissioner, 40 T.C. 345, 355 (1963) (court denied taxpayer nonrecognition of gain realized from sale of residence when taxpayer had not occupied old residence within

the sale of a residence that a taxpayer has left vacant for more than two years before the purchase of a new principal residence because a taxpayer may abuse section 1034 by renting the residence and claiming rent-related expenses for several years, and then selling the residence and claiming section 1034 rollover for any gain realized from the sale.[24] In certain circumstances, however, the Tax Court will consider a residence that the taxpayer vacated for more than two years before purchasing a new residence as the taxpayer's principal residence under section 1034 to avoid unjust results.[25] First, the Tax Court has considered a residence as the taxpayer's principal residence even though the taxpayer vacated the residence more than two years before purchasing a new residence if the taxpayer left the residence with the intent to return.[26]

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§ 1034 time limit for purchase of new residence). In *Stolk v. Commissioner* a taxpayer sold his old residence within a year of purchasing and occupying his new principal residence. *Id.* at 347. At the time of the *Stolk* case, § 1034 required the sale of the old residence and the purchase of the new residence to occur within a one-year period. *See* I.R.C. § 1034(a) (West 1963). However, the Stolks had vacated the old residence two years before its sale. 40 T.C. at 346-47. The Tax Court denied the Stolks nonrecognition of the gain realized from the sale of the old residence, reasoning that when the Stolks abandoned the residence with no intent to return, the residence ceased to be the Stolks' principal residence for purposes of § 1034. *Id.* at 355-56. Although Congress intended that a taxpayer could rent temporarily his old residence prior to sale and still claim § 1034 rollover, the *Stolk* court determined that the temporary rental exception applied primarily when a taxpayer has occupied the new principal residence and rents the former residence during the statutory period of one year before selling the former residence. *Id.* at 355. Since the Stolks rented their former residence for two years before the purchase of a new residence, the court held the rental was not a temporary rental under § 1034. *Id.*

The Tax Court followed *Stolk* in *Houlette v. Commissioner. See* Houlette v. Commissioner, 48 T.C. 350, 354-58 (1967) (court followed *Stolk* and denied taxpayer § 1034 nonrecognition of gain realized from sale of residence that taxpayer abandoned six years before sale). In *Houlette,* the court determined that a taxpayer abandoned his former residence by vacating the residence with no intention of returning, and offering it for rent or sale. *Id.* at 356-57. Since the taxpayer abandoned his former residence and did not occupy it for six years before the sale, the *Houlette* court denied nonrecognition of the gain realized from the sale. *Id.* Together, *Houlette* and *Stolk* establish the actual occupancy rule that a taxpayer actually must occupy his former residence within two years of the purchase of a new residence for the former residence to qualify as the taxpayer's old principal residence under § 1034. *See generally* Hartwell, *Sale or Exchange of Personal Residence: Section 1034,* 31 TAX L. REV. 531, 531-47 (1976) (actual occupancy rule under § 1034). The Tax Court, however, has fashioned two exceptions to the actual occupancy rule to relieve taxpayers who are unable to comply with the two-year time limit. *See infra* notes 26-27 and accompanying text (*Trisko* and *Clapham* exceptions to actual occupancy rule).

24. *See* Hartwell, *supra* note 23, at 537 (actual occupancy rule is courts' response to taxpayer's argument that residence qualifies as principal residence under § 1034 if taxpayer used such residence as his principal residence at one time).

25. *See infra* notes 26-27 and accompanying text (*Trisko* and *Clapham* exceptions to actual occupancy rule). Courts have stated that a taxpayer who has vacated his residence for more than two year prior to sale may claim § 1034 nonrecognition of the gain only in extraordinary circumstances. *See* Houlette v. Commissioner, 48 T.C. 350, 354 (1967) (only exceptional and unusual circumstances warrant conclusion that residence is taxpayer's principal residence under § 1034 if taxpayer is not occupying residence at time of sale). *But see* Lipton, *Handling the Treatment of Renting a Former Residence While Awaiting Its Sale,* 58 J. TAX'N 170, 173 (1983) (*Clapham* and *Trisko* opinions provide broad exceptions to actual occupancy rule).

26. *See* Trisko v. Commissioner, 29 T.C. 515, 519-20 (1957). The taxpayers in *Trisko v. Commissioner* moved out of their old residence in February of 1948 when Mr. Trisko's employer

Second, if the taxpayer abandons his residence intending to sell but is unable to sell the residence within two years of vacating it due to circumstances beyond the taxpayer's control, such as a poor housing market, the Tax Court nevertheless will consider the residence as the taxpayer's principal residence for purposes of section 1034.[27] However, as the length of time that a residence is vacant or rented prior to sale increases, the taxpayer will have a harder time proving that he intended to return to the residence or that he desired to sell the residence but could not do so.[28]

If a taxpayer uses property as his residence, section 262's prohibition of personal consumption deductions will preclude the taxpayer from taking deduc-

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transferred Trisko overseas. *Id.* at 516. While the Triskos were overseas, they rented their former residence. *Id.* The first lease of the residence ran for one year, at which time the Triskos changed the lease to a month-to-month tenancy so that they could reoccupy the residence upon their return from overseas. *Id.* The taxpayers claimed and received rental deductions for the years in which they rented the residence. *Id.* In 1951 the Triskos returned and attempted to occupy their residence but could not evict the tenants due to rental control laws. *Id.* at 516-17. Since the Triskos could not occupy their former residence, they purchased a new one at a price in excess of the value of the old residence. *Id.* at 517. To afford the new residence, the Triskos sold the old residence subject to the tenancy. *Id.* In their tax returns the Triskos claimed nonrecognition of the gain realized from the sale of the former residence. *Id.* The IRS denied the Triskos § 1034 nonrecognition of the gain, claiming that the former residence was not the Trisko's principal residence under the rollover provision but, rather, was property held for the production of income. *Id.* at 519. The Tax Court rejected the IRS argument and held that the Triskos could defer recognition of the gain realized from the sale pursuant to § 1034. *Id.* at 519-20. Specifically, the court reasoned that since the Triskos intended to return to the residence and occupy it as their principal residence, the rental was a secondary consideration to provide for care and maintenance of the residence while the Triskos were overseas. *Id.* at 519. The court, therefore, determined that the rental of the residence was a temporary rental and thus did not preclude nonrecognition of the gain realized from the sale of the residence. *Id.* at 519-20. Consequently, the *Trisko* court allowed the taxpayers nonrecognition of the gain realized from the sale of the residence even though the taxpayers had vacated the house more than a year prior to its sale and had rented the residence and claimed rental deductions. *Id.; see also* Barry v. Commissioner, 40 TAX CT. MEM. DEC. (P-H) ¶ 71,179, at 71-794 (1971) (taxpayer allowed § 1034 rollover on sale of residence even though he had not occupied residence for several years and had rented residence and taken rental deductions because rental was temporary rental that did not bar application of § 1034 to sale).

27. *See* Clapham v. Commissioner, 63 T.C. 505, 512 (1975) (court held taxpayer who abandoned his residence intending to sell could claim § 1034 rollover when sale occurred more than two years after abandonment because market conditions prevented sale of residence and forced taxpayer to rent residence). The taxpayers in *Clapham v. Commissioner* rented their residence for more than two years prior to its sale. *Id.* at 506-07. In considering whether § 1034 applied to the gain realized from the sale of the Claphams' old residence, the *Clapham* court reasoned that since the Claphams at all times desired to sell their former residence rather than rent it, the rental was ancillary to the Claphams' sales efforts and therefore was a temporary rental that did not preclude nonrecognition of the gain realized from the sale. *Id.* at 512; *see infra* notes 81-89 and accompanying text (*Clapham* court's decision to apply § 1034 to sale of residence when rental of residence was ancillary to sale).

