PATH DEPENDENCE IN TAX SUBSIDIES FOR HOME SALES

Lily Kahng*

ABSTRACT

At a time of looming fiscal crisis and virtual unanimity that tax expenditures must be curtailed, tax subsidies for homeownership stand out as among the most costly and unfair of these expenditures. As a result of tax subsidies for homeownership, the government foregoes billions of dollars in revenue each year, most of which benefits wealthy taxpayers. Moreover, subsidies for homeownership encourage overinvestment in housing and underinvestment in other business sectors, which impedes economic productivity, jobs creation, and the ability of U.S. businesses to compete in the global marketplace.

Scholars and commentators have analyzed extensively the tax subsidy for home mortgage indebtedness but have paid little attention to tax subsidies for home sales. This Article is the first to undertake a comprehensive examination of tax subsidies relating to home sales. The central thesis of this Article is that these subsidies rest upon questionable policy justifications, flawed logical reasoning, and poor design choices. To support this thesis, the Article traces the evolution of tax subsidies for home sales from their surprising origins in a World War I-era tax preference for requisitioned ships to their present incarnation as a practically unlimited tax exemption. This narrative account leads to several important findings. First, it shows how path dependence and bounded rationality have led lawmakers and policymakers to make questionable decisions and support problematic laws. Second, it demonstrates the power of the real estate lobby to shape the story—and the resultant legal rules—from both tax and social policy perspectives. Finally, it illuminates the political and rhetorical forces that have shaped tax subsidies for home sales. The Article argues that only by understanding where we were before and how we got to where we are now can we properly assess where we should go from here.

In assessing tax subsidies for home sales, the Article evaluates the subsidies by reference to the established tax policy criteria of efficiency and fairness while remaining cognizant of the broader context of the social and economic policies regarding homeownership. Although a comprehensive assessment of federal housing policies and the role of tax subsidies in structuring the domestic housing market lie beyond its scope, the Article offers important new insights that will contribute significantly to the ongoing policy dialogue about homeownership in our society. In particular, it analyzes the economic impacts of tax subsidies for home sales, including whether and to what extent the subsidies contributed to the real estate bubble. Moreover, the Article highlights the important, but underappreciated, disparate race and gender impacts of homeownership as a wealth-building vehicle. Finally, the Article calls for the repeal of tax subsidies for home sales and argues that the “exogenous shock” of the global financial crisis presents a rare and fleeting opportunity to effect this reform.

INTRODUCTION .......................................................................................... 189

I. A BRIEF HISTORY OF TAX SUBSIDIES FOR HOME SALES ....................... 191
   A. The Rollover Regime ................................................................. 191
      1. Rollover .............................................................................. 191
      2. One-Time Exclusion ............................................................ 193
   B. The 1997 Law .......................................................................... 195
      1. Rollover Regime Repealed and Gain Exclusion Enacted ................ 195
      2. Procedural Change ............................................................... 197
   C. Other Aspects of the Gain Exclusion ....................................... 199
      1. Basic Requirements and Special Rules ................................. 199
      2. Anti-Avoidance Measures .................................................. 200

II. HOW DID WE GET HERE? ..................................................................... 201
   A. Path Dependence and Bounded Rationality ................................ 201
      1. The Basic Concepts ............................................................ 201
      2. Path Dependence, Bounded Rationality, and Tax Subsidies for Home Sales .................................................. 203
   B. Politics ..................................................................................... 206
   C. The Role of the Real Estate Lobby ........................................... 209

III. WHERE WE ARE: AN ASSESSMENT ...................................................... 212
   A. Basis Recordkeeping .............................................................. 213
   B. Incentive Effects ....................................................................... 215
   C. Complexity ............................................................................. 221
   D. Avoidance Behavior ............................................................... 224
   E. Compliance .............................................................................. 224

IV. WHERE SHOULD WE GO FROM HERE? ................................................ 227
INTRODUCTION

Homeownership occupies a special place in the American psyche. In the mid-twentieth century halcyon era of peace and prosperity, the archetypal homeowner was a young married couple who would scrape together the down payment to buy a modest “starter” house. Then, as the husband advanced at work and children arrived, they would trade up, perhaps more than once, to a bigger and finer house. Finally, when the children had left the nest and the husband retired, the couple, with their mortgage paid off, would downsize and have a handsome amount left over to enjoy in their golden years.

In recent decades, the narrative around homeownership has changed. At the height of the housing bubble, the availability of easy credit and the prospect of seemingly limitless appreciation fueled a “get rich quick” mentality, in which the primary purpose of buying a home was to resell it at a handy profit. The American dream of homeownership metamorphosed from *Leave It to Beaver* to *Flip This House*.

The tax law has mirrored this shifting narrative through tax subsidies for home sales. At first, the law allowed a homeowner to defer paying the tax on a home sale as long as he bought a series of increasingly expensive houses.¹ Later, Congress added a one-time tax exemption on the deferred gain for homeowners who were fifty-five years or older and ready to downsize.² Then, in 1997, roughly coincident with the start of the housing bubble, Congress drastically changed the subsidy for home sales, exempting almost all gains from home sales.³ The tax benefits of house flipping became, as one lobbyist proclaimed, “almost too good to be true.”⁴

This Article is the first to comprehensively examine tax subsidies for home sales.⁵ Its central thesis is that these subsidies for home sales rest

---

5. The tax law provides a variety of tax subsidies for homeownership, the largest of which are the nontaxation of imputed rental income (including the home mortgage interest deduction), the deduction for real property taxes, and the exclusion of gain from home sales. *See* Larry Ozanne, *Taxation of Owner-Occupied and Rental Housing* 4–6 (Cong. Budget Office, Working Paper No. 2012-14, 2012).
upon questionable policy justifications, flawed logical reasoning, and poor design choices. To support this thesis, the Article traces the evolution of tax subsidies for home sales from their surprising origins in a World War I-era tax preference for requisitioned ships to their present incarnation as a practically unlimited tax exemption. This narrative account leads to several important findings. First, it shows how path dependence and bounded rationality have led lawmakers and policymakers to make questionable decisions and support problematic laws. Second, it demonstrates the power of the real estate lobby to shape the story—and the resultant legal rules—from both tax and social policy perspectives. Finally, it illuminates the political and rhetorical forces that have shaped tax subsidies for home sales. The Article argues that only by understanding where we were before


This Article is first to provide an in-depth analysis and critique of the tax subsidies related to home sales, including the current law on gain exclusion for home sales. Most of the prior research on these subsidies focuses on relatively narrow practical and planning issues related to the exclusion. See, e.g., Steven C. Dilley & Debra S. Callihan, Planning Ideas for Sale of a Residence, 80 TAX NOTES 949 (1998); Burgess J.W. Raby & William L. Raby, Multiple Homes but No Principal Residence?, 99 TAX NOTES 1363 (2003). There is one thoughtful policy critique of tax subsidies for home sales, but it predates the major changes made to the law in 1997 and does not address the current law gain exclusion. See Christine A. Klein, A Requiem for the Rollover Rule: Capital Gains, Farmland Loss, and the Law of Unintended Consequences, 55 WASH. & LEE L. REV. 403, 406–07 (1998) (arguing that I.R.C. § 1034 unintentionally promoted overinvestment in housing and conversion of farmland into suburban housing). A more recent article provides a policy critique of the current law on gain exclusion for home sales. See Bradford P. Anderson, Welcome to My Flipperhood: A Call to Repair the Residential Real Estate Tax Swindle, 7 GEO. J.L. & PUB. POL’Y 415, 419 (2009) (“The current housing and financial sector meltdown is not the result of a market failure, but is the natural, necessary, and presumably unintended result of the tax preferences extended to residential real estate in 1997.”). However, it provides no analysis of the legislative and political history of the provision; nor does it consider any of the extensive economic research related to tax subsidies for homeownership.
and how we got to where we are now can we properly assess where we should go from here.

In assessing tax subsidies for home sales, the Article evaluates the subsidies by reference to the established tax policy criteria of efficiency and fairness while remaining cognizant of the broader context of the social and economic policies regarding homeownership. Although a comprehensive assessment of federal housing policies and the role of tax subsidies in structuring the domestic housing market lie beyond its scope, the Article offers important new insights that will contribute significantly to the ongoing policy dialogue about homeownership in our society. In particular, it provides an analysis of the economic impacts of tax subsidies for home sales, including whether and to what extent the subsidies contributed to the real estate bubble. Moreover, the Article highlights the important, but underappreciated, disparate race and gender impacts of homeownership as a wealth-building vehicle. Finally, the Article calls for the repeal of tax subsidies for home sales and argues that the “exogenous shock” of the global financial crisis presents a rare and fleeting opportunity to effect this reform.

Part I provides a brief history of tax subsidies for home sales. Part II uses this history to analyze the ways in which path dependence and bounded rationality have shaped the law in ways that have led to dubious choices and undesirable outcomes. It then discusses the ways in which politics and the influence of interest groups contributed to the evolution of the law. Part III reassesses the law and questions the assumptions and choices that led to its enactment. It also addresses important and unforeseen consequences of the law that have yet fully to be understood. Part IV provides a broader framework for assessment, one that takes account of systemic incentives under the tax law and also considers the role of homeownership as a means to promote race and gender equality in the distribution of wealth. The Article concludes with proposals for reform and assesses the likelihood of such reform.

I. A BRIEF HISTORY OF TAX SUBSIDIES FOR HOME SALES

A. The Rollover Regime

1. Rollover

From 1951 through 1997, I.R.C. § 1034 provided for the nonrecognition of gain upon the sale of a principal residence, as long as the taxpayer purchased another principal residence of equal or greater value
within a specified time period before or after the date of the sale. (The requirement that the taxpayer reinvest in similar property—another principal residence in the case of I.R.C. § 1034—is called a “rollover” requirement in the vernacular.) I.R.C. § 1034 did not exempt the gain from tax but rather deferred it by giving the taxpayer a basis in the new residence equal to his basis in the old residence.

Conceptually, I.R.C. § 1034 had its antecedents in two other rollover provisions: I.R.C. § 1031, relating to like-kind exchanges, and I.R.C. § 1033, relating to involuntary conversions. Both of these allow for the deferral of gain as long as the taxpayer ends up with an investment in similar property.

6. See I.R.C. § 1034 (1994), repealed by Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 312(b), 111 Stat. 788, 839. As originally enacted, the specified time period for reinvestment in a new residence under I.R.C. § 1034 was within one year before or after the sale of the old residence. See Revenue Act of 1951, Pub. L. No. 82-183, § 318, 65 Stat. 452, 494. This time period was lengthened to 18 months before or after the sale of the old residence in 1975 (Tax Reduction Act of 1975, Pub. L. No. 94-12, § 1034, 89 Stat. 26, 32 (codified as amended in scattered sections of 26 U.S.C.)) and then lengthened again to two years before or after the sale of the old residence in 1981 (Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 1034, 95 Stat. 172, 197 (codified as amended in scattered sections of 26 U.S.C.)). Also, as originally enacted, the deferral could be used only once per year. See Revenue Act of 1951 § 318. This was changed to restrict the use of the deferral to once every two years, unless the home sale was due to a change in employment. See I.R.C. § 1034(d).

7. See I.R.C. § 1034(e). As a practical matter, when combined with other provisions, the deferral often results in permanent exclusion. See, e.g., Klein, supra note 5, at 417 (noting that the one-time exclusion under prior law I.R.C. § 121 and nonrecognition of gain on transfers at death under I.R.C. § 1014 allowed deferred gains to be excluded entirely); Ventry, supra note 5, at 259 (same).

8. The technical aspects of I.R.C. §§ 1031 and 1033 vary somewhat from I.R.C. § 1034, although all three provisions embody the rollover concept: I.R.C. § 1031 requires that the property be exchanged for “like-kind” property. See I.R.C. § 1031(a) (2006). I.R.C. § 1033 requires either that property be exchanged for property “similar or related in service or use” or that sale proceeds received on conversion be reinvested in similar use property within a specified time period. See I.R.C. § 1033(a) (2006).

More broadly, all three of these rollover provisions are grounded in the idea that a continued investment in similar property justifies an exception to the normal realization rules. Many scholars have concluded that this rationale for the rollover provisions is shaky at best. See Fred B. Brown, Proposal to Reform the Like Kind and Involuntary Conversion Rules in Light of Fundamental Tax Policies: A Simpler, More Rational and More Unified Approach, 67 Mo. L. Rev. 705 (2002) (criticizing §§ 1031 and 1033 as inefficient, inequitable, and costly to administer); Erik M. Jensen, The Uneasy Justification for Special Treatment of Like-Kind Exchanges, 4 Am. J. Tax Pol’y 193 (1985) (criticizing the efficiency and administrability rationales for I.R.C. § 1031 but endorsing the illiquidity rationale); Calvin H. Johnson, Impose Capital Gains Tax on Like-Kind Exchanges, 121 TAX NOTES 475 (2008) (arguing that the fairness, efficiency, and administrability arguments in favor of I.R.C. § 1031 are not persuasive in light of revenue needs); Marjorie E. Kornhauser, Section 1031: We Don’t Need Another Hero, 60 S. Cal. L. Rev. 397 (1987) (detailing political and legislative history of I.R.C. § 1031 and critiquing the provision on policy grounds); Daniel N. Shaviro, An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax, 48 TAX L. REV. 1 (1992). But see Cynthia Blum, Rollover: An Alternative Treatment of Capital Gains, 41 TAX L. REV. 385, 399-409 (1986) (proposing to extend rollover treatment to all realized capital gains to alleviate inefficiencies and inequities created by realization-based taxation).
I.R.C. § 1034 also owed much to the rhetoric of wartime exigency that accompanied the enactment of I.R.C. § 1033. I.R.C. § 1033 had been adopted in 1921 to address the government requisition of ships during World War I. The rationale for the provision was that it would have been unfair to impose a tax on involuntary dispositions and to deplete the ship owners’ funds available to replace their ships. Thirty years later, lawmakers relied on the rationale to justify the enactment of I.R.C. § 1034. The analogy seems strained—the country was not at war in 1951, and house sales are not ship seizures. Nonetheless, the Report of Committee on Ways & Means states that a home sale to change jobs or accommodate a larger family “partakes of the nature of an involuntary conversion”; that such sales are “particularly numerous in periods of rapid change such as mobilization or reconversion.” The Report notes further that I.R.C. § 1034 would not be limited to these situations, but instead would apply to all home sales, reasoning that it would be too difficult to administer a provision limited to “involuntary conversion” sales.

