# THE EXCLUSION OF CAPITAL GAINS ON THE SALE OF PRINCIPAL RESIDENCES: POLICY OPTIONS*

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FOR ALMOST 60 YEARS, CAPITAL GAINS ON SALES of taxpayers' homes have been preferentially treated, although a major change in these rules was adopted in 1997. At that time, a general exclusion available on each sale, subject to a dollar cap and ownership and occupancy holding period requirements, replaced two existing features: a deferral of gain when a new home was purchased and a smaller one-time exclusion. This paper discusses how the principal residence exclusion has worked, and addresses a number of potential design issues relating to equity, distributional effects, and administration and compliance.

## PRESENT RULES AND HOW WE GOT THERE

### Current Law

When an individual sells a personal residence, the excess of the sales price over the taxpayer's basis is a capital gain. Basis is original cost plus improvements (but not repairs and maintenance) plus the cost of the sale. Because pre-1997 law allowed gain to be deferred if a new residence was purchased, the basis may reflect a carryover basis from the sale of an earlier residence. That is, some taxpayers have deferred gains from prior sales that would be subject to tax. In addition, capital losses on personal residences may not be deducted.

Gain up to $250,000 for single returns and $500,000 for joint returns can be excluded if the taxpayer meets a use test (has lived in the house as a principal residence for at least two years out of the last five years) and an ownership test (has also owned the house for two years out of the last five). The use and ownership periods may be the same or different. The exclusion can be used once every two years.

There are some exceptions to these rules. Taxpayers not meeting the 2-year holding period requirement may be eligible for an exclusion up to a pro-rated cap if the sale was due to certain circumstances such as a change in employment or health. For people living in a nursing home, the test is one out of five years before entering the facility, with time spent in the nursing home also counting toward ownership time and use of the residence.

The dollar cap is not indexed for inflation and has fallen in real value (and even more relative to housing prices) since it was enacted in 1997. Over time, absent change, more sellers will become subject to the capital gains tax.

As with any other asset, gain (or loss) that accrues during the owner's lifetime is never subject to capital gains tax if an asset is held until death, as the heirs receive a stepped-up basis equal to the fair market value at the time of death.

### Prior Law Rules

Prior to 1997, gains on the sale of owner-occupied housing could be deferred or exempted under two provisions. If a replacement home was purchased within a specified period, gain was deferred as long as the new house cost as much as the old sold for. Otherwise, gain would be taxable up to the excess of the old over the new. Second, sellers over age 55 were allowed a one-time exclusion of $125,000. This exclusion was the same for single and married taxpayers and was "spoiled" if a taxpayer's spouse had used the exclusion prior to the marriage, resulting in marriage penalties in certain situations.

Because of the ways that capital gains tax could be postponed or avoided, little revenue was collected on capital gains on owner-occupied housing. Auten and Reschovsky (1998) estimated that in 1996, prior to the new exclusion, $1.1 billion of taxes were paid but realized gains were $115 billion (assuming that house sales reported and not reported on Form 2119 had similar gains).

At the same time, various features of the rules produced distortions believed to increase the price of owner-occupied housing and create other distortions in housing decisions. The rollover provision discouraged homeowners from downsiz-

*The views in this paper are those of the authors and do not necessarily reflect the views of the U.S. Department of the Treasury or the Congressional Research Service.

ing to smaller or less expensive homes as family circumstances changed (such as children growing up or approaching retirement). It also encouraged homeowners moving from a high-cost area to a low-cost one to purchase a larger home. Some argued that it discouraged the purchase of homes in inner cities, which were less expensive than those in the suburbs (Bier, 2000).

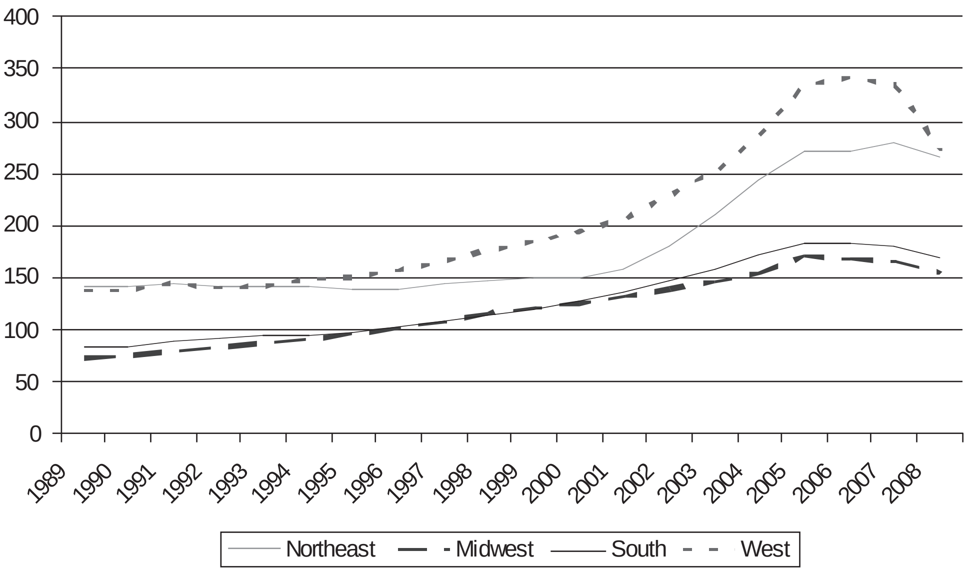
In addition, the exclusion at age 55 discouraged homeowners approaching that age from selling their home to downsize or move into rental housing. Several studies documented the decline in home sales at ages 53 and 54 and a jump at age 55 (Auten and Reschovsky, 1998). The marriage penalty and the possible spoiling of the exclusion when a potential spouse had used the one-time exclusion meant that planning was required to order marriage and sale for individuals over age 55 contemplating marriage.

