

The Exclusion of Capital Gains for Owner-Occupied Housing

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The Exclusion of Capital Gains for Owner-Occupied Housing

In recent Congresses, multiple bills have been introduced to alter the exclusion of capital gains tax on sales of owner-occupied housing, and in July 2025 President Trump indicated that the Administration is considering an elimination of the capital gains tax on homes.

For 70 years, capital gains on sales of taxpayers' homes have been preferentially treated. A revision in 1997 replaced two long-standing provisions—a provision allowing uncapped capital gains tax deferral (i.e., a rollover) when a new residence was purchased and a provision allowing a one-time exclusion of \$125,000 for sellers over age 55—with a capped exclusion for each sale. Although the cap adopted in 1997—\$500,000 for married couples and \$250,000 for single taxpayers—was higher than the cap for the over-age-55 sellers, it was less generous than the uncapped rollover provision. In addition, the dollar cap was not indexed for price changes, and, unlike the previous over-age-55 cap, was half as large for unmarried taxpayers.

Two factors in the years following the 1997 revision—(1) the rapid rise in housing prices and (2) interest in tax reform—suggested the capital gains exclusion, including the dollar cap, might be reconsidered. In the 119th Congress, two bills have been introduced: H.R. 1340 (Panetta) to double the exemptions and index them for inflation and H.R. 4327 (Greene) to eliminate the ceiling. In the 118th Congress, H.R. 1321 (Panetta) and H.R. 10009 (Lawler) would have doubled the exemptions and indexed them for inflation. Bills in previous Congresses also addressed this provision. In the 109th Congress, H.R. 2127 would have allowed taxpayers over the age of 50 to double the current exclusion, once in their lifetime. H.R. 2757 would have indexed the exclusion to price changes.

Given concerns about recently rising housing prices and inflation in general, some policymakers may reconsider the \$250,000/\$500,000 cap. The current treatment of capital gains could be maintained. However, some consideration might be given to changing the dollar ceiling. One option is to eliminate the ceiling. Another option is to adjust the ceiling for price changes.

Some have criticized the significant tax benefits for owner-occupied housing. Capital gains treatment is one of those benefits. Others may see an efficiency argument for eliminating or excluding a large portion of the tax gain on homes. Capital gains taxes on homes create barriers to labor mobility in the economy. Imposing capital gains taxes on homes also creates significant compliance costs, requiring individuals to keep records for decades and to make fine distinctions between improvements and repairs. Capital gains taxes also tend to distort housing choices, discouraging individuals from selling their homes because of changing family and health circumstances. Also, while the exclusion favors homeowners relative to renters, the taxation of gains in excess of a cap creates inequities between homeowners with different job circumstances, between those living in different parts of the country, and between those with different health outcomes. Exclusions of gains on homes can also contribute to tax avoidance schemes, especially ones that allow gains on investment properties to escape tax.

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Introduction

In recent Congresses, multiple bills have been introduced to alter the exclusion of capital gains on sales of owner-occupied housing, and in July 2025 President Trump indicated that the Administration is considering an elimination of the capital gains tax on homes. In the 119th Congress, two bills have been introduced: H.R. 1340 (Panetta) to double the exemptions and index them for inflation and H.R. 4327 (Greene) to eliminate the ceiling.

For 70 years, capital gains on sales of taxpayers' homes have been given preferential treatment. A revision in 1997 replaced two long-standing provisions—a provision allowing an uncapped capital gains tax deferral (i.e., a rollover) when a new residence is purchased and a one-time exclusion of \$125,000 of capital gains for sellers over age 55—with a capped exclusion for each sale. Although the 1997 cap—\$500,000 for married couples and \$250,000 for single taxpayers—was higher than the previous cap for the over-age-55 sellers, it was less generous than the uncapped rollover provision it replaced. In addition, the dollar cap was not indexed for price changes, and, unlike the previous over-age-55 cap, was half as large for unmarried taxpayers. The exclusion is allowed once every two years, subject to taxpayers meeting ownership and use tests.

The cap was presumably meant to eliminate any capital gains tax on home sales for the vast majority of taxpayers, but the rise in housing prices and the passage of time have reduced the value of the exclusion. With no revision and an increase in housing prices, an increasing share of gains would be subject to tax.

Housing prices fell during the financial crisis and did not regain their 2007 high point until 2013, when they again began rising. They rose steeply during the COVID-19 recession and recovery. If the \$250,000 and \$500,000 values had been increased to reflect the change in the average housing price between 1998 and 2025, they would now be approximately \$720,000 and \$1,440,000, respectively; if they had been increased to reflect the median housing price by 2025, they would be \$715,000 and \$1,430,000, respectively.¹ If they had been increased to reflect the general price rise in the economy (the gross domestic product, or GDP, deflator), they would be \$457,000 and \$913,000, respectively.²

This report examines the capital gains exclusion and the cap. The first section describes the current tax rules, the second section presents the historical development of the capital gains provisions, and the third, the coverage and cost. It then discusses potential justifications for capital gains relief, as well as tax avoidance problems that may arise. The final section discusses various options for change, primarily focusing on the dollar ceiling.

Current Tax Treatment

When an individual sells a personal residence, the excess of the sales price over the original cost plus improvements is a capital gain and is subject to tax. The individual is able to deduct any costs of the sale (such as commissions and advertising), and may be required to include gain that was deferred from previous home sales.

¹ For average and median house prices, see FRED Economic Data, *Average Prices of Houses Sold for the United States*, <https://fred.stlouisfed.org/series/ASPUS> and *Median Sales Price of Houses Sold for the United States*, <https://fred.stlouisfed.org/series/MSPUS>.

² See Bureau of Economic Analysis, *National Income and Product Accounts*, Table 1.1.4, <https://apps.bea.gov/iTable/iTable.cfm?reqid=19&step=2#reqid=19&step=2&isuri=1&1921=survey>.

Gain up to \$250,000 for single taxpayers and \$500,000 for married couples filing joint returns is excluded if the taxpayer meets a use test (has lived in the house for at least two years out of the last five years) and an ownership test (has owned the house, also for two years out of the last five). The exclusion can be used every two years.³

To minimize the tax, assuming the individual is subject to it, he or she must keep records of any improvements during the entire time the home is owned and also, to comply with the law, appropriately distinguish between expenditures that are repairs, which do not reduce gain, and those that are improvements, which do reduce gain.

For homes that were acquired before the 1997 change in tax law, there may also be deferred gain from previously owned residences. Under pre-1997 tax law, a taxpayer could defer the gain on a home sale if another residence was purchased. If the new residence cost as much or more than the old residence sold for, the tax on the entire gain was deferred. If the new residence cost less than the sale price of the old residence, gains tax was due on the difference between the value of the old and new residence (if less than the gain) and tax on the remainder was deferred. The additional gain from previously owned residences makes it more likely that total gains will exceed the cap; had the 1997 law been in place for many years, much or all of the prior gain would have been excluded.