2. One-Time Exclusion

I.R.C. § 1034, by allowing gain deferral as long as a homeowner traded up to a house equal or greater in value, subsidized the first stages of the idealized homeownership lifecycle: homeowners would raise their growing families in a series of larger and more expensive houses while at the same time increasing their wealth through homeownership, all without paying any tax. However, it also created a new problem in the latter phase of the lifecycle: with an empty nest and retirement impending, the married couple would want to cash out the savings in their home by downsizing. All those years of trading up to bigger and better houses, all the while retaining the

9. See Klein, supra note 5, at 420–24 (documenting the connection between I.R.C. §§ 1033 and 1034).
10. See id. at 420. To be precise, the 1921 provision allowed a deduction for converted property. See Revenue Act of 1921, Pub. L. No. 67-98, §§ 214(a)(12), 234(a)(14), 42 Stat. 227, 241, 257. It was replaced in 1924 by the nonrecognition provision that has been in effect with certain modifications since then. See Revenue Act, Pub. L. No. 68-176, § 203(b)(5), 43 Stat. 253, 256 (1924).
12. See Klein, supra note 5, at 421–24. Christine Klein notes the widespread support of I.R.C. § 1034 among lawmakers, along with the paucity of legislative history on the provision. She speculates that lawmakers supported the provision in part because it afforded a welcome moment of consensus during a highly contentious legislative session. See id. at 433.
15. See id. at 28.
historic basis of that first starter house, created the potential for a sizeable gain.

The problem was short-lived: in 1964, Congress enacted I.R.C. § 121.16 The new law allowed a one-time exclusion of up to $20,000 of the gain from a home sale, provided the taxpayer was at least sixty-five years old at the time of the sale and had owned and used the property as his or her principal residence for at least five of the eight years preceding the sale.17 The rationale for the exclusion was that it would impose an undue hardship on elderly taxpayers to tax them when they might need the funds for living expenses:

While present law generally provides adequately for the younger individual who is for one reason or another changing residences, it does not do so for the elderly person whose family has grown and who no longer has need for the family homestead. Such an individual may desire to purchase a less expensive home or move to an apartment or to a rental property at another location. He may also require some or all of the funds obtained from the sale of the old residence to meet his and his wife’s living expenses. Nevertheless, under present law, such an individual must tie up all of his investment from the old residence in a new residence, if he is to avoid taxation on any of the gain which may be involved.

Your committee concluded that this is an undesirable burden on our elderly taxpayers.18

What lawmakers failed to note is that elderly taxpayers owning homes with large built-in gains—that is, high value and low basis—were exactly the taxpayers who were likely to have availed themselves of I.R.C. § 1034 during their years as homeowners. Thus, the new exclusion bestowed another tax benefit on those who had already benefitted from deferral under I.R.C. § 1034.19

Initially, the one-time exclusion was relatively modest.20 Originally designed to address “the average and smaller homestead selling for $20,000

---

19. See CONG. BUDGET OFFICE, U.S. CONG., THE TAX TREATMENT OF HOMEOWNERSHIP: ISSUES AND OPTIONS 16–17 (1981) ("[T]he exclusion converts the continuing, interest-free loan on tax liabilities that the deferral provides into a permanent forgiveness of tax liabilities. It thus compounds the favorable tax treatment created by the deferral of capital gains on home sales.").
20. Even at its initial modest level, the exclusion caused concern:

The new exclusion for gains from the sale of residences by senior citizens seems ill-advised. As is the case with so many tax exemptions, the new exclusion appears to be a generous gesture when it is viewed in isolation. Upon comparative consideration, however, its true preferential character emerges. There is no particular reason why wealthy persons
or less, it applied only to the gain attributable to the first $20,000 of the selling price. However, from 1964 to 1997, Congress amended the exclusion several times to make it more generous—increasing the amount of gain eligible for the exclusion, lowering the age requirement, and decreasing the required time periods of ownership and use. Until 1997, a taxpayer could exclude up to $125,000 ($62,500 in the case of married persons filing separately) of gain on a home sale, provided he or she was at least fifty-five years of age at the time of sale and had owned and used the property as his or her principal residence for three of the five years preceding the sale. Despite the enhanced generosity of the one-time exclusion, it continued to be restricted to one-time use.

B. The 1997 Law

1. Rollover Regime Repealed and Gain Exclusion Enacted

With the Taxpayer Relief Act of 1997 (1997 Act), the tax treatment of home sales underwent a major change: Congress repealed I.R.C. § 1034 should not shoulder their proportionate share of the tax burden regardless of age. The exemption of a person from the income tax on the basis of age rather than economic status is difficult to justify.


21. H.R. REP. NO. 88-749, at 46. In 2012 dollars, $20,000 would be roughly $148,500. See U.S. DEP’T OF LABOR, BUREAU OF LABOR STATISTICS, CPI Inflation Calculator, http://www.bls.gov/data/inflation_calculator.htm (last visited Aug. 21, 2013). However, housing prices have increased at a much greater rate than inflation. In 1964, the median and average sales price for a new home was $18,900 and $20,500, respectively. In 2007, when housing prices peaked, the median and average was $247,900 and $313,600, respectively. As of 2010, the most recent year available, the average and median was $221,800 and $272,900, respectively. See U.S. DEP’T OF COMMERCE, U.S. CENSUS BUREAU, Median and Average Sales Price of New Homes Sold in the United States, http://www.census.gov/const/uspriceann.pdf (last visited Aug. 21, 2013).

22. See I.R.C. § 121 (1970) (prior to amendment in 1976). If the selling price was greater than $20,000, the taxpayer could exclude a part of the gain that corresponded to the proportion between $20,000 and the selling price. See id. Thus, for example, if a taxpayer sold a house for $30,000, in which he had a $5,000 basis, for a gain of $25,000, he would be able to exclude only two-thirds ($20,000/$30,000), or $16,667, of the gain. Mathematically, the exclusion amount could never exceed $20,000.

23. See Revenue Act of 1976, Pub. L. No. 94-455, § 1404(a), 90 Stat. 1520, 1733 (increasing exclusion amount to $35,000); Revenue Act of 1978, Pub. L. No. 95-600, § 404(a), 92 Stat. 2763, 2869 (increasing exclusion amount to $100,000 ($50,000 in the case of married persons filing separately)); Tax Incentive Act of 1981, Pub. L. No. 97-34, § 123, 95 Stat. 172, 197 (increasing exclusion amount to $125,000 ($62,500 in the case of married persons filing separately)).

24. See Revenue Act of 1978 § 404(a) (reducing age requirement to fifty-five).

25. See id. § 404(c)(1), (2), at 2870 (reducing the required period of use and ownership as the taxpayer’s principal residence to three of the five years preceding the sale).


27. See id.
and greatly expanded and liberalized I.R.C. § 121.28 (This Article refers to the prior law rollover provision of I.R.C. § 1034 and the one-time exclusion of I.R.C. §121 as the “rollover regime.” It refers to current law I.R.C. § 121 to as the “gain exclusion.”) Under the new gain exclusion, the maximum amount of the exclusion was set at $250,000 ($500,000 for married couples filing a joint return), doubling the exclusion amount for unmarried taxpayers, and quadrupling it for married couples.29 The use and ownership requirement was reduced to two of the five years preceding the sale (the “two-of-five use and ownership requirement”).30 And most importantly, the gain exclusion was no longer limited to one-time use by taxpayers fifty-five years of age or older—it could now be used repeatedly, not more than once every two years, by the same taxpayer, without regard to the age.31

Lawmakers offered a variety of rationales for adopting the generous new provision.32 First, they argued the rollover regime imposed too great an administrative burden on taxpayers. Noting that “many taxpayers buy and sell a number of homes over the course of a lifetime,” the Report of the Committee on Ways & Means (1997 House Report) bemoans the homeowner’s difficult task of keeping track of his basis in his house, a task that stretched back in time “in most cases, for many decades.”33 The Report ignores the fact that the reason that homeowners had to keep track of basis “for many decades” was that I.R.C. § 1034 had allowed them to defer the gain on the multiple home sales they had made during those decades. It does, however, note that the recordkeeping often ends up being needless because “most homeowners never pay any income tax on the capital gain on their principal residences, as a result of the rollover provisions and the $125,000 one-time exclusion.”34 Stated more simply, the rationale seemed

---

29. Under prior law, a married couple was allowed only one exclusion of $125,000. See I.R.C. § 121(b)(1) (amended 1997). There is no explanation of why the exclusion amount was raised so substantially. See id. Particularly for married couples, the new exclusion amount greatly exceeded the average and median selling price for new homes in 1997 ($146,000 and $172,000, respectively). See U.S. DEPT OF COMMERCE, U.S. CENSUS BUREAU, Median and Average Sales Price of New Homes Sold in the United States, http://www.census.gov/const/uspriceann.pdf (last visited Aug. 21, 2013).
31. See id. The limitation on use of the exclusion to once every two years (the “two-year limitation”) is similar to the two-year limitation on the use of the rollover provision. See I.R.C. § 121(b)(3) (2006); I.R.C. § 1034 (1994) (repealed 1997). See supra note 5 and accompanying text.
33. See id. at 347, reprinted in 1997 U.S.C.C.A.N. 678, 741. House Report 148 also discusses the difficulty of distinguishing between capital home improvement expenditures, which increase basis, and home repair expenditures which do not. See id.
34. See id.
to be, why require all this recordkeeping when we know no one’s going to pay tax anyway?35

Another rationale for the new law had to do with the undesirable incentive effects of the rollover provision. Because it required a taxpayer to reinvest the sale proceeds from his old house in a new house of equal or greater value in order to achieve complete deferral, it encouraged people to purchase increasingly expensive homes, promoting “an inefficient use of taxpayer’s [sic] financial resources,” particularly when people moved from a higher-cost to lower-cost region of the country.36

A third rationale offered for the gain exclusion was that the one-time exclusion impaired the mobility of elderly taxpayers who might “choose to stay in their homes even though the home no longer suits their needs”37 rather than sell their homes and pay tax on the gains.38

Finally, in support of the gain exclusion, the 1997 House Report cites potential “traps for the unwary,” that would be eliminated, such as the loss of the one-time exclusion that resulted from marrying someone who had already made use of the exclusion; the unexpected gain that might result from moving from a high-cost region of the country to a low-cost region; and the unexpected gains that might befall a divorcing couple.39

2. Procedural Change

The 1997 Act made one other obscure change related to I.R.C. § 121: it amended I.R.C. § 6045 to exempt most home sales from the reporting requirements of that provision.

35. Restating the argument this way is not entirely facetious. Tax commentator Lee Sheppard articulated the argument in similar fashion when she expressed support for a 1991 proposal to exclude gains on home sales:

    This leads to the first reason why this legislation is good, to wit, why not be honest about it? We are not serious about gains taxation on sales of personal residences, so why make people jump through hoops to qualify for an exclusion? It is vastly simpler to just exempt these sales from taxation.


37. Id.

38. House Report 148 overlooks the fact that this group of taxpayers has already benefitted from life-long deferral plus a one-time exemption, so that much, if not all, of their taxable gain would have accrued relatively recently, and would likely not be substantial. Also, there was no attempt to distinguish between more needy elderly taxpayers—for example, those who might need to go into assisted living or move closer to family members who could provide care—and those who might want to relocate purely out of personal preference.

39. See H.R. REP. NO. 105-148, at 348, reprinted in 1997 U.S.C.C.A.N. 678, 742. The characterization of these as “traps for the unwary” is questionable. Rather, these seem to be logical consequences of the law as it was intended to operate.
I.R.C. § 6045 requires brokers to report to the IRS information regarding their customers’ transactions, including names, addresses, and gross proceeds. Congress had explicitly extended it to apply to real estate transactions in 1986 with the enactment of a new subsection, I.R.C. § 6045(e). I.R.C. § 6045(e) requires a “real estate reporting person” to provide to the IRS and the seller of the property a form which contains the seller’s name, address, and taxpayer identification number; a general description of the property; the closing date; and the gross proceeds of the sale. A real estate reporting person is defined to be the person responsible for closing the transaction, such as the attorney or title company, or in the absence of such person, a person such as the mortgage lender, the seller’s broker, the buyer’s broker, or another person involved in the transaction.

The 1997 Act amended I.R.C. § 6045(e) to exempt a real estate reporting person from the obligation to file an information return if (1) the selling price was no greater than the exclusion amount ($250,000 for an unmarried seller; $500,000 for a married seller), and (2) the seller provided a written assurance that the property was the seller’s principal residence and that the entire gain was excludable under I.R.C. § 121.

The 1997 House Report’s stated reason for the broker reporting exemption is perfunctory: “The Committee believes that informational returns should not generally be required on sales of personal residences where the sales price does not exceed the amount eligible to be excluded from income.” Perhaps the impetus for the exemption derived from
antipathy towards the IRS and its intrusiveness into taxpayers’ lives, exemplified by Dole’s presidential campaign pledge to “end the I.R.S. as we know it,” and stop the “K.G.B.-like life style audits.”47 This antipathy culminated in a sweeping curtailment of IRS enforcement and collection powers in 1998.48 As Linda Goold, tax counsel for the National Association of Realtors, said about the Dole and Clinton proposals to expand the exclusion of home sale gains, “It’s the ultimate ‘get the I.R.S. out of your life’ provision.”49 The broker reporting exemption went even further in keeping the IRS out of taxpayers’ lives: not only would taxpayers pay no tax on gains from home sales and be relieved of basis recordkeeping; in addition, the IRS would not even know that they had sold their houses.