For a provision that collected little revenue, the recordkeeping and compliance burden for homeowners was significant. Given the possibility of selling the home, taxpayers had to keep records of purchase prices, sales costs and improvements for their previous residences with rollover gains as well as their current one. Distinguishing between repairs and improvements is an added difficulty.

## HOW HAS THE 1997 EXCLUSION PROVISION WORKED?

The primary goals of the principal residence exclusion enacted in 1997 were simplification and a middle-class tax break at a relatively low-revenue cost while addressing some of the distortions under prior law. At the time of enactment, fewer than 10,000 taxpayers were expected to have gains exceeding the maximum exclusions; only about 3 percent of taxpayers reported sales prices over the exclusion amounts so few would need to worry about the basis for tax purposes (Auten and Reschovsky, 1998). For several years, these initial projections seemed to be correct as unpublished tabulations show only about 2,000 taxpayers reported the maximum exclusion in 1999. As shown in Figure 1, median house prices were \$108,000 in the Midwest and South and \$143,500 in the Northeast; even in high-cost areas, only a small percentage of home sales was affected by the cap. House prices increased over time, especially in the South and the West since 2001. Median house prices peaked at \$343,000 in the West in 2006 and \$279,000 in 2007 in the Northeast, but remained under \$200,000 in the Northeast and Midwest. With the dramatic increase in house prices since 2000, however, many more sales would be at prices higher than the exclusion and potentially subject to tax.

*Figure:* **Median Existing Home Sales Prices, 1989-2008**



Prior to the enactment of the new exclusion in 1997, the IRS required a separate Form 2119 for sales of principal residences. With the anticipated decline in taxable sales, the IRS decided that this form was no longer needed and that taxpayer burden could be reduced by having taxpayers report principal residence sales directly on Schedule D along with other capital gain transactions.

We use the IRS Statistics of Income Sales of Capital Assets Study for 2007 and selected prior years, which record transactions on Schedule D and related forms. Since a separate form or line is no longer required, the observations of sales of residences were selected based on the descriptions provided by taxpayers, an SOI-assigned asset code, and other information on the return. In most cases, the starting point was the asset code for residences, which includes principal residences, secondary residences, vacation homes, and other personal residences (i.e., rental properties have a different code). The sample for this study includes about 2,200 observations.

As shown in Table 1, taxpayers reported 368,000 transactions that appear to reflect the sales of principal residences, secondary residences, and vacation homes. Note that these reported transactions reflected only 6.5 percent of the 5.675 million sales of existing homes reported by the National Association of Realtors for 2007. Approximately 6,200 could be identified as vacation homes and 11,000 as second or third residences. Most of the other 351,000 transactions are probably principal residences based on the taxpayer description and other information. Some observations, however, may be rental or other investment properties not qualified for the principal residence exclusion.[1] In nearly 60,000 cases, the taxpayer provided only partial information such as only the gain or loss (8,700 cases) or a basis exactly equal to the sales price (50,800 cases). Over 214,000 taxpayers reported an exclusion and as many as 274,000 exclusions can be implied counting those with an identical sales price and basis or only taxable gain.[2] In 32,000 cases, it could be determined that taxpayers received the maximum exclusion. There could be as many as 40,000 cases at the maximum if most of the 8,700 taxpayers reporting only a taxable gain amount had already deducted the maximum exclusion (over 90 percent of the 8,700 mentioned an exclusion). Taxable gains were reported for 98,600 principal residence sales and on 13,500 vacation or secondary residence sales. A loss was reported on about 37,000 sales that appeared to be principal residences and 3,100 deducted the loss even though that is not allowed. Losses were also deducted on about one-quarter of sales of vacation homes and over 400 secondary residences, possibly because the taxpayer had treated them as rental properties. The large number of loss cases may indicate a lack of understanding of the tax rules or confusion because of Congressional proposals to allow such losses.

