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The Home-Sale Exclusion: A Proposal Targeted at Eliminating Speculation

*Andrew Gahan**

“Tonight I propose a new tax cut for homeownership that says to every middle income working family in this country, if you sell your home, you will not have to pay a capital gains tax on it ever, not ever.”

– President Bill Clinton at the 1996 Democratic National Convention.¹

INTRODUCTION

Homeownership has long been considered an integral part of the American Dream, and the Internal Revenue Code certainly treats homeowners with preference.² The government has generally encouraged homeownership over the past eighty years.³ From 1999 to 2005, the rate of homeownership increased from 66.8% to over 69%, an all-time high.⁴ After the dramatic rise in home prices and subsequent burst of the housing bubble, which resulted in roughly four million foreclosures across the nation and precipitated the worst recession since the Great Depression, it is clear that the efficacy of homeownership promotion has its limits.⁵

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¹ U.S. NAT'L ARCHIVES & RECORDS ADMIN., PUBLIC PAPERS OF THE PRESIDENTS OF THE UNITED STATES, WILLIAM J. CLINTON 1412 (1996).

² ROBERT CARROLL ET AL., COSTS AND BENEFITS OF HOUSING TAX SUBSIDIES 1 (2011), available at http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic_Mobility/Pew_Housing_Report.pdf.

³ THE DEP'T OF THE TREASURY & U.S. DEP'T OF HOUS. AND URBAN DEV., REFORMING AMERICA'S HOUSING FINANCE MARKET: A REPORT TO CONGRESS 4 (2011), available at <http://www.treasury.gov/initiatives/documents/reforming%20america's%20housing%20finance%20market.pdf>.

⁴ Allen C. Goodman & Thomas G. Thibodeau, *Where are the Speculative Bubbles in US Housing Markets?*, 17 J. HOUSING ECON. 117, 118 (2008).

⁵ See Barbara Kiviat, *The Case Against Homeownership*, TIME MAG. (Sept. 11, 2010), <http://www.time.com/time/magazine/article/0,9171,2013850,00.html>; Tara Steele, *Nearly Four Million Foreclosures Completed Since Housing Crash*, AGBEAT (Dec. 3, 2012), <http://agbeat.com/housing-news/nearly-four-million-foreclosures-completed-since-housing-crash-began/> (“According to information provider, CoreLogic’s National Foreclosure Report for October [2012], there have been approximately 3.9 million completed foreclosures in the U.S. since the economic crash . . . in September 2008.”).

The housing bubble of the early 2000s was surely inflated by a number of different sources. Government policies promoting homeownership (mainly the loosening of lending standards), historically low interest rates, securitization of mortgage debt, and an active market of various financial instruments fueled by an irrationally exuberant marketplace expecting housing prices would ever rise, all contributed to its creation.⁶ Individual homeowners began taking advantage of the rapidly rising home prices, earning tax-free gains by buying and selling homes.⁷ The story of Ryan Wampler in a *New York Times* article exemplifies the opportunity afforded by the tax code in buying and selling personal residences, excluding the gain from income.⁸ The Taxpayer Relief Act of 1997 greatly increased the amount of gain a taxpayer could exclude from gross income on the sale of a personal residence.⁹ A tax provision originally intended to simplify the tax consequences of selling a home became an incredibly valuable tool in home speculation.¹⁰ What was previously available to those taxpayers aged fifty-five and older became available to taxpayers of all ages.¹¹ Tax preferences can have a powerful effect on investment decisions.¹² By giving such a large tax preference to gains realized from the sale of a principal residence, the Internal Revenue Code encourages people to view homes as short-term investments.¹³ If homeownership is still an important aspect of the American Dream, then the tax code should not accelerate the creation of housing bubbles by rewarding those taxpayers who happen to time correctly a series of purchases and sales, resulting in tax-free gains. The ability to use the tax code for short-term (and tax-free) housing investments should be eliminated. This can be accomplished by making the home-sale exclusion available on a

⁶ See *infra* Part II.A.

⁷ See, e.g., Vikas Bajaj & David Leonhardt, *Tax Break May Have Helped Cause Housing Bubble*, N.Y. TIMES (Dec. 18, 2008), http://www.nytimes.com/2008/12/19/business/19tax.html?_r=0.

⁸ *Id.* (“Three times in eight years, Mr. Wampler—himself a home builder and developer—sold his home in the Phoenix area, always for a nice profit. With prices in Phoenix soaring, he made almost \$700,000 on the three sales. And thanks to a tax break proposed by President Bill Clinton and approved by Congress in 1997, he did not have to pay tax on most of that profit.”).

⁹ See *infra* Part I.B.3.

¹⁰ See *infra* Part I.B.3.

¹¹ See *infra* Part I.B.

¹² U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-1009SP, UNDERSTANDING THE TAX REFORM DEBATE: BACKGROUND, CRITERIA, & QUESTIONS 38 (2005), available at <http://www.gao.gov/new.items/d051009sp.pdf>.

¹³ Bajaj & Leonhardt, *supra* note 7.

much more infrequent basis than the current once-every-two-years availability.¹⁴

As part of the discussion on the efficacy of government policies encouraging homeownership, this Comment addresses the popular home-sale exclusion found in section 121 of the Internal Revenue Code. Part I articulates how the section operates and gives an account of the Code's historical treatment of gains on the sale of a principal residence. Part II gives a cursory review of the housing bubble and major accepted causes, including arguments as to how section 121 may have contributed. Finally, Part III proposes amendments to the exclusion that may help eliminate its catalytic effects during home price increases and formation of housing bubbles.

I. EXCLUDING GAIN FROM THE SALE OF A PRINCIPAL RESIDENCE

A. The Current Treatment of Gains

Section 121 enables taxpayers to escape gain recognition on the sale of a principal residence.¹⁵ This exclusion from gross income is available so long as, during the five years preceding the sale, the taxpayer owned and used the property as his or her principal residence for periods aggregating two or more years.¹⁶ While there are limitations on the amount of gain that can be excluded, Congress set them high in an effort to ensure that most home sales would be tax free.¹⁷ The exclusion limitation for single filers is \$250,000¹⁸ and \$500,000 for taxpayers filing a joint return.¹⁹ This simply means that single-filing taxpayers selling a home will be able to exclude up to \$250,000 of gain from that sale, and married couples filing jointly will be able to exclude up to \$500,000 of gain. In addition, taxpayers may only apply section 121 to a sale or exchange once every two years.²⁰

For a husband and wife filing a joint return to qualify for the \$500,000 exclusion, one of the spouses must meet the ownership

¹⁴ See *infra* Part III.

¹⁵ I.R.C. § 121(a) (2012).

¹⁶ *Id.*

¹⁷ H.R. REP. NO. 105-148, at 347 (1997) (“By excluding from taxation capital gains on principal residences below a relatively high threshold, few taxpayers would have to refer to records in determining income tax consequences of transactions related to their house.”).

¹⁸ I.R.C. § 121(b)(1).

¹⁹ I.R.C. § 121(b)(2)(A).