28. *Compare* Clapham v. Commissioner, 63 T.C. 505, 512 (1975) (taxpayer who vacated and rented residence for more than two years before selling residence proved that market conditions prevented him from selling residence) *with* Houlette v. Commissioner, 48 T.C. 350, 356-57 (1967) (taxpayer who vacated and rented residence for more than six years before selling residence did not prove that he intended to return to residence).

tions for maintenance, insurance, or depreciation of the property.[29] To claim these deductions the taxpayer must cease using the property as a residence and convert the residence into property held for the production of income under section 212.[30] To establish conversion the taxpayer must show that he used the residential property in an activity engaged in for profit.[31] Courts generally have held that the rental of a former residence at fair market value[32] is an activity that the taxpayer engages in for profit.[33]

Section 183 of the IRC, which limits deductions for activities that the taxpayer does not engage in for profit, establishes a test for determining whether a taxpayer engages in an activity for profit.[34] Section 183's profit-production test focuses on whether a taxpayer had the honest objective of making a profit rather than a reasonable expectation of making a profit.[35] In determining whether a taxpayer had the honest objective of making a profit, courts examine

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29. *See* I.R.C. § 262 (West 1984) (taxpayers may not deduct personal, living or family expenses unless I.R.C. provides otherwise); *supra* note 12 (cases denying taxpayer deductions for expenses of maintaining personal residence).

30. *See* I.R.C. § 212 (West 1984) (taxpayers may deduct ordinary and necessary expenses arising from property that taxpayer holds for production of income); *see also* Horrmann v. Commissioner, 17 T.C. 903, 907-08 (1951) (taxpayer may claim maintenance and depreciation deductions for residential property provided taxpayer held property for production of income); Robinson v. Commissioner, 2 T.C. 305, 306-07 (1943) (taxpayer may claim maintenance and depreciation deductions for residence that taxpayer converted into property held for production of income); Treas. Reg. § 1.212-1(b) (1957) (taxpayer may deduct ordinary and necessary expenses incurred in connection with property taxpayer holds as rental property).

31. *See* Jasionowski v. Commissioner, 66 T.C. 312, 319 (1976) (taxpayer must rent residence with primary intention of making profit to claim maintenance and depreciation deductions); Byrne, *supra* note 8, at 393 (taxpayer must cease using property as residence and use residence in profit-making activity to establish conversion of personal residence to property held for production of income); *supra* note 8 and accompanying text (rental of residence at fair market value constitutes holding residence for production of income).

32. *See* People *ex rel.* Mortgage Comm'r v. Miller, 6 N.Y.S.2d 677, 679 (1938) (fair rental value of property is value lessor could rent property for in market if lessor is free and able to rent).

33. *See* Byrne, *supra* note 8, at 395 (actual rental of residential property converts residence into property taxpayer holds for production of income); *supra* note 8 (rental of residence at fair market value constitutes activity taxpayer engages in for profit).

34. I.R.C. § 183 (West 1984); *see infra* notes 35-40 and accompanying text (§ 183 test for determining whether taxpayer engages in activity for profit). Section 183 defines an activity that a taxpayer does not engage in for profit as an activity for which the taxpayer could not claim deductions under §§ 162 or 212. I.R.C. § 183(c) (West 1984). Since § 183 defines nonprofit activity in terms of § 212, the § 212 case law for determining whether a taxpayer engages in an activity for the production of income remains valid for determining whether a taxpayer engages in an activity for profit under § 183. *See* Jasionowski v. Commissioner, 66 T.C. 312, 321 (1976) (§ 212 case law still relevant in determining whether taxpayer engages in activity for profit because § 183 test derives from § 212 case law); Benz v. Commissioner, 63 T.C. 375, 383 (1974) (IRS regulation for § 183 originated in § 212 case law).

35. *See* Dunn v. Commissioner, 70 T.C. 715, 720 (1978) (determination of taxpayer's profit motive depends on taxpayer's good faith expectation of making profit instead of taxpayer's reasonable expectation of making profit); Gorod v. Commissioner, 42 TAX CT. MEM. DEC. (CCH) 1569, 1571 (1981) (§ 183 requires that taxpayer enter activity with bona fide intention of making profit rather than reasonable expectation of making profit); Treas. Reg. § 1.183-2(a) (1972) (taxpayer need not have reasonable expectation of making profit to prove that taxpayer engaged

objective factors rather than the taxpayer's subjective intent.[36] Courts generally do not require the taxpayer to show that the activity actually produced a profit, but instead examine all of the circumstances in each case to determine whether the taxpayer engaged in the activity for profit.[37] Additionally, the taxpayer normally bears the burden of proving that he in fact engaged in the activity for profit.[38] However, if for two or more out of five consecutive years

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in activity for profit). Courts determine whether a taxpayer had a good faith objective of making a profit from an activity by examining the totality of the circumstances of each case. *See* Churchman v. Commissioner, 68 T.C. 696, 701 (1977) (whether taxpayer engaged in activity for profit depends on all circumstances in each case); *see, e.g.*, Scull v. Commissioner, 45 TAX CT. MEM. DEC. (CCH) 540, 544-45 (1983) (taxpayer who rented residence at loss without written lease to assist relatives and without ascertaining fair market rental value of property did not rent residence with honest objective of making profit); Gorod v. Commissioner, 42 TAX CT. MEM. DEC. (CCH) 1569, 1571-72 (1981) (taxpayer established honest objective of making profit by showing that he repeatedly advertised property held for rent and kept property ready for rental even though he did not secure tenant for property); Wittstruck v. Commissioner, 39 TAX CT. MEM. DEC. (CCH) 1168, 1169-70 (1980) (court denied taxpayer rental deductions when court found even most optimistic person could not hope to profit by renting in manner that taxpayer rented property); Hollesen v. Commissioner, 38 TAX CT. MEM. DEC. (CCH) 1058, 1060-61 (1979) (taxpayer who used mobile home as recreational vehicle for greater time than taxpayer rented mobile home did not own mobile home with primary intent to make profit).

36. *See* Flowers v. Commissioner, 80 T.C. 914, 932 (1983) (courts give objective facts greater weight than taxpayer's statements of intent in determining whether taxpayer engaged in activity for profit); Scull v. Commissioner, 45 TAX CT. MEM. DEC. (CCH) 540, 542 (1983) (objective factors are more important than taxpayer's subjective intent under § 183 profit test); Treas. Reg. § 1.183-2(a) (1972) (courts should give greater weight to objective factors than taxpayer's subjective intent in determining whether taxpayer engaged in activity for profit under § 183). The treasury regulations to § 183 provide that courts should determine whether a taxpayer engaged in an activity for profit by examining all the facts and circumstances of each case. *Id.* The IRS, however, has established nine factors to guide courts in determining whether a taxpayer engaged in an activity for profit. *Id.* § 1.183-2(b)(1)-(9). These factors include the manner in which the taxpayer manages the activity, the taxpayer's expertise in the area, the time the taxpayer spends on the activity, the chance that assets used in the activity will appreciate in value, the taxpayer's record of losses regarding the activity, the amount of profits the taxpayer earns, the taxpayer's financial status, and the amount of enjoyment the taxpayer derives from the activity. *Id.* The nine factors, however, are more helpful to courts in determining whether taxpayers engaged in farming or other hobbies for profit than in determining whether taxpayers engaged in rental activity for profit because of the simple nature and sometimes short duration of rental activity. *See* Whittstruck v. Commissioner, 39 TAX CT. MEM. DEC. (CCH) 1168, 1169 (1980) (nine factors for evaluating whether taxpayer engaged in activity for profit are more relevant to farm and hobby activity than rental activity); Jasionowski v. Commissioner, 66 T.C. 312, 321 n.6 (1976) (*Jasionowski* court did not find IRS' nine factors helpful in determining whether taxpayers rented residence with intent to make profit because factors apply primarily to farm and hobby activity).