Table 2 shows the distribution of sales of principal residence sales reported on Schedule D for 2007 by income class, by the amount of gain and selling price, by the amount of exclusion, and by

*Table 1*
**Sales of Residences Reported on Federal Income Tax Returns, 2007**

| Numbers of Returns | All Residences | Principal Residences | | | | | Other Residences | |
|---|---|---|---|---|---|---|---|---|
| | | Total | Basic | Price=Basis | Gain only | Loss | Second | Vacation |
| Transactions | 368,119 | 350,987 | 254,467 | 50,848 | 8,741 | 36,931 | 10,958 | 6,174 |
| Exclusion | 214,478 | 214,478 | 214,091 | 387 | 0 | 0 | 0 | 0 |
| Maximum Exclusion | 32,173 | 32,173 | 32,173 | 0 | 0 | 0 | 0 | 0 |
| Taxable Gain | 112,178 | 98,639 | 89,810 | 0 | 8,741 | 105 | 9,527 | 4,012 |
| Loss | 39,759 | 36,931 | 0 | 0 | 0 | 36,931 | 685 | 2,143 |
| Loss claimed | 5,028 | 3,117 | 0 | 0 | 0 | 3,117 | 447 | 1,464 |
| All zeros | 6,421 | 6,421 | 0 | 6,420 | 0 | 0 | 0 | 0 |

Source: IRS Statistics of Income 2007 Sales of Capital Assets Study, tabulations by the authors.

Notes: In basic transactions, the exclusion can be determined from the sales price, basis and reported gain or from the description. In some transactions taxpayers report only a gain amount or the basis equals the sale price, often with a reference to Section 121. These returns are assumed to have some amount of exclusion unless the description mentions a loss. Transactions with a taxable gain may have reached the maximum exclusion but this generally cannot be determined. Loss includes transactions with negative gain or disallowed loss inferred from the description or the sales price and basis. Some taxpayers report all zeroes in the dollar fields, or only a sales price less than their maximum exclusion amount. Preliminary estimates based on a sample of approximately 2,200 observations.

*Table 2*
**Distribution of Sales of Principal Residences by AGI and Other Variables, 2007**