²⁰ I.R.C. § 121(b)(3)(A); *cf.* Treas. Reg. § 1.121-4(g) (2014) (providing that section 121 shall not apply to any sale or exchange in which the taxpayer elects not to have the section apply). *But see infra* note 29 (explaining that there are circumstances where a limited exclusion is available).

requirement,²¹ both spouses must meet the two-year use requirement,²² and neither spouse can have taken advantage of the exclusion within two years prior to the sale.²³ If these requirements are not satisfied, then the limitation will be the sum of the limitations “each spouse would be entitled if such spouses had not been married.”²⁴ In such a case, each spouse is “treated as owning the property during the period that either spouse owned the property.”²⁵

Properties treated as residences under section 121 are not limited to typical fixed homes.²⁶ And for those taxpayers using more than one property as a residence, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer’s principal residence, but a number of factors will also be used in coming to this determination.²⁷

The section also affords a reduced exclusion—in certain circumstances²⁸—for taxpayers failing to satisfy the ownership and/or use requirements as well as taxpayers that had previously applied section 121 to another sale less than two years before the sale at issue.²⁹ This reduced maximum exclusion is calculated as follows:

by multiplying the maximum dollar limitation of \$250,000 (\$500,000 for certain joint filers) by a fraction. The numerator of the fraction is the shortest of the period of time that the taxpayer owned the property during the 5-year period ending on the date of the sale or exchange; the period of time that the taxpayer used the property as the taxpayer’s principal residence during the 5-year period ending on

²¹ I.R.C. § 121(b)(2)(A)(i); Treas. Reg. § 1.121-2(a)(3)(A) (2014).

²² I.R.C. § 121(b)(2)(A)(ii); Treas. Reg. § 1.121-2(a)(3)(B).

²³ I.R.C. § 121(b)(2)(A)(iii); Treas. Reg. § 1.121-2(a)(3)(C).

²⁴ I.R.C. § 121(b)(2)(B).

²⁵ *Id.*

²⁶ Treas. Reg. § 1.121-1(b)(1) (2014) (“A property used by the taxpayer as the taxpayer’s residence may include a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation.”).

²⁷ Treas. Reg. § 1.121-1(b)(2) (“[R]elevant factors in determining a taxpayer’s principal residence, include, but are not limited to: (i) The taxpayer’s place of employment; (ii) The principal place of abode of the taxpayer’s family members; (iii) The address listed on the taxpayer’s federal and state tax returns, driver’s license, automobile registration, and voter registration card; (iv) The taxpayer’s mailing address for bills and correspondence; (v) The location of the taxpayer’s banks; and (vi) The location of religious organizations and recreational clubs with which the taxpayer is affiliated.”).

²⁸ See *infra* note 31 and accompanying text.

²⁹ I.R.C. § 121(c)(1); Treas. Reg. § 1.121-3(a) (2014) (“In lieu of the limitation under section 121(b) and § 1.121-2, a reduced maximum exclusion limitation may be available for a taxpayer who sells or exchanges property used as the taxpayer’s principal residence but fails to satisfy the ownership and use requirements described in § 1.121-1(a) and (c) or the 2-year limitation described in § 1.121-2(b).”).

the date of the sale or exchange; or the period of time between the date of a prior sale or exchange of property for which the taxpayer excluded gain under section 121 and the date of the current sale or exchange. The numerator of the fraction may be expressed in days or months. The denominator of the fraction is 730 days or 24 months (depending on the measure of time used in the numerator).³⁰

The special circumstances when the reduced maximum exclusion becomes available include sales or exchanges by reason of a change in place of employment, health, or, to the extent provided in the regulations, unforeseen circumstances.³¹ The preceding paragraphs describe the general application of section 121 as would apply to most taxpayers; however, the entire gamut of the section provides many nuanced and intricate rules expressed in both the Code and Regulations.³² For purposes of this Comment, the outline of section 121 as set out above shall serve as a sufficient platform to address the issues presented. The current rules governing gain recognition from the sale of principal residences found in section 121 have largely been in effect since the passage of the Taxpayer Relief Act of 1997 (TRA-97).³³ In prior years, there were two Code sections that governed gain recognition from the sale of a principal residence: sections 1034³⁴ and (prior) 121.³⁵

B. Historical Treatment of Gains

TRA-97 dramatically altered the treatment of gains on the sale of a principal residence.³⁶ Previously, taxpayers were able to defer gain through a rollover provision found in section 1034.³⁷ This section enabled nonrecognition of gain realized on the sale of a principal residence, so long as another principal home of equal or greater value was purchased within two years of such sale.³⁸ In addition to the rollover treatment provided in section 1034, prior section 121 allowed for a one-time exclusion of up to \$125,000 for taxpayers aged fifty-five and older.³⁹ Although the current treatment of home-sale gains has only been in force since 1997, section 121's predecessors were used for many decades to defer or exclude gain on the sale of a principal residence.

³⁰ Treas. Reg. § 1.121-3(g)(1). For examples illustrating this calculation, see *id.* § 1.121-3(g)(2).

³¹ I.R.C. § 121(c)(2)(B); *see also* Treas. Reg. § 1.121-3(c)-(e).

³² *See generally* I.R.C. § 121(a)-(g); *see also* Treas. Reg. §§ 1.121-1 to -5 (2014).

³³ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788.

³⁴ I.R.C. § 1034 (repealed 1997).

³⁵ I.R.C. § 121 (repealed 1997).

³⁶ *See infra* Part I.B.3.

³⁷ I.R.C. § 1034(a) (repealed 1997).

³⁸ *Id.*

³⁹ I.R.C. § 121(a)-(b) (repealed 1997).

1. Deferring, Not Excluding, Gain

Section 1034 first appeared in the Code in 1951, when Congress amended then-section 112—a prior version of current section 1031.⁴⁰ When The Revenue Code of 1954 was enacted, the rollover provision was divorced from section 112 and given its own place in the Code—section 1034.⁴¹ Over time the language of the section largely remained the same, allowing taxpayers the chance to defer recognition of gain by purchasing a new home of equal or greater value within a relatively short period of time.⁴² By itself, section 1034 enabled most taxpayers to escape gain recognition, but in 1964, Congress provided further relief for older homeowners.⁴³

2. The Once-In-A-Lifetime-Exclusion

That relief came in the form of (former) section 121's once-in-a-lifetime exclusion, initially limited to \$20,000, for taxpayers aged sixty-five years or older.⁴⁴ Originally, determining the amount a taxpayer could exclude required a few steps. First, the taxpayer must have turned sixty-five before the date of sale or exchange.⁴⁵ Second, the taxpayer would have had to own and use the property as his principal residence for an aggregate of five years over the eight years preceding the sale.⁴⁶ If the taxpayer established those two requirements, she proceeded to the thornier determination of the amount excludable. Under subsection (b), “[i]f the adjusted sale prices exceed[ed] \$20,000, the taxpayer [could] exclude part of the gain proportionate . . . between \$20,000 and the adjusted sale price.”⁴⁷ For example, if *T*, age sixty-five, sold his residence that had a

⁴⁰ Revenue Act of 1951, Pub. L. No. 183-521, 65 Stat. 452.

⁴¹ I.R.C. § 1034 (1954).