37. *See* Sherlock v. Commissioner, 31 TAX CT. MEM. DEC. (CCH) 383, 385 (1972) (existence of taxpayer's *bona fide* offer to rent property is more important than taxpayer's actual receipt of rental income in determining whether taxpayer rented property with primary intention of making profit); Treas. Reg. § 1.183-2(b)(7) (1976) (although taxpayers need not show profit to engage in activity for profit, existence of profit may be evidence that taxpayers had intent to profit). *But see* Scull v. Commissioner, 45 TAX CT. MEM. DEC. (CCH) 540, 544-45 (1983) (large losses from activity may be evidence that taxpayer did not engage in activity with expectation of making profit).

38. *See* Langford v. Commissioner, 42 TAX CT. MEM. DEC. (CCH) 1160, 1163 (1981) (taxpayer has burden to prove that he engaged in activity to make profit in order to claim § 212

the gross income from an activity exceeds the deductions allowable for the activity, then under section 183(d) courts will presume the taxpayer engaged in the activity for profit.[39] If the taxpayer establishes the section 183(d) presumption, the burden is on the IRS to prove that the taxpayer did not have the honest objective of making a profit.[40]

If a court determines that a taxpayer did not engage in an activity for profit, section 183 limits the profit-related deductions for the activity.[41] Congress enacted section 183 to close tax loopholes for hobby-loss activities or other activities that taxpayers undertake to create a loss which will shelter other income items.[42] To determine the deductions that section 183 allows for an activity, a taxpayer initially must subtract from the total income of the activity those deductions that the taxpayer could deduct without regard to whether the taxpayer engaged in the activity for profit.[43] Such nonprofit-related

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deductions); Golanty v. Commissioner, 72 T.C. 411, 426 (1979) (burden of proving intent to make profit under § 183 is on taxpayer).

39. *See* I.R.C. § 183(d) (West 1984). A taxpayer establishes the § 183(d) presumption that he engaged in an activity for profit if for two or more years out of a consecutive five-year period the gross income from the activity exceeds the amount of the deductions, such as interest or tax payment deductions under §§ 163 and 164, which the taxpayer could have claimed for the property regardless of whether he used the property in a profit producing activity. *Id. See generally* Lee, *A Blend of Old Wines in a New Wineskin: Section 183 and Beyond*, 29 TAX L. REV. 347, 354-59 (1974) (analysis of § 183(d) presumption that taxpayer engages in activity for profit).

40. I.R.C. § 183(d) (West 1984).

41. *Id.; see infra* notes 43-47 and accompanying text (method for determining deductions for activities that taxpayer did not engage in for profit under § 183).

42. H.R. REP. No. 413 (Part I), 91st Cong., 1st Sess. 71, *reprinted in* 1969-3 C.B. 200, 245; *see* Lee, *supra* note 39, at 348-53 (discussing legislative history of § 183).

43. *See* I.R.C. § 183(b) (West 1984); Treas. Reg. § 1.183-1(b)(1) (1972) (establishing three-tier system for determining deductions under § 183). Under the three-tier system for determining deductions under § 183, a taxpayer makes a tier-one calculation by subtracting from the gross income of an activity those deductions that the taxpayer could have claimed regardless of whether the taxpayer engaged in the activity for profit, such an interest deductions under § 163. *Id.* If any income remains after tier one, then in tier two the taxpayer may take deductions that he could have claimed had he engaged in the activity for profit provided the deductions do not result in a change in the basis of the property. *Id.* For example, maintenance and insurance deductions for rental property do not affect the basis of the property and therefore are appropriate tier-two deductions. *See* I.R.C. § 212 (West 1984) (taxpayer may deduct ordinary and necessary expenses incurred from property taxpayer holds for production of income). The tier-two deductions, however, cannot exceed the income remaining after the taxpayer makes the tier-one deductions. Treas. Reg. § 1.183-1(b)(1) (1972). *Id.* From any income remaining after the taxpayer takes the tier-two deductions, the taxpayer may take any deductions that he could have claimed had he engaged in the activity for profit which would affect the basis of the property involved in the activity. *Id.* For example, depreciation of rental property is an appropriate tier-three deduction because the taxpayer must reduce the basis of the property by the amount of the deduction. *Id.; see* I.R.C. § 1016(a)(2)(A) (West 1984) (taxpayer shall reduce basis of property for which taxpayer claimed depreciation deduction by amount of deduction if deduction resulted in reduction of taxpayer's taxes). As with the tier-two deductions, § 183 limits the tier-three deductions to the income remaining from the activity after subtracting the tier-one and tier-two deductions. *Id.* Consequently, § 183 prevents the taxpayer from using a loss incurred in activities that the taxpayer did not engage in for profit to shelter income from other sources. *See generally* Lee, *supra* note 39, at 359-65 (three-tier system for deductions under § 183).

deductions include interest expenses or tax deductions under sections 163 and 164.[44] From any income remaining after taking tax and interest deductions, the taxpayer may take those deductions that he could have claimed if he had engaged in the activity for profit.[45] Such profit-related deductions include maintenance and depreciation deductions under sections 212 and 167 or 168.[46] Section 183 thus limits the profit-related deductions for activities that the taxpayer does not engage in for profit to the income that remains after the taxpayer subtracts the nonprofit-related deductions from the gross income the activity generates.[47] Accordingly, section 183 prevents taxpayers from using deductions attributable to activities which the taxpayer did not engage in for profit to shelter the taxpayer's income from other sources.[48]

In considering the relationship between the rollover provisions of section 1034 and rental deductions for maintenance and depreciation under sections 212 and 167 or 168, the IRS contends that a residence cannot be a taxpayer's principal residence and property held for the production of income at the same time.[49] Specifically, the IRS argues that if a taxpayer rents his principal residence

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44. *See* I.R.C. § 163 (West 1984) (taxpayer may claim as deductions amount taxpayer pays as interest on indebtedness during tax year); *Id.* § 164 (taxpayer may claim as deductions amount taxpayer paid as state and local personal property taxes).

45. *See* I.R.C. § 183(b)(2) (West 1984); *supra* note 43 (three-tier system for calculating § 183 deductions).

46. *See* I.R.C. § 212 (West 1984) (taxpayer may deduct ordinary and necessary expenses attributable to property taxpayer holds for production of income); *Id.* § 167 (taxpayer may claim straight line depreciation deduction for reasonable exhaustion, and wear and tear of property that taxpayer used in trade or business or holds for production of income); *Id.* § 168 (accelerated cost recovery system for determining depreciation for property that taxpayer began using in trade or business or holding for production of income after January 1, 1981).

47. *See* 1 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 22.5.4 (1981) (deductions allowable under § 183).

48. *See supra* notes 42-47 and accompanying text (§ 183 prevents taxpayers from claiming profit-related deductions in excess of income taxpayers received from activity that they did not engage in for profit).