| Adjusted Gross Income ($1,000s) | Numbers of Reported Principal Residence Sales | | | | | Mean Dollar Amounts ($1,000s) | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Number | Exclusion | Maximum exclusion | Taxable gain | Loss | Sales price | Basis | Gain /Loss | Exclusion amount |
| Under $25 | 54,602 | 39,217 | 1,747 | 8,932 | 8,226 | 289.0 | 220.1 | 4.2 | 74.3 |
| $25 - 50 | 46,577 | 33,804 | 709 | 8,811 | 6,884 | 278.7 | 211.8 | 2.5 | 66.8 |
| $50 - 100 | 91,159 | 68,921 | 4,616 | 22,089 | 11,007 | 319.4 | 234.9 | 4.6 | 81.7 |
| $100 - 250 | 114,612 | 94,232 | 11,234 | 34,328 | 9,231 | 376.9 | 267.9 | 15.8 | 100.2 |
| $250 - 1m | 34,723 | 29,815 | 10,411 | 18,078 | 1,181 | 785.8 | 462.5 | 121.4 | 190.1 |
| $1m + | 9,314 | 7,690 | 3,454 | 6,400 | 402 | 1,601.3 | 953.5 | 650.4 | 207.8 |
| All classes | 350,987 | 273,680 | 32,173 | 98,638 | 36,931 | 408.2 | 281.9 | 36.6 | 98.7 |
| Size of gain | | | | | | | | | |
| Loss | 36,930 | 0 | 0 | 105 | 36,930 | 271.0 | 310.2 | -3.7 | 0.0 |
| Zero | 55,377 | 50,444 | 0 | 0 | 0 | 211.4 | 211.4 | 0.0 | 0.0 |
| Under $25 | 51,778 | 28,861 | 0 | 29,113 | 0 | 227.2 | 217.5 | 3.5 | 6.3 |
| $25 - 50 | 31,143 | 26,967 | 0 | 7,015 | 0 | 220.6 | 184.8 | 6.2 | 30.8 |
| $50 - 100 | 43,137 | 39,942 | 0 | 10,346 | 0 | 313.0 | 244.4 | 8.4 | 63.4 |
| $100 - 250 | 71,529 | 67,693 | 0 | 13,478 | 0 | 419.0 | 263.4 | 15.4 | 147.3 |
| $250 - 500 | 40,235 | 39,608 | 13,722 | 18,526 | 0 | 667.8 | 346.5 | 43.3 | 293.0 |
| $500 - 1m | 16,499 | 16,209 | 15,217 | 15,729 | 0 | 1,236.4 | 650.5 | 197.8 | 416.1 |
| $1m - 5m | 4,093 | 3,717 | 3,048 | 4,059 | 0 | 2,356.3 | 1,033.1 | 1,244.9 | 335.8 |
| $5m + | 267 | 238 | 185 | 267 | 0 | 9,484.5 | 1,748.9 | 3,932.5 | 204.8 |
| Sales price | | | | | | | | | |
| Zero | 16,107 | 11,175 | 928 | 9,686 | 0 | 0.0 | 0.0 | 199.8 | 18.8 |
| Under $50 | 13,703 | 8,334 | 0 | 1000 | 4,676 | 25.7 | 46.7 | -2.1 | 3.3 |
| $50 - 100 | 27,489 | 20,985 | 0 | 5,518 | 2,660 | 74.7 | 63.5 | 1.4 | 12.4 |
| $100 - 250 | 100,178 | 71,444 | 0 | 21,747 | 13,471 | 174.9 | 143.5 | 2.3 | 31.2 |
| $250 - 500 | 103,363 | 81,683 | 3,463 | 22,146 | 12,440 | 356.5 | 257.1 | 7.2 | 95.5 |
| $500 - 1m | 65,015 | 57,145 | 11,506 | 20,385 | 2,870 | 635.3 | 419.2 | 27.8 | 189.7 |
| $1m - 5m | 24,519 | 22,427 | 15,816 | 17,578 | 805 | 1,628.2 | 1,064.2 | 219.8 | 343.9 |
| $5m + | 614 | 487 | 460 | 578 | 9 | 8,583.7 | 3,677.4 | 2,352.8 | 300.3 |
| Exclusion | | | | | | | | | |
| Zero | 136,509 | 59,202 | 0 | 44,307 | 36,931 | 251.3 | 244.6 | 38.6 | 0.0 |
| Under $25 | 28,164 | 28,164 | 0 | 5,499 | 0 | 242.0 | 229.8 | 0.5 | 11.6 |
| $25 - 50 | 26,332 | 26,332 | 0 | 2,205 | 0 | 217.9 | 180.5 | 0.4 | 36.9 |
| $50 - 100 | 38,897 | 38,897 | 0 | 6,106 | 0 | 326.1 | 253.7 | 0.8 | 72.3 |
| $100 - 250 | 64,792 | 64,792 | 0 | 6,741 | 0 | 428.4 | 261.2 | 2.7 | 164.5 |
| $250 - 500 | 41,850 | 41,850 | 17,729 | 20,124 | 0 | 793.9 | 378.0 | 83.4 | 302.2 |
| $500 + | 14,443 | 14,443 | 14,443 | 13,656 | 0 | 1,575.8 | 811.4 | 267.3 | 500.0 |
| Region | | | | | | | | | |
| Northeast | 50,998 | 41,786 | 5,255 | 17,167 | 2,782 | 445.7 | 300.8 | 67.4 | 105.8 |
| NorthCentral | 59,513 | 38,053 | 420 | 14,244 | 11,263 | 220.3 | 190.7 | 7.2 | 30.9 |
| SouthAtlantic | 64,259 | 49,216 | 6,550 | 18,636 | 7,847 | 417.1 | 268.7 | 37.4 | 102.5 |
| SouthCentral | 38,798 | 31,494 | 2,001 | 6,678 | 5,964 | 254.5 | 192.6 | 18.1 | 49.0 |
| West | 72,178 | 53,034 | 5,194 | 22,258 | 5,938 | 427.6 | 291.5 | 25.0 | 117.3 |
| California | 65,192 | 55,748 | 11,144 | 21,062 | 4,440 | 600.4 | 401.0 | 58.5 | 156.7 |
| Marital status | | | | | | | | | |
| Single | 123,580 | 96,643 | 16,723 | 37,810 | 12,324 | 380.3 | 258.4 | 40.8 | 82.3 |
| Joint | 227,408 | 177,037 | 15,449 | 60,829 | 24,606 | 423.4 | 294.6 | 34.3 | 107.6 |
| Holding period | | | | | | | | | |
| Under 2 years | 53,676 | 22,204 | 641 | 16,249 | 17,466 | 336.3 | 316.1 | 14.9 | 19.7 |
| 2 -3 | 48,013 | 33,300 | 2,364 | 9,865 | 6,877 | 374.4 | 277.5 | 24.9 | 54.9 |
| 3 - 4 | 24,473 | 18,081 | 531 | 5,796 | 3,102 | 367.7 | 311.8 | 16.0 | 43.8 |
| 4 - 5 | 24,605 | 18,734 | 1,657 | 5,087 | 4,568 | 397.0 | 304.0 | 16.7 | 86.5 |
| 5 - 10 | 90,410 | 81,170 | 7,736 | 27,039 | 2,551 | 443.5 | 298.7 | 30.6 | 123.4 |
| 10 -15 | 39,408 | 34,364 | 5,546 | 11,944 | 1,170 | 441.5 | 257.6 | 53.8 | 151.6 |
| 15 - 20 | 22,957 | 20,703 | 4,505 | 6,846 | 1,139 | 497.8 | 316.9 | 47.1 | 145.3 |
| 20 - 30 | 19,409 | 18,253 | 3,948 | 6,797 | 57 | 476.4 | 230.1 | 98.5 | 166.9 |
| 30 and over | 28,036 | 26,872 | 5,246 | 9,015 | 0 | 367.6 | 165.4 | 77.5 | 144.2 |
| All classes | 350,987 | 273,680 | 32,173 | 98,638 | 36931 | 408.2 | 281.9 | 36.6 | 98.7 |