⁴² Compare I.R.C. § 1034(a) (1954) (providing a period of one year before and after the sale), with I.R.C. § 1034(a) (1996) (providing a period of two years before and after such sale).

⁴³ See Charles L. B. Lowndes, *The Revenue Act of 1964: A Critical Analysis*, 1964 DUKE L.J. 667, 687 (“As part of a continuing concern over senior citizens, the 1964 Act provides that a person sixty-five years of age or older who sells property which he has occupied as his principal residence for at least five of the preceding eight years, may elect to exclude the gain from the sale from his gross income, provided the adjusted sale price does not exceed \$20,000.”).

⁴⁴ Revenue Act of 1964, Pub. L. No. 88-272, § 206, 78 Stat. 19, 38; see also Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 L. & CONTEMP. PROBS. 233, 259 n.220 (2010) (noting that at the time that Congress set the exclusion limitation at \$20,000, the median home price was roughly \$12,000).

⁴⁵ I.R.C. § 121(a)(1) (1964).

⁴⁶ I.R.C. § 121(a)(2) (1964). Compare this requirement with the two-out-of-the-last-five-years requirement under current section 121. See *supra* note 15 and accompanying text.

⁴⁷ Lowndes, *supra* note 43.

basis of \$21,000 for \$30,000, he could have excluded \$6,000 (\$20,000/\$30,000 of the \$9,000 gain) from his income.⁴⁸

In 1976, this section was amended to increase the amount excludable to \$35,000.⁴⁹ At another point, the exclusion was increased to \$125,000⁵⁰ and the age requirement decreased to fifty-five.⁵¹ Along the way there were proposals that the age requirement be eliminated, offering a once-in-a-lifetime exclusion of \$100,000 for any taxpayer who otherwise qualified under section 121.⁵² For whatever reason, the proposed amendment did not become the law in 1978, but a much bigger change occurred in 1997.

3. The Taxpayer Relief Act of 1997

TRA-97 repealed sections 1034 and 121 in their entirety and replaced them with current section 121.⁵³ The deferment option under section 1034 was completely discarded and replaced by the much larger exclusion from gross income found in current section 121.⁵⁴ The major changes from the prior sections included discarding the age limitation, discarding the once-in-a-lifetime availability, and substantially increasing the amount of gain excludable from gross income.

The legislative history reveals multiple reasons for the change. Congress's first concern was one of simplification. The House Report reasons that many taxpayers will buy and sell multiple homes over a lifetime, and calculating the basis⁵⁵—which is used as the benchmark for calculating gain on the sale of a home—“is among the most complex tasks faced by a typical taxpayer.”⁵⁶ The report explains that “even though most homeowners never pay any income tax on the capital gain on their principal residences, as a result of the rollover provisions and the \$125,000 one-time exclusion, *detailed records of transactions and expenditures on home improvements must be kept, in most cases, for many decades.*”⁵⁷ To claim the exclusion, a taxpayer was required to calculate the basis in each home owned, adjusting for any untaxed gains from previous transactions

⁴⁸ *Id.*

⁴⁹ Revenue Act of 1976, Pub. L. No. 94-455, § 1404, 90 Stat. 1520, 1733.

⁵⁰ H.R. REP. NO. 97-215, at 28 (1981) (Conf. Rep.).

⁵¹ H.R. REP. NO. 95-1800, at 109 (1978) (Conf. Rep.).

⁵² H.R. REP. NO. 95-1445, at 7 (1978).

⁵³ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 312, 111 Stat. 788, 836.

⁵⁴ *Id.*

⁵⁵ Ordinarily, a taxpayer's basis in property is the cost of such property. I.R.C. § 1012(a) (2012).

⁵⁶ H.R. REP. NO. 105-148, at 347 (1997).

⁵⁷ *Id.* (emphasis added).

deferred under section 1034.⁵⁸ The basis calculation, Congress acknowledged, “may involve augmenting the original cost basis of each home by expenditures on improvements. In addition to the record-keeping burden this creates, taxpayers face the difficult task of drawing a distinction between improvements that add to basis, and repairs that do not.”⁵⁹ Any mistakes in this calculation of basis would lead to miscalculations of capital gains and either under or overpayment of tax liabilities resulting from the sale of principal residences.⁶⁰ The \$500,000 exclusion available every two years, Congress believed, would alleviate any difficulty in determining basis because few taxpayers “would have to refer to records in determining income tax consequences of transactions related to their house.”⁶¹

Other reasons for the change offered in the House Report included eliminating the encouragement of taxpayers to purchase larger and more expensive houses than they otherwise would,⁶² the constraint on the mobility of aging taxpayers,⁶³ and removing a potential marriage penalty.⁶⁴

Section 121 is but one of the housing subsidies afforded to homeowners in the Code. Other tax subsidies for homeowners include the mortgage interest deduction⁶⁵ and the property tax deduction.⁶⁶ Both of these Code provisions, along with an unwritten exclusion of imputed rent,⁶⁷ have been the subjects of

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.* (“To postpone the entire capital gain from the sale of a principal residence, the purchase price of a new home must be greater than the sales price of the old home. This provision of present law encourages 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 promotes an inefficient use of taxpayer’s financial resources.”).

⁶³ *Id.* (“Present law also may discourage some older taxpayers from selling their homes. Taxpayers who would realize a capital gain in excess of \$125,000 if they sold their home and taxpayers who have already used the exclusion may choose to stay in their homes even though the home no longer suits their needs. By raising the \$125,000 limit and by allowing multiple exclusions, this constraint to the mobility of the elderly would be removed.”).

⁶⁴ *Id.* at 348 (“[A]n individual is not eligible for the one-time capital gains exclusion if the exclusion was previously utilized by the individual’s spouse. This restriction has the unintended effect of penalizing individuals who marry someone who has already taken the exclusion.”).

⁶⁵ I.R.C. § 163(h) (2012).

⁶⁶ I.R.C. § 164(a)(1).

⁶⁷ Imputed rent is generally referred to as the rental value of the home. Larry Ozanne, *Taxation of Owner-Occupied and Rental Housing* 2 (Cong. Budget Office, Working Paper No. 2012-14, 2012), available at http://www.cbo.gov/sites/default/files/cbofiles/attachments/11-2-2012Taxation_of_Housing.pdf.

critique over the years.⁶⁸ In addition to the tax incentives of homeownership, the government has promoted homeownership in a number of other ways.⁶⁹ Not long after the passage of TRA-97, we experienced a bubble and burst in the computer technology industry commonly referred to as the “dot-com bubble.”⁷⁰ In the background of that bubble, another one was forming, one that would have much more damaging and lasting effects.

II. INFLATED HOME PRICES: CAUSES OF THE HOUSING BUBBLE

A majority of the 1990s, when adjusted for inflation, experienced relatively little increase in housing prices.⁷¹ Beginning in 1998, home prices began to increase sharply, topping off in 2006.⁷² While there are multiple theories of causes—or perhaps *the* cause—of the housing bubble and subsequent burst, this Comment, while first acknowledging some of the most widely accepted causes of the bubble, focuses on the preferential tax treatment of homeownership,⁷³ specifically the ability for a taxpayer to exclude up to \$500,000 of gain realized on the sale of a principal residence under IRC section 121,⁷⁴ as a catalyst to the creation of the housing bubble.