Capital gains on homes (and assets generally) held at least a year are taxed at lower rates that are linked to the permanent rate schedule prior to the 2017 tax cuts (P.L. 115-97): 0% for taxpayers in the 10% and 15% marginal income tax brackets; 15% for taxpayers in marginal income tax brackets above 15%, but below the top rate; and 20% for higher-income taxpayers. For 2025, the 15% rate begins applying at an adjusted gross income level of \$96,700 for joint returns (\$48,350 for single returns) and the 20% rate begins applying at \$600,050 for joint returns (\$533,400 for single returns). An additional 3.8% net investment income tax applies to taxpayers with incomes over \$250,000 for married couples and \$200,000 for singles. Neither the capital gains tax nor the net investment income tax applies to excluded gains.

A special relief provision for military families and the Foreign Service allows them to expand the five-year period for the ownership and use tests to up to 10 years while on qualified official duty.

Another provision that may influence a taxpayer's decision about selling a residence is a long-standing provision that allows the gain to be excluded entirely if the taxpayer does not sell the home and leaves it as part of his or her estate. If an individual keeps his or her house until death and leaves it to heirs, no tax on gain accumulated would be due, because the heir would be able to deduct the fair market value at time of death from sales price. Tax may be due if the heirs do not sell the home immediately after inheriting the property if the property increases in value. This rule is called a step-up in basis.

³ Some exceptions to these rules exist. If taxpayers have not lived in the primary residence for a total of two years out of the last five, they are eligible for a partial exclusion cap if the real estate was sold because of a change in employment, health, or unforeseen circumstances. The taxpayer can receive a portion of the exclusion cap, based on the portion of the two-year period they resided in the home. For example, a single taxpayer who lived in the house for one year and qualified for an exception would have a \$125,000 cap. For people living in a nursing home, the ownership and use test is lowered to one out of five years before entering the facility. And time spent in the nursing home still counts toward ownership time and use of the residence. For example, if a taxpayer lived in a house for a year, and then spent the next five years in a nursing home before selling the home, the full \$250,000 exclusion would be available.

No rationale is stated in the legislative history of this long-standing provision, although proposals have been made to alter it. One possible explanation is that it may help address the difficulty with establishing basis for assets held for a long time.

Development of the Current Rules

The gain realized upon the sale of a personal residence was taxed as capital gain until the passage of the Revenue Act of 1951 (P.L. 82-183). At that time, Congress passed a rollover provision that allowed for the deferral of capital gains tax if the proceeds of the sale were used to buy another residence of equal or greater value within a year before or after the sale of the old residence.

Congress stated that the rollover provision was in response to transactions that were

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.⁴

At that time, the economy had grown as a result of industrialization and residential moves were more frequent due to business transfers and other employment related changes. Congress also recognized that capital gains from home sales were, in part, a result of general inflation. During the congressional debate, the rollover provision was justified on the grounds that homeowners were changing homes, not to make a profit as investors, but rather in response to employment or family size changes.

The first exclusion from taxation for capital gains on the sale of a primary residence was enacted by the Revenue Act of 1964 (P.L. 88-272). The provision was available only for the elderly (aged 65 and older) and applied to residences sold after 1963. It was available on a one-time basis only, and was at the same level for both single and married individuals. To qualify, the house had to be occupied for five of the previous eight years. The exclusion of gain was limited to the amount attributable to the first \$20,000 of sales price. Above that level, a ratio was used to determine the gain subject to taxation, such that the amount of the exclusion depended on the relationship of sales price to basis, as well as the relationship between \$20,000 and sales price. For example, if the sales price were \$40,000, one-half of the gain (\$20,000/\$40,000) could be excluded. However, the actual amount excluded would be less than \$20,000, unless the house originally cost \$20,000. For example, if the basis in the house was \$10,000, the gain on the \$40,000 sale would be \$30,000. Of that \$30,000, one half, or \$15,000, would be excluded because \$20,000 was half the sales price.

The reason given for the exclusion was to reduce the burden on elderly taxpayers who would have to tie up all of their investment in a new home to avoid paying capital gains tax. The dollar restriction was due to a focus on the average and smaller home, thus suggesting a distributional motive.⁵

The amount of capital gains excludable from taxation for older taxpayers was increased three times in response to higher housing prices. The three increases were enacted by The Tax Reform Act of 1976 (P.L. 94-455), the Revenue Act of 1978 (P.L. 95-600), the Economic Recovery Tax Act of 1981 (P.L. 97-34) and finally, the Taxpayer Relief Act of 1997 (P.L. 105-34). The limit for elderly homeowners rose to \$35,000 in 1976, \$100,000 in 1978, and \$125,000 in 1981. The 1978 provision also liberalized the benefit by simply allowing an exclusion rather than a proportional share that depended on basis and lowered the age limit to 55. (There was consideration of

⁴ U.S. Congress, Senate Committee on Finance, *The Revenue Act of 1951: Report to Accompany H.R. 4473*, 82nd Cong., 1st sess., S.Prt. 82-781 (GPO, 1951), p. 34.

⁵ U.S. Congress, House Ways and Means Committee, *Report to Accompany H.R. 8363*, 88th Cong., 1st sess., H. Prt. 88-749 (GPO, 1963).

eliminating the age requirement altogether.) The 1978 change also reduced the holding period requirement to three out of the previous eight years.

In each case of capital gains relief, Congress cited the rising sale prices of homes as the source of large amounts of taxable capital gains on residences and the reason for adjusting the amount of capital gains that could be excluded from taxation.

When the rollover provisions and one-time exclusion for the elderly were replaced by the current exclusion (in the Taxpayer Relief Act of 1997, P.L. 105-34), a major reason given was to reduce the recordkeeping burden and to eliminate the need for referring to records and making judgements about what expenditures are improvements.

Other reasons cited for changing the tax law were to limit the distortions in behavior arising from the rollover treatment and from those elderly who had exceeded the exclusion limit or had already used it. Because the full deferral of tax required the purchase of a new residence of equal or greater value, the law may have encouraged taxpayers to purchase more expensive homes than they otherwise would have. The pre-1997 rules also discouraged some elderly taxpayers from selling their homes to avoid possible tax consequences. As a result, elderly taxpayers who had already used their one-time exclusion and those who might have realized a gain in excess of \$125,000 may have retained their homes even though it was desirable for them to move.

It was also clear from statistical data that between rollovers, exclusions, step-up in basis (which allowed capital gains to be avoided if the home were held until death and left to heirs), and under-reporting, very little capital gains on owner-occupied housing were taxed. Thus, little revenue was gained from a set of provisions that, nevertheless, caused distortions in behavior and complicated compliance. These observations supported a simple elimination of the capital gains tax on principal residences.

In 1997, Congress imposed what was characterized as a “relatively high” ceiling on the amount of excluded gain, \$500,000 for married couples. In a departure from the historic treatment of lifetime exclusions, however, the exclusion was only half as large for single taxpayers as for married couples—\$250,000. The previous treatment had cut the exclusion in half for married couples filing separately but not for single taxpayers, an important difference given that most married individuals who do not divorce are eventually widowed. Unlike the lifetime exclusion, however, the exclusion could be taken in each period. In contrast to many other dollar limits in the tax code, the amount of the exclusion was not indexed, so that it, like the previous exclusion, might need to be periodically revisited.