Source: IRS Statistics of Income 2007 Sales of Capital Assets Study, tabulations by the authors.
Notes: Capital gain classes are before any exclusion. Dollar amounts are in $1,000s. See Table 1 for detailed notes on data.

region and marital status. The proportion of taxpayers with taxable gains increases with income and prices of homes. California residents accounted for more than one-third of sales reported as using the maximum exclusion, while very few residence sales hit the maximum exclusion in the north central states. The largest numbers of home sales with reported acquisition and sale dates had holding periods between 5 and 10 years, consistent with other information on residential sales.

One policy concern has been home builders or remodelers using the exclusion to convert what would otherwise be ordinary income into a tax-free capital gain by owning and occupying a newly built or remodeled residence for two years to qualify for the exclusion. A comparison of the taxpayers who claimed an exclusion in 2007 with the 2004 and 2005 sales of capital assets revealed only a small number of observations in which taxpayers claimed an exclusion in both years. Using approximate weights, these would be fewer than 1,000 such repeat users reporting transactions on Schedule D. While the few cases may indicate few such abuses, it could also reflect the limits of the sample or lack of reporting of sales under the $250,000 and $500,000 exclusion amounts.

Some indication of compliance can be obtained by comparing tax return data with the information reported on Form 1099-S for real estate transactions (see Table 3). Form 1099-S, however, applies to all types of real estate transactions, and principal residence sales below the maximum exclusion amounts are generally exempted from this reporting requirement.

## ISSUES

This section discusses three issues: the general justifications for capital gains relief for owner-occupied housing, problems that arise from the fixed cap, and rationales for the cap.

### Justification for Capital Gains Relief for Owner-Occupied Housing

A major justification for exempting home sales from the capital gains tax is to avoid discouraging labor mobility. Home sales because of changes in employment or family size were part of the justification for the rollover provisions as they could be considered as comparable to involuntary conversions (U.S. Congress, Senate Committee on Finance, 1951). This argument relates to fairness, but the issue is also one of efficiency. A capital gains tax on owner-occupied housing causes a distortion by interfering with efficient choice of employment. Several studies have found evidence of significant distortions induced by the gains tax once an individual has a home and wishes to move (Auten and Reschovsky, 1998; Burman, Wallace, and Weiner, 1997) and that some of this affects employment decisions (Richards, 2008). Cunningham and Engelhardt (2008) found that the new exclusion increased the residential mobility rate of homeowners in their early 50s by 22-31 percent because the new exclusion no longer had an age 55 requirement. Shan (2011) found that in the affluent suburbs around Boston, the new exclusion resulted in increased sales of residences with modest gains, but may have generated an unintended lock-in effect on homes with capital gains over the exclusion amount.

*Table 3*
**Real Estate Sales Reported on Information Returns**

| Sales Amount ($1,000s) | Number of returns | Total Sales ($millions) | Mean Sales Amount |
|---|---|---|---|
| Zero | 1,110 | 0 | 0 |
| Up to $10k | 232,379 | 1,021 | 4,396 |
| $10 - 50k | 570,961 | 15,832 | 27,729 |
| $50 - 100k | 499,256 | 36,518 | 73,144 |
| $100 -250k | 980,755 | 161,260 | 164,425 |
| $250 - 500k | 619,464 | 214,033 | 345,513 |
| $500k - 1m | 315,857 | 212,471 | 672,680 |
| $1 m - 5m | 121,433 | 217,607 | 1,791,994 |
| $5m - 10m | 8,330 | 56,526 | 6,785,884 |
| $10m + | 8,565 | 460,557 | 53,771,967 |
| All | 3,358,110 | 1,375,826 | 409,702 |

IRS, Computer Data Warehouse, Form 1099s. Tabulations by the authors.