A. Non-Tax Explanations

It may be prudent to point out at the outset that any one cause would likely be insufficient to shoulder all of the blame for the development of the housing bubble.⁷⁵ In its simplest form, a

⁶⁸ See generally Rebecca N. Morrow, *Billions of Tax Dollars Spent Inflating the Housing Bubble: How and Why the Mortgage Interest Deduction Failed*, 17 FORDHAM J. CORP. & FIN. L. 751 (2012); William T. Mathias, *Curtailing the Economic Distortions of the Mortgage Interest Deduction*, 30 U. MICH. J.L. REFORM 43 (1996); Ventry, *supra* note 44, at 234.

⁶⁹ See *infra* Part II.A.1.

⁷⁰ For an overview of the “dot-com” bubble, see generally ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* xi–xiv (2d ed. 2005).

⁷¹ Jeff Holt, *A Summary of the Primary Causes of the Housing Bubble and the Resulting Credit Crisis: A Non-Technical Paper*, 8 J. BUS. INQUIRY 120, 121 (2009), available at <http://www.uvu.edu/woodbury/docs/summaryofthepriarycauseofthehousingbubble.pdf> (“Home prices were relatively flat throughout most of the 1990s. According to the S&P/Case-Shiller Index, home prices increased by about 8.3 percent from the 1st quarter of 1990 to the 1st quarter of 1997.”).

⁷² *Id.* (“Then home prices began a rapid increase—peaking in the 2nd quarter of 2006 over 132 percent higher than they had been in the 1st quarter of 1997.”).

⁷³ In addition to the exclusion allowed under section 121, other preferential tax provisions for homeowners include the mortgage interest deduction under I.R.C. § 163(h) and the property tax deduction under I.R.C. § 164(a)(1).

⁷⁴ See *infra* Part II.B.1.

⁷⁵ Holt, *supra* note 71, at 128 (“Each of the four primary causes played an important role in creating the housing bubble and the credit crisis. The combination of all four causes created a type of ‘perfect storm’ causing the housing bubble to be extreme and the

bubble can be described as a phenomenon in which assets are temporarily overpriced due to excessive public expectations of future price increases.⁷⁶

1. Government Promotion of Homeownership

It has been argued that the bubble began to inflate in 1997 as a result of various government policies intended to promote homeownership among the American people.⁷⁷ Some of these policies include the relaxing of mortgage-lending standards designed to allow individuals who previously would not have qualified for loans to do so.⁷⁸ The Community Reinvestment Act⁷⁹ (CRA) is a prime example. The CRA was implemented to offset redlining⁸⁰ and encourage commercial banks and saving associations to help meet the needs of borrowers in all segments of their communities, including low- and moderate-income neighborhoods.⁸¹ In the mid-1990s, regulations were promulgated to give bite to the CRA “by setting quotas for mortgage lending to distressed communities and threatening sanctions for banks who [sic] did not meet them.”⁸² It has also been argued that the CRA’s reach encompassed banks not formally covered by the Act.⁸³ For

resulting credit crisis to be severe. Three of the causes, though they contributed to the housing bubble, were not essential to the development of the bubble.”).

⁷⁶ Karl E. Case & Robert J. Shiller, *Is There a Bubble in the Housing Market?*, BROOKINGS PAPERS ON ECON. ACTIVITY, 2003, at 299 (“The term ‘bubble’ is widely used but rarely clearly defined. We believe that in its widespread use the term refers to a situation in which excessive public expectations of future price increases cause prices to be temporarily elevated.”).

⁷⁷ See Edward Pinto, *Acorn and the Housing Bubble*, WALL ST. J., Nov. 13, 2009, at A23, available at http://online.wsj.com/article/SB20001424052748703298004574459763052141456.html#mod=todays_us_opinion.

⁷⁸ *Id.* (“Less well understood is that this bubble was the result of government policies that lowered mortgage-lending standards to increase home ownership.”).

⁷⁹ 12 U.S.C. § 2901 (1977).

⁸⁰ “Credit discrimination (usu. unlawful discrimination) by an institution that refuses to provide loans or insurance on properties in areas that are considered to be poor financial risks or to people who live in those areas.” BLACK’S LAW DICTIONARY 1391 (9th ed. 2009).

⁸¹ Pinto, *supra* note 77.

⁸² Robert Hardaway, *The Great American Housing Bubble: Re-Examining Cause and Effect*, 35 U. DAYTON L. REV. 33, 36 (2009); see also Peter Wallison & Edward Pinto, *A Government-Mandated Housing Bubble*, FORBES (Feb. 16, 2009, 12:01 AM), http://www.forbes.com/2009/02/13/housing-bubble-subprime-opinions-contributors_0216_peter_wallison_edward_pinto.html (“New CRA regulations in 1995 required banks to demonstrate that they were making mortgage loans to underserved communities, which inevitably included borrowers whose credit standing did not qualify them for a conventional mortgage loan.”); Holt, *supra* note 71, at 124 (“In 1995 the Community Reinvestment Act was modified to compel banks to increase their mortgage lending to lower-income households. To meet the new requirements of the Community Reinvestment Act, many banks relaxed their mortgage lending standards.”).

⁸³ Hardaway, *supra* note 82, at 42 (“Those in the second camp respond that the CRA nevertheless put pressure even on banks not formally covered, and that the threat of sanctions increased that pressure.”).

example, some of the changes of the CRA worked to coerce banks into lending in low-income neighborhoods.⁸⁴

In sum, the CRA and its progeny enabled people to qualify for loans they never would have under traditional lending standards.⁸⁵ Lower lending standards increased the number of loans made with smaller down payments.⁸⁶ The increased purchasing power of borrowers “fueled a house price bubble of unprecedented magnitude over the period 1997–2006.”⁸⁷ While banks were typically averse to this type of higher risk lending, securitization and mortgage-backed securities offered the perfect opportunity to avoid it.⁸⁸

2. Securitization of Mortgage Debt

The securitization⁸⁹ of mortgage debt was inextricably intertwined with the housing bubble.⁹⁰ Mortgage-backed

⁸⁴ *Id.* at 43 (quoting Dennis Sewell, *Clinton Democrats Are to Blame for the Credit Crunch*, SPECTATOR, Oct. 4, 2008, at 14, 15) (“Changes were made to the Community Reinvestment Act to establish a system by which banks were rated according to how much lending they did in low-income neighborhoods. A good CRA rating was necessary if a bank wanted to get regulators to sign off on mergers, expansions, even new branch openings. A poor rating could be disastrous for a bank’s business plan.”).

⁸⁵ Holt, *supra* note 71, at 124 (“Standards for mortgage loans were fairly consistent in the decades prior to the development of the housing bubble. Most mortgages were 30-year fixed rate loans of at least 20 percent or mortgage insurance if the 20 percent down payment requirement were not met. [However, in the mid-1990s,] [d]own payment requirements and income requirements were reduced.”).

⁸⁶ Pinto, *supra* note 77 (“As a result of congressional and regulatory actions, the percentage of conventional first mortgages (not guaranteed by the Federal Housing Administration or the Veteran’s Administration) used to purchase a home with the borrower putting 5% or less down tripled from 9% in 1991 to 27% in 1995, eventually reaching 29% in 2007.”).

