THE NEED TO LOOK BACK FOR SALES OF A PRINCIPAL RESIDENCE

Mark R. Siegel*

I. INTRODUCTION

"There is something permanent, and something extremely profound, in owning a home."[1]

Home ownership is an essential part of the American dream. The desire to become a homeowner motivates Americans to save their hard-earned money to fulfill that dream.[2] Home ownership, unlike renting, allows owners to generate equity[3] in the property and presents the potential for future appreciation in value.[4] While owning a home offers a host of attractive benefits, the current tax consequences resulting from the sale of a home are not appealing to all Americans.

The Internal Revenue Code ("the Code") contains various provisions that apply to homeowners.[5] For decades, the Code has encouraged home ownership[6] by including rules to ease the tax burdens associated with a gain resulting from the sale of a principal residence.[7] While these tax incentives are nothing new, the governing rules concerning the sale of a principal residence have changed over time.[8]

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* Professor of Law, South Texas College of Law Houston; LL.M., Emory University; J.D., Florida State University; B.S.B.A., University of Florida.

1. Kenny Guinn, former Governor of Nevada.
2. *See* Diana Olick *The American Dream: Does It Still Include Owning a Home?*, NBC NEWS (Mar. 21, 2014), http://www.nbcnews.com/business/real-estate/american-dream-does-it-still-include-owning-home-n58706 ("Even after a devastating housing and mortgage crash that resulted in millions of foreclosures and trillions of dollars of home equity lost, the majority of Americans have not given up the idea that home ownership represents their economic dream.").
3. For purposes of this Article, equity is defined as the excess of the fair market value of the property over the mortgage on the property. Suppose a $100,000 home was purchased for $10,000 cash with a $90,000 mortgage; at this point, there is $10,000 of equity in the property. If the mortgage principal is paid down to $80,000 and the home remains valued at $100,000, the owner's equity in the home increases to $20,000.
4. For example, a home purchased for $100,000 cash may increase in value to $120,000 over a given period of time, generating a $20,000 increase in value.
5. *See, e.g.*, I.R.C. § 1012 (2012) (discussing a taxpayer's basis in property); *see also infra* Parts II-III.
6. *See, e.g.*, I.R.C. § 163(h) (authorizing the home mortgage interest deduction); I.R.C. § 164 (allowing a deduction for property taxes).
7. *See infra* Parts III-IV.
8. *See infra* Parts III-IV.

Part II of this Article reviews the income tax rules that apply generally to sales of all types of property, including homes. Part III discusses the current income tax provisions specifically targeting homeowners selling a principal residence, the strategies some taxpayers have used to mitigate income tax liability when the sale of their home produced a taxable gain, and reviews laws enacted to limit the scope of the principal residence exclusion where the home was not always used as a principal residence. Part IV discusses the former rules applicable to principal residence sales, which allowed homeowners to defer or avoid taxability when the sale produced a gain. Part V analyzes national housing price data to demonstrate the burden cast upon homeowners who are required to pay income tax for a sale under the current rules but were not required to do so under the former law. Part VI proposes that homeowners be given an election to apply the former income tax rules, thereby easing the burden on homeowners disadvantaged by the current rules, and it offers an alternative proposal to reinstating the rollover rules, namely, to amend § 121 to account for inflation.

II. GENERAL BACKGROUND FOR PROPERTY DISPOSITIONS

When property is sold, the seller must determine whether the sale resulted in a gain or a loss.[9] This is determined by subtracting the adjusted basis of the property from the amount realized.[10] The adjusted basis reflects the property's original cost,[11] including deductions for depreciation[12] and increases for capital improvements.[13] The amount realized is the amount

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9. *See generally* I.R.C. § 1001 (providing that gain arises from the excess of the amount realized over the adjusted basis and loss is the excess of the adjusted basis over the amount realized).

10. *See id.*

11. The cost is generally the amount paid for the property, including indebtedness the buyer assumes or takes subject to the acquisition of the property. *See id.* § 1012. However, if property is received by gift, the adjusted basis is initially determined under § 1015. *See id.* § 1015(a) (providing that the donee takes the donor's adjusted basis). If the property was acquired by will or inheritance, § 1014 is the applicable starting point to determine the adjusted basis. *See id.* § 1014(a) (providing that the adjusted basis equals the fair market value of the property at the date of decedent's death).

12. Depreciation deductions are dependent on the use of the property by the particular taxpayer. *See generally* I.R.C. §§ 167–168 (requiring the property be used in the taxpayer's trade or business or held for the production or collection of income to qualify for depreciation deductions).

13. The Internal Revenue Code requires individuals to capitalize "[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." *Id.* § 263(a). Generally, a capital improvement is an improvement which increases the life and value of the property. STUART M. SAFT, COMMERCIAL REAL ESTATE TRANSACTIONS § 3:24 (3d ed. 2010). Capital improvements made to the taxpayer's principal residence increase its adjusted basis. *See* I.R.C. § 1016(a)(1) (stating the basis of property must be adjusted for "expenditures . . . properly chargeable to capital account"). For example, expenditures for a new roof, remodeling a kitchen, adding a swimming pool or central air conditioning are capital improvements to a home that increase its adjusted basis. In contrast, expenses for routine maintenance and repairs to a principal residence do not increase the adjusted basis and are not deductible.

received for the sale and includes all forms of compensation.[14] If the amount realized exceeds the adjusted basis, there is a gain.[15] Alternatively, if the adjusted basis exceeds the amount realized, there is a loss.[16]

I.R.C. § 1001[17] serves an important role in quantifying the amount of gain or loss realized upon disposition of property.[18] It does not, however, address whether a calculated gain should be treated as a capital gain or ordinary income.[19] This distinction is important because long-term capital gains are generally afforded preferential tax rates.[20] In general, to be characterized as a capital gain, the property sold must be a capital asset,[21] and there must be a sale or exchange of the otherwise qualifying property.[22]

Section 1221(a) broadly defines "capital asset" as "property held by the taxpayer (whether or not connected with his trade or business)"[23] and delineates several enumerated exceptions.[24] Apart from the exclusions, virtually all property owned and used for personal or investment purposes qualifies as a capital asset.[25]

Once a sale or exchange of a capital asset has occurred, any resulting gain is a capital gain.[26] Then, the capital gain is classified as either long-term or short-term.[27] If the capital asset was held for more than one year at the time of its sale, the gain is considered long-term[28] and taxed at a maximum