C. Other Aspects of the Gain Exclusion

1. Basic Requirements and Special Rules

To meet the two-of-five use and ownership requirement of I.R.C. § 121, a taxpayer must have used and owned the property as his or her principal residence for periods aggregating at least two years during the five years ending on the date of the sale.50 The periods of use and ownership do not have to be simultaneous.51 Determining whether a property is the taxpayer’s principal residence, and for how long the taxpayer has used it and owned it as such is a complex inquiry that incorporates prior law as well as extensive regulations under I.R.C. § 121.52

47. Id.
50. I.R.C. § 121(a) (2006). In the case of married couples filing a joint return, in order to qualify for the $500,000 exclusion, only one spouse need satisfy the ownership component of the two-of-five ownership requirement, but both spouses must satisfy the use component. I.R.C. § 121(b)(2)(A). Failing this, each spouse will be eligible for the individual taxpayer exclusion if he or she otherwise meets the requirements for the exclusion. See I.R.C. § 121(b)(2)(B).
Under the two-year limitation, the gain exclusion cannot be used more than once every two years.\textsuperscript{53} In the absence of the two-year limitation, a taxpayer with multiple residences—who otherwise satisfied the two-of-five use and ownership requirement for those multiple residences—could claim multiple exclusions within a shorter time period.\textsuperscript{54}

The two-of-five use and ownership requirement and the two-year limitation are relaxed in cases where the taxpayer sells or exchanges his house due to a change in place of employment, health, or unforeseen circumstances.\textsuperscript{55} In these cases, the maximum amount of the exclusion is reduced in proportion to the amount of time the taxpayer owned and used the property as his principal residence.\textsuperscript{56}

In addition, I.R.C. § 121(d) contains special rules relating to property of a deceased spouse; property transferred to an individual by a spouse or former spouse incident to divorce; property used by a former spouse pursuant to a divorce or separation instrument; tenant-stockholders in a cooperative housing corporation; gains attributable to depreciation; involuntary conversions; taxpayers who become physically or mentally incapable of self-care; sales of remainder interests; expatriates; and property acquired from a decedent.\textsuperscript{57}

2. Anti-Avoidance Measures

Since the 1997 Act, Congress has enacted two anti-avoidance provisions in response to perceived abuses of the gain exclusion. The first, enacted in 2004, addresses a strategy that enabled a taxpayer to use the gain exclusion to shelter gains attributable to property held for investment or use in a trade or business.\textsuperscript{58} Typically, the taxpayer would exchange such property for new property in a like-kind exchange governed by I.R.C. § 1031. Under that provision, the taxpayer would not recognize gain with respect to the old property, but the gain would be preserved by assigning him a basis in the new property that would be equal to the basis in the old property. The taxpayer would then convert the new property to use as his principal residence for two years, and then sell it and exclude the gain.

\textsuperscript{53} See I.R.C. § 121(b)(3).

\textsuperscript{54} For example, suppose taxpayer $T$ owned Tara and Graceland for five years and lived first in Tara for two-and-a-half years and then in Graceland for two-and-a-half years. In the absence of the two-year limitation, $T$ could sell both Tara and Graceland at the end of the five-year period and exclude the gain from both.

\textsuperscript{55} See I.R.C. § 121(c)(2).

\textsuperscript{56} See I.R.C. § 121(c)(1); Treas. Reg. § 1.121-3(g) (2004). For example, if $T$, a single taxpayer, owned and used Manderley for six months and sold it due to employment relocation, the maximum exclusion amount would be one quarter (.5 years /2 years) of the full $250,000 exclusion amount.

\textsuperscript{57} For a discussion of these special rules, see Dilley & Callihan, \textit{supra} note 5.

under I.R.C. § 121. To address this perceived abuse, a special rule provides that where a taxpayer has acquired property in a like-kind exchange, he cannot use the gain exclusion upon subsequent sale of the property unless he has owned the property for at least five years.

The second anti-avoidance provision, enacted in 2008, is intended to address the perceived abuse in which a taxpayer would convert a vacation home or investment property to use as his principal residence for two years and then sell the home. In the absence of a special rule, the taxpayer would be able to use the gain exclusion to shelter gains attributable to the period he had used the property as a vacation home or investment property. Under the anti-avoidance provision, a taxpayer who otherwise qualifies for the gain exclusion must recognize the portion of gain allocable to certain periods for which he owned a property but did not use it as his principal residence.

II. HOW DID WE GET HERE?

This Part uses the history of tax subsidies for home sales developed in Part I to analyze the ways in which path dependence and bounded rationality have shaped the law, leading to dubious choices and undesirable outcomes. It then highlights the ways in which politics and the influence of interest groups contributed to the evolution of the law.

A. Path Dependence and Bounded Rationality

1. The Basic Concepts

At its most general, “path dependence means that where we go next depends not only on where we are now, but also upon where we have been. History matters.” More specifically, “the crucial feature of a historical
process that generates path dependence is positive feedback (or self-reinforcement). Given this feature, each step in a particular direction makes it more difficult to reverse course.”

The QWERTY keyboard is the paradigmatic example of path dependence and its consequences. The keyboard happened to gain popularity in the early days of the typewriter due to a minor and short-lived advantage it had over other keyboard designs. The more prevalent it became, the more beneficial it was for users to learn how to use it, and the more difficult it became to induce users to switch to an arguably superior design. In this way, a keyboard design that is inferior to others has become the standard.

According to Paul Pierson and other political scientists, path dependence operates with similar effects on decisions and outcomes in the context of political processes. Pierson theorizes that the temporal dimension of politics is crucial to understanding political outcomes, that instead of taking a “snapshot” view of political life, it is necessary to “situate particular moments (including the present) in a temporal sequence of events and processes stretching over extended periods.” He describes how path dependence results in self-reinforcing effects of early steps down a particular path:

In the presence of positive feedback, the probability of further steps along the same path increases with each move down that path. This is because the relative benefits of the current activity compared

64. See David, Clio, supra note 62.
65. In Paul David’s account, the QWERTY keyboard addressed a short-lived problem in the early design of the manual typewriter—it helped keep the keys from jamming—while a different keyboard, designed by Dvorak, enabled faster typing. See id. at 333–34. This account has been disputed. See Stan J. Liebowitz & Stephen E. Margolis, The Fable of the Keys, 33 J.L. & ECON. 1 (1990). Nonetheless, it is still widely cited as an intuitive example of path dependence. See The QWERTY Myth, ECONOMIST, Apr. 3, 1999, at 67 (noting QWERTY has achieved “iconic eminence” even though it is a myth).
67. See Id. at 332, 336.
69. See PIERSON, supra note 63, at 2.
with once-possible options increases over time. To put it a different
way, the costs of switching to some previously plausible alternative
rise.\textsuperscript{70}

The concept of bounded rationality is simple but powerful: people have
finite cognitive resources and therefore need to ration them in
decisionmaking processes.\textsuperscript{71} They may accomplish this by limiting the
information and choices they consider or by relying on heuristic
“shortcuts.”\textsuperscript{72} In recent years, scholars have invoked bounded rationality to
explain why the United States has had such different reactions to terrorism
and global climate change;\textsuperscript{73} why standard form contracts are often
inefficient;\textsuperscript{74} and why myriad aspects of law are affected by lawmakers’
“limited capacities for productive thinking.”\textsuperscript{75}

2. Path Dependence, Bounded Rationality, and Tax Subsidies for
Home Sales

As Part I has described, the original subsidy for home sales—the
rollover provision of I.R.C. § 1034—was justified by a dubious analogy to
wartime ship seizures.\textsuperscript{76} This was the first, ill-considered step on the path of
tax subsidies for home sales. Once in place, I.R.C. § 1034 gave rise to a
new phenomenon: taxpayers who had taken advantage of deferral over
many years and through multiple rollovers would face large gains when
they downsized. The characterization of this as an unfair hardship for
erly taxpayers obscured the fact that this very group—elderly taxpayers
who owned homes with high values and low bases—were exactly the
individuals who were likely to have availed themselves of I.R.C. § 1034
during their years as homeowners. Thus, with the one-time exclusion,
lawmakers bestowed yet another tax benefit on those who had already
benefitted from deferral under I.R.C. § 1034.\textsuperscript{77}

\textsuperscript{70}. \textit{Id}. at 21.
\textsuperscript{71}. See \textit{Herbert A. Simon, A Behavioral Model of Rational Choice}, 69 Q. J. ECON. 99, 104–05
(1955); \textit{see also James G. March, Bounded Rationality, Ambiguity, and the Engineering of Choice, 9
Bell J. Econ.} 587 (1978); \textit{Herbert A. Simon, Rational Decision Making in Business Organizations, 69
Am. Econ. Rev.} 493 (1979); \textit{Herbert A. Simon, Rational Choice and the Structure of the Environment,
63 Psychol. Rev.} 129 (1956).
\textsuperscript{73}. See \textit{Cass R. Sunstein, On the Divergent American Reactions to Terrorism and Climate
\textsuperscript{74}. See \textit{Russell Korobkin, Bounded Rationality, Standard Form Contracts, and
\textsuperscript{75}. See \textit{Hirsch, supra} note 72, at 1337.
\textsuperscript{76}. See \textit{supra} notes 9–15 and accompanying text.
\textsuperscript{77}. See \textit{Cong. Budget Office, The Tax Treatment of Homeownership: Issues and
Options} 15–16 (1981) (“[T]he exclusion converts the continuing, interest-free loan on tax liabilities
From a bounded rationality perspective, the one-time exclusion made some sense—elderly taxpayers who had deferred gains for many years would face an inordinately large gain when they finally got off the rollover bandwagon. However, a more fundamental solution to the problem would have been to eliminate the rollover regime that caused the problem to begin with. The original rationale for its enactment was shaky at best. Moreover, even if one agreed that a home sale was analogous to a ship seized in times of war, the problems created by multiple rollovers over many years were unforeseen and should have prompted a re-examination of I.R.C. § 1034.

The possibility of repealing the rollover provisions, however, was never even entertained as a possibility. This is a striking instantiation of the path dependence problem: once Congress enacted the rollover provision, homeowners began to accumulate deferred gains. To reverse course had become too costly at that point in time, even if the rollover provision had proved to be a mistake.78

Path dependence also posits that once a path is chosen, each step down the path entrenches the path more deeply and makes it more difficult to reverse course.79 With the enactment of the one-time exclusion, Congress took another step down the path, making it even more costly to reverse course. People expected not only to be able to defer the taxes on their gains from homes sales; they now expected never to have to pay them.

Congress took another giant step down the path in 1997. With most gains on most home sales now exempt from tax through the rollover provision, in combination with the one-time exclusion, the next logical step, it seemed, was to exempt home sales from tax entirely. As lawmakers reasoned at the time, the gain exclusion would eliminate the incentive, created under I.R.C. § 1034, for taxpayers to purchase increasingly expensive homes. It would also eliminate the need for burdensome basis recordkeeping that could stretch back for decades over multiple home sales. The very same goals could have been achieved by eliminating both the rollover provision and the one-time exclusion, and taxing gains on home sales, but to propose this would surely would have been political suicide. As path dependence predicts, reversing course was simply not an option.

---

78. The costs of reversing course include the political fallout: voters would have been extremely unhappy to have their home appreciation suddenly subject to tax. There would also be economic costs, in terms of disruption to the housing market.

79. See PIERSO, supra note 63, at 35 (“[S]ocial actors make commitments based on existing institutions and policies. As they do so, the cost of reversing course generally rises dramatically.”).
Bounded rationality limited the choice to the rollover regime or the gain exclusion, and as between the two, policymakers also agreed that the latter was preferable. Economist Martin Sullivan opined:

[T]his is probably one of the most sensible of the Clinton proposals. It allows senior citizens to sell their homes before they die without dire tax consequences. It also allows people who may need to move into a less costly home — because of divorce, a move to a lower-cost region, or the loss of a job — to not feel obligated to buy more house than they need just to avoid paying capital gains tax. It also eliminates the need for a lot of long-term recordkeeping.

A 1996 study by economists Leonard Burman, Sally Wallace, and David Weiner illustrates the limited universe of policy options that were considered. The study makes a thorough and critical assessment of the rollover regime and finds that it distorts homeowners’ behavior, is costly to administer, and exempts most gains from home sales from tax. Burman, Wallace, and Weiner conclude that “[t]he tax on capital gains on homes sales is an inefficient tax. It is easy to avoid. It raises little revenue, but it affects the housing choices of tens of thousands of homeowners every year.” The only alternative they consider is the repeal of the tax on gains


82. See Burman, Wallace & Weiner, supra note 80.

83. Using data from the 1993 IRS Statistics of Income File, Burman, Wallace, and Weiner identify slightly more than 1.5 million reported home sales (out of a total of 3.8 million existing home sales, according to an estimate of the National Association of Realtors). Of the reported home sales, a total of $50.5 billion in gains were reported, and almost all of the reported gain, $48 billion, was excluded under either the rollover provision of I.R.C. § 1034 ($30 billion) or the one-time exclusion of I.R.C. § 121 ($18 billion). See id. at 385. Burman, Wallace, and Weiner also estimate the costs of these provisions—in terms of compliance costs and the distortive effects on homeowners’ decisions about home purchases and sales—and find that these costs were “probably equal to at least two-thirds of the revenue collected, and possibly much more than 100 percent.” See id. at 388. They estimate the deadweight losses that results from people’s decisions not to rent, or not to buy less expensive houses, and the deadweight loss of compliance and recordkeeping associated with the rollover/one-time exclusion regime. See id. at 387–89.

84. Id. at 388.
from home sales—i.e., a gain exclusion. They do not consider a return to the pre-rollover law, under which gains on home sales were taxed fully even though, judged by their own evaluative criteria, this alternative would have improved the tax greatly: it would have raised much more revenue, been much more difficult to avoid, and have reduced compliance costs.

Path dependence and bounded rationality can help explain why lawmakers and policymakers began with the assumption that gains on home sales would continue to be tax-favored. With this assumption in place, they chose what they believed to be a superior regime of nontaxation. This is not to say, however, that lawmakers and policymakers were unaware that they were making judgments in a constrained universe of choices. Certainly, if asked why they had not also considered a return to full taxation of gains on home sales, many would have cited the political impossibility of such a proposal. As commentator Lee Sheppard observed: “The best solution—the enemy of the good—is to go cold turkey on tax incentives and let the decision to buy a house be a purely personal decision. But this, as we have seen, is politically impossible.”

The next Part highlights the central role that politics played in the 1997 enactment of the gain exclusion, and provides further insights into how and why it became the alternative to the rollover regime.