A second justification for capital gains relief is that the gains largely reflect inflation. Without inflation, the structure should fall in value because of aging, although the land value could increase. At the time the current regime was enacted, recent home price appreciation was 16 percent between 1991 and 1997 (Federal Housing Finance Agency, 2009), while the consumer price index (CPI) had increased by 15 percent (U.S. Department of Labor, 2009), so that virtually all of the increase in price reflected inflation. This relationship has broken down more recently, however. Despite the recent collapse of the housing bubble, house prices increased by 68 percent while the CPI rose only 31 percent between 1997 and 2008. Nevertheless, over long periods of time, much, perhaps most, of the gain in value of owner-occupied housing is due to inflation. This relationship is probably closer than is the case for other types of assets. For example, gains on corporate stock reflect reinvested earnings.

A third reason for capital gains relief is to treat taxpayers in different circumstances more equitably. Since there is a benefit from deferring taxes on gains and assets held until death can escape the capital gains tax entirely, imposing the tax may be viewed as unfair. For example, older individuals who need to move out of their residences and into assisted living homes or nursing homes would be taxed more heavily than the healthy who can remain in their homes.

One argument against capital gains relief for owner-occupied housing is that it causes too much housing consumption. However, housing is also favorably treated by allowing mortgage interest and property tax deductions, while also excluding imputed rent from income. For FY2008, the tax expenditures for the mortgage interest deduction, and property tax deduction, and capital gains exemption were $67 billion, $25 billion, and $17 billion respectively (Joint Committee on Taxation, 2008). Restricting these other subsidies would not introduce barriers to labor mobility. (The mortgage interest deduction is already capped, although at a very high level.) An additional argument made in the context of the current financial crises, is that the exclusion for gains on principal residences was a cause of the housing bubble and subsequent crash. The small amount of revenue collected under prior law (Auten and Reschovsky, 1998) suggests that the principal residence exclusion played little or no role. Various studies have concluded that the main causes of the housing bubble include low interest rates, credit market innovations such as securitization of mortgages, beliefs in ever-rising home prices and promoting homeownership, and other homeownership issues (Dokko et al., 2009).

### Problems of the Fixed Cap

While the 1997 rules were initially beneficial for almost all taxpayers, the cap made it less generous for those who had expensive homes which they planned to roll over. Over time, the former group would diminish while the numbers of taxpayers with gains exceeding the cap would increase because the cap is not indexed, especially for singles whose caps are half as large. Absent change, virtually all sellers will eventually be subject to the cap. Despite the recent fall in housing prices, the average price of homes at the end of 2008 was 68 percent higher than it was in 1997. If the $500,000 cap were indexed to reflect inflation it would be increased to $655,000 at the end of 2008 using the CPI. If it were indexed to the residential investment price index, it would be set at $760,000 (National Income and Product Accounts, 2009); and if it were indexed to inflation in home prices it would be set at $864,000. The value could also be indexed to median family income, leading to an exclusion in 2008 of $811,000 (U.S. Census Bureau, 2009).

Congress might increase the cap. However, given the uncertainty about legislative action and potential future gains, a prudent taxpayer would keep records, especially since singles have only half the exemption of married couples. Widows and widowers have their exemptions cut in half, unless they sell within two years and have not remarried.[3] Since they are exempt from half the gain that accrued until their spouse's death because of step up in basis, widows and widowers in these circumstances receive both an exclusion for half the value of the house, as well as the full exemption.[4] This treatment does create a marriage penalty, however, since the additional exclusion is allowed only if they do not remarry. At the same time, if they own the home for a considerable additional time, which may not be uncommon for widows given the typical age differences at marriage and life expectancies, the current treatment may lead to higher taxes because of the first spouse's death.

Once it is exceeded, the cap induces a lock-in effect that discourages some individuals who are wealthy or live in high-cost areas from selling their houses. This effect, unlike the prior law rollover provision, would also discourage these individuals from selling their houses even to purchase a new one, and, for this reason, also would discourage labor mobility. While still relatively small, this problem will grow over time absent legislative change.

### Rationale for the Cap

Eliminating the cap would cost revenue. Based on the data in Table 2, we estimate that the revenue loss from eliminating the cap would be around $1.9 billion per year, about 10 percent of the total of approximately $17 billion tax expenditure for the capped exclusion. The other obvious reason for the cap was distributional, so that wealthy taxpayers would not be able to receive a substantial tax reduction from a multi-million dollar housing gain. However, other features of the tax code could be used to achieve distributional goals and the benefit for the exemption above the cap is generally small compared to the benefits of lower tax rates on dividends and capital gains for high-income taxpayers. As discussed in the following section, another reason for a cap is to limit tax sheltering and income-shifting opportunities.

### Avoidance Techniques

Avoidance techniques generally fall into two categories: those associated with using the exclusion to avoid tax on other types of income, and those associated with avoiding the cap. Eliminating the cap would eliminate the latter techniques but magnify the former.