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14. I.R.C. § 1001(b) ("The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."). If the property is encumbered by indebtedness, the relief of the indebtedness is treated as money received by the seller, and thus, it is included in the amount realized. 2925 Briarpark, Ltd. v. C.I.R., 163 F.3d 313, 317 (5th Cir. 1999).
15. I.R.C. § 1001(a) ("The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.").
16. *Id.*
17. All references to statutory sections not otherwise specified are to the Internal Revenue Code.
18. I.R.C. § 1001(a)
19. *See generally id.* § 1001.
20. David Carris, *Capital Gains Taxation: A Full Circle?*, 14 T. MARSHALL L. REV. 43, 44 (1989).
21. I.R.C. § 1221(a).
22. *See id.* § 1222. Although a sale or other disposition of property occurs under § 1001, thereby necessitating the computation of a gain or a loss, the "sale or exchange" requirement in § 1222 is not automatically met through satisfying the "sale or other disposition" requirement in § 1001(a).
23. *Id.* § 1221(a).
24. *Id.* § 1221(a)(1)-(8) (listing the categories of property excluded from the capital asset definition).
25. *See id.* § 1221(a).
26. I.R.S., SALES AND OTHER DISPOSITIONS OF ASSETS, PUBLICATION 544 (2015), https://www.irs.gov/publications/p544/ch02.html.
27. I.R.C. § 1222.
28. *Id.* § 1222(3).

rate of 20%.[29] If the capital asset was held for one year or less, the gain is short-term[30] and taxed as ordinary income at a maximum rate of 39.6%.[31]

By its express terms, § 1001 applies to the sale or other disposition of property; as a result, § 1001 covers various transactions concerning the disposition of any type of property.[32] Because § 1001 applies to personally owned and used property, it covers the sale of a principal residence.[33] Thus, absent the additional rules addressing sales of principal residences discussed *infra*, homeowners selling their home at a gain under § 1001 will have immediately taxable capital gains.

III. CURRENT PROVISIONS

Because many taxpayers aspire to become homeowners, the purchase of a home is a common, but not necessarily frequent, transaction. In addition to the major financial commitment associated with home ownership—including homeowner's insurance, property taxes, and expenses for maintenance and repairs—there is a lingering concern about the eventual sale of the principal residence.

As a general rule, the gain realized upon the disposition of a home is recognized, and therefore, it is included in a taxpayer's gross income.[34] A taxpayer is able to avoid the immediate tax consequences of a gain if the Code provides a non-recognition provision or a provision that excludes the gain from gross income. Under the current tax code, for example, if certain requirements are met, a capital gain resulting from the sale of a principal residence will not be taxed if it qualifies for exclusionary treatment under § 121.[35]

A. Section 121

The Taxpayer Relief Act of 1997 ("TRA 1997") amended § 121[36] to provide for a recurring[37] exclusion of up to $250,000 (or $500,000 if married

29. I.R.S., TOPIC 409—CAPITAL GAINS AND LOSSES (Oct. 10, 2016), https://www.irs.gov/taxtopics/tc409.html.
30. I.R.C. § 1222(1).
31. I.R.S., *supra* note 29.
32. *See generally* I.R.C. § 1001(a).
33. *Id.*
34. *Id.* § 1001(c) ("Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.").
35. *See id.* § 121(a).
36. *See* STAFF OF J. COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 54 (Comm. Print 1997).
37. In general, the exclusion is allowed repeatedly, but no more frequently than once every two years. *See* I.R.C. § 121(b)(3).

filing jointly) of gain realized on the sale of a principal residence.[38] Prior to its amendments, § 121 allowed a one-time exclusion of $125,000.[39] The Joint Committee on Taxation explained the reason for the amendments as follows:

> Calculating capital gain from the sale of a principal residence was among the most complex tasks faced by a typical taxpayer. Many taxpayers buy and sell a number of homes over the course of a lifetime, and are generally not certain of how much housing appreciation they can expect. Thus, even though most homeowners never paid 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 under prior law, detailed records of transactions and expenditures on home improvements had to be kept, in most cases, for many decades. To claim the exclusion, many taxpayers had to determine the basis of each home they owned, and appropriately adjust the basis of their current home to reflect any untaxed gains from previous housing transactions. This determination could involve augmenting the original cost basis of each home by expenditures on improvements. In addition to the record-keeping burden this created, taxpayers faced the difficult task of drawing a distinction between improvements that add to basis, and repairs that do not. The failure to account accurately for all improvements could lead to errors in the calculation of capital gains, and hence to an under- or over-payment of the capital gains on principal residences. By excluding from taxation capital gains on principal residences below a relatively high threshold, few taxpayers will have to refer to records in determining income tax consequences of transactions related to their house.
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> To have postponed the entire capital gain from the sale of a principal residence under prior law, the purchase price of a new home must have been greater than the sales price of the old home. This provision of prior law encouraged some 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. This promoted an inefficient use of taxpayer's financial resources.[40]

Moreover, the previous law discouraged elderly taxpayers from selling their homes if the capital gain from a sale exceeded $125,000, or if they already used the exclusion on a previous sale.[41] Under these circumstances,

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38. The exclusion equals $500,000 if married filing a joint income tax return and either spouse meets the ownership requirements and both spouses meet the use requirements of § 121(a). *Id.* § 121(b)(2)(A).

39. *See* STAFF OF J. COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 54 (Comm. Print 1997).

40. *See id.* at 54–55.

41. *Id.* at 55.

taxpayers may have remained in homes that no longer suited their needs.[42] This constraint on the mobility of the elderly and others under similar circumstances was extinguished when Congress raised the $125,000 limit and allowed multiple exclusions.[43]

To qualify for a § 121 exclusion, the seller must own and occupy the property as a principal residence for at least two of the five years prior to the sale or exchange.[44] If the seller fails to meet this requirement due to relocation of employment, health, or other unforeseen circumstances, the seller is allotted a reduced exclusion amount equal to the fraction of the two years the requirements are met.[45] For example:

> Taxpayer A purchases a house that she uses as her principal residence. Twelve months after the purchase, A sells the house due to a change in employment. A has not excluded a gain under § 121 on a prior sale or exchange of property within the last 2 years. Thus, A is eligible to exclude up to $125,000 of the gain from the sale of her house (12/24 × $250,000).[46]

The 1997 enactment of § 121 encouraged astute homeowners to track valuation changes in their principal residences.[47] Homeowners anticipating a gain approaching § 121's exclusion amounts ($250,000 or $500,000) could sell their home before exceeding the statutory cap. Other homeowners, however, may have belatedly found themselves with an anticipated gain in excess of these limitations. For example, a single homeowner with a $750,000 adjusted basis in the home and fair market value of $1,200,000 has a $450,000[48] built-in gain, which exceeds the $250,000 limit.

