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A Requiem for the Rollover Rule: Capital Gains, Farmland Loss, and the Law of Unintended Consequences

by

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I. Introduction

Every year, over one million acres of prime crop land are lost to the sprawling growth of suburban areas in the United States.¹ Open fields and wildlife habitat are plowed under for the construction of endless rows of new houses. At the same time, traditional town centers collapse, giving way to faceless strip malls at the edge of town. In many cases, the new developments blur into one another, distinguishable only by subdivision name: Eagle's Landing, Wild View, Goose Haven.² Those names evoke the land's rural heritage, conjuring up images of pastoral tranquillity. Ironically, those appellations describe that which has been lost, rather than that which remains.

Are these changes merely the work of free market forces? Do they simply represent the basic, frontier instinct of Americans to spread out across the continent in the quest for that special plot of land that offers space and privacy and safety from the turmoil of the cities?³ Not necessarily. Although many Americans freely choose the comforts of new subdivisions over established neighborhoods, many are motivated to purchase new homes by forces other than personal taste and free choice. What can account for this distortion? One surprising culprit may be the rollover rule of former § 1034 of the Internal Revenue Code (Code).⁴

1. See Keith Schneider & Florence Schneider, *America's Farthest-Reaching Environmental Issue*, GREAT LAKES BULL., Winter 1997, at 6, 6 (citing estimate of American Farmland Trust).

2. See HOME BUILDERS ASS'N OF METROPOLITAN DENVER, BOULDER COUNTY CHAPTER, TOUR OF NEW HOMES (May 3, 4, 10, 11, 1997).

3. See generally Henry R. Richmond, *From Sea to Shining Sea: Manifest Destiny and the National Land Use Dilemma*, 13 PACE L. REV. 327 (1993) (discussing statutory approaches to containing development of farmland).

4. I.R.C. § 1034 (1994) (repealed 1997).

Although many writers have linked relentless suburban growth to federal tax policies such as the home mortgage interest deduction, few have blamed former § 1034.⁵ That section created a home sale preference, permitting home owners who sold their principal residences at a profit to defer tax liability (to "roll over" the gain). The tax relief, however, was limited by an important prerequisite: to qualify for the benefit of § 1034, taxpayers were required to "buy up" by purchasing another home of greater or equal value within two years of the sale.⁶ The rollover rule first appeared as § 318(a) of the Revenue Act of 1951.⁷ After minor amendment, at the time of its repeal in 1997, the rule provided:

If property . . . used by the taxpayer as his principal residence is sold by him and, within . . . 2 years . . . [a new residence] is purchased and used by the taxpayer as his principal residence, gain (if any) from such sale shall be recognized only to the extent that the taxpayer's adjusted sales price . . . of the old residence exceeds the taxpayer's cost of purchasing the new residence.⁸

Thus, for almost half a century, the rollover rule created a powerful incentive for home sellers to buy up to qualify for tax deferral. Every year, over four million families sell their homes.⁹ Many complied with the buy-up prerequisite, with fewer than 4% of home sales triggering tax liability for capital gains.¹⁰

Was the rollover rule a desirable provision of our national tax policy? A cursory examination misleadingly suggests that § 1034 simply created a benevolent preference for home sellers. When enacting the precursor to § 1034 in 1951, Congress perceived an urgent need to eliminate the hardship¹¹ that taxing the "ephemeral profits"¹² from home sales created. Congress noted

5. See *infra* notes 21, 309-10 and accompanying text.

6. See *infra* Part II.A.

7. Revenue Act of 1951, Pub. L. No. 82-183, § 318, 65 Stat. 452, 494 (codified at I.R.C. § 112(n)(1) (1939)).

8. I.R.C. § 1034(a) (1994) (repealed 1997) (emphasis added).

9. See *FY 98 Budget Education Issues: Hearings Before the House Comm. on Ways and Means*, 105th Cong. (1997) [hereinafter *Education Hearings*] (statement of Donald C. Lubick, Acting Assistant Secretary (Tax Policy), Dep't of the Treasury), available in 1997 WL 8219493; NATIONAL ASSOCIATION OF REALTORS, REAL ESTATE OUTLOOK, MARKET TRENDS & INSIGHT, Feb. 1998, at 13.