Two bills in the 109th Congress addressed this provision. H.R. 2127, introduced by Representative Filner, would have allowed taxpayers over the age of 50 to exclude an amount that is double the current cap, but it was available only once in their lifetime. H.R. 2757, introduced by Representative Andrews, would have indexed the exclusion. Other legislation (H.R. 3803 by Representative McCarthy and S. 4075 by Senator Schumer) was introduced to change the amount of the exclusion for surviving spouses to that of a married couple.

In the 110th Congress, S. 138 was introduced to allow a surviving spouse to exclude up to \$500,000 of gain from the sale or exchange of a principal residence owned jointly with a deceased spouse if the sale or exchange occurs within two years of the death of the spouse. That provision was also included in H.R. 3648, the Mortgage Forgiveness Debt Relief Act of 2007, which was signed into law as P.L. 110-142 on December 20, 2007. Capital gains tax rates were also changed in 1997. Before that time, capital gains were taxed at ordinary rates with a 28% cap, leading to two rates of 15% (for the ordinary 15% bracket) and 28% for all other brackets. The 1997 legislation reduced those rates to 10% and 20%, respectively. In 2003, rates were reduced to 15% for 2003-2008 for those in the higher brackets and to 5% in 2003-2007 and 0% in 2008 for

taxpayers in the 15% bracket or lower. These rates were extended and in 2012 made permanent, with a rate of 20% for the top bracket, leading to the current rates of 0%, 15%, and 20%. Health reform legislation in 2010 provided for a tax of 3.8% on high-income taxpayers on various forms of passive income, including capital gains. The exclusion also applies to the 3.8% tax.

In the 119th Congress, two bills have been introduced: H.R. 1340 (Panetta) to double the exemptions and index them for inflation and H.R. 4327 (Greene) to eliminate the ceiling. In the 118th Congress, two bills were introduced: H.R. 1321 (Panetta) and H.R. 10009 (Lawler), both of which would have doubled the exemptions and indexed them for inflation.

Effects of the Exclusion and Cap

The revenue cost of the exclusion is estimated at \$46.4 billion for FY2025.⁶ The initial estimate for this provision was \$5.6 billion in FY1998, although the estimate was more than doubled to \$12.9 billion for FY2000 (which may have reflected better data availability).⁷ These estimates were smaller than the amounts estimated for the previous provisions that allowed unlimited deferral of taxes with a replacement home (\$8.6 billion for FY1997) and the more limited exclusion of gains for those over the age of 55 (\$4.9 billion for FY1997).

A study examining the provision using 2007 data indicated that 0.57% of home transactions were subject to the \$500,000 and \$250,000 ceilings. An additional 1.17% had taxable gain due to sales that did not meet the holding period requirements. Thus, few taxpayers owed capital gains tax on the sale of principal residences.⁸ The share paying tax due to the ceilings represented a rise from the time of enactment, when a much smaller number of transactions was expected to be subject to the exclusion. Data from 1999 indicated that only 0.04% of taxpayers were affected.⁹ The rise in the share reflected the 58% increase in the average and median price of houses between 1999 and 2007.

Data are not available to project the number of transactions affected currently, but the share should rise significantly, as average house prices have risen by 75% for the median sale and 65% for the average since 2007. Current data on sales prices of existing homes indicate that 35% of home sale prices in 2025 were at \$500,000 or more and 45% were at prices of \$250,000 to \$500,000.¹⁰ Because about a third of sales involved single individuals, assuming they were evenly distributed in the \$250,000 to \$500,000 class, 50% of taxpayers had sale prices that could potentially expose them to capital gains taxes (as compared to 3% at the time the provision was enacted). While sales price is one variable that determines the fraction of home sellers actually

⁶ Joint Committee on Taxation, *Estimates Of Federal Tax Expenditures For Fiscal Years 2024-2028*, JCX-48-24, December 11, 2024, <https://www.jct.gov/publications/2024/jcx-48-24/>.

⁷ Joint Committee on Taxation, *Estimates Of Federal Tax Expenditures For Fiscal Years 1998-2002*, JCS-22-97, December 15, 1997, <https://www.jct.gov/publications/1997/jcs-22-97/> and *Estimates Of Federal Tax Expenditures For Fiscal Years 2000-2004*, JCS-13-99, December 22, 1999, <https://www.jct.gov/publications/1999/jcs-13-99/>.

⁸ See Gerald Auten and Jane G. Gravelle, "The Exclusion of Capital Gains on the Sale of Principal Residences: Policy Options," National Tax Association Proceedings, 102 Annual Conference on Taxation, 2009, <https://ntanet.org/wp-content/uploads/proceedings/2009/012-auten-the-exclusion-capital-2009-nta-proceedings.pdf>. Because of the way taxpayers reported their transactions, it was not possible to determine precisely which taxpayers reached the maximum exclusion.

⁹ The Auten and Gravelle study indicated that 2,000 taxpayers were subject to the limit in 1999. In that year, home sales were 5.21 million. See TitleNews Online Archive, "2001 A New Record, December Existing-Home Sales Strong?" NAR Reports, January 28, 2002, <https://www.altal.org/news/news.cfm?20020128-2001-A-New-Record-December-Existing-Home-Sales-Strong—NAR-Reports>.

¹⁰ National Association of Realtors, "Existing Home Sales," Supplemental Data, May 2025, <https://www.nar.realtor/sites/default/files/2025-06/ehs-05-2025-supplemental-data-2025-06-23.pdf>.

subject to the tax, another factor depends on the difference between the basis (the cost of acquiring the home plus any improvements) and the sales price. In the 2007 data, basis was around 50% of sales price. Although there is no way to estimate the share subject to tax, given this basis a small portion (e.g., single filers selling near the top of the price range) of sales between \$250,000 and \$500,000 would owe taxes. Taxpayers in this category most likely to be subject to tax are those who have owned their homes for a long time and have a low basis. The data for 2021 also indicate that 16% of sales prices were above \$750,000 and 8% were above \$1 million. Significant portions of these taxpayers were likely to pay taxes because of the limit.

The gains subject to tax because of the limit have been estimated at 9% of the excluded tax for 2007.¹¹ The gains due to nonqualifying sales have been estimated at 1.3% of the excluded tax. These shares would be higher because of the increase in the top rate of the capital gains tax from 15% to 20%, implying around a 12% share compared to a 9% share for the effect of the limit if all included gain is subject to a 20% tax and all excluded gain is subject to a 15% rate (9% times 20/15 equals 12%).¹² Most of the included gain would probably be subject to the additional net investment income tax of 3.8%, which would raise the share to around 14% (9% times 23.8/15 equals 14.3%). If this ratio applied to the current \$46.3 billion estimate, the tax on included gain would be \$6.5 billion.