B. Politics

The idea of an expanded gain exclusion for home sales was first put forth by Pennsylvania Congressman Richard T. Schulze in 1989, and then again in 1990, 1991, and 1992. Schulze’s proposal would have eliminated the age and dollar amount limitations but retained the one-time use limitation. The two largest Schulze campaign contributors during his time

85. Id. at 383, 389. They assess the relative merits of a complete repeal of the tax on gains from home sales, as compared to the rollover/one-time exclusion regime. They note that neither the Clinton proposal nor the Dole proposal would eliminate entirely the tax on gains from sales. Id. at 383. They note that repeal of the tax would eliminate behavioral distortions, but they express concern about adding yet another additional subsidy to homeownership. To address this concern, they also propose reducing other homeownership subsidies. Id. at 389.


in Congress were the National Association of Home Builders and the National Association of Realtors.\textsuperscript{88}

Schulze argued that a widely available exclusion for home sales would help garner broad support for reinstating a capital gains preference because it would counteract the perception that the capital gains preference benefitted only wealthy taxpayers.\textsuperscript{89} In addition, Schulze claimed that because of the incentive created under I.R.C. § 1034 to trade up to more expensive homes, “homeowners practically have to build mansions . . . to avoid being hit with a stiff tax on the gain of the sale to their home.”\textsuperscript{90} He further argued that an expanded exclusion would eliminate basis recordkeeping; provide relief for homeowners forced to sell due to divorce, illness, or age; make housing more affordable by reducing housing price distortions; allow homeowners more quickly to move up from starter homes to larger homes; and eliminate the tax on gains attributable to inflation.\textsuperscript{91}

Although Schulze’s proposal was not enacted, his idea—and the rationales for it—gained traction in Washington. In the early years of the Clinton Administration, members of Clinton’s tax policy team had proposed to exempt most gains from home sales as a simplification measure that would eliminate the need for homeowners to keep track of their basis in their homes.\textsuperscript{92} Later, in December 1995, Clinton had offered up the proposal to Republican congressional leaders to appease their demands for broad tax cuts.\textsuperscript{93}

Then, in 1996, as Clinton fought to keep the White House for a second term, Republican presidential candidate Bob Dole proposed to exempt most gains from home sales as part of a massive tax cut plan.\textsuperscript{94} The Dole proposal was more generous than the Schulze proposal: it did away with


\textsuperscript{89} See Letter from Dick Schulze, Member of Congress, to Dan Rostenkowski, Chairman, Comm. on Ways & Means (June 19, 1989), in Schulze asks Rosty and Brady for Capital Gains Relief on Residences and Depreciable Property, 89 TAX NOTES TODAY 133-2 (1989).

\textsuperscript{90} Id.

\textsuperscript{91} See id.; see also Sheppard, supra note 35, at 1433 (providing further details about Schulze’s justifications for an expanded I.R.C. § 121).

\textsuperscript{92} See Vikas Bajaj & David Leonhardt, Tax Break May Have Helped Cause Housing Bubble, N.Y. TIMES (Dec. 18, 2008), http://www.nytimes.com/2008/12/19/business/19tax.html?pagewanted=all&r=0 (reporting that Leslie B. Samuels, Assistant Treasury Secretary for Tax Policy, and Eric J. Toder, Deputy Assistant Treasury Secretary for Tax Analysis, both from 1993 to 1996, were interested in exempting gains from home sales as a simplification measure).


\textsuperscript{94} Along with his proposal to expand the exclusion of gain for home sales, Dole proposed to cut income tax rates by 15% across the board, cut capital gains rates in half, enact a $500 child credit, expand Individual Retirement Accounts, and reform the IRS, while at the same time he pledged to achieve a balanced budget within five years. See Seelye, supra note 46.
the one-time use limitation on the exclusion; increased the exclusion amount to $250,000 for married taxpayers who owned and used their homes for at least three of five years preceding the sale, and for taxpayers who had owned their homes between ten and twenty years; and incrementally increased the exclusion amount to a maximum of $250,000 for single taxpayers and $500,000 for married taxpayers.\textsuperscript{95}

Clinton had to come up with a plan to compete with Dole’s. His political strategists advised him to propose a major cut in capital gains, but Clinton’s economic advisers, concerned with the budgetary consequences, opposed the idea.\textsuperscript{96} Instead, they seized upon the expanded gain exclusion for home sales as a way to appeal to a broad swath of voters.\textsuperscript{97} At the same time, because very few home sellers paid tax under the rollover regime, the revenue loss from an expanded exclusion was estimated to be quite small.\textsuperscript{98} As one journalist summarized,

[Broadening the capital gains exemption [for home sales is] a deficit-conscious Presidential candidate’s dream. Here, after all, is a tax break with great popular appeal that requires only modest offsetting revenues. And here, miracle of miracles, is a tax break that even passes muster with policy wonks—and for many of the same reasons that it would please homeowners.\textsuperscript{99}

Not to be outdone by Dole, Clinton put forth a proposal that was even more generous in certain respects: it eliminated the one-time use restriction (like Dole’s) and provided an exclusion of $250,000 ($500,000 for married taxpayers) to homeowners who owned their homes for a mere two of five years preceding the sale. Clinton unveiled his proposal at the Democratic National Convention\textsuperscript{100} and cited it during the presidential debates when asked whether he intended to cut capital gains taxes.\textsuperscript{101} Clinton won the election, and in 1997, he signed into law the provisions that essentially codified his proposal.\textsuperscript{102}

\textsuperscript{96} See Bajaj & Leonhardt, supra note 92.
\textsuperscript{97} See id.; Passell, supra note 80.
\textsuperscript{98} The gain exclusion was estimated to cost $1.6 billion over six years. In contrast, Dole’s tax plan was estimated to cost $542 billion. See Gray, supra note 93.
\textsuperscript{99} See Passell, supra note 80.
\textsuperscript{100} President Bill Clinton, Address by the President to the Democratic National Convention (Aug. 29, 1996) (transcript available at http://www.4president.org/speeches/clintongore1996convention.htm).
\textsuperscript{102} See supra notes 28–45 and accompanying text.
In summary, the political story shows how the gain exclusion became the favored choice of lawmakers. The idea began as the hobby horse of a congressman generously funded by the real estate lobby. It gained traction as a simplification measure in the early years of the Clinton administration, and then did duty as a capital gains sop Clinton offered to the Republicans during the 1995 budget negotiations. Finally, it gathered momentum during the 1996 presidential campaign, both as a component of Dole’s ambitious tax-cutting agenda, and, perhaps more crucially, as a vehicle for Clinton to demonstrate his support for capital gains tax cuts while at the same time preserving his credentials as a deficit hawk. The specific features of the new law—for example, the two-of-five use-and-ownership requirement—were more the product of an “anything you can do, I can do better” contest between Clinton and Dole, than thoughtful policy design.

Given this political backstory, it becomes clear why lawmakers ignored the possibility of moving toward a more comprehensive tax on gains from home sales. Although this alternative would have ameliorated many of the undesirable features of the rollover regime, with the Gingrich-led Republicans agitating for tax cuts, no politician in his right mind would have made such a proposal.

Economists and other commentators did not face the same political costs of reversing course that lawmakers did. Yet, virtually all of them approved of the new law and the rationales for it and did not consider other options.103 In their defense, the mainstream media expected commentators to react to the proposals on the table and compare them to the status quo at the time, and they probably would not have been interested in hearing about alternatives, such as taxing gains on home sales, that were political nonstarters. Furthermore, policymakers often have to be pragmatic and support the “less bad” alternative. Nonetheless, the approval of commentators helped clear the way for the gain exclusion to become the law.

C. The Role of the Real Estate Lobby

The real estate lobby was another important actor in nudging lawmakers down the path to the gain exclusion. The presence of the real estate lobby in U.S. housing policy has been pervasive since the New

---

103. See supra notes 80–85 and accompanying text. Some commentators did point out Clinton’s political sleight of hand in claiming that an expanded exclusion would both cut capital gains tax but result in almost no revenue loss. See Sullivan, supra note 81, at 683 (“Given the already generous benefits available for capital gains on sales of personal residences, this proposal is not as big a deal as the administration would like taxpayers to believe.”); Passell, supra note 80 (“Hardly anybody pays the capital gains tax on housing, so eliminating it wouldn’t make much difference . . . .” (quoting Princeton economist Harvey Rosen)).


109. See Schulze, supra note 88 and accompanying text.

110. See Ravo, supra note 49 and accompanying text.

111. See Adams, infra note 144 and accompanying text.
of real estate lobby influence. The statement of Richard Woodbury on behalf of the National Association of Realtors corresponds closely with the analysis and language of the 1997 House Report.\textsuperscript{112}

Woodbury’s statement (1) details the difficulties faced by taxpayers in keeping track of basis “over the course of a lifetime” under the rollover regime; (2) discusses the incentive under the rollover regime to “buy ever more expensive housing, even though they might not need it,” noting especially that “homeowners who relocate from high housing cost areas are perceived as driving up the cost of housing when they relocate to lower cost areas”; and (3) criticizes the one-time exclusion for being allowable only once, and for not being available where a widow or widower who has already used the exclusion remarries someone who has not.\textsuperscript{113}

In comparison, the 1997 House Report (1) details the difficulties of keeping track of basis “for many decades” under the rollover regime; (2) discusses how the rollover regime encourages taxpayers “to purchase larger and more expensive houses than they otherwise would in order to avoid a tax liability, particularly those who move from areas where housing costs are high to lower-cost areas”; and (3) discusses how the one-time exclusion discourages elderly people from moving, and also presents “traps for the unwary” in the case of widowed and divorced taxpayers.\textsuperscript{114}

This remarkable similarity between Woodbury’s statement and the 1997 House Report does not mean that the real estate lobby dictated the terms of the 1997 law. It is possible that both documents simply reflect objective and widely held views about the problems with the rollover regime. However, the real estate lobby’s top priority was to promote its own interests; to think otherwise would be naïve. The parallels between the documents, along with the fact that not a single individual or organization offered testimony in opposition to the views of the real estate lobby, suggest that it exerted considerable influence. The real estate lobby not only helped push through the substantive law change but also provided the reasoning and specific language that became the official explanation for why Congress changed the law.\textsuperscript{115}

The testimony of the real estate lobbyists during the 1997 Hearing also offers hints about other aspects of the law that they may have influenced. The 1997 House Report gives no explanation for the generous increase in


\textsuperscript{113.} See id. The statement of C. Kent Conine on behalf of the National Association of Homebuilders also cites basis recordkeeping as a problem with the rollover regime. See id. at 214.


\textsuperscript{115.} See id.; 1997 Hearing, supra note 112, at 70.
the amount of the exclusion, from $125,000 to as much as $500,000 (for married taxpayers). Woodbury points out that less than two percent of home sales exceeded $500,000 at the time, which meant that almost all home sales would be exempt from tax.\footnote{116. See 1997 Hearing, supra note 112, at 71.} He characterizes this as a simplification measure because almost all homeowners would be relieved of recordkeeping burdens.\footnote{117. See id.} In the absence of any explanation for how the new exclusion amount was determined, one can speculate that the National Association of Realtors, which compiles authoritative data about home sales, was eager to suggest $500,000 as the new exclusion amount.

Another hint of the real estate lobby’s influence relates to the broker reporting exemption for home sales, which, as is discussed below, severely impairs the ability of the IRS to enforce the new law.\footnote{118. See infra notes 190–201 and accompanying text.} The 1997 House Report offers little insight as to the reasons for the reporting exemption.\footnote{119. See H.R. REP. NO. 105-148, at 421, reprinted in 1997 U.S.C.C.A.N. 678, 822 (“The Committee believes that informational returns should not generally be required on sales of personal residences where the sales price does not exceed the amount eligible to be excluded from income.”).} However, there is some indication that the real estate lobby advocated for it. In his statement for the 1997 Hearing, C. Kent Conine, on behalf of the National Association of Homebuilders, discusses at length the fact that most taxpayers who sold their homes under the rollover regime were not required to pay any tax, and that “only half of all home sellers even file the proper form.”\footnote{120. See 1997 Hearing, supra note 112, at 214.} Woodbury reiterates the National Association of Realtors’ talking point that the new law “is the ultimate ‘Get the IRS out of your life’ proposal.”\footnote{121. See id. at 71.} Again, one can speculate that the real estate lobby would have known about the broker reporting requirement and would also have been acutely aware of the importance of eliminating it.

This Part has explored how path dependence and bounded rationality, in a complex interaction with politics and the influence of interest groups, have brought the tax law to a place where almost all gains on home sales are exempt from tax. Building on this more nuanced and complete understanding of how the law developed, the next Part reassesses the law.

III. WHERE WE ARE: AN ASSESSMENT

This Part revisits the reasons for repealing the rollover regime and replacing it with the gain exclusion. It finds that many of the purported advantages of the gain exclusion relative to the rollover regime are
questionable. Moreover, the gain exclusion has created new problems that were not foreseen at the time it was enacted.

A. Basis Recordkeeping

The burden of keeping track of basis over long time periods was cited by virtually all lawmakers, policymakers, and commentators as a major problem under the rollover regime. As described above, the rollover regime deferred tax on the gain from a home sale by transferring a taxpayer’s basis in his old residence to his new residence, thereby preserving the amount of gain that went unrecognized on the old residence. This process of transferring basis could continue through a succession of home sales qualifying for rollover. The purported problem of basis recordkeeping was an important component of the “baby with the bathwater” argument—that taxing home sales was so burdensome and difficult, and collected so little tax, it would be better to jettison the tax entirely, and simply exempt all home sales from tax.

To be sure, basis recordkeeping can be costly and challenging. Joseph Dodge and Jay Soled have documented substantial and widespread compliance issues related to basis generally, not just basis in houses. Amidst the rampant noncompliance uncovered in a 1979 study—which Dodge and Soled judge to be the most accurate available—personal residence sales stood out as one of the worst categories.