⁸⁷ *Id.*

⁸⁸ See, e.g., Kofi Bofah, *Does Securitization Reduce Bank Risk?*, SAN FRANCISCO GATE, <http://homeguides.sfgate.com/credit-securitization-reduce-bank-risk-2975.html> (last visited Mar. 19, 2014) (“Banks orchestrate these transactions to reduce their exposure to individual financial risks [This] effectively pass[es] default risks onto investors who choose to buy securitized products.”).

⁸⁹ For a simple explanation of securitization, see Andreas Jobst, *What is Securitization*, FIN. & DEV., Sept. 2008, at 48, available at <http://www.imf.org/external/pubs/ft/fandd/2008/09/pdf/basics.pdf> (“Securitization is the process in which certain types of assets are pooled so that they can be repackaged into interest-bearing securities. The interest and principal payments from the assets are passed through to the purchasers of the securities.”). See also JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 570 (7th ed. 2013) (“Securitization is the transfer of illiquid debt into tradable securities.”); ANDREW DAVIDSON ET AL., SECURITIZATION: STRUCTURING AND INVESTMENT ANALYSIS 3 (2003) (“The process of packaging financial promises and transforming them into a form whereby they can be freely transferred among a multitude of investors is securitization.”).

⁹⁰ See *Securitization of Assets: Problems and Solutions: Hearing Before the Subcomm. on Sec., Ins., & Inv. of the U.S. S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. 1 (2009) (statement of Patricia A. McCoy, George J. and Helen M. England Professor of Law and Director, Insurance Law Center, University of Connecticut School of Law), available at <http://www.banking.senate.gov/public/index.cfm?FuseAction=>

securities⁹¹ (MBSs) provided investors with a chance to take advantage of a booming real estate market without actually owning property.⁹² Collateralized debt obligations⁹³ (CDOs) allowed investment banks to split up—otherwise known as “tranch”—the revenue streams of any special purpose entity⁹⁴ (SPE) and pay out to investors on a priority schedule that was structured by risk and return preferences, suiting the needs of particular investors.⁹⁵ Furthermore, credit default swaps⁹⁶ (CDSs) guarded against the risk of bad debt for investors seeking a steady lower-risk investment.⁹⁷ The viability of these financial tools essentially relied on home prices continuing to rise.⁹⁸ Banks became originators instead of lenders and had “little incentive to worry about the quality of any single mortgage since the mortgage [would] soon be sold.”⁹⁹ Because banks were less worried about creditworthiness and were willing to lend with less money down¹⁰⁰—in some instances no money down—buyers were able to pay higher prices for housing. While banks were willing to

Files.View&FileStore_id=02242b1f-27e9-4aa0-ae0f-3a1c0eacc7e6 (“During the housing bubble, private-label securitization financed the majority of subprime and nontraditional mortgages. This system proceeded on the assumption that housing prices would keep going up. When housing prices fell and people could not refinance out of unaffordable loans, investors lost confidence in private-label mortgage securitization and the system collapsed in August 2007.”).

⁹¹ “Mortgage-backed securities (MBS) are debt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property.” *Mortgage-Backed Securities*, SEC.GOV, <http://www.sec.gov/answers/mortgagesecurities.htm> (last visited Mar. 19, 2014).

⁹² Manav Tanneeru, *How a ‘Perfect Storm’ Led to the Economic Crisis*, CNN (Jan. 29, 2009), <http://www.cnn.com/2009/US/01/29/economic.crisis.explainer/>.

⁹³ A CDO is an investment-grade security backed by a pool of bonds, loans, and other assets. *Collateralized Debt Obligation – CDO*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/cdo.asp> (last visited Mar. 30, 2013).

⁹⁴ Also known as a Special Purpose Vehicle (SPV), an SPE is “an entity set up, usually by a financial institution, specifically to purchase assets and realize their off-balance-sheet treatment for legal and accounting purposes.” Jobst, *supra* note 89, at 48.

⁹⁵ Anna Katherine Barnett-Hart, *The Story of the CDO Market Meltdown: An Empirical Analysis* 7 (Mossavar-Rahmani Ctr. for Bus. & Gov’t, Working Paper No. 4, 2009), available at <http://www.hks.harvard.edu/m-rebg/students/dunlop/2009-CDOmelt-down.pdf> (“[T]ranching of the cash flows made it possible to create securities with different risk profiles appropriate to specific investors.”).

⁹⁶ “A credit default swap is . . . where the purchaser of the swap makes payments up until the maturity date of a contract. Payments are made to the seller of the swap. In return, the seller agrees to pay off a third party debt if this party defaults on the loan. A CDS is considered insurance against non-payment. A buyer of a CDS might be speculating on the possibility that the third party will indeed default.” *Credit Default Swap – CDS*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/creditdefaultswap.asp> (last visited Mar. 21, 2013).

⁹⁷ *Id.*

⁹⁸ Hardaway, *supra* note 82, at 39.

⁹⁹ Holt, *supra* note 71, at 125.

¹⁰⁰ Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1194–95 (2012).

lend at unprecedented high loan-to-value ratios, borrowers were encouraged to do so because historically low interest rates made it incredibly cheap to do so.

3. Low Interest Rates

Mortgage interest rates in the United States hit an all-time high in October of 1981 at 18.45%¹⁰¹ as the Federal Reserve increased interest rates in a successful effort to combat inflation.¹⁰² For the most part, mortgage interest rates fell over the next two decades, with the 30-year fixed rate mortgage falling below 6% in early 2003.¹⁰³ The low rate continued through most of 2005.¹⁰⁴

In addition to low mortgage rates, from 2002 to 2004 the Federal Reserve pushed the federal funds rate¹⁰⁵ down to historically low levels in an attempt to strengthen the recovery from the 2001 recession.¹⁰⁶ Low short-term rates “not only fueled growth in the dollar volume of mortgage lending, but had unintended consequences for the type of mortgages written.”¹⁰⁷ The short-term rates became lower relative to 30-year rates, and “[a]djustable-rate mortgages (ARMs), typically based on a one-year interest rate, became increasingly cheap relative to 30-year fixed-rate mortgages.”¹⁰⁸ With an ARM, a home purchaser who could not afford the payment of a mortgage with a regular fixed-rate mortgage would be able to afford the payment of an ARM loan because the rate started out much lower.¹⁰⁹ With

¹⁰¹ *30-Year Fixed-Rate Mortgages Since 1971*, FREDDIE MAC, <http://www.freddiemac.com/pmms/pmms30.htm> (last visited Apr. 4, 2013) [hereinafter FREDDIE MAC].

¹⁰² Holt, *supra* note 71, at 121; see also Paul Volcker, *What Led to the High Interest Rates of the 1980s?*, PBS (May 29, 2009, 12:02 PM), <http://www.pbs.org/newshour/businessdesk/2009/05/what-led-to-the-high-interest.html>.

¹⁰³ FREDDIE MAC, *supra* note 101.

¹⁰⁴ Holt, *supra* note 71, at 121.