As an example of how tax on investment income could be avoided before recent changes, consider a married couple who have a primary residence and a rental property. The couple could sell the primary residence and exclude up to $500,000 of gain, move into the rental property and after two years, sell that property and again exclude a $500,000 gain. (Depreciation is recaptured and taxed, however). It made no difference if most of the appreciation on the second property was realized when it was a rental unit.

Two provisions, added in 2004 and 2008, deal with such situations on rental properties. The first prevented individuals from exchanging rental property in a like-kind exchange, which allowed rollover of any accrued capital gains, and then qualifying for the exclusion on the newly acquired property, unless there was a 5-year ownership period. The second disallowed the exclusion for the share of time the property was rented as compared to being used as a principal residence. This new allocation provision, however, applies only to rental periods before the residency requirement and not those after.

Another avoidance approach is to purchase a home with a significant amount of land that is actually held for investment. A taxpayer is allowed to sell vacant land adjacent to the home separately from the home itself, as long as the home is also sold either two years before or two years after the sale of the vacant land. The land must be used as part of the home (which would rule out farm land, timber land, and other uses but not simple speculation).

Another avoidance issue is the professional "fixer-upper." An individual buys a home that needs substantial renovation, fixes it up, lives in it for two years, and then sells the home. This gain reflects untaxed labor income of the individual, which is now excluded from tax. In fact, this approach can be used by professional home builders who would normally be paid for their services.

An individual who has both a regular home and a vacation home may be able to convert the vacation home to principal residence status, effectively living in the original home in part, but after the required holding period selling the vacation home, avoiding capital gains, and moving back to the regular home. Which home is deemed to be the principal residence is based on a facts-and-circumstances assessment. It is not easy to establish the vacation home as the principal residence, though it may be feasible in some cases and, of course, the IRS cannot audit every case of this type.

Some avoidance techniques are aimed at avoiding the cap itself and would disappear without the cap. One is house swapping, where wealthy individuals sell their homes back and forth periodically to qualify frequently for the capital gains tax exclusion. Transactions costs could be minimal with mutual agreement and individuals may not even live in the exchanged homes. Such arrangements are illegal but may be difficult to detect.

## OPTIONS FOR CHANGE

Since the enactment of the current regime, there have been many legislative proposals to alter the provision in addition to those that were enacted. H.R. 2127 (109th Congress) and H.R. 2757 (111th Congress) would have allowed taxpayers over the age of 50 to exclude an amount double the current cap, but available only once in their lifetime. H.R. 2757 (109th Congress) and S. 12 (110th Congress) would have indexed the cap for inflation. H.R. 3803 and S. 4075 (109th Congress) would change the cap for surviving spouses to that of a married couple. S. 12 (110th Congress) would have allowed a rollover provision along with the exclusion.

### Eliminate the Cap

As discussed above, the cap introduces uncertainty that requires recordkeeping, it burdens those who tend to stay in their houses for a long time, and creates an incentive for turnover in high cost areas. These effects apply for taxpayers anticipating large gains and become gradually more binding and the uncertainty greater with a fixed dollar cap. It also creates problems with the trade-off between equitable treatment of singles and married couples. Eliminating the cap, however, would reduce revenues and would favor high-income individuals, although distributional and revenue objectives may be met in other ways. Eliminating the cap would also increase the potential gains from the avoidance schemes discussed in the previous section, although there may be ways to address avoidance directly, as discussed below.

### Index the Cap

Another option would be to index the cap. As noted earlier, the cap could be indexed to some measure of inflation which would preserve the real value of the exclusion. Using the CPI, for example, would have increased the exclusion of $655,000 by the end of 2008.[5] The share of home sales over the cap could be eroded gradually over time, however, by rising real incomes and house prices. An alternative would be to index the exclusion to home prices or incomes, which would be better suited to preserving the large share of residences having gains below the cap and reducing uncertainty with respect to the probability of gains exceeding the exclusion. Using house prices would have increased the $500,000 exclusion to $864,000 by the end of 2008. The use of house prices might accentuate housing bubbles and cycles, although historically, national housing bubbles are uncommon. Another alternative that would help prevent an increasing share of sales from exceeding the cap would be to index the cap by the growth in median income, which would have increased the exclusion to $811,000 at the end of 2008. Both house prices and median incomes would generally increase slightly more rapidly than consumer prices, reflecting increases in the general standard of living.

### Substitute a Larger Lifetime Cap

Another option to reduce the inequity between those who hold their houses for different periods and the incentive to turn over is to substitute a larger lifetime cap. A disadvantage is that individuals who might potentially exceed the cap would need to keep records for each sale. There would also be complexities in allocating the lifetime cap for taxpayers with multiple marriages and IRS monitoring of the cumulated lifetime gains.