49. *See* Bolaris v. Commissioner, 81 T.C. 840, 848 (1983) (IRS argued that property which constituted taxpayer's principal residence under § 1034 could not be property which taxpayer held for production of income under § 212); Private Letter Ruling No. 8132017 (April 30, 1981). In Letter Ruling 8132017, the IRS denied the taxpayers rental deductions that the taxpayers had claimed for the rental of their principal residence prior to sale. The taxpayers rented the residence at its fair market value several times over a four-year period. *Id.* The taxpayers eventually sold the residence and claimed nonrecognition of the gain pursuant to § 1034. *Id.* The IRS ruled that § 1034 applied to the sale under *Clapham v. Commissioner. Id.; see infra* notes 81-89 and accompanying text (*Clapham* court held that rental of a principal residence ancillary to sale did not bar application of § 1034 to gain realized from sale). The IRS then ruled that because the rental activity did not preclude application of § 1034 to the sale of the residence, the taxpayers did not rent the residence with the intent to make a profit. Private Letter Ruling No. 8132017 (April 30, 1981). Specifically, the IRS stated that because § 1034 applied, the property was the taxpayers' principal residence in contradistinction to property that the taxpayers held for the production of income. *Id.* The IRS admitted that residential property rented at a fair market rental is ordinarily property that a taxpayer holds for the production of income regardless of whether the rental actually produces a profit. *Id.* The IRS, however, determined that a fair market rental differs from a presale rental because in a fair market rental situation the taxpayer usually rents for long periods of time, hoping to profit from appreciation of the property, or from a future

temporarily prior to sale of the residence to qualify for section 1034 rollover, then the taxpayer's dominant motive was the sale of the residence.[50] Since the taxpayer's dominant motive was to sell rather than to rent the residence for a profit, the IRS contends that section 183 should apply to limit deductions for the rental activity.[51] The Tax Court, in *Bolaris v. Commissioner*,[52] adopted the IRS contention that section 183 limits rental deductions for the rental of a taxpayer's principal residence prior to sale.[53]

In *Bolaris*, the taxpayers lived in a residence that they had purchased in 1975 for $44,000.[54] In July 1977, the Bolarises started construction of a new principal residence and on July 14 began efforts to sell the old residence in anticipation of occupying the new residence.[55] When the Bolarises occupied the new residence in October of 1977, they still had not secured a buyer for the old residence.[56] To ease the financial burden of owning both properties, the Bolarises began renting their former residence until they could find a buyer for the property.[57] The Bolarises finally sold the old residence in August of 1978 for $70,000.[58] In their tax returns for 1977 and 1978, the Bolarises claimed nonrecognition of the $20,708.48 gain from the sale of the old residence pursuant to section 1034.[59] The Bolarises also claimed deductions for expenses

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increase in rental income. *Id.* On the other hand, the IRS concluded that since in a presale rental situation the taxpayer at all times intends to sell his residence, the taxpayer cannot argue that the residence may appreciate in value or that the rental eventually may produce a profit. *Id.* Consequently, the IRS ruled that the taxpayers did not engage in the presale rental for profit, and, accordingly, applied § 183 to the presale rental. *Id. But see infra* notes 93-99 and accompanying text (temporary rental distinction under § 1034 should not apply to question of rental deductions under §§ 212 or 183); *supra* note 8 and accompanying text (residence rented at fair market value is property taxpayer holds for production of income even though taxpayer also offers property for sale).

50. *See supra* note 49 (IRS argues that taxpayer's temporary rental of residence prior to sale is not activity that taxpayer engages in for profit).

51. *See* Bolaris v. Commissioner, 81 T.C. 840, 848 (1983) (IRS argued that property which was taxpayer's principal residence under § 1034 could not be property held for production of income under § 212); *see also* Lipton, *supra* note 25, at 171 (IRS will argue § 183 applies to limit rental deductions when taxpayer rents residence at loss and holds residence for sale); *supra* note 49 (Private Letter Ruling discussing IRS position regarding rental deductions and § 1034 rollover).

52. 81 T.C. 840 (1983).

53. *Id.* at 848-49.

54. *Id.* at 841-42.

55. *Id.*

56. *Id.*

57. *Id.* The Bolarises' first tenant occupied the residence in October of 1978, renting on a month-to-month tenancy at the fair market rental value of the house. *Id.* The tenancy continued until the Bolarises decided that the likelihood of selling the former residence increased if the residence was vacant. *Id.* Accordingly, the Bolarises ended the tenancy and the tenant vacated the Bolarises' former residence at the end of May, 1978. *Id.* The Bolarises subsequently found a buyer for the former residence. *Id.* The Bolarises again rented the residence in August, 1978 to the buyer at the fair market rental value of the house until the buyer could obtain financing to complete the sale. *Id.*

58. *Id.*

59. *Id.* at 843.

and depreciation in connection with the rental of the old residence under sections 212 and 167.[60]

The Tax Court in *Bolaris* held that the Bolarises rightfully deferred recognition of the gain from the sale of the old residence pursuant to section 1034.[61] While the IRS did not contend seriously that section 1034 did not apply to the gain, the IRS argued that the court should disallow nonrecognition of the gain if the court allowed the rental deductions because, if the court allowed the rental deductions, the residence would be property held for the production of income and thus would not be the taxpayer's principal residence within the section 1034 rollover provisions.[62] The Tax Court determined that at all times the Bolarises' primary motive was to sell the residence rather than to hold the residence as income-producing property.[63] The court noted that since the Bolarises' dominant motive was to sell the residence rather than to rent the residence, the rental activity was ancillary to the Bolarises' sales efforts.[64] The court stated that since the rental activity was ancillary to the sales efforts, the rental was the type of temporary rental activity which Congress intended should not preclude application of section 1034 to the gain realized from the sale of a principal residence.[65] Consequently, the Tax Court held that the

60. *Id.* The Bolarises claimed maintenance and insurance deductions under § 212, and depreciation expenses under § 167. *Id.* In 1977, the Bolarises received a rental income of $1,271.00 and claimed deductions of $1,505.28 for mortgage interest, $252.77 for property taxes, $542.67 for miscellaneous rental expenses, $236.00 for insurance, and $377.00 for depreciation, resulting in a loss for 1977 of $3,738.00. *Id.* For 1978, the Bolarises received a rental income of $2,717.00 and claimed deductions of $4,911.68 for mortgage interest, $720.32 for property taxes, $692.12 for miscellaneous rental expenses, and $1,120.16 for depreciation, resulting in a loss of 1978 of $4,727.28. *Id.*

61. *See id.* at 843-48 (*Bolaris* court held § 1034 applied to sale of Bolarises' former residence); *see also infra* notes 81-89 and accompanying text (*Clapham* court's holding that rental of principal residence prior to sale did not bar application of § 1034 to sale when taxpayers dominant motive was to sell residence).

62. *See* Bolaris v. Commissioner, 81 T.C. 840, 844 (1983). The IRS admitted that under the facts in *Bolaris* the taxpayers should qualify for § 1034 rollover. *Id.* The IRS argued, however, that if the court allowed the Bolarises maintenance and depreciation deductions under §§ 212 and 167, the court should disallow nonrecognition of the gain from the sale of the residence under § 1034. *Id.; see supra* notes 49-51 and accompanying text (IRS argument that property cannot be taxpayer's principal residence and property held for production of income at same time).

63. 81 T.C. 840, 844-47 (1983). The *Bolaris* court found that a poor real estate market prevented the Bolarises from selling their former residence and consequently the Bolarises rented their former residence to ease the financial strain of owning both their old and new principal residences. *Id.* When the Bolarises decided that a vacant house had a better chance of selling than a rented house, the Bolarises ended the first month-to-month tenancy. *Id.* at 842. Consequently, the *Bolaris* court concluded that the Bolarises' primary motive at all times was to sell the residence rather than to make a profit from the rental. *Id.* at 848-50.

64. *Id.* In determining that the Bolarises' rental was ancillary to their sales efforts, the *Bolaris* court followed the Tax Court's decision in *Clapham v. Commissioner*. *Id.* at 845-47; *see* Clapham v. Commissioner, 63 T.C. 505, 512 (1975) (court held that § 1034 applied to sale of residence even though taxpayers rented residence prior to sale because taxpayers' dominant intent was to sell rather than to rent residence); *infra* notes 81-89 and accompanying text (*Clapham* court's reasoning that rental ancillary to sale does not bar application of § 1034 to sale).