¹⁰⁵ The “federal funds rate” is the interest rate at which a depository institution lends immediately available funds—balances at the Federal Reserve—to another depository institution overnight. *Federal Funds Rate*, INVESTOPEDIA, <http://www.investopedia.com/terms/f/federalfundrate.asp> (last visited Mar. 10, 2013).

¹⁰⁶ Holt, *supra* note 71, at 122–23 (“The U.S. economy entered into a recession in March of 2001. Over the course of 2001, the Federal Reserve lowered the federal funds rate eleven times, from 6.50 percent to 1.75 percent. When the economic recovery proved sluggish and no sign of significant inflation appeared, the Fed continued its low interest rate policy, lowering the federal funds rate to 1.25 percent in November of 2002 and to 1.00 percent in June of 2003. The Fed began gradually increasing the rate in June of 2004, but the rate remained at 2.00 percent or lower for more than three years.”).

¹⁰⁷ Lawrence H. White, *Federal Reserve Policy and the Housing Bubble*, 29 CATO J. 115, 118 (2009).

¹⁰⁸ *Id.*

¹⁰⁹ Holt, *supra* note 71, at 123 (“For example, the monthly principal and interest payment on a \$200,000 30-year fixed rate mortgage with an interest rate of 6 percent would be about \$1,200. The monthly principal and interest payment on a \$200,000 30-year ARM with an initial interest rate of 4 percent would be only about \$950.”).

a booming housing market, lenders developed variations of ARMs. Borrowers looking for even lower payments could choose to pay only interest, thus never paying down the loan. Or a borrower could choose to pay only a portion of the interest, which would then increase the principal by adding the unpaid interest on top of the principal.¹¹⁰ These ARMs made monthly mortgage payments much more affordable for people, and thus enabled home prices to rise.¹¹¹ Real estate prices began to look like bargains as interest rates fell.¹¹² Low rates and expanding mortgage credit increased demand for, and prices of, existing houses, and encouraged the construction of new housing on undeveloped land.¹¹³ In essence, “the Fed’s easy-credit policy (combined with encouragements for riskier mortgage lending) inflated the housing bubble,”¹¹⁴ and researchers at the International Monetary Fund found that “the unusually low level of interest rates in the United States between 2001 and 2003 contributed somewhat to the elevated rate of expansion in the housing market, in terms of both housing investment *and the run-up in house prices up to mid-2005.*”¹¹⁵

4. Irrational Exuberance

“Irrational exuberance”¹¹⁶ is a term “now often used to describe a heightened state of speculative fervor.”¹¹⁷ One assumption led to widespread confidence in the housing market: home prices would never fall.¹¹⁸ Even after the bubble burst, it has been argued that this belief was not irrational.¹¹⁹

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² White, *supra* note 107, at 119.

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *Id.* (emphasis added) (quoting R. CARDARELLI ET AL., THE CHANGING HOUSING CYCLE AND THE IMPLICATIONS FOR MONETARY POLICY 19 (2008), available at <http://www.imf.org/external/pubs/ft/weo/2008/01/pdf/e3.pdf>).

¹¹⁶ Alan Greenspan made this term famous in a black-tie dinner speech entitled “The Challenge of Central Banking in a Democratic Society” before the American Enterprise Institute at the Washington Hilton Hotel in December of 1996. See Robert J. Shiller, *Definition of Irrational Exuberance*, IRRATIONALEXUBERANCE.COM, <http://irrational-exuberance.com/definition.htm> (last visited Feb. 1, 2014). Greenspan said: “But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?” *Id.*

¹¹⁷ *Id.*

¹¹⁸ See, e.g., Jonathan McCarthy & Richard W. Peach, *Are Home Prices the Next “Bubble”?*, FRBNY ECON. POLY REV., Dec. 2004, at 1, 2, available at <http://www.newyorkfed.org/research/epr/04v10n3/0412mcca.pdf> (opining that market fundamentals sufficiently explained the increase in home prices and that a bubble did not exist).

¹¹⁹ Hardaway, *supra* note 82, at 45 (suggesting that a sixty-seven year trend of increasing home prices justified the assumption of homebuyers, banks, investment banks, hedge funds, or money market funds that prices would in fact continue to rise).

But Robert Shiller points out that although home prices had gone up on average over the past century, the increase occurred in two short periods: right after World War II and since 1998.¹²⁰ As prices began to soar, people started believing that if they didn't purchase a house, they would be priced out of the market.¹²¹ This now-or-never attitude, coupled with incredibly lax lending standards, led people to purchase homes priced well above typical multiples of earnings.¹²² Despite rising prices and the risk involved with extremely leveraged positions,

[h]ome buyers continued to purchase homes (often for speculative purposes) even though the monthly payments would eventually prove unmanageable. They assumed that they would be able to "flip" the home for a profit or refinance the loan when the adjustable rate increased. This too would work if home prices kept rising.¹²³

The dream of owning a home, the chance at striking it rich, and the assurance that home investments were not risky led the market to continue to bid up prices until they were no longer sustainable.

B. Section 121: A Catalyst to Bubble

Akin to many of the other proffered causes of the housing bubble, section 121 could never shoulder all of the blame for the rapid increase in home prices. Very few have articulated an argument accusing the home sale exclusion as a major cause of the housing bubble, but even those mentioning its contribution have been met with skepticism and rebuff.¹²⁴ The housing bubble was undoubtedly the result of an amalgam of causes. While factors such as the government's zealous promotion of homeownership, securitization of mortgage debt, low interest rates, and widespread belief of a continued increase of prices may serve as some of the more popular explanations for the bubble, the argument that section 121 played a part is by no means undermined simply because of the existence of other

¹²⁰ SHILLER, *supra* note 70, at 12–14.

¹²¹ *Id.* at 17–18.

¹²² *Id.* at 13 ("The ascent in home prices after 1997 was much faster than the increase in incomes, and this raises concerns about the long-run stability of home prices, especially in the most volatile states. In the eight most volatile U.S. states from 1985 to 2002, the median price of a home rose from 4.9 years' per capita income to 7.7 years' per capita income; thus in these states there are significant new stresses on family budgets in making mortgage payments.").

¹²³ Holt, *supra* 71, at 126.

¹²⁴ See, e.g., Len Burman, *Did the Capital Gains Tax Break on Home Sales Help Inflate the Housing Bubble?*, TAX POLY CENTER (Dec. 22, 2008, 1:17 PM), <http://taxvox.taxpolicycenter.org/2008/12/22/did-the-capital-gains-tax-break-on-home-sales-help-inflate-the-housing-bubble/> (arguing that the tax break did not help inflate the housing bubble).

explanations. In fact, multiple theories of the cause of the housing bubble reinforce the importance of understanding all contributing factors in order to ensure that such a devastating bubble and subsequent burst does not repeat itself. Another bubble of that magnitude is unlikely to occur anytime soon.¹²⁵ That prediction, however, does nothing to lessen the need to eradicate lingering bubble impetus.