The tax would be larger, however, because the increase in prices increases gains while holding the ceiling fixed, and gains would increase proportionally more. For example, a house with a sales price of \$2 million, with a basis of 50% or \$1 million, would leave a gain of \$1 million, with \$0.5 million above the cap. Now prices increase by 65% so that the price is \$3.3 million and gain is \$1.65 million, with \$1.15 million above the cap. The \$0.5 million gain from 2007 is adjusted to \$0.825 using current tax expenditure estimates, but the actual gain is now \$1.15 million; a further increase of 39% is needed to bring the \$0.825 million up to \$1.15 million. How large this adjustment is depends on the distribution of gains within the affected group. Using only growth rates and assuming the same type of distribution in 2007, the average sales price necessary to produce a 9% share of gain taxed would be \$1.34 million and would suggest an additional doubling of the revenue loss. However, because of the shape of the distribution (proportionally more taxable gain associated with higher-priced houses in the category), it would be smaller than \$10 billion.

Considerations Surrounding Capital Gains Tax Relief on Residences

Economists have often been critical of preferential treatment of certain types of activities, because that preferential treatment distorts behavior and causes a misallocation of capital. Tax preferences also narrow the tax base and require higher marginal tax rates for a given revenue target; these higher tax rates in turn magnify other distortions. Tax preferences also can be inequitable, favoring those who engage in tax-preferred activities. (Tax preferences are also sometimes criticized because they favor higher-income individuals; the appropriateness of such criticisms

¹¹ There are later data on sales of residences reported in IRS statistics through 2015 at <https://www.irs.gov/statistics/soi-tax-stats-sales-of-capital-assets-reported-on-individual-tax-returns>. However, these data are greatly affected by the financial crisis and the decline in the number and price of home sales. Between 2007 and 2010 gains on residences subject to tax fell by 70%, and by the last year data are available gains were still 30% below their 2007 level. This disruption makes it difficult to rely on data during that period.

¹² This ratio would be somewhat high because some of the excluded gain currently would have been taxed at 20% and some of the included taxed at 15%. However, some of the excluded gain would be taxed at a zero rate while very little if any of the included gain would be, which would increase the ratio.

depends on one's view of how taxes should be distributed and whether such preferences are offset by a more graduated rate structure.)

Some could also argue that the favorable treatment for owner-occupied housing may divert investment from business investment. Absent a market failure, this type of perceived misallocation could be viewed as reducing the efficiency of the economy. Favorable capital gains treatment for housing is not the only tax benefit it receives, and other benefits may have broader implications in economic terms. The implicit income from housing is not subject to tax, yet costs such as mortgage interest and property taxes are allowed as deductions, at least for those who itemize. Tax cuts enacted in 2017 (P.L. 115-97) and extended and enhanced in 2025 (P.L. 119-21) narrowed the gap between the tax treatment of business income and owner-occupied housing by reducing taxes on investments and limiting itemizers. For assets excluding land and inventories, investments in the business sector were taxed at an effective rate of 18.1% and investments in owner-occupied housing at -9.5%. Under current law these rates are 9.0% and -0.09%.¹³ Housing is often claimed to provide other benefits that justify favorable treatment, although such benefits have not generally been measured.¹⁴

It is not clear whether the prospect of future capital gains relief plays an important role in inducing additional investment in housing. Unlike mortgage interest deductions, future capital gains relief provides no immediate cash flow benefit, and may be heavily discounted due to the delay and uncertainty of the benefit.

In addition, there are several policy arguments that may support providing some relief for capital gains on owner-occupied houses and restricting other owner-occupied housing tax benefits if a reduction in the preferential treatment of owner-occupied housing is desired. Among the rationales offered for relief is that it may reduce the barriers to labor mobility, potentially contributing to economic efficiency. Other reasons include reduction in other inefficiencies that distort housing costs; more equitable treatment among homeowners in different circumstances; and reduction of compliance burdens. Some empirical studies suggest that significant distortions are induced by the gains tax once an individual has a home and wishes to move.¹⁵

In contrast, the exclusion can contribute to compliance problems, by allowing a potential for tax sheltering. These tax sheltering problems are discussed below in the "Contribution of Provision to Tax Sheltering and Avoidance" section.

The possible forms of capital gains revisions are closely tied to these rationales and issues. Therefore, following the general discussion of the rationales, this report also considers the implications of the particular forms of these potential changes.

Labor Mobility

One of the reasons for having some type of relief is to minimize the barriers to labor mobility. To have an efficient market economy that can respond to changes in tastes and technology, it is imperative to have as few barriers to labor mobility as possible. This consideration was reflected

¹³ CRS calculations based on CRS Report R48277, *CRS Model Estimates of Marginal Effective Tax Rates on Investment Under Current Law*, by Mark P. Keightley and Jane G. Gravelle. 2017 and 2027 tax rates are from CRS Report R48153, *Marginal Effective Tax Rates on Investment and the Expiring 2017 Tax Cuts*, by Jane G. Gravelle and Mark P. Keightley.

¹⁴ See CRS In Focus IF11305, *Why Subsidize Homeownership? A Review of the Rationales*, by Mark P. Keightley for a discussion.

¹⁵ Leonard E. Burman, Sally Wallace, and David Weiner, "How Capital Gains Taxes Distort Homeowners' Decisions," *Proceedings of the 89th Annual Conference on Taxation of the National Tax Association* (National Tax Association, 1997), pp. 382-390.

in the rationale for the rollover provision enacted in 1951. Americans' taste and preference for owning their own homes inevitably creates barriers to a willingness to relocate, barriers that cannot be avoided. Imposing capital gains tax at sale adds to that barrier.

The rollover provision, as it existed in prior law, provided some relief but still left some barriers to mobility in place. One problem arose because of regional differences in housing prices, which still exist. If the individual was moving to an area that generally has lower prices (e.g., from California to Arizona), it might be sensible to buy a house that was similar in quality but cost less because of lower overall area prices (which might also have included a lower salary). This shift would result in a capital gain, and the individual then might have been discouraged from making the move or induced to purchase a larger house than otherwise desirable. Circumstances where it might have been more desirable to rent rather than to purchase a new home when relocating may also have existed (e.g., when the family is moving because of economic hardship or the new location is expected to be the place of employment for only a few years). The rollover provision would not have reduced the capital gains barrier in that case. Thus, the rollover provision was imperfect in its elimination of labor mobility barriers.

The capped exclusion eliminates all barriers, as long as the cap is not exceeded, and reduces the cost of labor mobility. Unless the cap is increased explicitly or indexed to housing prices, however, an increasing share of individuals will be affected by the ceiling over time and barriers to labor mobility will grow.

Other Distortions

Aside from the labor mobility issue, capital gains taxes on owner-occupied housing can cause other distortions. Capital gains taxes on assets in general cause a lock-in effect (i.e., discourage changes in portfolio allocations by replacing old assets with new assets). That the lock-in effect for homes in particular may impose greater costs. Financial assets are more likely to be close substitutes, so the lock-in effect is probably not very costly. (However, it is also possible to swap real estate investments without paying a capital gains tax via a 1031 exchange.) Some might argue that people should be encouraged to hold on to investments in the stock market for a long period of time, in order to average out the ups and downs of the market, and the lock-in effect may actually be beneficial in some cases.