65. 81 T.C. 840, 847; *see supra* notes 17-18 and accompanying text (Congress intended the taxpayer could rent his residence temporarily prior to sale and still claim § 1034 rollover).

Bolarises' temporary rental of their residence prior to its sale did not bar section 1034 nonrecognition of the gain realized from the sale of the Bolarises' residence.[66]

After holding that section 1034 applied the sale of the Bolarises' former residence, the Tax Court addressed the Bolarises' claim for rental deductions under section 212 and 167.[67] The Bolarises argued that the rental of the residence at its fair market value established that the rental was a profit activity.[68] The IRS, however, contended that because the rental did not bar the application of section 1034 to the realized gain, the rental did not convert the property from principal residence status into income-producing property and therefore the rental was not an activity engaged in for profit for purposes of sections 212 and 167.[69] Accordingly, the IRS contended that because section 183 applies to activities not engaged in for profit, section 183 should limit the amount of profit-related deductions the Bolarises could claim from the temporary rental of their former residence.[70] The Tax Court noted that ordinarily the rental of a former residence at fair market value suggested that the rental was a profit-making activity.[71] The court, however, agreed with the IRS that the factors which allowed the Bolarises to claim the section 1034 rollover precluded a finding that the Bolarises engaged in the rental to make a profit.[72] The court reasoned that since the rental was a temporary rental that did not bar application of section 1034 to the gain realized from the sale of the residence, the rental was ancillary to the sale of the residence.[73] The Tax Court stated that because the rental was ancillary to the sale of the residence to the extent that the Bolarises' dominant motive was to sell the residence rather than to hold it for the production of income, the Bolarises did not

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66. 81 T.C. 840, 847; *see infra* notes 81-89 and accompanying text (*Clapham* court held that rental of residence ancillary to sale was temporary rental that did not preclude application of § 1034 to sale of residence).

67. 81 T.C. 840, 847-50; *see supra* note 60 (deductions Bolarises claimed in connection with rental of their former residence).

68. 81 T.C. 840, 848; *see supra* note 8 and accompanying text (courts generally consider rental of residences at fair market value as activity that taxpayers engage in for profit).

69. *See* 81 T.C. 840, 848 (IRS argued that facts which established that rental did not bar § 1034 also established that Bolarises did not retain former residence for production of income). The IRS argued that since the Bolarises' rental was ancillary to their sales efforts, the Bolarises did not rent the residence with the objective of making a profit. *Id.; see supra* notes 61-66 and accompanying text (*Bolaris* court found that Bolarises' rental of former residence was ancillary to sales efforts).

70. 81 T.C. 840, 848; *see supra* notes 41-48 and accompanying text (§ 183 limitation on deductions for activity that taxpayer does not engage in for profit).

71. 81 T.C. 840, 849; *see supra* note 8 and accompanying text (courts and IRS generally view rental of residence at fair market value as activity that taxpayer engaged in for profit).

72. 81 T.C. 840, 849-50. The *Bolaris* court determined that since the Bolarises only rented on a month-to-month tenancy, and ended the tenancy when they decided a vacant residence would sell faster than a rented one, the Bolarises did not rent their residence with the primary intention of making a profit. *Id.; see supra* note 63 and accompanying text (fact that Bolarises limited their rental activities to facilitate sale of their residence indicated that Bolarises' rental activity was ancillary to sale of residence).

73. 81 T.C. 840, 849-50.

rent the residence with the primary motive of making a profit.[74] Accordingly, the Tax Court held that section 183 applied to the rental activity to limit the Bolarises' deductions for maintenance expenses and depreciation.[75]

The dissent in *Bolaris* argued that Congress did not intend for sections 1034 and 212 to be mutually exclusive, and that consequently the application of section 1034 to the realized gain from the sale of a residence does not make section 183 automatically apply to any presale rental of the residence.[76] The dissent stated that although Congress intended that taxpayers should be able to rent temporarily a residence before sale and still claim the section 1034 rollover for gain realized from the sale of the residence, Congress did not intend for courts to treat temporary rentals differently than other rentals for the purpose of applying section 212.[77] Accordingly, the dissent maintained that whether the rental was ancillary to the sale is not important in determining whether the taxpayer engaged in the rental for profit under either section 212 or section 183.[78] Since the Bolarises rented their former residence at its fair market value, the dissent concluded that the court should allow the Bolarises the deductions pursuant to sections 212 and 167.[79]

In determining that the rental of a former residence ancillary to sale does not prevent application of section 1034 to any gain realized from the sale, the *Bolaris* court relied heavily on the Tax Court's reasoning in *Clapham v. Commissioner*.[80] In *Clapham*, the taxpayer abandoned their residence intend-

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74. *Id.; see supra* notes 69-70 and accompanying text (IRS argued in *Bolaris* that rental ancillary to sale was not activity that taxpayer engaged in for profit).

75. 81 T.C. 840, 850. The Bolarises could not claim any deductions for rental activity under § 183 because they did not receive rental income in excess of the deductions attributable to the property without regard to whether they rented the residence for profit. *Id.* In 1977, the Bolarises received rental income of $1,271.00 but had mortgage interest and property tax deductions under §§ 163 and 164 totalling $1,757.55. *Id.* at 851 (Korner, J., concurring). In 1978, the Bolarises received rental income of $2,717.00 but had mortgage interest and property tax deductions totalling $5,632.00. *Id.* Since no rental income remained after subtracting the deductions for mortgage interest and property taxes from the gross rental income, the Bolarises could not claim any rental deductions under § 183. *Id; see supra* notes 43-46 and accompanying text (§ 183 method for determining deductions attributable to activity that taxpayer did not engage in for profit).

76. 81 T.C. 840, 853 (Wilbur, J., dissenting).

77. *Id.* The dissent in *Bolaris* noted that a temporary fair market rental of a new principal residence before occupancy by the taxpayer clearly would be an activity the taxpayer engaged in for profit, thus entitling the taxpayer to maintenance and depreciation deductions for the property. *Id.* The dissent also noted that a new principal residence, even though formerly rented, still could be the taxpayer's new principal residence under § 1034. *Id.* The dissent concluded that the *Bolaris* holding requires different treatment of the old and new principal residences under § 1034 by denying taxpayers maintenance and depreciation deductions for the temporary rental of their old principal residences prior to sale. *Id.* The dissent maintained, however, that Congress intended both the old and new principal residence under § 1034 to receive like treatment from the courts. *Id.*

78. *Id.*

79. *Id.*

80. *See id.* at 847-50 (*Bolaris* court held that rental ancillary to sale is not activity that taxpayers engage in for profit); Clapham v. Commissioner, 63 T.C. 505, 512 (1975) (rental of residence ancillary to sale did not preclude application of § 1034 to gain realized from sale).

ing to sell it.[81] The taxpayers, however, could not find a buyer for the residence and resorted to renting the residence.[82] After renting the residence for three years, the Claphams were able to sell the residence.[83] A year before the sale of the former residence, the Claphams had purchased a new principal residence.[84] Since the sale of the former residence occurred within two years after the purchase of the new residence, the Claphams claimed nonrecognition of the gain realized from the sale of the former residence under section 1034.[85] The IRS denied the Claphams the section 1034 rollover, arguing that section 1034 did not apply because the former residence ceased to be the Claphams' principal residence when the Claphams abandoned the residence with no intent to return.[86] The Tax Court, however, stated that the Claphams' intent at all times during the rental of the property was to sell the residence rather than to hold the property for the production of income, but that a poor housing market prevented the Claphams from obtaining a buyer.[87] The court reasoned that since the Claphams at all times desired to sell the residence, the rental was ancillary to the sale of the residence and therefore was the type of temporary rental Congress contemplated as being consistent with application of section 1034.[88] Accordingly, the Tax Court held that section 1034 permitted the Claphams to defer recognition of the gain realized from the sale of the Claphams' former residence.[89]