B. Section 1031 Like-Kind Exchanges

Instead of a cash sale, homeowners may contemplate disposing of the residence in exchange for other property. Section 1031 provides that when certain types of property of a like kind are exchanged, the realized gain or loss from the disposition will not be recognized.[49] Section 1031 contains

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42. *See id.*
43. *Id.*
44. I.R.C. § 121(a) (2012).
45. For example, an otherwise qualifying seller who owns and occupies the residence for 6 months (out of the two-year requirement) may exclude one-fourth of the regular exclusion amount. *Id.* § 121(c).
46. 26 C.F.R. § 1.121-3(g)(2) (2014).
47. *Id.* § 121(b)(2).
48. $1,200,000 - $750,000=$450,000.
49. I.R.C. § 1031(a)(1) ("No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment."). If property other than qualifying property is received in the exchange, then some part of the gain, but not loss, regarding the property given up will be recognized. *Id.* § 1031(b)-(c).

specific rules for both the property disposed of and the property received by the taxpayer.[50] To qualify for the § 1031 non-recognition treatment, the property must be qualified.[51] The property relinquished in the exchange must be either property held for productive use in a trade or business or property held for investment purposes.[52] Similarly, the property received in the exchange must be either held for productive use in a trade or business or for investment purposes.[53]

Section 1031 permits postponing recognition of a gain realized on an exchange until the subsequent disposition of the property acquired in the exchange.[54] In an exchange, the property received will have an adjusted basis equal to the total adjusted basis of the property relinquished with certain adjustments.[55] The adjusted basis is reduced by the amount of any money received and increased by the amount of any gain (or decreased by any loss) that was recognized on the exchange.[56]

In general, § 1031(a) is inapplicable to an exchange of a principal residence because neither the residence exchanged nor the home received is held for investment purposes or for use in a trade or business.[57] Without more, the exchange of the principal residence at a gain in excess of the § 121 limited exclusion amounts would not qualify for like-kind treatment under § 1031 because of the non-qualifying use as a principal residence.[58]

C. Sections 121 and 1031 Combined

Section 121's dollar amount limitation prompted homeowners to attempt to combine the benefits of §§ 121 and 1031 to avoid current taxation.[59] For example, both sections may apply to the following exchange: Taxpayer A uses the home as a principal residence for at least two years and subsequently changes her principal residence. Then, A rents the former principal residence for a period of three years or less. Thereafter, A exchanges the now qualifying rental property for another residence that is held for the production of income. Under these circumstances, both §§ 121 and 1031 apply to the exchange.

50, *See generally id.* § 1031.

51. I.R.S., LIKE-KIND EXCHANGES UNDER IRC CODE SECTION 1031, FS-2008-18 (Feb. 2008), https://www.irs.gov/uac/like-kind-exchanges-under-irc-code-section-1031.

52. I.R.C. § 1031(a)(1).

53. *Id.*

54. *Id.* § 1031(d).

55. *Id.*

56. *Id.* The effect of these adjusted basis rules is to substitute the basis of the old property into the newly acquired property for subsequent taxation upon disposition.

57. *Id.* § 1031(a)(1).

58. *See generally id.* § 1031 (requiring that the property be held for productive use in a trade or business or property held for investment purposes).

59. Rev. Proc. 2005-14, 2005 I.R.B. 528-529, 4.

Homeowners with highly appreciated homes desired the ability to exclude the first $250,000 or $500,000 of gain under current § 121 and the balance of any gain to qualify for tax deferral through a § 1031 exchange.[60] Revenue Procedure 2005-14 granted homeowners' wishes by paving the way to convert a once qualifying principal residence into a qualifying use under § 1031, without forfeiting the § 121 exclusion or the § 1031 deferral.[61] This allowed homeowners to convert property held, used, and treated as a principal residence into investment or business property.[62] Revenue Procedure 2005-14 permitted the benefits of both: a gain exclusion resulting from the disposition of a principal residence and the deferral of any excess gain under § 1031 with respect to the same property in one exchange.[63]

Thus, when property meeting the ownership and use requirements of § 121 is exchanged for property meeting the § 1031 requirements, both §§ 121 and 1031 apply to the exchange as follows: (1) the gain realized on the residence exchanged is excluded to the extent permitted by § 121, with § 1031 applicable to any remaining gain; (2) although the current non-recognition treatment of § 1031 applies, when both §§ 121 and 1031 apply, gain may be recognized to the extent that any cash or other property received in the exchange exceeds the gain excluded under § 121;[64] (3) the adjusted basis of the business or investment property received equals the adjusted basis of the property exchanged, less the amount of any money received and increased for any gain recognized, including for these purposes any gain excluded by § 121.[65]

D. Section 121(b)(5): Non-qualified Use of a Principal Residence

Section 121 underwent another change in 2008.[66] Section 121(b)(5) prevents the § 121 exclusion from applying to gain allocated to periods of nonqualified use.[67] A period of nonqualified use covers any use of the property after 2008 other than as the principal residence of the taxpayer, the taxpayer's spouse, or the taxpayer's former spouse.[68] In general, nonqualified use includes periods the owner moved out of the principal residence to facilitate a sale and periods where the property was used as a

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60. *Id.* at 1.
61. *Id.* at 8.
62. *Id.* at 3–5.
63. *Id.* at 3–4.
64. Rev. Proc., *supra* note 59, at 4.
65. *Id.*
66. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (2008).
67. I.R.C. § 121(b)(5)(A) (2012).
68. *See id.* § 121(b)(5)(C).

rental or vacation residence preceding its use as a principal residence.[69] Thus, in general, the exclusion does not apply to periods a residence was used for either of these purposes.

However, § 121(b)(5) contains several exceptions allowing certain periods to qualify for the exclusion, even when the property is not used as a principal residence.[70] For example, there is an exception for periods up to five years following the property's use as a principal residence.[71] Consequently, the outcome is significantly different depending on whether the nonqualified use precedes or follows the qualified use. This suggests that Congress enacted § 121(b)(5) to address situations where a taxpayer initially acquired a second home to be used as a vacation home or rental property and later converted it into a principal residence.

In sum, before § 121(b)(5) was enacted, if the two-year ownership and use requirements of § 121 were met, the $250,000/$500,000 exclusion would apply.[72] Now, however, § 121(b)(5) precludes excluding any gain allocated to the periods of the property's nonqualified use[73]—which does not include any use during the five years following the last date the property was used as a principal residence.[74] Thus, even if the taxpayer left the principal residence unoccupied prior to sale or rented it out, that subsequent period is not a period of nonqualified use within the meaning of § 121(b)(5).[75]

While § 121(b)(5) curtailed taxpayers from using § 121's gain exclusion treatment for property formerly used as vacation or rental properties, it did not eliminate the strategy Revenue Procedure 2005-14 encourages. Revenue Procedure 2005-14 remains an option for principal residences with built-in gain amounts exceeding the exclusions permitted by § 121 alone.[76] These homeowners can combine § 1031 with the § 121 exclusion, and subsequent rental activities necessary to qualify the former principal residence as § 1031 investment or business property will not be considered nonqualified use under § 121.[77] This strategy, however, is not