But are the problems of basis recordkeeping as insurmountable as was readily assumed in the assessment of the rollover regime? The law relating to basis for inherited property is instructive on this question. Dodge and Soled cite the ill-fated 1976 law relating to basis in inherited property as

122. See supra notes 33, 80–81 and accompanying text.
123. See supra note 33 and accompanying text. In addition, the taxpayer might also have adjustments to basis over the years by reason of home improvements made to one or more of the series of homes. See supra note 33 and accompanying text.
124. Burman, Wallace, and Weiner quantify the compliance cost of taxing home sales under the rollover regime by estimating how many hours taxpayers spend filling out the forms required at that time. See Burman, Wallace & Weiner, supra note 80, at 388. A broader measure of compliance costs would also attempt to quantify the efforts of the IRS—through audits, litigation and other means—to ensure that taxpayers complied with the law.
126. See id. at 580. Dodge and Soled assert that the noncompliance problem for home sales was largely eliminated by the 1997 expansion of I.R.C. § 121. See id. at 580, n.216 (“The personal residence gain reporting issue has been largely (if not completely) swept under the rug by the expansion of I.R.C. § 121 (excluding up to $250,000 of gains per taxpayer per qualified principal residence sale).”). This is not entirely true; basis recordkeeping is still necessary for many homeowners.
the sole instance in which basis noncompliance received explicit
attention.127

The 1976 law provided for a carryover basis for inherited property,
which had the effect of preserving gains that went unrealized upon property
transfers at death.128 (Prior law had provided for a fair market value basis
upon such transfers, which had the effect of exempting such gains from
tax.129) Practitioners, estate administrators, and lobbyists waged a relentless
war against the law, complaining that keeping track of carryover basis over
many years would be impossibly complex and difficult. In 1980, Congress
repealed the law retroactive to its effective date.130

Twenty years later, the same tactic would again be deployed
successfully to enact the gain exclusion for home sales. Because keeping
tabs on deferred gains through historic basis was too difficult, the argument
went, the solution should be to exempt gain from tax. However, as
Lawrence Zelenak puts it, “tax policy should not be held hostage to
taxpayers’ refusal to comply with reasonable record-keeping rules.”131

Dodge and Soled argue that basis recordkeeping is not an impossible
task, and they propose many compliance and enforcement mechanisms to
increase the accuracy of basis reporting.132 Similarly, in the inherited
property context, Zelenak makes a careful assessment of the claims about
the difficulties of basis recordkeeping and is quite skeptical about their
validity.133 Zelenak places particular weight on the experience of Canada.
In 1971, Canada enacted a capital gains tax at death, which necessitates a
determination of historic basis at death.134 Zelenak finds that basis
determination is “simply not a major problem” in Canada.135 Zelenak
concludes that “it is difficult to take seriously the argument that problems
of basis determination make a death gains tax impractical.”136

The analyses of Dodge and Soled and Zelenak suggest that one of the
principal criticisms of the rollover regime was probably overstated and
likely underexamined. This is not to say that the rollover regime should

127. See id. at 541–42.
130. See Dodge & Soled, supra note 125, at 541–42; Lawrence Zelenak, Taxing Gains at Death,
131. See Zelenak, supra note 130, at 391.
132. See Dodge & Soled, supra note 125, at 583–97 (proposing to expand third party reporting,
heighten the duty of taxpayers to keep track of basis, and simplify the computation of basis).
133. See Zelenak, supra note 130, at 388–92.
134. See id. at 382.
135. See id. at 391.
136. Id. at 392. But see David J. Herzig, Something from Nothing: Taxing Assets Accurately,
2011 MICH. ST. L. REV. 1057, 1063–72 (describing the difficulties encountered by taxpayers in keeping
track of basis).
have been retained. However, it does suggest that the relative merits of the rollover regime and the gain exclusion should be reexamined, particularly in respect of the argument that basis recordkeeping is so difficult and costly that we should simply abandon all hope of taxing gains on home sales.

B. Incentive Effects

Another important and widely noted criticism of the rollover regime had to do with its incentive effects. I.R.C. § 1034 encouraged people to reinvest in ever-more expensive homes, resulting in overinvestment in owner-occupied housing (the “buy up incentive”) and penalizing those who chose to “buy down,” that is, move to cheaper homes.

Substantial evidence supports the claim that the buy up incentive of the rollover regime did in fact have these effects on individuals’ behavior. While it is difficult to quantify the social costs of the effects, the assumption is that they were undesirable—the buy up incentive resulted in

---

137. The 1997 Report does not couch the shortcomings of the rollover regime in terms of incentive effects and the systemic inefficiencies created by them. Rather, the 1997 Report seems more concerned with the unfair result to individual homeowners. See supra notes 32–39 and accompanying text. Nonetheless, the efficiency rationales for repealing the rollover regime and adopting the gain exclusion were articulated by commentators at the time and since have become part of the accepted wisdom for why the rollover regime was flawed.

138. A related incentive, which was not explicitly considered at the time of the rollover regime was repealed, has to do with labor mobility. The effects on labor mobility of the rollover regime and the gain exclusion have received more attention in recent years, and are discussed below. See infra notes 212–214 and accompanying text.

139. See Gerald Auten & Jane G. Gravelle, The Exclusion of Capital Gains on the Sale of Principal Residences: Policy Options, in NATIONAL TAX ASSOCIATION PROCEEDINGS FROM THE 102ND ANNUAL CONFERENCE ON TAXATION, 103, 103–04 (2009), available at http://www.ntanet.org/images/stories/pdf/proceedings/09/012.pdf; see also Jane G. Gravelle & Pamela J. Jackson, Cong. Research Serv., RL32978, THE EXCLUSION OF CAPITAL GAINS FOR OWNER-OCCUPIED HOUSING 3, 6 (2007); Burman, Wallace & Weiner, supra note 80, at 387 (estimating that in 1993, about eight percent of home sellers would have chosen to “buy down” rather than “buy up” had their gains been exempt from tax instead of subject to the rollover regime); William H. Hoyt & Stuart S. Rosenthal, Capital Gains Taxation and the Demand for Owner-Occupied Housing, 72 Rev. Econ. & Stat. 45, 45, 52 (1990) (finding that the rollover regime may cause some families to buy up when they might otherwise prefer to buy down and may create a deadweight loss because of price distortions); William H. Hoyt & Stuart S. Rosenthal, Owner-Occupied Housing, Capital Gains, and the Tax Reform Act of 1986, 32 J. Urban Econ. 119, 136–37 (1992) (finding that the 1986 increase in capital gains rates increased the incentive to buy up, and that reducing capital gains rates caused some homeowners to buy down); Gerald Auten & Andrew Reschovsky, The New Exclusion for Capital Gains on Principal Residences, 7–11 (U.S. Treas. Dep’t Office of Tax Analysis, Working Paper No. 7X, 1998) (on file with author); Todd Sinai, Taxation, User Cost, and Household Mobility Decisions, (Wharton Sch., Univ. of Penn., Working Paper No. 303) (finding a reduction in tax rates on gains sales affects individuals’ decisions whether to buy up but has little effect on their decision whether to move).

There is also evidence that the one-time exclusion promoted mobility among homeowners of age 55–64, although surprisingly, many of these homeowners did not “downsize” as had been contemplated when the one-time exclusion was enacted. See Sandra Newman & James Reschovsky, An Evaluation of the One-Time Capital Gains Exclusion for Older Homeowners, 15 Real Est. Econ. 704, 706–17 (1987); Sandra Newman & James Reschovsky, Federal Policy and the Mobility of Older Homeowners, 6 J. Pol’y Analysis & Mgmt. 402, 406–07 (1987).
an overinvestment in owner-occupied housing relative to other capital assets or drove up prices for such housing.\textsuperscript{140}

The 1997 repeal of the rollover regime and adoption of the gain exclusion were intended to remove these undesirable effects. There is evidence that the 1997 law did alter homeowners’ behavior as expected: more homeowners sold their houses in the years immediately following the new law,\textsuperscript{141} and more of them bought down.\textsuperscript{142}

At the same time, however, the gain exclusion introduced new incentives and created new distortions. It allowed a taxpayer to exclude up to $250,000 (if single) or $500,000 (if married) of gain on a home sale, and in contrast to the rollover provision, the taxpayer did not have to reinvest the sale proceeds in another home to achieve this result.\textsuperscript{143} But where better to reinvest the sale proceeds than in another house that would yield another tax free gain two years later? The website of the National Association of Realtors features this snappy description of the strategy:

\textsuperscript{140} Burman, Wallace, and Weiner quantify the behavioral distortions caused by the rollover regime by estimating the deadweight losses that result from people’s decisions not to rent or not to buy less expensive houses, and the deadweight loss of compliance and recordkeeping associated with the rollover/one-time exclusion regime. See Burman, Wallace & Weiner, supra note 80, at 387–89. In addition to these costs, there may be other social costs related to the buy up incentive, such as increased friction on labor mobility. See infra notes 214–221 and accompanying text. Moreover, scholars have theorized that the overinvestment in housing caused by tax subsidies for homeownership contributes to suburban sprawl, environmental degradation, and other social ills. See Mona L. Hymel, The Population Crisis: The Stork, The Plow, and the IRS, 77 N.C. L. REV. 13, 112–16 (1998) (arguing that tax subsidies for homeownership promote suburban sprawl, overconsumption of housing, and overreliance on auto transportation); Klein, supra note 5, at 406–07 (arguing that I.R.C. § 1034 unintentionally promoted overinvestment in housing and conversion of farmland into suburban housing); Mann, supra note 5 (arguing that the home mortgage interest deduction encourages suburban sprawl).


It is not clear that the increased frequency of home sales has persisted. Cunningham and Engelhardt speculate that prior to the 1997 Act, homeowners just under the age of 55 might have delayed their home sales, awaiting the new law, which would result in a short-lived increase in home sales immediately after enactment of the new law. See Cunningham & Engelhardt, supra, at 814. Biehl and Hoyt’s findings appear to bear this out: they found that the new law increased home sales in the years 1998–1999, but found no evidence that the new law increased home sales in the years 2002–2004. See Biehl & Hoyt, supra, at 17, 19.

\textsuperscript{142} See Biehl & Hoyt, supra note 141, at 17, 19 (finding that the 1997 law resulted in downward mobility during both periods they studied, 1998–1999, and 2002–2004, suggesting a lasting effect). Cunningham and Engelhardt were unable to observe whether people sold their homes in order to trade down because the census data they relied upon does not provide that information. Cunningham & Engelhardt, supra note 141, at 815.

\textsuperscript{143} See Biehl & Hoyt, supra note 141, at 1.
This is the best. In fact, I can hardly believe this myself. Here’s how it works:

If you have owned and occupied your principal residence for at least two of the past five years, you can earn up to $500,000 on the sale of that house and pay no federal income tax whatsoever. That’s assuming you are married—singles get up to $250,000 tax free. And here comes the kicker:

You can do this as often as every two years for the rest of your life.

This is as good an excuse for getting married as I have ever heard. Buy a fixer-upper in an up and coming neighborhood, work on it nights and weekends for two years, then sell it at a nice profit and pocket the cash, totally free of federal taxes. And most states recognize the federal exclusion, so you put the cash away totally tax free. You don’t have to re-invest, you don’t have to be age 55, and you can do this every two years forever. No, I’m not kidding.

. . . .

Many of these benefits came into being with the 1997 tax law, but lots of folks are just finding out about them now, so buy and sell to your heart’s content. Just don’t plan on staying forever.144

So, while some homeowners were freed from the buy up constraint of the rollover regime and used the gain exclusion to buy down to a more modest house—perhaps freeing up capital to invest elsewhere or facilitating a work relocation to a lower cost region of the country—other homeowners became serial “flippers.”

This new incentive effect—the “flipping” incentive—was largely unremarked-upon at the time the gain exclusion was enacted. Lawmakers were much more focused on extolling the economic and social benefits of the gain exclusion.145 Some experts opined that the gain exclusion would have practically no effect because most gains on home sales were already exempt from tax.146 Others speculated that the gain exclusion might cause

144. John Adams, Tax Benefits of Home Ownership Are Almost Too Good to Be True, REALTOR.COM, http://www.realtor.com/basics/buy/closepossession/taxbenefits.asp (last visited Aug. 21, 2013). Given that realtors receive commissions on home purchases and sales, it is not surprising that realtors would characterize this exclusion as “the best” of all tax benefits—better than even the home mortgage interest deduction or the real property tax deduction—and would highlight the ability to use the exclusion repeatedly. See Kay Bell, Capital Gains Home-Sale Tax Break a Boon for Owners, BANKRATE.COM (Oct. 18, 2004), http://www.bankrate.com/finance/real-estate/capital-gains-home-sale-tax-break-a-boon-for-owners-4.aspx.

145. As one senator proclaimed: “By letting hard-working Americans keep more of their own money, we allow them to preserve their family, prepare for their own future, and invest in the nation’s economy.” 143 CONG. REC. S8405 (daily ed. July 31, 1997) (statement of Sen. Smith).

146. See Sullivan, supra note 81, at 683 (“Given the already generous benefits available for capital gains on sales of personal residences, this proposal is not as big a deal as the administration
homeowners to buy down and shift their investments to other sectors, also helping bring down housing prices.147 One economist, Eugene Steuerle, identified the flipping incentive and speculated that it might cause owners of expensive homes to sell them more frequently than they had in the past.148

There were anecdotal reports that the gain exclusion may have contributed to the record number of home sales in the year after it was enacted.149 However, it was several years before comprehensive evidence began to emerge.150 During that time, we experienced an unprecedented boom and bust in the real estate market, which precipitated the global financial crisis. As a result, the question whether the gain exclusion contributed to excessive levels of homeownership and inflated prices has taken on an added urgency.

Research on this question is underway, but it is not yet clear whether and to what extent the gain exclusion helped create the real estate bubble. In 2008, New York Times economic reporters Vikas Bajaj and David Leonhardt, suggested that it did:

[M]any economists say that the law had a noticeable impact, allowing home sales to become tax-free windfalls. A recent study of the provision by an economist at the Federal Reserve suggests that the number of homes sold was almost 17 percent higher over the last decade than it would have been without the law.

By favoring real estate, the tax code pushed many Americans to begin thinking of their houses more as an investment than as a place to live. It helped change the national conversation about

would like taxpayers to believe.”); Passell, supra note 80 (“Hardly anybody pays the capital gains tax on housing, so eliminating it wouldn’t make much difference . . . .” (quoting Princeton economist Harvey Rosen)).

147. See Passell, supra note 80 (reporting on economist Alan Auerbach’s views).

148. See Eugene Steuerle, The Newly Mobile—and Immobile—Rich, 76 TAX NOTES 1481, 1481–82 (1997). Steuerle notes that the flipping incentive is offset by transactions costs, the benefits of deferral, and, in the case of very expensive houses, the possibility of incurring some tax on sale. See id.; see also Michael H. Morris, The Relevance of the Principal Residence Gain Exclusion, 121 TAX NOTES 684 (2008) (analyzing effects of I.R.C. § 121 as a function of house value, appreciation, and frequency of sale).


150. See supra notes 146–47 and accompanying text.
housing. Not only did real estate look like a can’t-miss investment for much of the last decade, it was also a tax-free one.151

In response, Burman questioned Bajaj and Leonhardt’s interpretation of the study they cite and their claim that the gain exclusion contributed to the housing bubble. He defended the gain exclusion as preferable to the undesirable rollover regime it replaced and stated that “it certainly is not a significant factor in the housing bubble.”152

In 2011, Hui Shan, whose then-unpublished study had been cited by Bajaj and Leonhardt, finalized and published the study. In addition, one other unpublished study emerged that specifically studied the effects of the gain exclusion on the frequency of home sales.153

In her study, Shan uses records of selling prices and dates of sales provided by a private company to examine single-family, residential home sales in sixteen cities and towns in the Boston metropolitan area from 1982 through 2008.154 The cities and towns were relatively homogeneous with high house prices and no active market for second homes.155 The homeowners were mostly high-income and well-educated.156 Shan’s data does not include information about the actual gains realized on individual home sales. Instead, she extrapolates median house prices for each year she studies, and then, based on the change in median price during the time for which a house was owned, she imputes a gain to a selling homeowner.157 Shan finds that home sales rates increased by as much as 19% to 24% after the 1997 law change for sales with gains between $0 and $500,000.