The *Clapham* court was correct in finding that Congress intended not only that section 1034 ordinarily should not apply to property that a taxpayer holds for the production of income, but also that in certain circumstances taxpayers

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81. 63 T.C. at 512. The taxpayers in *Clapham* offered their old residence for sale in August, 1966. *Id.*

82. *Id.* The Claphams received no offers to purchase their residence until the spring of 1967, when the Claphams received an offer to lease the residence with an option to purchase. *Id.* Financial circumstances compelled the Claphams to accept the offer. *Id.* The Claphams' tenant, however, vacated the house without buying in the spring of 1968. *Id.* The Claphams again listed the residence for sale. *Id.* The Claphams still could not secure a buyer and again rented the residence in the fall of 1968 until December. *Id.* at 507. The residence remained vacant until the Claphams sold it in June, 1969. *Id.*

83. *Id.* at 507. The Claphams sold their former residence for $32,000.00. *Id.* Since the basis of the residence was $26,453.00, the Claphams realized a gain on the sale of their former residence of approximately $5,500.00. *Id.*

84. *Id.* The Claphams purchased a new principal residence in September, 1968 for $31,500.00. *Id.*

85. *Id.* At the time the Claphams claimed the § 1034 rollover, § 1034 required that the purchase of the new residence and the sale of the former residence occur within one year. *See* I.R.C. § 1034 (1963).

86. 63 T.C. 507-508 (1975).

87. *Id.* at 506-07. The *Clapham* court emphasized that a poor real estate market prevented the Claphams from securing a reasonable offer to purchase the residence and forced the Claphams to rent the residence until they could find a buyer. *Id.*

88. *Id.* at 510-12; *see supra* notes 17-20 and accompanying text (Congress intended for taxpayers to be able to rent their principal residences temporarily before sale and still claim benefits of § 1034 rollover).

89. 63 T.C. at 512.

like the Claphams could claim the section 1034 rollover if they temporarily rented their former residence prior to sale.[90] Congress did not intend to deny taxpayers the benefits of section 1034 in the event that market circumstances prevented a taxpayer from selling his former residence at the time the taxpayer vacated it.[91] Consequently, as the *Clapham* court held, when a rental is ancillary to sales efforts, the rental is a temporary rental and therefore not the kind of income-producing activity that precludes application of section 1034.[92]

However, the rental ancillary to sale rationale in *Clapham* is applicable only for the purpose of determining whether a residence is a taxpayer's principal residence under section 1034.[93] No evidence exists suggesting that Congress intended that the temporary rental exception for applying section 1034 to residential property which the taxpayer has rented should affect the application of sections 212 or 183 to the rental activity.[94] The *Clapham* case did not involve the issue of rental deductions for the years the Claphams rented their former residence prior to sale, nor did the *Clapham* opinion mention whether the Claphams had claimed or received deductions for their rent-related expenses.[95] The *Bolaris* court, however, took the *Clapham* ancillary to sales rationale for holding that a rental was only a temporary rental under section 1034 and applied the rationale to limit rent-related expenses to those section 183 allows.[96] The *Bolaris* court did not explain why the ancillary to sale rationale of *Clapham* should apply also to sections 212 and 183.[97] Rather, the *Bolaris* court merely held that if rental activity was ancillary to a taxpayer's sales efforts and thus a temporary rental under section 1034, then the rental was not a profit-making activity and consequently section 183, instead of section 212, controls the extent of rental deductions.[98] By blindly applying the *Clapham*

90. *See supra* notes 17-20 and accompanying text (Congress intended that taxpayer could rent temporarily his principal residence before sale consistent with § 1034 even though § 1034 ordinarily does not apply to property taxpayer holds for production of income).

91. *See supra* note 1 and accompanying text (§ 1034 is relief provision that Congress enacted to help taxpayers who have to change residences).

92. 63 T.C. at 512.

93. *See id.* at 507 (*Clapham* court stated that sole issue in *Clapham* was whether Claphams' rental activity was type which precluded application of § 1034 to gain realized from sale).

94. *See* Bolaris v. Commissioner, 81 T.C. 840, 853-55 (1983) (Wilbur, J., dissenting) (*Bolaris* dissent argued that Congress did not intend for temporary rental exception under § 1034 to affect application of §§ 212 or 183 to rental activity); *infra* notes 101-15 and accompanying text (§ 280A(d)(4) suggests that Congress did not intend that taxpayer could not claim rental deductions for temporary rental of principal residence prior to sale).

95. *See* 63 T.C. at 507 (sole issue in *Clapham* was whether sale of Claphams' former residence qualified for § 1034 treatment); *see also* Maule, *supra* note 14, at 9 n.12 (*Clapham* opinion did not reveal whether Claphams' sought rental deductions).

96. *See Bolaris*, 81 T.C. 840, 847-50 (court held that since rental of residence was ancillary to sale, taxpayer did not rent residence with primary intention of making a profit).

97. *See id.* at 853-54 (Wilbur, J., dissenting).

98. *Id.* at 850. Although the *Bolaris* court noted that the availability of rental deductions would depend on the circumstances of each case, the court stated that as a general proposition, a taxpayer's temporary rental of his principal residence ancillary to sales efforts would not qualify for rental deductions under § 212. *Id.*

ancillary to sales analysis to the rental activity in *Bolaris*, the *Bolaris* court rendered sections 1034 and 183 mutually inclusive, and sections 1034 and 212 mutually exclusive.[99]

Congress, however, has indicated no intent that sections 1034 and 212 should be mutually exclusive.[100] Moreover, a 1978 amendment to section 280A of the IRC implies that Congress condones taxpayers taking both rent-related deductions and section 1034 rollover at the same time.[101] Congress passed section 280A to cover the rental deductions available to a taxpayer who both rents and makes personal use of a residence during a year.[102] Although Congress passed section 280A mainly to limit rental deductions that taxpayers may claim from the rental of vacation homes, section 280A may apply to any property that a taxpayer uses as a dwelling unit.[103] Congress enacted section 280A to replace the activity for profit test of section 183 for determining whether a taxpayer may claim rent-related deductions because of the difficulty in determining a taxpayer's dominant intent in renting a vacation home for a few months out of a year.[104] Section 280A changes the method for determining rental deductions from the section 183 profit test to an inquiry into the amount of personal use the taxpayer makes of a residence that he also rents during the year.[105] Section 280A allows a taxpayer to claim rental deduc-

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99. *See id.* at 853 (Wilbur, J., dissenting) (*Bolaris* dissent criticizes majority for effectively rendering §§ 1034 and 212 mutually exclusive).

100. *See id.* (Congress did not intend to amend § 212 by enacting § 1034).

101. *See* I.R.C. § 280A(d)(4) (West 1984) (§ 280A limitations on rental deductions do not apply to taxpayer who rents principal residence under § 1034 for qualified rental period); *infra* notes 102-15 and accompanying text (§ 280A(d)(4) implies that Congress intended taxpayer to be able to deduct losses incurred in rental of taxpayer's principal residence prior to sale).

102. *See* JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 94th Cong., 2d Sess. 136, 142-43, *reprinted in* 1976-3 (Vol. 2) C.B. 148, 154-55 [hereinafter cited as JOINT COMM. ON TAXATION]. Congress stated that under §§ 212 and 183 courts have had difficulty in determining whether a taxpayer who lives in a residence part of the year and rents the residence for the other part of the year is engaged in an activity for profit. *Id.* Congress noted that the problem is even more difficult when the property is a taxpayer's vacation home. *Id.* Consequently, Congress replaced the §§ 212 and 183 profit test with § 280A which allows deductions a taxpayer could take regarding residences that the taxpayer both lives in and rents during the same year according to the amount of personal and rental use the taxpayer makes of the property. *Id. See generally* Goff, *Commingling Business and Personal Use of Real Property: Severe Restrictions Under the 1976 Tax Reform Act*, 13 GONZ. L. REV. 493 (1978) (analysis of § 280A).