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69. The portion of the gain allocable to nonqualified use periods is calculated as follows: Allocable Gain = Gain x (Nonqualified Use Periods / Ownership Period). Treas. Reg. 1.121-1(e)(1) (2002). Therefore, nonqualified use exists when rental property is subsequently converted into a principal residence.
70. *See* I.R.C. § 121(b)(5)(c)(ii).
71. *Id.* § 121(a).
72. *See supra* Part III.A.
73. I.R.C. § 121(b)(5).
74. *Id.* § 121(b)(5)(C)(ii)(I) ("[Nonqualified use does not include] any portion of the 5-year period [ending on the date of sale] which is after the last date that such property is used as the principal residence of the taxpayer or the taxpayer's spouse").
75. STAFF OF J. COMM. ON TAXATION, 110TH CONG., TECHNICAL EXPLANATION OF DIVISION C OF H.R. 3221, THE "HOUSING ASSISTANCE TAX ACT OF 2008" AS SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON JULY 23, 2008, at 63–64 (Comm. Print 2008).
76. *See generally* Rev. Proc. 2005-14, *supra* note 59, at 4–6.
77. *Id.*

without its drawbacks. To avoid being taxed on the excess gain resulting from a sale, homeowners concerned about § 121 built-in gain will be required to retain ownership of property they were otherwise ready to sell.[78]

IV. SALES OF PRINCIPAL RESIDENCES BEFORE 1997

Prior to revising § 121 in 1997 through the advent of the $250,000/$500,000 exclusion approach, there were two key provisions applicable to the sale of a principal residence: §§ 1034 and 121.[79] These provisions incorporated two important features: the "gain rollover rule" and a one-time exclusion.[80]

A. Section 1034: The Gain Rollover Rule

Prior to 1951, homeowners who sold their principal residence at a gain were taxed on the capital gain.[81] In 1951, Congress enacted § 1034 to relieve this burden.[82] As originally enacted, § 1034 generally provided that if a taxpayer sold his principal residence, and purchased a new principal residence within one year before or after such sale, the gain would be recognized on a limited basis.[83] The gain recognized on the sale of the old residence, however, was limited to the lesser of the gain realized on the sale or the amount by which the adjusted sales price of the old residence exceeded the cost of purchasing the new residence.[84]

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78. *Id.*
79. *Id.*
80. *Id.*
81. Sarah Lovinger, *Sec. 121 Exclusion of Gain from Sale of a Principal Residence*, TAX ADVISOR (Nov. 1, 2010), http://www.thetaxadviser.com/issues/2010/nov/clinic-nov10-story-04.html.
82. JACOB STEWART SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS 1604 (2003). The legislative history of § 1034 states:

> [Section 1034 is proposed] to eliminate a hardship under existing law which provides that when a personal residence is sold at a gain the difference between its adjusted basis and the sale price is taxed as a capital gain. The hardship is accentuated when the transactions are necessitated by such facts as an increase in the size of the family or a change in the place of the taxpayer's employment. In these situations, the transaction partakes of the nature of an involuntary conversion. Cases of this type are particularly numerous in periods of rapid change such as mobilization or reconversion. For this reason the need for remedial action at the present time is urgent.

Id.

83. *See* Shaw v. Comm'r, 69 T.C. 1034, 1036 (1978).

> [S]ection 1034(a) provides generally that if a taxpayer's principal residence (old residence) is sold, and within 1 year before or after such sale, other property is purchased and used by the taxpayer as his principal residence (new residence), then the gain recognized on the sale of the old residence shall be limited to the lesser of the gain realized on such sale or the amount by which the adjusted sales price of the old residence exceeds the cost of purchasing the new residence.

Id.

84. *Id.*

Section 1034 was revised on multiple occasions to extend the one-year period—eventually allowing for a two-year replacement period.[85] If the cost of the new residence exceeded the adjusted sales price of the old home, § 1034 provided for complete non-recognition of the gain.[86] Thus, a homeowner could avoid paying income tax on a gain by purchasing a more expensive replacement residence. However, if the cost of the replacement residence was less than the adjusted sales price of the old residence, gain would be recognized accordingly. As noted by the Tax Court:

> Section 1034 was designed to mitigate the financial burden associated with taxing the gain on the sale of a taxpayer's principal residence by deferring recognition of the gain where the taxpayer, for one reason or another, sells his principal residence and in effect uses the proceeds of such sale to acquire another principal residence within a relatively short period of time.[87]

Section 1034 was an example of one of the non-recognition provisions in the Code; accordingly, it did not permanently exclude the gain from taxation.[88] Instead, § 1034 operated as a tax deferral provision by reducing the adjusted basis of the new residence by an amount equal to the unrecognized gain on the sale of the old residence.[89] Through the non-recognition treatment and accompanying adjusted basis reduction, § 1034 became known as "the gain rollover rule."[90]

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85. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172; *see also* I.R.C. § 1034(a) (2012).

> If property (in this section called 'old residence') used by the taxpayer as his principal residence is sold by him and, within a period beginning 2 years before the date of such sale and ending 2 years after such date, property (in this section called 'new residence') is purchased and used by the taxpayer as his principal residence, gain (if any) from such sale shall be recognized only to the extent that the taxpayer's adjusted sales price (as defined in subsection (b)) of the old residence exceeds the taxpayer's cost of purchasing the new residence.

Id.

86. I.R.C. § 1034(a) (repealed 1997).
87. *Shaw*, 69 T.C. at 1036.
88. I.R.C. § 1034.
89. *Id.* § 1034(e).

> Where the purchase of a new residence results, under subsection (a) or under § 112(n) of the Internal Revenue Code of 1939, in the nonrecognition of gain on the sale of an old residence, in determining the adjusted basis of the new residence as of any time following the sale of the old residence, the adjustments to basis shall include a reduction by an amount equal to the amount of the gain not so recognized on the sale of the old residence. For this purpose, the amount of the gain not so recognized on the sale of the old residence includes only so much of such gain as is not recognized by reason of the cost, up to such time, of purchasing the new residence.

Id.

90. *See* John C. Morrow, *Blowing Hot and Cold at the Same Time: Section 1034 Rollover and Rental Deductions on Rental and Sale of Principal Residence*, 41 WASH. & LEE L. REV. 1509, 1510 n.6 (1984) (explaining the non-recognized gain from the sale of the old principal residence would be

The basic mechanics of rollover treatment in § 1034 can be illustrated by the following example: In year one, Taxpayer A purchases a home for $100,000. At the beginning of year four, A sells the home for $175,000. At the end of year four, A purchases a replacement home for $200,000. The $75,000 gain on the sale of the old home will be deferred because the $200,000 replacement home was timely purchased. The adjusted basis in the replacement home equals $125,000: the $200,000 cost minus the unrecognized $75,000 gain on the sale of the old residence. Because the purchase price of the new home exceeded the adjusted sales price of the old residence, A's gain on the sale was not currently taxable.

If, however, A purchased a replacement residence costing less than $175,000, a gain would be recognized on the difference. For example, if the replacement residence was purchased for $150,000, $25,000 of the $75,000 gain would be taxed. The adjusted basis in the replacement residence would equal $100,000: the $150,000 purchase price minus the $50,000 of unrecognized gain.