### Increase the Cap for Singles Relative to Married Couples or Increase the Cap for Surviving Spouses

The pre-1997 one-time exclusion provided the same cap for married couples and single individuals, resulting in significant marriage penalties in certain situations, while the current per person exclusion is twice as high for a married couple. Because of economies of scale, one might expect single persons to have houses more than half the size and cost of those of married couples. Thus, there may be seen to be some inequity in allowing a cap only half as large. Providing anything more than half the cap, however, would produce a marriage penalty, since marriage would lose the couple part of the cap, and divorce would increase the total potential exclusion.

One option less likely to create problems and yet deal with a potential inequity would be to allow the full married exclusion for surviving spouses who have not remarried and owned the house in question with the spouse, but make this an alternative to step up in basis. Since women tend to marry older men and also tend to live longer than men, having only half the exclusion may reduce the benefit that would have occurred had the spouse survived. To be penalized for widowhood or widowerhood seems unfair, but whether an individual would gain or lose from this change would depend on whether the gains accrued before or after the death of the spouse. A marriage penalty is probably less of an issue in these circumstances and is offset by the option to choose basis step up. This option could also simplify recordkeeping and compliance, but could increase the complexity of tax and marital planning due by increasing the number of taxpayer options. This option would also address the double benefit received by surviving spouses during the 2-year window, who receive both a step up on half (or, in community property states, all) of the basis, as well as the full exclusion. For these taxpayers, the marriage penalty would be reduced.

### Increase the Limit for Those Over a Certain Age

Another possibility is to increase the limit for those over a certain age (e.g., 55). One reason for such an increase is that the older the individual the more likely they are to have accumulated gain from previous residences under the pre-1997 regime and the more likely they are to have owned the home for a longer period of time. As under pre-1997 law, however, this approach would produce a lock-in effect as that age is approached.

### Increase the Holding Period Requirements and the Time Between Uses; Sliding Scale Based on Holding Period

A revenue raising provision that could be used to fund other changes is to increase the holding period requirements or the time between uses to more than two years. Normally, gain is likely to be modest over short holding periods, except for unusual circumstances or expensive properties. Expanding the holding periods to three years (out of six) or four years (out of seven or eight) could be considered. The proportionally reduced maximum hardship exclusions would still be available to cover most hardship situations. A longer holding period would also discourage some of the abuses, such as home builders and remodelers moving into houses for a 2-year period to qualify for the exclusion on gain, which includes return to labor income.

Another option is to have a maximum exclusion that increases with the number of years in the home. For example, an exclusion that is $100,000 for each year would provide an exclusion of $200,000 for two years but $1,000,000 for ten years. It should not create much of an incentive for holding or for turnover if gain is expected to occur smoothly. The per year exclusion could be set at a level that would exclude most homes. This type of exclusion would make it more difficult for developers to avoid tax on business income, but would modestly increase complexity.

### Revisions to Improve Compliance and Deal with Abuse

One approach to improving compliance is to increase taxpayer reporting on returns. Examination of transactions reported by taxpayers suggests that it may be desirable to have a separate form or separate section on Schedule D for reporting the sale of principal residences. The casual reporting of many transactions and near invisibility of such transactions among other capital gain transactions may encourage noncompliance. Compliance might be improved by separate reporting that requires standard reporting of basic eligibility information. In addition, enforcement of the filing of Form 1099-S could also be made more strict.

Other revisions could be directed at abuse. Developer abuses could be addressed by marking to market at the time of occupancy and allowing only gain above that value to be eligible for the exclusion. The amount of land that could be attached to a dwelling could be limited to a fixed amount of land or land sold separately from the dwelling could not be allowed an exclusion. In the case of residences that had been rented, the prorating of gains into rental and non-rental periods could be extended to all periods, including those after the residency test is met.

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## Notes

1 Some observations may be rental or other investment properties as taxpayers described sales only as a "house," "home," or "residence." In some such cases, an exclusion could be inferred from the sales price, basis and gain, or the description. In some cases, especially those reporting a taxable gain, it was unclear whether the transaction reflected the sale of a principal residence.

2 Reporting identical sales price and basis could also reflect a nondeductible loss. These were counted as loss cases if a loss was mentioned in the description.

3 The provision allowing the $500,000 exemption if the residence is sold within two years of the spouse's death was enacted in 2007 and represents a liberalization compared to prior law. Previously, the residence had to be sold in the same tax year as the spouse's death.

4 In community property states, spouses receive step up on 100 percent of the basis.

5 While there are other price indexes, such as the GDP deflator or the residential investment deflator, indexes based on the Consumer Price Index are generally considered superior for tax administration purposes because these other indexes are revised periodically, while the CPI measure remains unchanged other than updating the base year of the index.

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