Different types of housing, however, may be less substitutable for each other; the difference between the house to which an owner is "locked-in" and the home he desires may be more important than for various alternative financial assets. And with no relief provisions, capital gains taxes discourage moving, whether to a larger house (e.g., to accommodate a larger family) or a smaller one (when children have grown and left the home or to simplify maintenance during retirement). As noted above, a rollover treatment can cause people to buy too much housing or continue to own when renting might be optimal. The once-in-a-lifetime exclusion that aided the elderly was aimed at older individuals who might wish to sell their houses to move into smaller and more easily maintained houses, to move to a rental status, or to "cash out" the value of the house for other purposes. If the exclusion cap does not come into play, these distortions do not exist, but, as noted above, if the cap does not rise with housing prices it will become increasingly binding.

The current provision permitting a capped exclusion every two years actually creates, for those affected, the opposite distortion. It favors higher-income individuals who move more frequently. For instance, an individual who has a capital gain at the limit can move, take advantage of the gains exclusion, and then, within, two years take advantage of it again, while the individual who sells only once, but has an equal gain would have to pay tax. Suppose, for example, that one

taxpayer (a single individual) realizes a capital gain of \$200,000 on the sale of a home, purchases another home, and then sells that second home two years later, earning an additional \$200,000 in capital gains. The taxpayer would be able to exclude \$400,000. If a similar taxpayer experiences a single gain of \$400,000 in the same time period, he or she may exclude only \$250,000. Of course, any tax benefits from moving more often may have little effect on behavior, given the transactions costs and general burdens of changing residences.

Equity Issues

The caps on both the prior one-time exclusion and the current exclusion were enacted to impose gains taxes on higher-income individuals with large capital gains, and therefore the caps are presumed to have a vertical equity objective because they limit the benefit for high-income taxpayers.

The cap, however, can also be seen as producing some horizontal inequities. First, the limited exclusion combined with the step-up in basis at death causes older taxpayers who had to move from their homes due to ill health to pay taxes not assessed on their healthier counterparts who remain in their homes until their death and leave the houses to their heirs with no capital gains tax.

The cap itself also produces some inequities among individuals who sell their homes and who are affected by the cap. These inequities are of three types: (1) between those who move frequently and those who do not; (2) between people living in different regions of the country; and (3) between married couples in which both spouses survive until the point they wish to sell and those in which only one spouse survives.

In the first case, people who buy and sell frequently (and are thus less likely to accrue a large gain in a particular sale) are less likely to be affected by the tax. For example, a married couple who sells every five years and gets a \$150,000 gain on each sale would not pay a gains tax. If a similar couple buys a house and sells after 20 years with the same accumulated gain (four times \$150,000 or \$600,000), they will pay a tax.

Taxpayers living in states and locations where the cost of living, including housing prices, tends to be high, are more likely to be affected by the cap even in cases where their real incomes and standard of living are the same as those who are not affected. For example, taxpayers in California and Massachusetts are more likely to be affected than taxpayers in Mississippi and Oklahoma.

In addition, the tax is more likely to fall on elderly taxpayers who have lost a spouse than married couples who remain alive at the time they wish to sell their house. Although the tax laws allow the gain for the spouse who is deceased to be excluded (half the gain at that time), further capital gain exclusions are limited by the lower ceiling that applies to singles.¹⁶ For example, suppose the gain on a house is \$400,000. In the case of a married couple who sells, the entire gain will be excluded. In the case of a surviving spouse, the exclusion will be \$250,000 plus half of any gain that accrued during the deceased spouse's life; if that gain is less than \$150,000 some tax will be due. Because most women marry men who are older than they are, and because women live

¹⁶ If a surviving spouse and the decedent owned the home jointly, the basis in the home changes after the death of the decedent. The new basis for the half interest that the decedent owned will be one-half of the fair market value on the date of death (or alternate valuation date). For example, suppose a couple jointly owned a home that had an adjusted basis of \$100,000 on the date of one spouse's death. The fair market value on that date was \$200,000. The new basis in the home is \$150,000 (\$50,000 for one-half of the adjusted basis plus \$100,000 for one-half of the fair market value).

longer than men, a significant number of widows are likely to live in the house after the spouse has died.

Recordkeeping

Recordkeeping required to deal with the capital gains tax on residences is complex. To comply with tax regulations, taxpayers have had to keep detailed records of the financial expenditures associated with their home ownership. The taxpayer needs to record the original cost of the residence, any costs added at the time of purchase, and any capital improvements. In the latter case, taxpayers also have had to differentiate between those expenditures that affected the basis of the property and those that were merely for maintenance or repairs.¹⁷ In many instances, these records have to be kept for decades. Congress has addressed this issue, stating in the reasons for the 1997 increase in the exclusion that

calculating capital gain from the sale of a principal residence was among the most complex tasks faced by a typical taxpayer.... [A]s 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.¹⁸

The 1997 tax law simplified income tax administration and record keeping by providing a “relatively high threshold, few taxpayers will have to refer to records in determining income tax consequences of transactions related to their house.”¹⁹

The capital gains exclusion, however, was not indexed for inflation or for housing price changes. In addition, gain on houses increased proportionally more. For example, if the basis (the original cost) of the house in 1997 were half the market value purchase price, a 150% increase in value would mean a 300% increase in the gain. This appreciation means that many more taxpayers would be subject to the ceiling. Without an indexing procedure, some of the potential recordkeeping benefits from the 1997 revision have been lost. It would be unwise for many taxpayers to abandon recordkeeping given that the exclusion is covering fewer and fewer sales over time and there is no commitment from the government to index the provision, so that the simplification from less recordkeeping is likely to be diminished.

Contribution of Provision to Tax Sheltering and Avoidance

The presence of a special exclusion contributes to the possibility of using the tax benefit to avoid capital gains taxes in unintended ways. This section discusses several ways this might occur.

¹⁷ Calculating capital gains requires a measure of basis. A taxpayer’s basis in real estate is cost (or fair market value if acquired by inheritance). The cost of property is the amount paid for it in cash, debt obligations, other property, or services, which can include the purchase price and certain settlement or closing costs. When calculating the gain or loss on the sale of a residence, the basis is adjusted for changes made since the acquisition of the property. Increases to basis include the cost of capital improvements, such as air conditioning or a new roof; special assessments for local improvements; and any other additions that have a useful life of more than one year. Examples of decreases to basis include any capital gain that was postponed from the sale of a previous home before May 7, 1997; deductible casualty losses or insurance payments received for casualty losses; payments received for granting an easement or right-of-way; depreciation allowed if the home was used for business or rental purposes; a first-time homebuyer credit (allowed to certain first-time buyers of a home in the District of Columbia); and energy conservation subsidy excluded from gross income because it was received to buy or install any energy conservation measure.

¹⁸ U.S. Congress, Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997*, 105th Cong., 1st sess. (GPO, 1997), pp. 54-55.

¹⁹ U.S. Congress, Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997*, 105th Cong., 1st sess. (GPO, 1997), pp. 54-55.