B. Section 121: One-time Exclusion

In addition to § 1034, former § 121 also applied to principal residence sales.[91] Section 121, however, operated differently than § 1034.[92] The tax-free rollover approach set forth in § 1034, applicable when a more expensive replacement residence was purchased, differed from the exclusionary approach in § 121.

Under § 121, homeowners above the requisite age were allowed a one-time exclusion of the gain limited by a ceiling amount.[93] As originally enacted, the taxpayer needed to be sixty-five at the time of the sale but subsequent amendments reduced the age to fifty-five.[94] Thus, a fifty-five-year-old seller who owned and used the property as a principal residence for at least three of the five years preceding its sale could exclude up to $125,000 of the gain from gross income.[95]

C. Legislative History of the Taxpayer Relief Act of 1997

The legislative history behind the TRA 1997 offers several reasons for revising the former §§ 1034 and 121 that applied to the sale or exchange of a

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rolled over through the continuation of the taxpayer's investment in the replacement residence together with the reduction in the adjusted basis of the replacement residence in an amount equal to the non-recognized gain).

91. *See* Taxpayer Relief Act of 1997, 105 Pub. L. No. 105-34, 111 Stat. 788.

92. *Id.*

93. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172.

94. *See* Taxpayer Relief Act of 1997, 105 Pub. L. No. 105-34, 111 Stat. 788.

95. *See* Revenue Act of 1978, Pub. L. 95-600, 92 Stat. 2763.

principal residence.[96] To calculate whether the sale or disposition of a home produced a gain or loss, § 1001(a) requires the taxpayer to ascertain the home's adjusted basis.[97] Calculating adjusted basis under former § 121 required taxpayers to distinguish between capital improvements—which increase basis—and repairs—which do not increase basis.[98] This required taxpayers to keep detailed records of transactions and expenditures on home improvements.[99] Without knowing the adjusted basis of the property sold, the taxpayer, in many instances, was unable to determine if the sale fell within the exclusion amount, whether that amount was $125,000, $250,000, or $500,000.

The TRA 1997 sought to simplify the complex calculation.[100] In response, the revised rules "exclude[ed] from taxation capital gains on principal residences below a relatively high threshold."[101] However, to ascertain whether the sale results in a gain falling within the exclusion, taxpayers still must determine if they have made capital improvements[102] that increased their adjusted basis. This solution, premised on simplifying record keeping, presupposes that the new thresholds are sufficiently high enough to prevent any tax liability in the first instance, particularly if taxpayers avail themselves of the exclusion as often as once every two years.

Although the new rules permit taxpayers to utilize the exclusion multiple times, this is a hollow incentive because it is unlikely many homeowners will move as frequently as permitted in order to avoid taxes. In contrast, the frequency with which § 121 may be invoked can lead to speculative investments in residential real estate, particularly absent any requirement for the purchase of another principal residence. The current law ignores that many taxpayers, if given a choice, might prefer record keeping when tax savings are at stake because potential savings could outweigh the perceived burden, and it requires burdensome monitoring of the fair market value of the home as part of the tax planning strategy.

The TRA 1997's legislative history states that prior law discouraged some owners from selling their homes if the sale would result in a gain in excess of the exclusion.[103] The increased exclusion mitigates—but does not

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96. *See generally* STAFF OF J. COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 54–55 (Comm. Print 1997).

97. I.R.C. § 1001(a) (2012).

98. *See generally* STAFF OF J. COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 54–55 (Comm. Print 1997).

99. *See id.*

100. *See generally* STAFF OF J. COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 54 (Comm. Print 1997).

101. *Id.*

102. *See* 26 C.F.R. § 1.263(a)-1 (2014) (explaining the general rule for tax treatment of capital expenditures); *id.* § 1.162-4 (explaining the general rule for tax treatment of repairs).

103. STAFF OF J. COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 55 (Comm. Print 1997).

eliminate—this problem.[104] For example, the exclusion limits may not prevent income taxation for homeowners residing in areas where housing is more expensive. Furthermore, many older homeowners now find themselves subject to taxation in situations where they have owned their residences for decades and continue to reside in the neighborhoods where their families grew up.[105]

V. ANALYSIS

A. Housing Data Analysis

Section 121's current per sale exclusion rewards those who sell principal residences on a more frequent basis, so long as ownership changes occur no more frequently than once every two years.[106] In fact, the new rules encourage sales motivated solely by the need to avoid capital gains tax when gains will exceed the $250,000/$500,000 exclusion limits. Under the current provisions, homeowners need to monitor their homes' value in order to ascertain how close they are to these exclusionary limits.[107] As the increase in value over the adjusted basis in the residence approaches the applicable dollar cap, the homeowner may be prompted to sell the residence to avoid owing capital gains tax.

Table A depicts changes to home values to provide a framework for understanding the monitoring process relative to the exclusion limits.[108] Table A is based upon the housing data reports prepared by the Federal Housing Finance Agency (FHFA).[109] The annual percentages[110] are derived from the House Price Index reported by the FHFA and are in connection with the data applicable to the movement of single-family home prices in the

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104. *See, e.g.*, STAFF OF J. COMM. ON TAXATION, 110TH CONG., TECHNICAL EXPLANATION OF DIVISION C OF H.R. 3221, THE "HOUSING ASSISTANCE TAX ACT OF 2008" AS SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON JULY 23, 2008, at 63–64 (Comm. Print 2008) (providing for further amendments and revisions to I.R.C. § 121).

105. STAFF OF J. COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 55 (Comm. Print 1997).

106. *Id.*

107. I.R.C. § 121 (2012).

108. *See* Table A.

109. *See generally* FED. HOUSING FIN. AGENCY, *Data Sets*, http://www.fhfa.gov/DataTools/Downloads (last visited Nov. 26, 2016).

110. The percentages in Exhibit A relate to the monthly data report figures.

United States.[111] Table A assumes the taxpayer owned a home in 1997 at the various value increments stated.[112]

For example, the 1997 sample values begin at $250,000, increase to $300,000, and thereafter increase in $100,000 increments. The sample starting home price values can be used as proxies for the homeowner's adjusted basis in the residence. These starting values may exceed actual adjusted basis figures if the home was purchased years earlier at a lower acquisition price. Table A then illustrates the annual valuation changes to that home based on the home price movement nationally.

At the $250,000 and $300,000 price level starting point, the data shows that a single taxpayer could sell his home and be within the $250,000 exclusion from tax, since the values do not exceed $500,000 and $550,000, respectively. At these price levels, the married filing jointly homeowner is well within the $500,000 exclusion. Thus, for homes at this starting point, the increased exclusion threshold achieves the legislative goal to simplify record keeping.

However, the new per sale exclusion is not beneficial to all homeowners. As Table A demonstrates, some homeowners are better off under the former § 1034 rollover rules permitting deferral of taxation. For these homeowners, there is a distinct disadvantage to the repeal of the former rollover rules.