There are (at least) three ways section 121 may have acted as a stimulant to the inflation of the housing bubble. First, by providing such a large exclusion (as opposed to a limited exclusion and rollover provision under prior law), the tax code favored gains realized from an investment in housing over gains from an investment in other capital assets. Thus, section 121 increased the value of an investment in housing because the after-tax takeaway had potential to be much greater. Second, TRA-1997 provided a significant exclusion to the entire home-owning populace, a larger and different demographic than under prior law. Lastly, the once-in-a-lifetime limitation for the exclusion under prior law was repealed and replaced with the ability to take advantage of a bigger exclusion every two years.

1. Increase in After-Tax Value of Housing Investment

Upon enacting section 121, Congress greatly increased the appeal of a personal residence as an investment. The new section, when compared to other investment options, increased the after-tax return one could receive on a personal residence.¹²⁶ As the after-tax return of an investment in a personal residence increases, the price a purchaser is willing to pay for a home necessarily increases.¹²⁷ Investing in housing was now more appealing to people because it was “an investment they could understand” and the possibility of taking up to \$500,000 of tax-free profit was more than enough incentive for “citizens in

¹²⁵ Robert J. Shiller, *Housing Bubbles are Few and Far Between*, N.Y. TIMES (Feb. 5, 2011), available at <http://www.nytimes.com/2011/02/06/business/06view.html>.

¹²⁶ See Gary L. Maydew & Robert D. Swanson, *Personal Residences Now Offer More Tax Shelter*, 62 PRAC. TAX STRATEGIES 235, 235 (1999) (“When taxpayers and practitioners think of post-1986 tax shelters, they likely envision real estate, oil and gas working interests, or other exotic investments. The personal residence, however, while not exotic or exciting, has traditionally been a good way to shelter income from taxation, and TRA '97 has greatly improved the after-tax return on personal residences.”) (emphasis added).

¹²⁷ Seth Hanlon, *Tax Expenditure of the Week: Tax-Free Capital Gains for Primary Residences*, CENTER FOR AM. PROGRESS (Apr. 6, 2011), <http://www.americanprogress.org/issues/open-government/news/2011/04/06/9386/tax-expenditure-of-the-week-tax-free-capital-gains-for-primary-residences/> (“This rule . . . also inflates home values because it means that investments in homes get a better after-tax return than other investments—raising the price that future buyers are willing to pay.”).

search of half-millionaire status.”¹²⁸ But if the new provision actually increased the value of a home—by increasing the after-tax return—then it does not necessarily contribute to a bubble, which is “a situation in which excessive public expectations of future price increases causes prices to be temporarily elevated.”¹²⁹ On the other hand,

[b]y favoring real estate, the tax code pushed many Americans to begin thinking of their houses more as an investment than as a place to live. It helped change the national conversation about housing. Not only did real estate look like a can't-miss investment for much of the last decade, it was also a tax-free one.¹³⁰

The more people with an eye toward an investment in housing, the more momentum a national belief in a continual increase of housing prices would have.

2. Qualifying for the Exclusion: A Change in Demographic

Under prior law, only those taxpayers aged fifty-five and older qualified for any exclusion and it was capped at \$125,000.¹³¹ By eliminating the age requirement, the exclusion was available to the entire home-owning populace. The new provision offered tax-free gains—up to \$500,000—to anyone who purchased a house and used it as a principal residence for two years.¹³² A necessary element of a housing bubble is a population willing to purchase homes at inflated prices. By enlarging the group of people who benefit from the exclusion, the group of buyers willing to purchase homes increases because the higher prices go, the more valuable the exclusion becomes.

In addition to enlarging the *number* of homeowners able to qualify for the exclusion, the *type* of homeowners changed. Before, those able to exclude any gain were fifty-five and older, but after the new provision was enacted, all taxpayers that owned a home became eligible.¹³³ Older investors tend to be more risk averse and thus, less likely to engage in speculative practices.¹³⁴ On the other hand, younger taxpayers “have a

¹²⁸ Vernon L. Smith, *The Clinton Housing Bubble*, WALL ST. J., Dec. 18, 2007, at A20, available at <http://online.wsj.com/article/SB119794091743935595.html>.

¹²⁹ Case & Shiller, *supra* note 76.

¹³⁰ Bajaj & Leonhardt, *supra* note 7.

¹³¹ See *supra* Part I.B.

¹³² See *supra* Part I.A.

¹³³ See *supra* Part I.

¹³⁴ Steven M. Albert & John Duffy, *Differences in Risk Aversion Between Young and Older Adults*, 1 NEUROSCIENCE AND NEUROECONOMICS 3, 7 (2012), available at www.dovepress.com/getfile.php?fileID=12034; see also Tapen Sinha, *Are Older People More Risk Averse?*, BOND U. BUS. DISCUSSION PAPERS, June 1992, at 1, 8, available at http://epublications.bond.edu.au/cgi/viewcontent.cgi?article=1034&context=discussion_pa

lifetime to make up for a high-risk investment that goes bad.”¹³⁵ By extending an opportunity to exclude gain to a demographic that is less averse to risk on average, the chance of section 121 being used for speculative purposes goes up. Part of the appeal of using section 121 for speculative purposes is that it is available every two years.

3. Short Exclusion Cycle

Unlike the prior exclusion available before TRA-97, which provided a once-in-a-lifetime exclusion to older taxpayers, the new provision can be utilized an unlimited number of times so long as two years have passed since the last application of section 121.¹³⁶ This once-every-two-years availability is the crux of how section 121 may have been used for speculative purposes—thus contributing to the run-up of housing prices.¹³⁷ Evidence suggests that after the law changed, the number of home sales increased as the new code section alleviated a “lock-in” effect.¹³⁸ Homeowners were able to turnover homes frequently without having to recognize gain. The ability to take advantage of the exclusion every two years is frequent enough for some homeowners to buy and sell *solely* in order to realize tax-free gains.¹³⁹ While some would argue that the reason for making the exclusion available every two years is because the new section absorbed the old rollover provision and taxpayers weren’t paying any taxes on gains under the prior law,¹⁴⁰ there’s a difference between deferring gain that is reinvested and excluding gain that can be used for any purpose.¹⁴¹

Buying and selling homes every two years as a way to earn tax-free income was not the purpose of section 121.¹⁴² Nevertheless, during times of rapid increase in prices, the large

pers (“[O]n the average for gain situations older people are more risk (loss) averse than younger people.”).

¹³⁵ RICHARD T. WILLIAMSON, *SELLING REAL ESTATE WITHOUT PAYING TAXES: A GUIDE TO CAPITAL GAINS TAX ALTERNATIVES* 10 (2003).

¹³⁶ See *supra* Part I.A.

¹³⁷ Hanlon, *supra* note 127.

¹³⁸ Hui Shan, *The Effect of Capital Gains Taxation on Home Sales: Evidence from the Taxpayer Relief Act of 1997* 4 (Divs. of Research & Statistics and Monetary Affairs Fed. Reserve Bd., Working Paper No. 2008-53, 2008), available at <http://www.federalreserve.gov/pubs/feds/2008/200853/200853pap.pdf>.

¹³⁹ See Bajaj & Leonhardt, *supra* note 7.

¹⁴⁰ See, e.g., Burman, *supra* note 124.