---

151. Bajaj & Leonhardt, supra note 92; see also Anderson, supra note 5, at 419 (asserting, without providing any evidence, that “[t]he current housing and financial sector meltdown is not the result of a market failure, but is the natural, necessary, and presumably unintended result of the tax preferences extended to residential real estate in 1997”). Bajaj and Leonhardt note that factors other than the tax exclusion, such as lax lending standards, regulatory failure, falling interest rates, and irrational expectations about housing prices probably played larger roles. See generally Bajaj & Leonhardt, supra note 92.


153. See Hui Shan, The Effect of Capital Gains Taxation on Home Sales: Evidence from the Taxpayer Relief Act of 1997, 95 J. PUB. ECON. 177 (2011); Andrea J. Heuson & Gary Painter, The Impact of the Taxpayer Relief Act of 1997 on Housing Turnover in the U.S. Single Family Residential Market (June 2011) (unpublished manuscript) (on file with author). Two 2008 studies, by Cunningham and Engelhardt, and Biehl and Hoyt, also found evidence of increased home sales after 1997, but both were limited to homeowners nearing age 55. In addition, neither study addresses the question whether the 1997 law contributed to the real estate bubble. See supra notes 141–142 and accompanying text.


155. See id. at 180.

156. See id.

157. See id. at 181.
although the impact was more pronounced immediately after the law change and declined over time.\textsuperscript{158}

In sum, Shan finds evidence that the gain exclusion contributed to an increase in home sales, but she is also careful to provide caveats about this finding. She notes that her sample is not representative of the population at large.\textsuperscript{159} She also notes that her paper does not measure the effects of the new law on investment in housing versus other investments, nor does it observe where people moved once they sold their houses.\textsuperscript{160}

Another recent study examines the effect of the 1997 law on home sales nationwide.\textsuperscript{161} Using American Housing Survey data to estimate the quantity of housing stock and information from the National Association of Realtors about the number of home sales, Andrea Heuson and Gary Painter estimate housing turnover rates from 1980 to 2006.\textsuperscript{162} They find that housing turnover increased significantly after 1997.\textsuperscript{163} Heuson and Painter also use longitudinal information from the Panel Study of Income Dynamics\textsuperscript{164} to determine whether selling homeowners traded up or traded down.\textsuperscript{165} They found that both trading up and trading down increased significantly among households of all ages after 1997.\textsuperscript{166}

Heuson and Painter investigate specifically whether the increase in trading up that they observe might be the result of the flipping incentive—that is, whether homeowners traded up more frequently after 1997 to “reset the basis that determines future excludable capital gains calculations.”\textsuperscript{167} They hypothesize that trading up will be more frequent in the highest appreciation areas because homeowners will need to reset their basis more frequently to avoid exceeding the exclusion amount.\textsuperscript{168} To test this, they compare rates of trading up in high-appreciation states—Arizona, California, Florida, and Nevada—to rates of trading up in general.\textsuperscript{169} They do not find evidence that trading up was more frequent in these states.\textsuperscript{170}

\textsuperscript{158. See id. at 186, 188. This suggests that homeowners who had planned to sell their homes in the time leading up to the 1997 law change may have delayed their sales, leading to a temporary increase in home sales immediately after the new law took effect. This is consistent with the findings of Biehl and Hoyt and Cunningham and Engelhardt. See supra note 141.}
\textsuperscript{159. See id. at 188.}
\textsuperscript{160. See id.}
\textsuperscript{161. See Heuson & Painter, supra note 153.}
\textsuperscript{162. See id. at 7–8.}
\textsuperscript{163. See id. at 18.}
\textsuperscript{164. The Panel Study of Income Dynamics is a long running longitudinal household survey conducted by the Institute for Social Research, Survey Research Center, University of Michigan.}
\textsuperscript{165. See Heuson & Painter, supra note 153, at 12–14.}
\textsuperscript{166. See id. at 18.}
\textsuperscript{167. Id. at 13.}
\textsuperscript{168. See id. at 14.}
\textsuperscript{169. See id.}
\textsuperscript{170. See id. at 15, 19.}
Thus, they conclude that there is no clear evidence that the flipping incentive caused the increase in trading up after 1997.\footnote{171}

Despite the lack of evidence that the flipping incentive caused an increase in trading up, Heuson and Painter nonetheless speculate that the 1997 law “might have played a small role in the formation of the house price bubble.”\footnote{172} They speculate that the relatively small impact of the tax law change may have generated large impacts through a feedback mechanism.\footnote{173} However, in the end, they conclude more research is needed to understand why trading up increased after 1997.\footnote{174}

To summarize, the research on the effects of the gain exclusion on home sales is relatively sparse and, with respect specifically to the flipping incentive, inconclusive. A complete understanding of the incentives and their exact effects awaits further research, which will no doubt be forthcoming—virtually every study in this area ends with a call for additional research. For the time being, however, what is clear is that the gain exclusion clearly increased the frequency of home sales, both trade-ups and trade-downs—consequences that were not anticipated nor intended at the time of its enactment. Moreover, even a remote possibility that the gain exclusion contributed to the global financial crisis is sobering and warrants a reconsideration of the law.

\section*{C. Complexity}

The gain exclusion was supposed to streamline administration of the law by eliminating the need to keep track of basis. However, as discussed above, the difficulty of keeping track of basis was probably overstated. Moreover, the argument that the gain exclusion would simplify the law proves too much: it is always easier to impose no tax, but the costs of doing so—lost revenue, unfairness, and efficiency—must be weighed against the simplification benefits. Furthermore, the gain exclusion retains other complexities of the rollover regime and introduces new ones.

For example, the determination of whether a property is the taxpayer’s residence and for how long the taxpayer has owned it and used it as such in order to meet the requirements under I.R.C. § 121 is a complex inquiry that incorporates prior law as well as extensive new regulations under I.R.C. § 121.\footnote{175}

\footnotesize{\begin{itemize}
  \item \footnote{171. See id. at 19.}
  \item \footnote{172. See id. at 18.}
  \item \footnote{173. See id. at 18–19.}
  \item \footnote{174. See id. at 19.}
  \item \footnote{175. See Dilley & Callihan, supra note 52, at 108–11 (describing prior law and possible applicability to new I.R.C. § 121); Dilley & Callihan, supra note 5, at 930–52 (discussing the prior law relating to meaning of principal residence and its implications for planning under new I.R.C. § 121);}
\end{itemize}}
Another area of burgeoning complexity relates to the reduced exclusion where a taxpayer fails to satisfy the two-of-five use-and-ownership requirement or the two-year limitation due to unforeseen circumstances.\(^{176}\) Exactly what constitutes “unforeseen circumstances” is an evolving and expanding universe.\(^{177}\) In regulations, the IRS specifies “unforeseen circumstances” safe harbors that include involuntary conversion; natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence; cessation of employment; change in employment resulting in the inability to pay housing costs and basic reasonable living expenses; death; divorce or legal separation; and multiple births resulting from the same pregnancy.\(^{178}\) In addition to the safe harbors, the reduced exclusion is also available if the primary reason for the home sale relates to unforeseen circumstances.\(^{179}\) Specific “unforeseen circumstances” in which the IRS has ruled that the reduced exclusion is available include an adult child...
moving back in with her parents;\textsuperscript{180} caring for a disabled parent;\textsuperscript{181} a pregnancy discovered after a relationship had ended;\textsuperscript{182} a larger blended family including adolescent children of the opposite sex;\textsuperscript{183} a traumatic gunpoint robbery;\textsuperscript{184} an assault by neighbor and threats against and assault on a son in a neighborhood with criminal activity;\textsuperscript{185} assault of a child on a school bus, causing trauma and poor school performance;\textsuperscript{186} unforeseeable aircraft noise;\textsuperscript{187} and a police officer joining a K-9 unit and needing to move to a community that allowed animals.\textsuperscript{188} There are millions of unreported home sales each year,\textsuperscript{189} and as a portion of them make their way through the IRS audit process, there is no doubt that the courts will add to the jurisprudence of “unforeseen circumstances.”\textsuperscript{190}

There are many other special rules under the gain exclusion that also contribute to its complexity. These include rules relating to property of a deceased spouse; property transferred to an individual by a spouse or former spouse incident to divorce; property used by a former spouse pursuant to a divorce or separation instrument; tenant-stockholders in a cooperative housing corporation; gains attributable to depreciation; involuntary conversions; taxpayers who become physically or mentally incapable of self-care; sales of remainder interests; expatriates; and property acquired from a decedent.\textsuperscript{191}

\textsuperscript{189.} The sales are unreported because the IRS eliminated broker reporting and taxpayer reporting for most home sales. See infra notes 194–203 and accompanying text. As a practical matter, therefore, the complex rules described here may end up not being applied in many cases in which they should be. Nonetheless, the compliance and administration costs of these complex rules are still burdensome; conscientious taxpayers who sell their homes each year must still consider the possible applicability and consequences of the complex rules, and the IRS must do the same for home sales that are subject to audit.
\textsuperscript{190.} To date (Feb. 25, 2013), there are only two reported cases on the issue. See Chiarito v. Comm’r, T.C. Summ. Op. 2010-149, at *3 (2010) (finding that the need to build an industrial kitchen and the losses incurred by the taxpayers’ catering business did not constitute unforeseen circumstances requiring them to sell their house because they knew of this circumstance when they bought the house); Gates v. Comm’r, 135 T.C. 1, 13 n.17 (2010) (finding that taxpayers did not demonstrate that the “unsustainable” debt they incurred to construct their house qualified as unforeseen circumstances); see also Samuel A. Donaldson, The Easy Case Against Tax Simplification, 22 VA. TAX REV. 645, 662–65 (2003) (discussing the extreme complexity created by the “unforeseen circumstances” aspect of I.R.C. § 121 and arguing that there is no easy way to reduce it).
\textsuperscript{191.} See I.R.C. § 121(d) (2006); see also Dilley & Callihan, supra note 5, at 949–58 (discussing these special rules).
D. Avoidance Behavior

The gain exclusion presents many opportunities to avoid paying tax on a home sale gain. Some tax avoidance strategies are arguably within the letter of the law, but upon learning of them, Congress has curtailed them.\textsuperscript{192} Other strategies, such as dividing ownership among family members so that each family member can make use of a separate exclusion amount, continue to be viable. Other strategies lack even the patina of legitimacy but are difficult to police. One example of this is the reported practice of taxpayers who own high-value houses “swapping” them back and forth every two years in order to “freshen” their basis and shelter the maximum amount of gain every two years.\textsuperscript{193}

Perhaps the most serious abuse of the gain exclusion is its use by professional “fixer-uppers,” who buy, renovate, and resell properties.\textsuperscript{194} Some of these individuals may not even have a colorable claim to have satisfied the requirements of I.R.C. § 121, and if they are found to be dealers in such property, any gains they realize should be taxed as ordinary income.\textsuperscript{195} Some of these individuals may claim to satisfy the two-year use-and-ownership requirement and other requirements of I.R.C. § 121.\textsuperscript{196} As the following discussion makes clear, the IRS has little ability to monitor or enforce against avoidance behaviors.

E. Compliance

The avoidance problems described above are compounded by the fact that the 1997 Act repealed broker reporting for home sales governed by I.R.C. § 121.\textsuperscript{197} This provision has been completely unnoticed, but its impact cannot be overstated.

Broker reporting is part of the extensive network of information reporting requirements that plays a crucial role in tax compliance.\textsuperscript{198}

\textsuperscript{192} For example, the exclusion is now restricted where a taxpayer converts a vacation or investment property to a principal residence, or where a taxpayer acquires property in a like-kind exchange and converts it into use as a principal residence. See I.R.C. § 121(b)(5), (d)(10); \textit{supra} notes 58–61 and accompanying text.
\textsuperscript{193} See \textit{Gravelle & Jackson, supra} note 139, at 11.
\textsuperscript{194} See \textit{id. at 10}; Auten & Gravelle, \textit{supra} note 139, at 107.
\textsuperscript{196} Even in these cases, there is an argument that this gain ought to be taxed because it is attributable to the untaxed labor income of the individual. See \textit{Gravelle & Jackson, supra} note 139, at 10.
\textsuperscript{197} See \textit{supra} notes 40–49 and accompanying text.
\textsuperscript{198} Other transactions or payments subject to information reporting include dividends, I.R.C. § 6042 (2006); interest, I.R.C. § 6049 (2006); and “rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income”
Information reporting is second to withholding in terms of its effectiveness in increasing compliance.\textsuperscript{199} Its importance will continue to increase with the technological advances and globalized economy of the twenty-first century.\textsuperscript{200} However, despite the proven efficacy of information reporting, I.R.C. § 6045(e)(5) (1997) repealed it for most home sales.

Pursuant to I.R.C. § 6045(e)(5), the IRS eliminated broker reporting for home sales with gross proceeds of no more than $250,000 ($500,000 in the case of married taxpayers filing jointly) as long as the seller of the home provides written assurances about the selling price of the house and the seller meets the requirements of I.R.C. § 121 relating to use and ownership of the house.\textsuperscript{201} At the same time, although not required by the 1997 law to do so, the IRS also eliminated the requirement that taxpayers themselves report home sales where they claim an exclusion under I.R.C. § 121.\textsuperscript{202} In effect, taxpayers are on the “honor system” as to their eligibility to exclude gains from home sales. Because neither the taxpayers nor brokers are required to report home sales with gains claimed to be excluded under

\begin{itemize}
\item \textit{199. For example, in its most recent study of 2006 data, the IRS found that amounts subject to both withholding and substantial information reporting (i.e., wages and salaries) were misreported by 1%. Amounts subject to substantial information reporting only (i.e., dividends, interests, pensions and annuities, unemployment compensation and Social Security benefits) were misreported by 8%. Amounts subject to some information reporting (i.e., deductions, exemptions, partnership and Subchapter S income, capital gains and alimony income) were misreported by 11%. Income not subject to either withholding or information reporting (i.e., nonfarm proprietor income, rents and royalties, farm income, income from sales of business property) was underreported by 56%. See \textsc{Internal Revenue Serv., Tax Gap for the Tax Year 2006, Overview, Jan. 12, 2012}, chart 1, http://www.irs.gov/pub/newroom/overview_tax_gap_2006.pdf; see also Tax Gap: Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance: Hearing Before the Subcomm. on Fed. Fin., Mgmt, Gov’t Info., and Int’l Sec., S. Comm. on Homeland Sec. and Governmental Affairs, 109th Cong. 6 (2005) (statement of Michael Brostek, Director of Strategic Issues, GAO), available at http://www.gao.gov/new.items/d06208t.pdf (putting the rate of noncompliance for income subject to some information reporting at 7.1% and for income subject to substantial information reporting at 4.2%); see also Kahng, supra note 40, at 323–24.}
\item \textit{201. See Rev. Proc. 2007-12, 2007-1 C.B. 354.}
\item \textit{202. Prior to the 1997 Act, the IRS had required taxpayers to file Form 2119 for sales of principal residences. In 1998, the IRS declared Form 2119 obsolete and instead requires certain home sales to be reported on Form 1040, Schedule D, relating to Capital Gains and Losses. DEP’T OF THE TREAS., INTERNAL REVENUE SERV., PUB. NO. 523, SELLING YOUR HOME 1 (for use in preparing 1998 returns), http://www.irs.gov/pub/irs-prior/p523--1998.pdf. However, taxpayers were instructed not to report home sales in which they had gains that were fully excluded under I.R.C. § 121. See \textit{id.} at 15. This directive not to report continues to be in effect today. See DEP’T OF THE TREAS., INTERNAL REVENUE SERV., PUB. NO. 523, SELLING YOUR HOME 19 (for use in preparing 2012 returns), http://www.irs.gov/pub/irs-pdf/p523.pdf.}
\end{itemize}
I.R.C. § 121, it is virtually impossible for the IRS effectively to administer the gain exclusion. In addition, it is impossible to ascertain how many taxpayers claim gain exclusions, the amounts of the exclusions they claim, and the frequency with which they claim exclusions.