103. *See* I.R.C. § 280A(f) (West 1983) (dwelling unit in § 280A includes property such as home, boat, apartment, mobile home, condominium, or any similar property or structures connected with such property).

104. *See supra* note 102 (Congress enacted § 280A to avoid difficult profit motive determination regarding rental of residence that taxpayers also use as personal residence during year).

105. *See* I.R.C. § 280A(d) (West 1984). If a taxpayer uses a dwelling unit either more than 14 days in a year, or at least 10% of the number of days during the year that the taxpayer rents the unit, whichever is greater, § 280A applies to the maintenance and depreciation deductions. *Id.; see infra* notes 106-08 and accompanying text (§ 280A(c)(5) limits deductions taxpayer may claim for rental of vacation home to rental income less deductions attributable to home regardless of whether taxpayer rented home). If § 280A does not apply to the rental of a dwelling, a taxpayer still must prove that he rented the dwelling with the intent to make a profit in order to

tions for the time that the taxpayer rented the unit.[106] However, the rental deductions cannot exceed the gross income that the taxpayer receives from the rental of the unit less the nonprofit-related deductions, such as interest or property tax deductions, that the taxpayer may claim for the unit without regard to whether the taxpayer rented the unit.[107] The effect of the section 280A limit on rental deductions is, like section 183, to prevent a taxpayer from claiming deductions in excess of the rental income to shelter other items of income.[108] Congress, however, determined that the section 280A limitation on rental deductions may work unnecessary hardships on taxpayers by preventing taxpayers from taking rental deductions, even though the taxpayers legitimately try to convert their residences into income-producing property but are unable to secure a tenant or are unable to rent their residences at a profit.[109] Consequently, Congress amended section 280A in 1978 with section 280A(d)(4) which specifically excludes rental of a residence from the limitations of section 280A if the taxpayer rents the residence for a qualified rental period,[110] and the residence is also the taxpayer's principal residence under section 1034.[111] A qualified rental period includes the fair market rental of a principal residence prior to sale.[112] Thus, section 280A(d)(4) shows that Congress intended taxpayers to be able to take full advantage of section 212 and 167 rental deductions, in excess of the rental income received, for the rental of a principal

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avoid the § 183 limitation on deductions for activities that a taxpayer does not engage in for profit. *See* JOINT COMM. ON TAXATION, *supra* note 102, at 156 (§ 183 applies to nonprofit rental of vacation home if § 280A does not apply to rental); *supra* notes 42-48 and accompanying text (§ 183 limitation on deductions for activities that taxpayer does not engage in for profit).

106. *See* I.R.C. § 280A(e)(1) (West 1984) (taxpayer may claim as deduction for rental of dwelling portion of total expenses equivalent to rental portion of total time taxpayer rented or used dwelling); *see also* Bolton v. Commissioner 694 F.2d 556, 558 (9th Cir. 1982) (taxpayer could allocate as rental expense 75% of total maintenance expenses for residence when time taxpayer rented residence was 75% of total time taxpayer used or rented residence).

107. I.R.C. § 280A(c)(5) (West 1984). Congress stated that courts should decide the deductions allowable for rental activity under § 280A(c)(5) using the same procedure established in the regulations to § 183. JOINT COMM. ON TAXATION, *supra* note 102, at 156; *see supra* note 43 (§ 183 procedure for limiting deductions for activity that taxpayer does not engage in for profit).

108. *See* BITTKER, *supra* note 47, at ¶ 22.6.4 (§ 280A(c)(5) limits overall rental deductions to gross rental income that taxpayer receives); *supra* notes 42-48 and accompanying text (§ 183 limits deductions for activity that taxpayer did not engage in for profit to income taxpayer received from activity).

109. *See* JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, 95th Cong., 2d Sess. 346-47 (1979) (taxpayer's personal use of principal residence during year should not prevent taxpayer from claiming deductions for part of year that taxpayer rented residence); BITTKER, *supra* note 47, at ¶ 22.6.4 (Congress amended § 280A to relieve injustice of applying § 280A limitations to taxpayers who try to convert residential property into rental property).

110. I.R.C. § 280A(d)(4)(B) (West 1984). A qualified rental period under § 280A is a period of 12 or more consecutive months that begins or ends in the taxable year in which the taxpayer sells or exchanges the residence, or a period of less than 12 months that begins in the year the taxpayer sells the residence provided the taxpayer rents the residence or holds the residence for a fair rental. *Id.*

111. *Id.*

112. *See supra* note 110 (definition of qualified rental period under § 280A(d)(4)(3)).

residence prior to sale and still qualify for section 1034 rollover.[113] However, by holding that section 183 necessarily applies to presale rental activity if section 1034 applies to the sale, the *Bolaris* court effectively negates the tax advantage section 280A(d)(4) provides because section 183, like section 280A, prevents the taxpayer from deducting any loss from the rental activity in excess of income from the activity.[114] In contrast, section 280A(d)(4) implies that if section 1034 applies to the sale of a residence, section 183 should not limit automatically any rental deductions if the taxpayer rented the residence prior to sale.[115]

Although by virtue of section 280A(d)(4), section 280A limitations do not apply to the rental of a principal residence for a qualified rental period, to preclude application of section 183 a taxpayer still must show that the rental was a profit-producing activity.[116] Since sections 212 and 1034 are not mutually exclusive, the temporary rental distinction under section 1034 should not affect resolution of whether the taxpayer engaged in the activity for profit for purposes of section 212 or 183.[117] Consequently, the *Bolaris* court had no justification to overturn the general rule that the rental of a residence for fair market value is an activity that a taxpayer engages in for profit and not subject to the limitations of section 183.[118] Since the Bolarises rented the residence at its fair market value, the *Bolaris* court should not have limited the Bolarises to those deductions section 183 permits but rather should have allowed the Bolarises to claim all the deductions arising from the rental of the residence prior to sale.[119]

Moreover, the *Bolaris* court's application of the *Clapham* ancillary to sale rationale to the Bolarises' rental activity is not sound because it may lead to inconsistencies under the IRC.[120] In *Bolaris*, the taxpayers rented their former residence at a loss for purposes of section 183 because the rental income did

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113. *See supra* text accompanying notes 110-12 (Congress amended § 280A to allow taxpayer to claim rental deductions in excess of rental income received if taxpayer rented his principal residence for qualified rental period).

114. *See supra* notes 71-76 and accompanying text (*Bolaris* court held § 183 applies to rental of principal residence prior to sale if § 1034 applies to gain realized from sale); *supra* notes 110-12 (Congress amended § 280A to allow taxpayer to take rental deductions in excess of rental income if taxpayer rents principal residence for qualified rental period).

115. *See supra* text accompanying notes 113-114 (*Bolaris* holding negates congressional intent to allow taxpayers to claim rental deductions in excess of rental income with respect of principal residence for qualified rental period).

116. *See* I.R.C. § 280A(a) (West 1984) (taxpayers may claim rental deductions that § 280A does not provide only pursuant to other IRC provisions).

117. *See* Bolaris v. Commissioner, 81 T.C. 840, 853-55 (1983) (Wilbur, J., dissenting) (temporary rental distinction under § 1034 should not affect application of §§ 212 or 183 to rental activity).

118. *See supra* note 8 and accompanying text (rental of residence at fair market value is activity taxpayer engages in for profit).

119. *See* Bolaris v. Commissioner, 81 T.C. 840, 855 (1983) (Wilbur, J., dissenting) (taxpayer in *Bolaris* should have received all claimed rental deductions).