Converting Rental Property to Owner-Occupied Property

Capital gains avoidance can occur by converting rental property to owner-occupied property. After this conversion, the property can be sold and the capital gains excluded up to the allowable amount, as long as the property has been owned and used as a principal residence for at least two years during the five-year period ending on the date of the sale of the residence. For example, consider a married couple who have a primary residence and a rental property and both properties have substantially appreciated in value. The couple can sell the primary residence and claim a capital gain exclusion of up to \$500,000 on that residence. The couple can then move into the rental property and use that as the primary residence. After two years the taxpayers could then sell the property and realize a gain of which up to \$500,000 can be excluded under the law. It makes no difference that most of the appreciation on the second property was realized when it was a rental unit. Current tax law, however, does require that any depreciation on the rental property be recaptured and taxed as ordinary income with a cap of a 25% rate.²⁰

An example of the depreciation recapture can be seen in the following example. A married couple sells their primary residence which had an adjusted basis (purchase price plus capital improvements) of \$100,000 for \$200,000. In prior years, the property had been a rental property and the couple had claimed \$50,000 in depreciation deductions on the home. The taxable gain for the sale would be \$100,000, which is the sales price minus the adjusted basis. Of that gain, \$50,000 is tax-free and the \$50,000 taken as depreciation deductions in the past would be subject to a 25% capital gains tax.

“Like-Kind” Property Exchanges

Taxpayers can avoid paying tax on the gain from the sale of their real estate property by participating in a “like-kind” property exchange. Under section 1031 of the Internal Revenue Code, like-property exchanges offer business owners or investors a way to trade their property for something of similar value and type without reporting a profit and, thereby, defer paying taxes on the gain. In the case of residential property, this exchange can be combined with the exclusion of capital gains to allow taxpayers to avoid capital gains tax on some of the deferred gain. Some gain on the original investment property would be taxed as recaptured depreciation, and some may be taxed if the total remaining gain exceeds the cap. For example, a taxpayer who owns a rental property can participate in a like-kind exchange for another residential property, which then becomes the taxpayer’s primary residence. The taxpayer must meet the ownership and use tests for a minimum of five years before the taxpayer can then sell the property and exclude capital gains up to the allowable amount. Essentially, the taxpayer will have sold real estate and avoided capital gains taxation on some, and perhaps most, of the capital gains earned on both properties.

Prior to October 2004 when the American Jobs Creation Act of 2004 (P.L. 108-357) was enacted, there was no minimum holding period for properties acquired through like-kind exchanges. The exclusion of gain on the sale of a principal residence applied after two years, when the ownership and use tests for the provision would have been met. The 2004 law requires the taxpayer to hold the exchanged property for a full five years, as opposed to two, before the residence can qualify as a principal residence. This change reduced, but did not eliminate, the attractiveness of combining like-kind exchanges with the principal residence exclusion.²¹

²⁰ The recapture rule, enacted by the Taxpayer Relief Act of 1997, applies to depreciation claimed after May 6, 1997. Any depreciation taken before that date is “forgiven” and not recaptured.

²¹ More information available in CRS Report RS22113, *The Sale of a Principal Residence Acquired Through a Like-Kind Exchange*, by Gregg A. Esenwein (out of print but available to congressional staff from the author).

Sharing Capital Gains

If taxpayers expect huge gains from owning, then selling a house—more than can be excluded from tax under the new rule—they could divide ownership of the house to maximize the amount of capital gain that could be excluded. If, for example, a married couple owns their residence together with an adult son and he meets the ownership and use tests for one-third of the property, the son may sell his share for a \$250,000 gain without incurring a tax. His parents could simultaneously sell their share for \$500,000 without tax, sheltering as much as \$750,000 in capital gains. Note that this avoidance technique arises not from the exclusion, but from the presence of a cap. This approach to tax avoidance involves some constraints and risks: the child must live in the residence, and the property could be subject to attachment for the child's debts.

Including Investment Property with the Home

This avoidance technique might be termed the “land with a small house” strategy. A taxpayer can purchase a house with a significant amount of land as an investment, and then use the exclusion for the residence to also exclude gain on the land. A taxpayer can also sell vacant land adjacent to your home separately from the home itself, as long as the home is also sold either two years before or two years after the sale of the vacant land. There are some restrictions on this exclusion for land, one being that the land must not only be adjacent to the home but used as part of the home (which would rule out farm land, timber land, and other uses but not simple speculation).

The Professional “Fixer-Upper”

An individual can buy a house that needs substantial renovation as a principal residence, fix it up, live in it for two years, and then sell the home. This gain reflects untaxed labor income of the individual, which is now excluded from tax. In fact, this approach can be used by professional builders who would normally be paid for their services.

Cottage and Home

An individual who has both a regular home and a vacation home can take measures to shift the vacation home to principal residence status. Such an individual may effectively continue to live in the original home in part, but after the required holding period can sell the vacation home, avoid capital gains, and move back to the regular home as a permanent residence. Which home is determined to be the principal residence is based on a facts and circumstances assessment, including the length of time the taxpayer lives in each home, the location of employment and the principal residences of family members, mailing addresses (on bills and correspondence, tax returns, drivers' licenses, and car and voter registrations), the locations of banks used, and the location of recreational associations and churches where the taxpayer has a membership. Thus, it is not easy to establish the vacation home as the principal residence, though it may be feasible in some cases and, of course, the Internal Revenue Service cannot audit every case of this type.

House Swapping

In this avoidance technique, wealthy individuals sell their homes back and forth periodically to qualify frequently for the capital gains tax exclusion. If they mutually agree to this arrangement, the transactions costs could be minimal (i.e., a lawyer to search the title and record the transaction). They may not even live in the exchanged homes. Such an arrangement is illegal (a sham transaction) but may be difficult to detect. This avoidance technique arises from the existence of the cap.

Options for Change

Although numerous potential ways exist to deal with capital gains taxes on owner-occupied housing, including retaining the current rules or returning to the pre-1997 rules, two areas where changes might be considered are the ceilings on the exclusion and in rules relating to investment property and tax sheltering.

Options for addressing the ceilings could include eliminating the ceilings altogether, indexing the ceilings either with respect to general inflation or housing prices, changing the relative ceilings between single and joint returns, or changing the basic structure of the ceilings.

Eliminating the Ceilings

One policy option could be to remove the ceilings altogether. For some taxpayers, the exclusion with ceilings enacted in 1997 increases their tax liability, because they might otherwise have used the rollover provision and then held the asset until death.

One advantage of eliminating the ceilings would be the elimination of any remaining distortions (such as incentives not to sell a house even if it would be desirable) and recordkeeping requirements. This efficiency gain would reflect not only benefits to high-income individuals who actually pay the tax, but also the much larger group who, because of uncertainty, need to keep records.

Other circumstances could cause such a taxpayer to be over the limit. The percentage gain figure cited above is averaged across the country. In several cities across the country, including some in California, the average value of houses has increased more quickly. Another circumstance in which the ceiling would be exceeded is if a spouse dies before most of the additional appreciation occurs. In that case, the surviving spouse could be over the exclusion limit because the exclusion would be limited to about \$350,000 (\$100,000 for half the appreciation that had already occurred and the \$250,000 limit for single individuals). Finally, while some individuals sell houses more frequently, others live in them for a very long time. These examples illustrate that individuals who are living in houses that may currently have accrued gains or have values well below the limit on the capital gains exclusion would need to keep records given the uncertainty about how long the house will be owned, what the appreciation rate will be, whether and when Congress might act to change the ceiling, and whether a spouse might die.