The lack of information regarding I.R.C. § 121 is acutely apparent in the study of reported residence sales conducted by economists Gerald Auten and Jane G. Gravelle. Using IRS data from 2007 tax returns, Auten and Gravelle identify approximately 368,000 reported home sales, 351,000 of which appear to be principal residence sales. Of these reported principal residence sales, they estimate that as many as 274,000, or 78%, involve excluded gains under § I.R.C. 121.

The 368,000 reported home sales that Auten and Gravelle studied represent only 6.5% of the 5.674 million sales of existing homes in 2007. Thus, taxpayers did not report the other 5.3 million home sales for the year. If one assumes, as Auten and Gravelle found with respect to reported sales, that 78% of these taxpayers claimed gain exclusions, this would mean there are an additional 4.13 million unreported home sales in which taxpayers claimed gain exclusions. However, this may not be a useful computation because it appears that many of the taxpayers who reported their home sales should not have done so because they claimed their gains were entirely excludable under I.R.C. § 121. In other words, the percentage of taxpayers who reported their home sales and claimed gain exclusions should be much lower than the 78% Auten and Gravelle found.

The only way the IRS can identify home sales for which the exclusion was improperly claimed is through the audit process. In 2010, the IRS audited only 1.1 percent of returns filed by individuals. See DEPT OF THE TREASURY, INTERNAL REVENUE SERV., PUBL. NO. 55B, DATA BOOK 2010 tbl. 9a, at 22 (2011).

204. See Auten & Gravelle, supra note 139, at 103–04.

205. The other 17,000 appear to be sales of vacation homes or second or third residences. See id. at 105.

206. See id. The uncertainty in their estimates arises from incomplete or inaccurate taxpayer reporting. Id.

207. The figure for total existing home sales comes from the National Association of Realtors. See id. Auten and Gravelle found that a total of 368,000 apparent home sales, of which about 17,200 appeared to be sales of secondary residences and vacation homes. See id. In addition, they speculate that some of the remaining 351,000 may be rental or investment properties that do not qualify for gain exclusion under I.R.C. § 121, but they do not have enough information to ascertain this. See id.

208. Auten and Gravelle found that of the total 351,000 principal residence sales, 98,600 taxpayers reported taxable gains and 37,000 reported losses. See id. The implication is that the remaining 215,000 of reported sales may have involved gains that were entirely excluded under I.R.C. § 121. It is likely that most of these sales should not even have been reported by the taxpayers, as the IRS no longer requires taxpayer reporting if the taxpayer claims the gain exclusion. See supra note 202 and accompanying text.

209. One possible explanation for this over-reporting by taxpayers is that brokers sometimes file unnecessary information returns when not necessary, either out of carelessness or an abundance of caution or because they are not knowledgeable about the reporting exemption. If a taxpayer receives an unnecessary information return from the broker, he may in turn report the home sale on his return out of an abundance of caution or because he mistakenly believes he is required to.
same time, the percentage of taxpayers who did not report their home sales and claimed gain exclusions should be very high. A more accurate estimate might assume that almost all of the 5.3 million unreported home sales involved gains claimed to be excluded.

Under either analysis, it is clear that there were several million unreported home sales in 2007 in which taxpayers claimed gain exclusions under I.R.C. § 121. These home sales were probably not reported by brokers either because of the broker reporting exemption described above. The most notable revelation of Auten and Gravelle’s study is that every year, there are millions of home sales and billions of unreported gains about which the IRS has no information. It does not know who the selling taxpayers are, how much gain they have realized, how long they have claimed to own and use their homes as principal residences, and whether they have met the other requirements of I.R.C. § 121.

In summary, a reassessment of the policy rationales for the 1997 law reveals them to be unpersuasive in many respects. The administrative concerns related to basis recordkeeping under the rollover regime were overstated and underexamined. The gain exclusion retains much of the complexity of the prior law and also creates substantial new complexities. Furthermore, by reason of an obscure procedural loophole, the gain exclusion is virtually unenforceable. Finally, while the effects of the buy-up incentive under the rollover regime were problematic, and were mitigated by the gain exclusion, the gain exclusion also created other incentive effects. The impact of these new incentive effects is not yet fully understood, but the possibility that the gain exclusion contributed to the real estate bubble is troubling.

The next Part turns to the question of how to reform the law. In considering where we want to go with tax subsidies for home sales, it strives to step away from the constraints of path dependence and bounded rationality and to address the broader tax and social policy questions implicated by this inquiry.

IV. WHERE SHOULD WE GO FROM HERE?

In assessing where we should go from here, this Part provides a broader framework that takes account of systemic incentives under the tax law and also considers the role of homeownership as a means to promote race and gender equality in the distribution of wealth. With these broader

210. Auten and Gravelle report that 3.36 million real estate information returns were filed in 2007. However, because most principal residence sales are exempt from broker reporting, they indicate that most of these are likely to be nonresidential real estate transactions and non-principal residence sales. See id. at 107.
considerations in mind, it then proposes specific reforms for the taxation of home sales.

A. Revisiting Incentives

In evaluating the incentive effects of the tax treatment of home sales—whether the rollover regime or the gain exclusion—the bigger picture has been overlooked. It is important to keep in mind that even in the absence of the rollover regime and the gain exclusion, gains on home sales would be tax-preferred in the same way that all capital gains are—they are taxed at rates substantially lower than other sources of income.211

This general capital gains preference is intended to ameliorate a systemic incentive relating to the taxation of all capital gains—the lock-in effect. The lock-in effect is a product of our realization based system—the imposition of a tax at the time of the sale or exchange of assets acts as a toll charge on such sales or exchanges, thereby impairing mobility of capital and resulting in an inefficient allocation of resources.212 The lock-in effect is “probably the most widely publicized argument” in favor of the reduced rate of tax on capital gains.213

Against this backdrop of the general capital gains preference, both the rollover regime and the gain exclusion can be seen as “super-preferences” which treat a particular capital asset—owner-occupied housing—even more preferentially than other capital assets. Both the rollover regime and the gain exclusion provide extra mitigation of the general lock-in problem described above, but each creates new, undesirable incentives.

The rollover regime created the buy-up incentive, whereby a home seller had to buy a house of equal or greater value to avoid a capital gains tax—a sort of “micro lock-in” effect, in which people could move their capital freely as long as they kept it in owner-occupied housing.

211. As of 2013, the maximum nominal federal income tax rates on ordinary income and capital gains are 39.6% and 20%, respectively. (The actual maximum rates are higher because of the phase-out of deductions for high-income taxpayers and the healthcare tax on capital gains.) With a few brief exceptions, capital gains have been taxed at preferential rates for the entire history of the income tax. See Gregg A. Esenwein, Cong. Research Serv., 98-473 E, Individual Capital Gains Income: Legislative History (2007).


213. Walter J. Blum, A Handy Guide of the Capital Gains Arguments, 44 Tax Notes 1145, 1152 (1989). As Blum observes, the lock-in effect is not caused by the taxation of capital gains, but rather is caused by the failure to tax those gains as they accrue. See id. Another way to eliminate the lock-in problem would be to move away from a realization-based system of tax. See Mary Louise Fellows, A Comprehensive Attack on Tax Deferral, 88 Mich. L. Rev. 722 (1990).
The incentive effects of the gain exclusion operate differently from those of the rollover regime—people are no longer penalized for moving capital from owner occupied housing to other investments. However, the gain exclusion, by reason of its zero rate of tax on gains from owner-occupied housing, creates a positive incentive for people to keep their capital in owner occupied housing, so there is still a “micro lock-in” problem. Moreover, the gain exclusion also adds a flipping incentive, with all of its attendant problems.

Whether the systemic lock-in effect, alone or in combination with other reasons, justifies the general capital gains preference is hotly debated, and beyond the scope of this Article to address comprehensively. If one accepts the validity of a general capital gains preference, the question remains whether providing extra-preferential treatment to owner-occupied housing is worth the costs of the “micro lock-in” problem that such extra-preferential treatment creates.

Certainly, there are arguments why owner-occupied housing is a unique capital asset that warrants special treatment. Other capital assets—such as stocks, bonds and other financial assets—are relatively substitutable and an individual owning a diversified portfolio of such assets can plan purchases and sales to minimize lock-in effects. In contrast, a residence is a large and unique capital asset; therefore, the gain is not easily sheltered. Moreover, the reasons for selling one residence and buying another may involve nonfinancial considerations such as changing family size. Finally, and perhaps most important, changing residences may be directly related to a change in geographic location for employment reasons. Any tax, even a preferential capital gains tax, creates a barrier to labor mobility, which undermines economic productivity.

The arguments for a super-preference for gains on home sales are persuasive, and yet, there are countervailing considerations. As has been

214. See GRAVELLE & JACKSON, supra note 139, at 6; Burman, Wallace & Weiner, supra note 80, at 382–83. Other “special” assets that receive preferred treatment—over and above the reduced capital gains rate—include property received in a like-kind exchange and involuntarily converted property. See supra notes 7–8 and accompanying text.

215. See GRAVELLE & JACKSON, supra note 139, at 6; Burman, Wallace & Weiner, supra note 80, at 383.

216. See Burman, Wallace & Weiner, supra note 80, at 383.

217. See GRAVELLE & JACKSON, supra note 139, at 6; Auten & Reschovsky, supra note 139, at 8–9.

218. See GRAVELLE & JACKSON, supra note 139, at 5–6; Auten & Gravelle, supra note 139, at 107.

discussed above, both of the super-preferences with which we have experience—the rollover regime and the gain exclusion—have had unintended adverse consequences. Moreover, one of the strongest arguments for a “super preference”—that it reduces friction on labor mobility—is a double-edged sword: a tax preference for gains on home sales also encourages overconsumption of housing, which can lead to more people owning houses instead of renting or inflated housing prices. Some economists believe that high homeownership rates, which have been promoted by government policies including tax subsidies, have an adverse impact on labor mobility that outweighs the benefit in terms of employment.\textsuperscript{220} If this is true, then a super preference for gain on homes sales adversely affects labor mobility.

Furthermore, research emerging in the aftermath of the global financial crisis suggests labor mobility may be affected differently depending on housing market conditions. For example, one recent study found that in a “down” real estate market, homeowners’ mobility is reduced because homeowners may not want to sell their homes at a loss, especially if their mortgage exceeds the selling price, or they may not be able to find a buyer easily.\textsuperscript{221} In this situation, a super preference for gains on home sales will not help mobility at all, as homeowners contemplating a move face the prospects of losses, not gains.

Finally, as is discussed below in the Conclusion, the gain exclusion is not the only tax preference for homeownership. Other preferences amplify the “micro lock-in” incentive that encourages people to keep their capital in owner-occupied housing. As a result, the costs of the incentive, in terms of overinvestment in housing and underinvestment elsewhere, are extremely high. It seems unlikely that they would be outweighed by the benefits of a super preference for gains on home sales.

\textit{B. Wealth and Homeownership}

Federal tax and housing policies promoting homeownership are premised in part on the assumption that homeownership can lead to private

\textsuperscript{220} See Andrew Oswald, The Housing Market and Europe’s Unemployment (May 1999) (unpublished manuscript), available at http://individual.utoronto.ca/holderman/Oswald.pdf; see also HOMEOWNERSHIP AND THE LABOUR MARKET IN EUROPE (Casper van Ewijk & Michiel van Leuvensteijn eds., 2009) (providing empirical evidence for and expanding upon Oswald’s hypothesis that the barriers homeownership creates in terms of labor mobility outweigh the benefits of homeownership in terms of increased likelihood of being employed, and that consequently, government subsidies for homeownership should be reduced).

\textsuperscript{221} See Fernando Ferreira, Joseph Gyourko & Joseph Tracy, \textit{Housing Busts and Household Mobility}, 68 J. URB. ECON. 34 (2010).
Promoting increased levels of homeownership—in particular among women and minorities—was a central agenda item of both the Clinton and the George W. Bush administrations, with the explicit goal of improving the economic status of these disadvantaged groups.

The gender and race dimensions of wealth inequality in the United States are indisputable and deeply troubling. Women of all races are less wealthy than men, and the wealth disparity is particularly acute for single women of color. That women are poorer than men is not a new observation: the “feminization of poverty” has been studied extensively by feminist and poverty law scholars.

Until recently, however, a more comprehensive picture of wealth inequalities between men and women—taking into account race, life stage, marital status—was obscured by the fact that most women spent most of their adult lives in marriage and were assumed to share resources with their husbands. Now, for the first time in history, more than half of adult women in the United States are single. Single women are now a significant demographic group whose wealth holdings can be ascertained. This has revealed the disturbing findings described above—that women are less wealthy than men across the board, with women of color occupying the lowest rungs of the economic ladder.

That race, along with gender, plays a role in wealth inequalities in the U.S. is, sadly, not surprising. In their seminal book, Black Wealth/White Wealth, Melvin Oliver and Thomas Shapiro describe the phenomenon of...