120. *See infra* notes 122-27 and accompanying text (rental of two residences at fair market value ancillary to sales efforts could receive different treatment under § 183).

not exceed the deductions allowable for the residence regardless of whether the Bolarises rented the residence for profit.[121] Accordingly, the Bolarises could not claim the section 183(d) presumption that an activity is a profit activity if the taxpayer receives income from the activity in excess of the nonprofit-related deductions for the activity.[122] However, if a taxpayer renting his former residence prior to sale receives rental income in excess of the deductions otherwise allowable, then the taxpayer could claim the section 183(d) presumption that the taxpayer engaged in the activity for profit and accordingly the IRS would bear the burden of proving the taxpayer did not rent the residence for a profit.[123] If a taxpayer who rented his residence prior to a sale at its fair market value could claim the section 183(d) presumption, then the IRS would have difficulty showing that the taxpayer did not rent the residence to make a profit.[124] Furthermore, if a taxpayer can show taxable income remaining from the presale rental income after the taxpayer takes all of the rental deductions, the IRS probably would not be able to convince a court to apply section 183 to the presale rental activity.[125] Quite possibly, the rental of two residences ancillary to sale and at a fair market value would receive different treatment under section 183 depending on whether the activity actually produced a profit.[126] Yet the section 183 profit test concerns whether a taxpayer had the honest objective of making a profit rather than whether the taxpayer actually

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121. *See supra* note 75 and accompanying text (Bolarises' gross income from rental of residence did not exceed deductions Bolarises could have claimed for residence regardless of whether they rented residence for profit).

122. *See* I.R.C. § 183(d) (West 1984); *supra* notes 39-40 and accompanying text (section 183(d) presumption that taxpayer engaged in activity for profit).

123. *See supra* notes 39-40 and accompanying text (§ 183(d) presumption that taxpayer engaged in activity for profit).

124. *See supra* text accompanying note 40 (IRS bears burden of proving that taxpayer did not engage in activity for profit when taxpayer meets § 183(d) presumption that taxpayer engaged in activity for profit); *see also* Lipton, *supra* note 25, at 171-72 (Lipton created hypothetical situation in which rental of identical residences would receive different treatment under § 183). In Lipton's hypothetical situation, two taxpayers live next door to each other in identical residences. *Id.* at 172. At the same time, each taxpayer vacates and attempts to sell his residence. *Id.* The taxpayers are unable to sell their respective residences, so they begin renting the residences for the same fair market rental. *Id.* Taxpayer A has rental income remaining after he subtracts both nonprofit and profit-related deductions from the gross rental income because taxpayer A has low interest payments to make on his residence. *Id.* at 171-72. Taxpayer B, however, has no rental income remaining after he subtracts nonprofit-related expenses from the gross rental income because Taxpayer B has high interest payments to make on his residence. *Id.* at 172. Accordingly, taxpayer B is renting at a loss. *Id.* Lipton contends that the IRS will not be able to argue successfully that § 183 applies to taxpayer A's rental because taxpayer A not only met the § 183(d) presumption that he engaged in the activity for profit but also showed a taxable profit from the rental. *Id.* Lipton maintains, however, that the IRS will apply § 183 to limit taxpayer B's rental deductions because taxpayer B rented at a loss and could not claim the § 183(d) presumption that he engaged in the rental for profit. *Id.* Consequently, Lipton concludes that the fair market rental of identical residences prior to sale could receive different treatment under § 183. *Id.*

125. *See* Lipton, *supra* note 25, at 172 (IRS probably could not establish that rental was not profit-producing activity when rental actually produced profit).

126. *See supra* note 124 and accompanying text (hypothetical situation in which two identical residences rented for same amount receive different treatment under § 183 because differing

produced a profit.[127] The inconsistent treatment under section 183 of the same activity underscores the conclusion that the temporary rental distinction under section 1034 should not apply to sections 212 or 183.

Since the temporary rental exception for applying section 1034 rollover to the gain realized from the sale of a principal residence that a taxpayer rented prior to sale should not affect determination of whether the presale rental was a profit-producing activity, the *Bolaris* court should have allowed the Bolarises' claimed rental deductions under sections 212 and 167 for the fair market rental of their principal residence prior to sale.[128] Ordinarily, the fair market rental of a residence entitles a taxpayer to deductions for expenses attributable to the rental.[129] The *Bolaris* court, however, bypassed the fair rental rule by applying the *Clapham* ancillary to sale rationale for determining when a presale rental is a temporary rental under section 1034 to the question of whether the Bolarises engaged in the presale rental for profit.[130] The *Clapham* case, however, did not concern the issue of rental deductions for a presale rental, but only concerned whether the Claphams' presale rental precluded application of section 1034 to the gain realized from the sale of the Claphams' old residence.[131] The effect of *Bolaris* is to render section 183 applicable to the presale rental of a residence, thereby limiting the rental deductions to the income the taxpayer receives from the presale rental, whenever section 1034 applies to the sale of a residence.[132] Yet by enacting section 280A(d)(4) of the IRC, which excludes the presale rental of a principal residence at fair market value from the limitations of section 280A, Congress implied that taxpayers should be able to claim rental deductions in excess of rental income for the rental of a principal residence prior to sale.[133] Moreover, the

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mortgage interest rates allow one residence to meet § 183 presumption).

127. *See supra* notes 35-37 and accompanying text (taxpayer engaged in activity for profit for purposes of § 183 if taxpayer engaged in activity with honest objective of making profit).

128. *See* Bolaris v. Commissioner, 81 T.C. 840, 853-55 (1983) (Wilbur, J., dissenting) (fact that taxpayer's fair market rental of residence was ancillary to taxpayer's sales efforts for residence should not prevent taxpayer from claiming rental deductions).

129. *See supra* note 8 and accompanying text (courts generally view fair market rental of residence as activity taxpayer engages in for profit).

130. *See* Bolaris v. Commissioner, 81 T.C. 840, 847-50 (1983) (taxpayer's rental of residence ancillary to sales efforts was not activity taxpayer engaged in for profit); *supra* notes 73-75 and accompanying text (*Bolaris* court applied *Clapham* ancillary to sale rationale to Bolarises' rental activity); *supra* notes 81-89 and accompanying text (*Clapham* court's analysis that rental ancillary to sale is temporary rental for purposes of § 1034).

131. *See supra* notes 95 and accompanying text (sole issue in *Clapham* was whether Claphams' rental activity precluded application of § 1034 to gain realized from sale of Claphams' residence).

132. *See* Bolaris v. Commissioner, 81 T.C. 840, 850 (as general proposition rental of principal residence ancillary to sale is not activity taxpayer engages in for profit).

133. *See* I.R.C. § 280A(d)(4) (West 1983) (limitations of § 280A shall not apply to taxpayer who rents his principal residence for qualified rental period); *supra* note 110 and accompanying text (qualified rental period includes rental of principal residence prior to sale); *supra* note 106-08 and accompanying text (§ 280A limits amount of rental deductions taxpayers may claim for dwelling taxpayer both rented and occupied during year to gross rental income received from rental).

Bolaris rationale calling for section 183 treatment of the presale rental of a residence when section 1034 applies to the sale may lead to inconsistent results under the IRC if a taxpayer actually produces a profit from a presale rental.[134] Consequently, the Tax Court should reconsider *Bolaris* and allow taxpayers rental deductions for the presale rental of a principal residence at fair market value.[135]

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134. *See supra* notes 120-27 and accompanying text (presale rental of two identical residences at fair market value could receive different treatment under § 183 depending on whether rental produced profit).

135. *See* Bolaris v. Commissioner, 81 T.C. 840, 855 (1983) (Wilbur, J., dissenting) (taxpayers in *Bolaris* should receive full amount of rental deductions claimed under §§ 212 and 167).