At the $400,000 starting point, the data shows that home prices increase above $650,000, becoming taxable eight years later in 2005. Table A illustrates that the $250,000 exclusion limit is exceeded in a shorter time period as the price level starting point increases. At the $900,000 level and beyond, the $250,000 limit is exceeded as soon as four years later. Sales within this four to eight-year time period may be counter to homeowners' attachment to their principal residence. The timing of the forced sale to fall within the exclusion limit may be especially premature for the single taxpayer.[113]

Although the exclusion limit is double for married filing jointly homeowners,[114] the price movement relevant to the $500,000 exclusion presents similar concerns. At the $600,000 starting level, Table A's values

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111. *See generally* FED. HOUSING FIN. AGENCY, *Housing Price Index*, http://www.fhfa.gov/DataTools/Downloads/Pages/House-Price-Index.aspx (last visited Nov. 26, 2016).

112. The changes made to § 121 as a result of the TRA are effective to principal residence sales or exchanges occurring after May 6, 1997. STAFF OF J. COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 56 (Comm. Print 1997).

113. Table A ends at a $1,100,000 starting level. Because of the mathematical calculations involved with the given rates of appreciation, as the starting levels increase, the quicker the exclusion amounts will be met or exceeded.

114. *See* I.R.C. § 121(b)(2)(A) (2012). Technically, the doubling of the exclusion limit to $500,000 requires satisfaction of the § 121 eligibility requirements. *Id.*

approach $1,100,000. The time period from 2007 through 2010 played a large role in this outcome because values dropped 4.4%, 8.5%, 2.75%, and 4.45%, respectively. At the $700,000 and $800,000 starting levels, the $500,000 exclusion is first exceeded in 2005—eight years later. At the $900,000 through $1,100,000 starting levels, the exclusion is exceeded in 2004—seven years later—when the value first exceeds $1,400,000, $1,500,000, and $1,600,000, respectively.

The values in Table A are from home price movements nationally and do not reflect the experience of any particular region or state. As a result, it is possible that a home at any given starting level in Table A increases more quickly than depicted above. For example, the starting levels discussed above may not reflect the appropriate level for traditionally high-cost housing areas.[115] Therefore, in certain instances, the sale may need to occur sooner than Table A indicates.

B. The Data's Impact on Homeowners

For a number of reasons, the married couple may not be contemplating the sale of their home within the applicable seven to eight-year time frame supported by the data. For instance, they may live in a good school district for the children, the commute to work is manageable, every day shopping is convenient, the neighbors are friendly, or their current residence is near their family and friends. Even if a couple does want to sell their home, their options may be limited depending on the condition of the market.

Nationally, some geographic regions are dealing with low inventories of homes for sale.[116] As a result, finding a replacement residence may be a problem, especially in particular regions with low housing inventories where frantic bidding wars may ensue when a home goes on the market. When homeowners are contemplating selling their principal residence, the lack of available replacement homes or fears of being unable to timely acquire the next home has a chilling effect on their decision. Attempts to stay within the increased exclusion limit under current law may trigger sales not on the owner's timeline but on the timeline dictated by number crunching.

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115. New York, California, Chicago, Washington D.C. and South Florida are frequently included on lists of high-cost housing areas. *See* Kathleen Elkins, *The 11 most expensive cities in America*, BUSINESS INSIDER (Mar. 1, 2016, 7:02 PM), http://www.businessinsider.com/most-expensive-cities-in-america-2016-3/#-11.

116. *See* Diana Olic, *Low Supply Plagues Spring Housing: Here's Where it is Worst*, CNBC (May 24, 2016, 9:42 AM), http://www.cnbc.com/2016/05/24/low-supply-plagues-spring-housing-heres-where-it-is-worst.html; Chris Trapani, *Why is Housing Inventory so Low? Parsing the Reasons Why Fewer Houses are on the Market*, INMAN (Apr. 2, 2015), http://www.inman.com/2015/04/02/why-is-housing-inventory-so-low/; Daily Real Estate News, *6 Ways to Explain Low Inventory*, REALTOR MAG. (Mar. 22, 2016), http://realtormag.realtor.org/daily-news/2016/03/23/6-ways-explain-low-inventory.

For many homeowners, the current exclusion is beneficial because it permits a sale without the imposition of taxes. However, the statutory limit—allowing sales no more than once every two years—fails to provide certain owners the ability to decide to sell their principal residence or constrains the timeline of such sale. The data in Table A highlights that there is a cohort of homeowners unable to control if and when they sell their homes. The TRA 1997 did not ease the tax burden for these residential owners. Almost twenty years after its enactment, the replacement tax exclusion thresholds no longer seem insurmountable since housing prices have increased in various areas throughout the country.

As discussed, for some homeowners, the rules created by the TRA 1997 are less favorable than the former law. Due to the passage of time and appreciating housing prices, these homeowners fare better under the former rollover rule than current law. For this cohort, the data demonstrates that it does not take a lifetime before the current exclusion amount is exceeded and taxes are triggered by a sale. Sales in the four to eight-year period are tax driven to avoid exceeding the exclusion limit, and thus, taxpayers should be given the option to receive rollover treatment under the former law.

VI. PROPOSAL

To remedy this problem and restore homeowners' ability to control the timing and the decision to sell their homes, the Code should be amended to permit an election to apply the former § 1034 rollover rule. This way, the decision to sell will be vested in the homeowner who could, for example, elect to avoid gain recognition on the sale (if in excess of the exclusion limit) by purchasing a replacement residence within two years after the old residence was sold.

A. Election to Receive Rollover Treatment

Reinstating § 1034 as an elective provision allows homeowners to avoid the adverse results of immediate taxation under operation of the current law. By making the election, homeowners will be able to defer the recognition of gain triggered upon sale. This is the appropriate solution under current market conditions and the Code. Moreover, this solution encourages uniformity and promotes autonomy.

1. The Data Shows Inefficient Use is No Longer the Reality

At one time, § 1034's gain deferral requirement—applicable when a more expensive replacement residence is purchased—was viewed as

promoting inefficient use of financial resources.[117] However, the overall national increase in the House Price Index suggests that replacement residences will likely cost more, and thus, this is no longer a concern.[118] The House Price Index shows that, despite the decline in home prices in 2007 through 2010, home prices have increased on a national basis since the enactment of the TRA 1997.[119] As a result, those searching for replacement residences may not automatically be able to relocate by moving to lower cost areas. Even those looking to downsize may not be able to locate a less expensive replacement home because smaller suitable homes may be selling at a premium under market conditions. Especially for elderly homeowners who have owned their homes for decades, the ability to elect to defer taxes will promote and restore the original expressed legislative intent of avoiding the hardship of owing taxes upon the sale of the principal residence.[120]

2. The Code Supports Favorable Treatment to Highly Valued Residences

There is already congressional support in the Code encouraging home ownership and precedent for extending favorable treatment to highly valued principal residences. Section 163, for example, permits the owner of a principal residence to deduct the interest paid on the home mortgage.[121] The following example illustrates the mechanics of § 163(h). Suppose ABC Mortgage agreed to finance 80% of the purchase price of a $1,250,000 home and qualified the Mortgagor for the full $1,000,000 of acquisition indebtedness. Mortgagor has cash for the remaining $250,000 balance. As a result, Mortgagor is able to acquire a home for $1,250,000 and deduct the mortgage interest.[122]

As a result of the mortgage foreclosure situation in the late 2000s, § 108(a)(1)(E) was enacted to afford taxpayers relief in the event of income

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117. STAFF OF J. COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 56 (Comm. Print 1997). Gain deferral is further achieved through the adjusted basis reduction provisions contained in former § 1034(e).