Eliminating the ceilings would also eliminate the inequities that arise among homeowners. These inequities tend to arise because of differences in housing prices across states and localities, differences that lead to more or less frequent sales of houses, and differences among elderly homeowners that arise from different health outcomes that require the sale of a house.

Eliminating the ceilings has some disadvantages. It would involve a revenue loss. In addition, some people might see its expected favoritism of high-income individuals to be a disadvantage. Any reduction in tax progressivity, however, would be minor. The revenue loss from eliminating the ceilings is relatively minor in comparison to the revenue loss for the exclusion in general and the taxes collected on other assets of high-income individuals. As estimated above, the cost of eliminating the ceiling is expected to be several billion dollars. This amount is small relative to the capital gains taxes paid by high-income individuals. For example, CBO estimates that \$261 billion was paid in capital gains taxes in FY2025; most of this tax is paid by high-income

individuals.²² It is also small compared with total income taxes, with taxes paid by those with \$200,000 or more in income estimated at \$2,092 billion for 2025.²³ Thus, while the taxes paid above the exclusion are concentrated in higher-income families, they are small compared with overall taxes on capital gains or all taxes paid by high-income individuals.

For example, in 1999,²⁴ reported taxable capital gains on the sales of residences were in the range of \$3.7 billion to \$4.9 billion.²⁵ Assuming a 20% tax rate, the tax on this amount was less than \$1 billion and much of this amount may be due not to the cap but to failing to qualify in other ways. For that same year, the reported revenue loss from untaxed capital gains was estimated at \$5.8 billion.²⁶ Thus, the presence of the cap limited the amount of revenue loss from the exclusion of capital gains by less than—perhaps much less than—17%.

Data collected on tax returns filed in 1995 and 1996 (before the 1997 change) indicate that the benefits did not solely or even largely accrue to high income individuals if income is measured without including the gain itself.²⁷ These data show large shifts in the distribution between 1995 and 1996, but in both years from 20% to 25% of the tax that would have been collected under the new law accrued to individuals with incomes below \$20,000. In 1996, very little of the tax (less than 20%) would have been paid by those with incomes over \$100,000. The distribution of the tax that one might normally think would accrue to high-income individuals may reflect sales due to divorce, job loss, and ill health. Wealthy individuals may be more likely to have the resources to keep their houses through these types of changes.

As these data suggest, compared with other capital gains provisions, the cap on residential capital gains has relatively small revenue effects and plays a relatively small role in the distribution of the tax burden. Therefore, although revenue and distributional issues may be of concern, other changes could easily be made that would accomplish those same goals.

²² Congressional Budget Office, “Revenue Projections,” January 2025, <https://www.cbo.gov/data/budget-economic-data#3>. The Tax Policy Center estimates that 93% of the tax on capital gains and dividends is paid by those with income over \$200,000 and that 72% is paid by those with income over \$500,000. See “Table 23-0017—Distribution of Individual Income Tax on Long-Term Capital Gains and Qualified Dividends by Expanded Cash Income Level, 2025,” <https://taxpolicycenter.org/model-estimates/distribution-individual-income-tax-long-term-capital-gains-and-qualified-93>, Capital gains alone would be even more concentrated in higher incomes.

²³ Computed from Congressional Budget Office, “Revenue Projections,” January 2025, <https://www.cbo.gov/data/budget-economic-data#3>. The Tax Policy Center estimates that 80% of income taxes are paid by those with income over \$200,000. Tax Policy Center, “Table T22-0097—Share of Federal Taxes—All Tax Units, By Expanded Cash Income Level,” 2025, <https://taxpolicycenter.org/model-estimates/baseline-share-federal-taxes-october-2022/t22-0097-share-federal-taxes-all-tax-units>. 50% of income taxes are estimated to be paid by those with incomes over \$500,000, or about \$1.3 trillion.

²⁴ U.S. Department of the Treasury, Internal Revenue Service, *Statistics of Income*, Short Term and Long Term Capital Gains by Asset Type, Tax Year 1999, <https://www.irs.gov/statistics/soi-tax-stats-sales-of-capital-assets-reported-on-individual-tax-returns>.

²⁵ Inconsistencies in how the exclusion was actually reported on returns results in some uncertainty about the actual size of the gain, but it should fall between these two values.

²⁶ U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1999-2003*, committee print, 105th Cong., 2nd sess., December 14, 1998, JCS-7-98, p.18.

²⁷ See Gerald Auten and Andrew Reschovsky, *The New Exclusion for Capital Gains on Principal Residences*, National Tax Association, Working Paper, October 1998. A previous version of this paper was published in the *Proceedings of the 90th Annual Conference on Taxation of the National Tax Association* (National Tax Association, 1998), pp. 223-230.

Indexing the Dollar Cap

Rather than eliminating the cap, another approach would be to adjust the ceiling to reflect recent price changes and index it for future price changes. A commitment to indexing, rather than intermittently changing the cap as has occurred with prior exclusions, would provide individuals more assurances that they might not need to keep records. This change would cost less revenue. Using the 2007 data, for example, doubling the exemptions would have cost about 60% of the cost of eliminating them entirely, while increasing them by 180% (to reflect the change in housing prices) would cost about 70%. This cost would rise over time.²⁸

Which index would be appropriate depends on the objective of the cap. The change in housing prices has far outstripped the change in the overall price level by any measure. If the objective of the cap is to maintain a fixed inclusion to exclusion ratio, a house price index would be appropriate. If the objective is to fix the cap in real terms, an index to a general price rise would be appropriate.

The Single Versus Joint Exclusion

Another issue is whether the single exclusion should remain at a level that is half the joint exclusion. In making the cap half as large for singles (or twice as large for married couples), the provision departed from historical practices for the over-age-55 exclusion. The 1997 change doubled the existing \$125,000 exclusion for singles, although that exclusion had not kept pace with house price changes because it had not been changed since 1981. If the 1981 value had been adjusted based on the average house price, it would be \$680,000 in 2021.²⁹ Thus, single individuals who might have been eligible for the old age exclusion have lost ground compared with some historical periods, while married couples have lost less. For an equivalent revenue cost, this approach favors married individuals relative to single individuals, including widows and widowers. (Both types of taxpayers could have been made worse off because there was no cap on rollovers.)

Allowing the exclusion to be half as large for single taxpayers may have reflected, to some extent, the tax planning problems faced by divorcing couples. If each taxpayer has the same ceiling, then it is more advantageous to sell a house with a large gain after the divorce, when each individual could have a full exclusion. This problem may have been less important for older individuals in the past when divorce was less likely, but with the exclusion substituting for rollover treatment, many more divorcing couples would be facing this problem. Higher-income individuals who divorced and optimized their timing may be worse off under the post-1997 changes because they were not eligible for an uncapped rollover or larger exclusion. However, the new rules are beneficial for moderate income divorcing couples who wish to trade down. The change in relative exclusions could have addressed the problem of unmarried couples who own houses together, an issue that arose as part of the discussion of the “marriage penalty” in the income tax rate structure. This latter phenomenon is probably not very numerically important since, according to

²⁸ This estimate eliminated the tax on the \$250,000 to \$1 million classes of gains and increased the exemptions for the \$1 million and over classes.