---

222. Jordan Rappaport, The Effectiveness of Homeownership in Building Household Wealth, FED. RES. BANK OF KAN. ECON. REV. 35, 36 (4th Quarter 2010), https://www.kansascityfed.org/publicat/econrev/pdf/10q4Rappaport.pdf. (“Conventional wisdom has long suggested that homeownership is an effective way to build household wealth. Consistent with this belief, homeownership is often considered to be a key part of the American Dream.”).

223. See infra notes 229, 231 and accompanying text.

224. A recent study found that single black and Hispanic women have one penny of wealth for every dollar of wealth owned by their single male counterparts and a small fraction of a penny for every dollar of wealth owned by white women. Excluding vehicle ownership, single black women have a median wealth of $100 and Hispanic women, of $120, as compared to their black and Hispanic male counterparts, who have a median wealth of $7,900, and $9,730, respectively. Single white women have a median wealth of $41,500. See Mariko Chang & Meizhu Lui, Lifting as We Climb: Women of Color, Wealth, and America’s Future, INSIGHT CTR. FOR CMTY. ECON. DEV. 5 (Spring 2010), http://www.insightced.org/uploads/CRWG/LiftingAsWeClimb-WomenWealth-Report-InsightCenter-Spring2010.pdf.

225. This phrase was first used by Diana Pearce to describe the increased risk of poverty for divorced women. See Diana Pearce, The Feminization of Poverty: Women, Work and Welfare, 11 URB. & SOC. CHANGE REV. 28 (1978).


entrenched economic inequality between blacks and whites in the United States, which they call the “sedimentation of racial inequality.” The phrase powerfully evokes the image of today’s economic inequality as constructed from past layers of stunted opportunities and scarce resources—the result of discriminatory practices and policies stretching back in time over many generations. In keeping with Oliver and Shapiro’s thesis about the deep intransigence of this problem, the most recent data indicates that racial wealth inequalities not only persist, but are worsening.

Similar patterns of wealth distribution can be seen in homeownership. African Americans and Latinos own lower value homes than whites and have homeownership rates that are lower than whites’ by twenty percentage points or more. Married couples—in particular, white married couples—own homes at well above the national average. Single people of color own homes at the lowest rates and with the lowest values.

Given the similar inequalities in wealth distribution in general on the one hand, and homeownership on the other, it is easy to see why homeownership has been embraced by many progressives as a means to

---

228. See Melvin L. Oliver & Thomas M. Shapiro, Black Wealth/White Wealth: A New Perspective on Racial Inequality 51 (1995).

229. In relative terms, the “wealth gap” between non-Hispanic white and African-American families increased more than fourfold between 1984 and 2007. The absolute values are equally stark: in 2007, the median value of wealth holdings (excluding home equity) for white families was $100,000; for African-American families, $5,000. See Thomas M. Shapiro, Tatjana Meschede, & Laura Sullivan, The Racial Wealth Gap Increases Fourfold, INST. ON ASSETS & SOC. POL’Y (May 2010), http://www.insightcced.org/uploads/CRWG/IASP-Racial-Wealth-Gap-Brief-May2010.pdf. Similar wealth disparities exist between non-Hispanic white and Hispanic families. In 2002, the median wealth of Hispanic households was $7,932, as compared to a median wealth of $88,651 for white households. See Rakesh Kochhar, The Wealth of Hispanic Households: 1996 to 2002, PEW HISPANIC CTR. 5 (Oct. 18, 2004), http://pewhispanic.org/files/reports/34.pdf. And as the number of single women has increased, it is now possible to discern, within each layer of racial inequality, an even more finely grained sedimentation: women are trapped at the bottom of each layer, with dire consequences for themselves and their dependents.


ameliorate race and gender inequalities in the distribution of wealth.\footnote{233} Mariko Lin Chang conceptualizes homeownership as an entrée to what she calls the “wealth escalator”—the variety of financial benefits such as employee fringe benefits, favorable tax laws, and government benefits that enable individuals to accumulate more wealth more quickly.\footnote{234} Like many others, Chang advocates making homeownership more accessible to remedy wealth inequality.\footnote{235}

The goal of increasing levels of homeownership among minorities and women was embraced by the Clinton Administration as part of its sprawling plan to increase homeownership.\footnote{236} Perhaps more surprisingly, it was then co-opted by the Bush Administration. In George W. Bush’s vision for an “ownership society,” homeownership was portrayed as an equal-opportunity path to individual financial empowerment and upward mobility:

For millions of our citizens, the American Dream starts with owning a home. Homeownership gives people a sense of pride and independence and confidence for the future. When you work hard, like you’ve done, and there are good policies coming out of our Nation’s Capital, we’re creating a home—an ownership society in this country where more Americans than ever will be able to open up their door where they live and say, “Welcome to my house. Welcome to my piece of property.”\footnote{237}
As part of his ambitious agenda to promote homeownership, President Bush, with the eager support of the real estate lobby, targeted minorities with special initiatives.\textsuperscript{238} However, as the last decade has proved, homeownership is not always a ride on the “wealth escalator.” Indeed, evidence from the subprime mortgage crisis indicates that homeownership can cause a precipitous descent down that escalator, especially for people of color.\textsuperscript{239} The subprime mortgage market and the real estate bubble inflicted harms on many homeowners,\textsuperscript{240} but minority homeowners and their communities were particularly hard hit.\textsuperscript{241}

This recent history with homeownership as a remedy for wealth inequality casts doubt on the ability of the government to effect socio-economic change in this way. More fundamentally, it raises questions about whether and to what extent private wealth accumulation ought to be the goal of a just and fair society.

\section*{C. Proposals for Reform}

The history of tax preferences for home sales reveals that the gain exclusion rests upon questionable policy justifications, flawed logical reasoning, and poor design choices. Moreover, it is difficult to justify a super preference for owner-occupied housing relative to other capital assets, especially when the consequences of doing so have been shown to be unpredictable and possibly very damaging. Moreover, the events of


\textsuperscript{241} See Ojeda, Jacquez & Takash, \textit{supra} note 239, at 15–22 (describing how African Americans and Latinos borrowed using subprime mortgages at disproportionately high levels and how they have suffered disproportionately severe declines in wealth); \textit{see also} Rivera et al., \textit{supra} note 239, at 4–16.
recent years have called into question fundamental premises about the value of homeownership and the government’s role in promoting it.

In light of these considerations, the gain exclusion should be repealed, and no special tax preference for home sales beyond the normal capital gains preference should be substituted in its place. Rather, gains on home sales ought to be taxed in the same manner as other capital gains.

This proposal will strike some as extreme, but it is certainly within the realm of possibility. One obvious objection will relate to liquidity—that a taxpayer who sells a home and buys a new one will not have the funds to pay a tax on the gain from the sale. Another complaint will be the unfair surprise of imposing a tax on gains from home sales when such gains largely have been exempt from tax for decades. A third objection will be that taxing home sales will have a dampening effect on the housing market at a time when the recovery of that market is viewed as crucial to a broader economic recovery, or that it will cause other adverse economic effects.

The liquidity and the unfair shock problems are relatively minor, at least for the time being, for two principal reasons. First, capital gains rates are at historic lows (zero or five percent) for all but the top one percent of taxpayers, whose capital gains rate is also quite low (twenty percent). Second, few taxpayers own homes with large unrealized gains. Many homes that might have a very low historic basis due to the rollover regime have either been sold since the 1997 law was enacted, or have been transferred through inheritance—which means their bases have been “freshened.” After 1997, the real estate bubble resulted in an enormous run up in home values, but most of this appreciation has been erased as the bubble has deflated. As of 2012, home prices had returned to 2002 levels.


243. See Laura Saunders, High Earners Facing First Major Tax Increase in Years, WALL ST. J., Jan. 2, 2013, at A1. In addition, many high-income taxpayers are likely to have capital loss carryovers from recent years that they can deduct against gains on home sales.

244. It is estimated that it takes about fifteen years for half of single-family homebuyers to move out of homes they purchased. Paul Emrath, How Long Buyers Remain in their Homes, HOUSINGECONOMICS.COM (Feb. 11, 2009), http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=110770&channelID=311 (last visited Aug. 21, 2013).

incure large tax liabilities. For those who would owe a large tax, a variety of mechanisms could be used to ease any hardship. Those whose ownership predates the 1997 law could be allowed the current law’s gain exclusion under a grandfather provision. For others owing a substantial tax, the payment of tax could be spread over a number of years.

The impacts of repealing the gain exclusion on the housing market or other aspects of the economy are difficult to predict. It is possible that housing prices would decline, which could compound the short-term problems we are experiencing with the substantial correction in the housing market. On the other hand, prices might rise, as homeowners facing a tax will be more reluctant to sell. It seems plausible that a tax would generate incentive effects opposite to those of the exclusion—that homeowners might become less mobile and that home sale frequency might decrease. However, at least one study indicates that a tax on home sales has the greatest effect—in terms of increased price and decreased sale frequency—on homes held primarily for investment, with little effect on principal residences. This suggests that the impact on labor mobility of a tax on principal residence might not be as great as some would predict.

CONCLUSION

This Article recommends what some might consider to be a radical change in law—the repeal of the exclusion for gains on home sales and a return to taxing those gains in the same manner as other capital gains, as was done more than sixty years ago. At the same time, the Article has argued that path dependence, having taken us long and far down the path of tax subsidies for home sales, makes it extremely difficult to reverse course. Are the reforms proposed here even possible under this path dependent account?

246. Several studies of real property taxes have found that real property prices fall when these taxes are imposed. See John D. Benjamin, Edward N. Coulson & Shiawee X. Yang, Real Estate Transfer Taxes and Property Values: The Philadelphia Story, 7 J. REAL ESTATE FIN. & ECON. 151 (1993); Benjamin Dachis, Gilles Duranton & Matthew A. Turner, Sand in the Gears: Evaluating the Effects of Toronto’s Land Transfer Tax (C.D. Howe Inst., Working Paper No. 277, 2008), available at http://www.cdhowe.org/pdf/commentary_277.pdf; Sara Johnson & Asieh Mansour, The Impacts of a Real Estate Transfer Tax on the Massachusetts Economy (1997). However, transfer taxes differ greatly from capital gains taxes, so it is not clear that these findings are transferable to a capital gains tax.


248. See id.

249. See id.
Path dependence theorists posit that change is sometimes possible. Among the mechanisms or conditions they identify that can prompt change, two are particularly promising here.250 The first is learning—that is, we can learn from our mistakes and the mistakes of others and make corrections.251 One principal goal of this Article is to contribute to such learning in the hope that it will reveal mistakes and lead to correction.

What we have learned from our experience with tax subsidies for home sales is that special tax preferences can be harmful in unpredictable and significant ways and that once they establish a toehold, they are difficult to reverse. More generally, the complexity of the tax legislative process—the intertwined policy and politics, the presence of highly organized and powerful interest groups, and the difficulties of foreseeing and quantifying the economic impacts of tax preference—casts doubt on the wisdom of using the tax law to effectuate social and economic policies. Moreover, based on our recent experience with the housing market and its particularly adverse impacts on minority homeowners and communities, we must reevaluate how the government can more effectively promote equality and prosperity. Finally, we must confront the fundamental questions of whether an “ownership society” should be our vision of a just and fair society, and, if not, what the alternatives might be.

In addition to learning, a second condition that can prompt change is the occurrence of an “exogenous shock”—an unforeseen event that alters a previously stable arrangement.252 The global financial crisis is just such an exogenous shock. It has caused lawmakers and policymakers to question their basic assumptions about the desirability of homeownership and the role of the federal government in promoting homeownership, laying the groundwork for law reform. Furthermore, the crisis has brought an increased urgency to the serious fiscal challenges we must confront. As part of any solution to our budgetary woes, there is near unanimity that tax expenditures must be curtailed.253

As we contemplate cuts in tax expenditures, tax subsidies for homeownership demand especially close scrutiny for several important reasons. First, they are extremely costly. The three largest homeownership subsidies—the home mortgage interest deduction, the exclusion of gains from home sales, and the state and local property tax deduction—are

250. A third mechanism for reversing course is competition. See PIERN, supra note 63, at 40. This mechanism seems unlikely to play a role in tax reform.
251. See id.
252. See PIERN, supra note 63, at 52; Steinmo, supra note 68, at 129.
estimated to cost $704 billion for the five-year period from 2011 through 2015.\textsuperscript{254}

Tax subsidies for homeownership are not only expensive; they are also too generous in their treatment of housing relative to other investments. As a result of the subsidies, the effective rate of tax on owner-occupied housing is near zero or even slightly negative, according to recent estimates, while the rate of tax on business investment is as high as twenty-four percent.\textsuperscript{255} This has led to less business investment, lower productivity, and ultimately, lower wages and living standards.\textsuperscript{256}

Finally, to return to the idea that an exogenous shock can be a change agent, tax subsidies for homeownership are inextricably linked with the housing and finance policies that contributed to the real estate bubble and global financial crisis.\textsuperscript{257} Our foundational assumptions and beliefs about homeownership have been shaken, and we have a rare and fleeting opportunity to set a new course. Repealing the gain exclusion for home sales should be our first step on this new path.

\textsuperscript{254.} See Staff of J. Comm. on Taxation, 112th Cong., Estimates of Federal Tax Expenditures for Fiscal Years 2011–2015 36 (Comm. Print) (2012). This figure is comprised of $464 billion for the home mortgage interest deduction, $123 billion for the exclusion of gains from the home sales, and $117 for the state and local property tax deduction. See id. Only three other tax subsidies for individuals are of similar magnitude: The exclusion for employer provided health insurance ($725 billion); the deferral of tax for employer provided retirement savings ($640 billion); and the reduced rate of tax on capital gains and dividends ($625 billion). See id. at 42, 43, 37.

\textsuperscript{255.} See President’s Advisory Panel on Fed. Tax Reform, Simple, Fair and Pro-Growth: Proposals to Fix America’s Tax System 71 (2005) (estimating effective rate on owner occupied housing to be near 0%; on business investment to be 22%); Cong. Budget Office, Taxing Capital Income: Effective Rates and Approaches to Reform 8–9 (2005) (estimating implicit rate of tax on owner occupied housing to be 5.1%; on business investment to be 24.2%).


\textsuperscript{257.} See id. at 5 (describing how the home mortgage interest deduction leads to excessive borrowing and how tax subsidies for homeownership lead to overconsumption of housing, both of which contributed to the real estate bubble); William G. Gale, Jonathan Gruber & Seth Stephens-Davidowitz, Encouraging Homeownership Through the Tax Code, 115 Tax Notes 1171, 1187 (2007) (“[T]ax policies toward housing are inequitable, inefficient, and expensive.”).