118. *See* discussion *supra* Part V and *infra* Table A.

119. *See infra* Table A.

120. *See generally* STAFF OF J. COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 55 (Comm. Print 1997).

121, *See* I.R.C. § 163(h)(3) (2012). The home mortgage used to acquire the principal residence meets the definition of acquisition indebtedness since it is "indebtedness which. . . is incurred in acquiring, constructing or substantially improving any qualified residence of the taxpayer and . . . is secured by such residence." *Id.* § 163(h)(3)(B)(i)(I)-(II). However, the aggregate amount of indebtedness permitted to generate the interest deduction must not exceed $1,000,000. *Id.* § 163 (h)(3)(B)(ii). The $1,000,000 cap is upon the underlying indebtedness, not the value of the principal residence itself. *Id.*

122. Interest on the $1,000,000 acquisition indebtedness remains deductible if the mortgagor decided to purchase an even more expensive home by increasing the amount of cash used to make the purchase.

resulting from the discharge of the mortgage on the principal residence.[123] Taxpayers can exclude up to $2,000,000 of gross income from the discharge of qualified principal residence indebtedness.[124] The exclusion from gross income is available if the amount of the mortgage debt is reduced or the residence is lost through foreclosure.[125] With the ability to exclude up to $2,000,000 from gross income attributable to principal residence mortgage debt relief, Congress has clearly covered higher priced residences. Moreover, through the latest legislative extension, the exclusion provision remains effective for indebtedness discharged through 2016.[126]

3. An Election to Reinstate the Former Rules Promotes Uniformity

The former law operated without geographical bias. To a certain extent, the current law may achieve its desired purpose in areas where home prices and appreciation are less likely to exceed the § 121 exclusion amounts. However, many areas throughout the country receive disparate treatment with § 121's dollar amount limitations because housing values nationally are not uniform or equal; home prices in many regions of the country are significantly higher than in others. These areas include the traditional regions with the highest housing market prices,[127] other areas experiencing favorable economic growth, or climates contributing to increased housing prices. The inconsistency in housing values generates a lack of uniformity in taxation under current § 121, even though the same type of asset is being sold.

In 1997, the exclusion limits in the per sale exclusion rules were considered relatively high, at least when compared to the historical exclusion

123. The Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, 121 Stat. 1803, § 2(a)-(b); *see also* H.R. Rep. No. 110-356 (2007).

124. I.R.C. § 108(h)(2). For § 108(h) purposes, qualified principal residence indebtedness is acquisition indebtedness as defined in § 163(h)(3)(B). *Id.* § 163(h)(3)(B). Acquisition indebtedness is indebtedness used to acquire, construct, or substantially improve the principal residence. *Id.* § 163(h)(3)(B)(i)(I). The adjusted basis of the principal residence must be reduced by the amount excluded, but not below zero. *Id.* § 108(h)(1).

125. *See id.* § 108(a)(1)(E), (h); *see also* STAFF OF J. COMM. ON TAXATION, 110TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 110TH CONGRESS, at 48–49 (Comm. Print 2009); H.R. REP. NO. 110-356, at 4–5 (2007). The transfer of property through foreclosure can result in income from the discharge of indebtedness where the fair market value of the property is less than the amount of the indebtedness discharged. *See* Treas. Reg. § 1.1001-2(c) Example (8) (2012).

126. Protecting Americans From Tax Hikes Act of 2015, Pub. L. No. 114-113, 129 Stat. 2242, Div. Q. (2015) (modifying the exclusion to apply to qualified principal residence indebtedness discharged in 2017 if discharge is made under a binding written agreement entered into in 2016).

127. This includes, among others, Northeastern cities such as Boston, New York, and Washington D.C.; Western cities such as Los Angeles and San Francisco; Midwest cities such as Chicago; and Southern cities such as Palm Beach, Ft. Lauderdale, and Miami. *See* Amelia Josephson, *The Most and Least Severely Housing Cost-Burdened Cities*, SMARTASSET (Apr. 12, 2016), https://smartasset.com/mortgage/the-most-and-least-severely-housing-cost-burdened-cities (listing several of the high-cost housing markets).

figures.[128] However, that was almost twenty years ago. The current law for principal residence sales creates the potential for disparate taxation between those living in high-cost areas and those living in low-cost areas. Allowing the rollover election will mitigate the disparate results based upon the homeowners' residential region. A taxpayer selling a principal residence in a low-cost region can rely on the exclusion amount provided by current law to avoid owing taxes. On the other hand, a taxpayer residing in a high-cost region who cannot avoid taxes because of the gain in excess of the current exclusion will be able to defer taxation through the mechanics of the rollover election. As a result, taxpayers nationwide will receive equal treatment for the sale of the same type of asset.

The rollover election will reinstate some of the recordkeeping aspects of the former law. As an elective provision, taxpayers faced with postponing current taxation may not view this as an obstacle. In any event, even under current law, some level of record keeping is required to properly ascertain the amount of gain to compare to the exclusion.

4. Homeowner Autonomy

Reinstating the pre-1997 rollover rules will provide homeowners with the option to defer gain on any appreciation in value without becoming rental property owners—an especially attractive option to homeowners who were only doing the latter to defer taxation. Current law requires principal residence values to be monitored to ascertain whether built-in gain levels remain within § 121 exclusion amounts. Reinstating the former law will allow homeowners to regain the autonomy of deciding when it is most desirable and appropriate to sell their property, without the constant obligation to monitor fluctuations in value. The current § 121 exclusion amounts will no longer serve as a constraint for electing homeowners.

Changes to the one-time exclusion in the former § 121 further impacted seller behavior. The current § 121 exclusion may be used repeatedly over a homeowner's life—permitting an exclusion once every two years. This repetitive exclusion may have created a class of homeowners buying residential property as an investment for tax-free income rather than as a principal residence. The speculative nature of the transaction is enhanced by the fact that, unlike the operation of favorable tax treatment in former § 1034, current § 121 fails to require the proceeds from the sale of the principal

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128. Prior to 1997, the once-in-a-lifetime exclusion was $125,000. STAFF OF J. COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 55 (Comm. Print 1997).

residence be used to purchase another residence.[129] Restoring the rollover rule through an election will mitigate this speculative investing and reduce the unequal application of the tax laws resulting from the disparity in housing prices throughout the nation.