²⁹ Different values would be found if indexing were introduced from earlier levels. For example, using the Census Bureau’s average new house index cited above, indexing from the 1964 level would have implied a current exclusion that was slightly larger than the \$250,000 one now allowed: \$274,500. The value had deteriorated by 1976, so that the exclusion indexed from that point would be \$200,000. Indexing from 1978, when a much larger exclusion was enacted would produce a value of \$439,000.

Census data, unmarried couples were only 7% of households.³⁰ Moreover, because they tend to be younger, they are less likely to be homeowners.

Many of the single individuals selling homes, outside of divorcing couples, are likely to be widows or widowers and the remainder are largely people who have never been married or who have been divorced for some time. By reducing the exclusion ceiling for them, not only is the benefit reduced relative to historical values, but complexity is introduced because more individuals will be subject to filing requirements and paying taxes. As noted above, 80% of houses sold are estimated to have values over \$250,000.

Although it eliminated the complexity for divorcing couples, the halving of the exclusion especially magnified compliance problems for surviving spouses. Although surviving spouses can receive the benefit of the step-up in basis for the half of the house allocated to the decedent, the lower ceiling not only increases the frequency with which basis must be calculated (any time the sales price is \$250,000 or more) but also requires the measurement of the basis step-up.³¹ These individuals may be more likely to have houses that fall into the taxable range because they were married, perhaps for a long time. The lower limit in general adds to the risk that even a couple with a modest house will have to keep complex records because of the possibility that one of them will die before the house is sold.

One potential change would be to allow surviving spouses to opt for the \$500,000 exclusion as a substitute for the step-up in basis if they are selling a house they lived in with their spouse, a move that would simplify compliance for those whose housing values fall between \$250,000 and \$500,000. H.R. 3803, introduced by Representative McCarthy in the 109th Congress, proposed this allowance for certain surviving spouses.

In the 110th Congress, a similar proposal was introduced by Senator Schumer (S. 138) and included in H.R. 3648, the Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142), which was signed into law on December 20, 2007. Specifically, the new law allows a surviving spouse to exclude from gross income up to \$500,000 of the gain from the sale or exchange of a principal residence owned jointly with a deceased spouse *if* the sale or exchange occurs within two years of the death of the spouse *and* other ownership and use requirements have been met. This provision is limited to widows or widowers who sell their houses quickly.

Changing the Structure of the Exclusion

Another option is to change the structure of the exclusion in general. For example, there could be a much larger lifetime exclusion, with each sale of a home using up part of the exclusion. A lifetime exclusion would eliminate the incentive to turn over houses frequently and would eliminate the penalty for holding on to one's home for a long period of time. It would shift benefits (even for the same revenue cost) from very wealthy people who sell houses frequently to people who are less wealthy but have lived in their houses for a long time. It would, however, add to administrative costs and to complexity for some people who would need to keep track of the amount of the exclusion consumed.

A different approach would be that embodied in H.R. 2127 of the 109th Congress, which would have allowed a one-time doubling of the exclusion for those over the age of 50.

³⁰ Benjamin Gurrentz, "Cohabiting Partners Older, More Racially Diverse, More Educated, Higher Earners," September 23, 2019, <https://www.census.gov/library/stories/2019/09/unmarried-partners-more-diverse-than-20-years-ago.html>.

³¹ Surviving spouses can get the full step-up of the entire gain in community property states, such as California.

Tax Sheltering of Investment Gains

A final issue is whether additional measures should be taken to prevent the use of the exclusion from sheltering gains earned from investment property. Little to no evidence exists as to the seriousness of this issue. According to revenue estimates, the restriction on like-kind exchanges enacted in 2005 (requiring a five-year test) will have a negligible revenue effect (\$200 million over 10 years).³² The revenue loss from the converting of investment property into a residence is likely larger.

These tax sheltering problems are not unique to current law; they existed under prior law as well.

To deal with the investment and like-kind exchanges, the provision requiring longer residence periods for like-kind exchanges could be expanded to property used as an investment. Another more direct approach, which might be used to raise revenue to finance cap expansions, would be requiring the gain attributable to investment property to be separated out and taxed, as recaptured depreciation is now taxed.

The conversion of investment property is probably the most significant tax avoidance scheme. Techniques such as buying a house with extensive land, establishing a vacation home as a residence, or explicit house swapping can probably only be addressed through tax auditing. These shelters would perhaps be made less attractive with longer holding periods, but longer holding periods have other consequences (such as interfering with mobility). The effect of longer holding periods would not be as onerous, however, because houses held for a short period of time are likely to have little appreciation, especially after deducting real estate commissions and other selling costs. Partial exclusion could be allowed for cases where sales were due to employment changes, and other factors. In addition, record keeping for a few years is not the burden that would be the case if the house was owned for decades. House swapping would be reduced or eliminated if the ceilings were increased or eliminated. It is very difficult to deal with the professional “fixer-upper” problem, although, as in the case of other tax avoidance schemes, longer holding period requirements would discourage such methods.

Conclusion

Capital gains on sales of taxpayers’ homes have been preferentially treated in the tax code for decades. Current law allows an exclusion from income taxation of up \$500,000 in capital gains for couples (\$250,000 for singles). Several arguments are made in support of this preferential treatment. Capital gains taxes on homes create barriers to labor mobility in the economy. Imposing capital gains taxes on homes also creates significant compliance costs, requiring individuals to keep records for decades and to make fine distinctions between improvements and repairs. Capital gains taxes also tend to distort housing choices, discouraging individuals from selling their homes because of changing family and health circumstances. The taxation of gains in excess of a cap creates inequities between homeowners with different job circumstances, those living in different parts of the country, and those with different health outcomes. Exclusions of gains on homes do, however, contribute to tax avoidance schemes, especially ones that allow gains on investment properties to escape tax.

³² U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects of the Conference Agreement for H.R. 4520, The “American Jobs Creation Act of 2004,”* committee print, 108th Cong., 2nd sess., October 7, 2004, JCX-69-04.

The exclusion from capital gains tax for owner-occupied housing currently exempts most homeowners from the tax. Although the capital gains exclusion adds to the magnitude of homeowner preferences that may distort investment, there are reasons to exempt capital gains on home sales from tax. The rise in housing prices juxtaposed with the fixed dollar cap for the exclusion, however, has increased the share of homeowners subject to gains tax. The possibility of capital gains tax in the future, arising from a cap that does not keep pace with housing prices, substantially reduces the number of taxpayers who could be freed from detailed record keeping. The problems associated with the gains tax could be eliminated or mitigated with the elimination of the cap or by indexing it to housing prices. The ceiling on the excluded gain, presumably adopted for revenue and distributional reasons, is, however, of small consequence compared with other provisions (such as the general taxes and taxes on capital gains and dividends). A complication of increasing or eliminating the ceiling, however, is the increased opportunity for tax sheltering activities, which may suggest additional restrictions aimed at these activities.

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