¹⁴¹ See, e.g., Kay Bell, *Capital Gains Tax Break is a Boon for Most Owners*, BANKRATE (May 16, 2005), <http://www.bankrate.com/brm/news/real-estate/REguide/tax-breaks1.asp> (“Another bonus of the new rules: You don’t have to buy another home with the sale proceeds. You can use the money to travel to Europe in style, buy an RV and drive across the country or get all those designer shoes you never could afford before.”).

¹⁴² See *supra* Part I.B.3.

exclusion enables just that. Even those suggesting section 121 contributed very little to the housing bubble acknowledge that “there are flaws in the implementation of the 1997 law” and that “[i]t shouldn’t apply to people who flip homes every two years.”¹⁴³ In the end, even if section 121 had a less-than-significant part in creating the housing bubble, the provision provides ample opportunity for speculation. If there is a simple solution—which this Comment suggests there is—then section 121 should be amended to eradicate speculative application of the exclusion.

III. A SIMPLE FIX

Section 121 was enacted primarily to simplify the tax consequences of selling a home, eliminate the encouragement of purchasing more expensive homes than a taxpayer otherwise would, remove a restraint on the mobility of the elderly, and lift a potential marriage penalty.¹⁴⁴ The legislative history reveals no intention of enabling taxpayers to turn personal residences into short-term investments; however, that’s exactly the opportunity that has been afforded to those willing to ride increasing home prices in search of tax-free income.

While the exclusion cannot by itself create a housing bubble,¹⁴⁵ it can act as a catalyst as soon as prices do start to increase, because the faster prices increase, the more valuable the exclusion becomes. Eliminating the ability to use section 121 for speculative purposes would require nothing more than eliminating the ability to apply the section once every two years by simply extending the period in which a person must live in the residence. This is not a novel suggestion.¹⁴⁶ In a 2005 report, an advisory panel for President Bush made a similar suggestion: “The Panel recommends that the length of time an individual must own and use a home as a principal residence to qualify for the tax exemption be increased from two out of five years to three out of five years.”¹⁴⁷ Others have also suggested requiring a longer period of use, up to ten years, in order to reduce excess volatility in housing prices.¹⁴⁸ Another way the section could be limited in order to dampen speculation is to

¹⁴³ Burman, *supra* note 124.

¹⁴⁴ See *supra* Part I.B.3.

¹⁴⁵ The exclusion is still available and there is no current “bubble.”

¹⁴⁶ See, e.g., PRESIDENT’S ADVISORY PANEL, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA’S TAX SYSTEM 74–75 (2005), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/Simple-Fair-and-Pro-Growth-Proposals-to-Fix-Americas-Tax-System-11-2005.pdf>.

¹⁴⁷ *Id.*

¹⁴⁸ WILLIAM LIM, THE U.S. TAXPAYER RELIEF ACT OF 1997 AND THE SUBSEQUENT HOUSING BUBBLE 9 (2011), available at <http://wbiconpro.com/314-Lim.pdf>.

allow its application once every five years instead of the once every two years under current law. By limiting the ability to take advantage of the section to once every five years, the possibility of earning tax-free income from flipping houses drastically decreases.

A personal residence remains a popular tax shelter¹⁴⁹ and the appeal of section 121 flourishes during times of home price increases. After a housing boom and bust, resulting in roughly four million foreclosures,¹⁵⁰ many people are left in worse positions than they were before buying into the American Dream. Homeowners will benefit from gradual rises in home values, but not from rapid increases that inevitably come crashing down. If limiting the applicability of section 121 to home sales decreases the chance of another housing bubble, then the relatively simple fix is something Congress should consider.

CONCLUSION

Because the housing bubble was the result of a number of factors, it is not surprising that the elimination of one or more of those factors has chilled the housing market. The most significant reaction to the financial crisis was the tightening of lending standards.¹⁵¹ Even creditworthy borrowers are now finding it difficult to obtain funds.¹⁵² Restricting the availability of credit to guard against loan default may seem a natural response to the credit crisis, but some argue that in order for the economy to make a full recovery, the housing market must make a full recovery.¹⁵³

¹⁴⁹ See, e.g., William Baldwin, *Eighteen Ways to Get Tax-Free Income*, FORBES (Feb. 7, 2011, 5:53 PM), <http://www.forbes.com/sites/baldwin/2011/02/07/eighteen-ways-to-get-tax-free-income/> (suggesting taking advantage of the home sale exclusion by buying a fixer-upper, working on it yourself, and selling it after the two-year requirement is satisfied).

¹⁵⁰ Steele, *supra* note 5.

¹⁵¹ See generally Nick Timiraos, *Fannie Mae Tightens Underwriting for Interest-Only Mortgages*, WALL ST. J. (Apr. 30, 2010, 6:24 PM), <http://online.wsj.com/article/SB10001424052748703871904575216683364999118.html>; Jeannine Aversa, *More Banks Stiffen Rules, Fed Finds*, WASH. POST (Feb. 5, 2008), http://articles.washingtonpost.com/2008-02-05/business/36796286_1_domestic-respondents-federal-reserve-survey-foreign-banks.

¹⁵² Suzy Khimm, *Are Creditworthy Americans Having Trouble Getting Mortgages?* WASH. POST (Mar. 1, 2012, 9:00 AM), http://www.washingtonpost.com/blogs/wonkblog/post/are-creditworthy-americans-having-trouble-getting-mortgages/2012/02/29/gIQAcdoziR_blog.html.

¹⁵³ Sam Hughes, *A Strong Housing Market Is Critical to Our Economic Recovery*, CENTER FOR AM. PROGRESS (Nov. 15, 2012), <http://www.americanprogress.org/issues/housing/news/2012/11/15/45042/a-strong-housing-market-is-critical-to-our-economic-recovery/>.

If this is true, one can expect government policies to be geared toward keeping home prices high and even facilitating their return to prior highs.¹⁵⁴ While less people now “think of housing as an investment” and may even see it “as risky,” that alone does not preclude another bubble from forming.¹⁵⁵ Indeed, despite the slow housing market, “many people continue to think of housing as an investment.”¹⁵⁶ So long as section 121 encourages taxpayers to “buy and sell to [their] heart’s content,”¹⁵⁷ it will remain an appealing tool for speculation because it may “take a while for the housing market to recover fully,”¹⁵⁸ but “it does seem that we are in danger of encountering another whopper bubble *someday*.”¹⁵⁹ As bubbles are hard to predict, as well as hard to identify in the midst of one, Congress should act sooner rather than later in constricting the ability of taxpayers to turn homes into short-term investments in hopes of earning tax-free capital gains, because such speculation only hastens the formation of a bubble.

¹⁵⁴ See Hardaway, *supra* note 82, at 40–41 (“For example, federal government policy has been largely geared toward keeping home prices high . . .”).

¹⁵⁵ Shiller, *supra* note 125.

¹⁵⁶ *Id.*

¹⁵⁷ John Adams, *Tax Benefits of Home Ownership Are Almost Too Good to Be True*, REALTOR.COM, <http://www.realtor.com/basics/buy/closepossess/taxbenefits.asp?source=web> (last visited Apr. 10, 2013).

¹⁵⁸ Shiller, *supra* note 125.

¹⁵⁹ *Id.* (emphasis added).