B. Alternative to Rollover Reinstatement

Although an election to reinstate the former rollover rule is the favored approach, it is not the only solution. There is an alternative solution that may satisfy those in favor of current taxation, while also mitigating some of the concerns previously discussed.

Instead of implementing changes to the timing of the taxable event—as a return to § 1034 rollover treatment would prompt—§ 121 could be amended in a manner to promote the progressivity of the income tax code and assist homeowners whose homes have appreciated beyond the current exclusions. The applicable $250,000/$500,000 exclusion amounts date back almost twenty years now.[130] Rather than continuing to rely on these fixed dollar limits, the Code should be amended to provide that these amounts are indexed for inflation.

Inflation adjustments are not new to the Code and can be found in numerous existing tax provisions.[131] To incorporate adjustments for inflation in § 121, a new paragraph (3) could be added to subsection (b) of § 121 as follows:

> (3) Inflation Adjustment:
>
> (A) In general. In any taxable year beginning after 2015, the $250,000 and $500,000 amounts in paragraphs (b)(1) and (b)(2)(A) shall each be increased by an amount equal to—(i) such dollar amount, multiplied by (ii) the cost-of-living adjustment under § 1(f)(3) for the calendar year in which the taxable year begins, by substituting "calendar year 2014" for "calendar year 1992" in subparagraph (B) thereof.
>
> (B) Rounding. (i) Dollar limitation. If the amount in paragraph (b)(1) as increased under subparagraph (A) is not a multiple of $1,000, such amount shall be rounded to the nearest multiple of $1,000. If the amount in paragraph (b)(2)(A) as increased under subparagraph (A) is not a multiple

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129. Andrew Gahan, *The Home-Sale Exclusion: A Proposal Targeted at Eliminating Speculation*, 18 CHAP. L. REV. 267, 284 (2014) ("[T]here's a difference between deferring gain that is reinvested and excluding gain that can be used for any purpose.").

130. *See generally* STAFF OF J. COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 55–56 (Comm. Print 1997).

131. *See, e.g.*, I.R.C. §§ 62(d)(3), 179(b)(6) (2012) (income tax); *id.* § 2503(b)(2) (gift tax); *id.* § 2010(c)(3)(B) (estate tax).

> of $10,000, such amount shall be rounded to the nearest multiple of $10,000.

VII. CONCLUSION

The long-standing tradition of non-taxability upon the sale of a principal residence through the application of the rollover rules and the one-time exclusion provision was replaced with rules that may result in capital gains for homeowners. Under the replacement rules in effect since 1997, the housing price data demonstrates the detrimental impact on certain homeowners when a home appreciates in value in excess of the exclusion amount currently available. Since many homeowners would fare better under the former law, a tax election to apply the former law will remedy this problem, provide greater uniformity to the disparity caused by geographic differences in housing prices, mitigate speculative investing in homes prompted by the current law's more frequent allowance, and restore autonomy to homeowners making the decision to sell their homes.

Table A

Year	1997	1998	1999	2000	2001	2002	2003
Time Period	0	1	2	3	4	5	6
Interest Rate		3.64%	6.21%	6.72%	6.65%	6.65%	8.08%
Home Price 1	$250,000	$259,096	$275,196	$293,688	$313,226	$334,066	$361,075
Home Price 2	$300,000	$310,916	$330,236	$352,426	$375,871	$400,880	$433,290
Home Price 3	$400,000	$414,554	$440,314	$469,901	$501,162	$534,506	$577,721
Home Price 4	$500,000	$518,193	$550,393	$587,376	$626,452	$668,133	$722,151
Home Price 5	$600,000	$621,831	$660,471	$704,851	$751,742	$801,759	$866,581
Home Price 6	$700,000	$725,470	$770,550	$822,327	$877,033	$935,386	$1,011,011
Home Price 7	$800,000	$829,108	$880,629	$939,802	$1,002,323	$1,069,013	$1,155,441
Home Price 8	$900,000	$932,747	$990,707	$1,057,277	$1,127,614	$1,202,639	$1,299,871
Home Price 9	$1,000,000	$1,036,385	$1,100,786	$1,174,752	$1,252,904	$1,336,266	$1,444,301
Home Price 10	$1,100,000	$1,140,024	$1,210,864	$1,292,228	$1,378,194	$1,469,892	$1,588,731

Year	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Time Period	**7**	**8**	**9**	**10**	**11**	**12**
Interest Rate	10.32%	9.82%	2.20%	-4.40%	-8.50%	-2.75%
Home Price 1	$398,321	$437,429	$447,052	$427,390	$391,054	$380,302
Home Price 2	$477,986	$524,915	$536,463	$512,868	$469,265	$456,363
Home Price 3	$637,314	$699,886	$715,284	$683,823	$625,687	$608,484
Home Price 4	$796,643	$874,858	$894,104	$854,779	$782,109	$760,605
Home Price 5	$955,971	$1,049,829	$1,072,925	$1,025,735	$938,530	$912,726
Home Price 6	$1,115,300	$1,224,801	$1,251,746	$1,196,691	$1,094,952	$1,064,846
Home Price 7	$1,274,629	$1,399,772	$1,430,567	$1,367,647	$1,251,374	$1,216,967
Home Price 8	$1,433,957	$1,574,744	$1,609,388	$1,538,603	$1,407,796	$1,369,088
Home Price 9	$1,593,286	$1,749,715	$1,788,209	$1,709,558	$1,564,217	$1,521,209
Home Price 10	$1,752,614	$1,924,687	$1,967,030	$1,880,514	$1,720,639	$1,673,330

Year	2010	2011	2012	2013	2014	2015
Time Period	13	14	15	16	17	18
Interest Rate	-4.45%	-0.95%	6.45%	7.32%	5.17%	6.00%
Home Price 1	$363,392	$359,927	$383,154	$411,192	$432,439	$458,385
Home Price 2	$436,070	$431,912	$459,784	$493,431	$518,927	$550,062
Home Price 3	$581,427	$575,883	$613,046	$657,908	$691,902	$733,416
Home Price 4	$726,784	$719,854	$766,307	$822,384	$864,878	$916,771
Home Price 5	$872,141	$863,824	$919,569	$986,861	$1,037,853	$1,100,125
Home Price 6	$1,017,498	$1,007,795	$1,072,830	$1,151,338	$1,210,829	$1,283,479
Home Price 7	$1,162,855	$1,151,766	$1,226,092	$1,315,815	$1,383,805	$1,466,833
Home Price 8	$1,308,211	$1,295,737	$1,379,353	$1,480,292	$1,556,780	$1,650,187
Home Price 9	$1,453,568	$1,439,707	$1,532,615	$1,644,769	$1,729,756	$1,833,541
Home Price 10	$1,598,925	$1,583,678	$1,685,876	$1,809,246	$1,902,731	$2,016,895