10. Some of these home sales were exempt from capital gains taxes because of a one-time exclusion of up to \$125,000 of gain, previously available to taxpayers age 55 and over. *Education Hearings*, *supra* note 9 (statement of Donald C. Lubick).

11. H.R. REP. NO. 82-586, at 27 (1951), reprinted in 1951 U.S.C.C.A.N. 1781, 1808 (noting that then-current tax law created hardship by taxing profits from home sales as capital gains).

12. 96 CONG. REC. APP. A1983 (1950) (statement of Rep. Camp).

that such profits were often the product of inflation, and the taxpayer would need to reinvest the entire proceeds from the sale of the first home to purchase a similar replacement home.¹³ In such a case, Congress believed it inequitable to exact an income tax on proceeds that were not clearly "income."¹⁴

Despite its laudable goal of supporting home ownership, § 1034 unwittingly promoted the needless destruction of farmland and the unchecked proliferation of suburban housing developments. How did these unintended consequences come about? In many regions of the country, housing prices increase as one moves out of the city center and into the county.¹⁵ As a result, buying up may have required the purchase of a relatively expensive, new suburban home. The tax distortion is particularly evident in communities that experienced a significant influx of new residents from more expensive regions. In that case, existing homes were simply too inexpensive to satisfy the buy-up requirement and the new residents created a tax-induced demand for the construction of luxury homes encroaching upon the surrounding countryside.

This Article is a requiem for the rollover rule, which existed for forty-six years until its repeal in 1997.¹⁶ In dismantling the rule, Congress eliminated the buy-up requirement, but failed to realize all of the rule's adverse consequences.¹⁷ Why should we examine a section of the Code that is no longer in effect? The answer is quite straightforward: tax reform is fluid, subject to changing political philosophies. Congress can repeal and re-enact provisions of the tax code in rapid succession.¹⁸ As a result, a nation cannot have an informed, rational, and constructive tax policy on home sales without a continuing effort to understand fully the choices and mistakes of the past. This Article provides an exposé of the unintended consequences of the roll-

13. See 97 CONG. REC. 11,721 (1951) (statement of Sen. Long).

14. *Id.*

15. See, e.g., Thomas E. Bier & Ivan Maric, *IRS Homeseller Provision and Urban Decline*, 16 J. URB. AFF. 141, 143 (1994) (noting higher prices of homes sold in suburbs of Cleveland than within Cleveland city limits). See also *infra* Part VI.B.3.

16. See *infra* Part VIII.B. In 1997, Congress repealed § 1034 (including the rollover rule), but created a new home sale preference in an amended § 121. See *infra* Part VIII.B.

17. See *infra* Part VIII.B.

18. In 1986, for example, Congress repealed the preference for individual long-term capital gains, but "kept in place all of the complex definitional and computational paraphernalia." MARVIN A. CHIRELSTEIN, *FEDERAL INCOME TAXATION* ¶ 16.01, at 299 (1994). Seven years later, Congress reintroduced the capital gains preference as a reaction to the increase in tax rates. *Id.* at 298-300; see also Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV. 913, 914 (1987) (viewing tax legislation as contract and explaining accelerating rate of tax change as representative of shift from longer- to shorter-term contracts between legislators and private interests).

over rule and thereby offers insurance against the resurrection of the rule by some future Congress.

This Article offers no opinion as to whether tax breaks for home owners are justifiable in theory. Rather, it contends simply that in practice the rollover rule proved to be an ill-conceived mechanism for limiting such preferential treatment. In other words, in the specific case of § 1034, the detrimental effects of the rollover rule and its buy-up requirement overshadowed any benefits that the home sale preference created. Part II presents the broader context of § 1034, discussing federal policies favoring home owners over renters and favoring capital gains over ordinary income. The § 1034 home sale preference was consistent with both of these long-standing predilections. Part III discusses the origin of the rollover rule, which was patterned after 1921 legislation relating to the government requisition or condemnation of ships during World War I. In that Part, this Article questions whether the analogy between involuntary conversions and home sales was an appropriate model for § 1034. Part IV examines the legislative history of the Revenue Act of 1951, highlighting how the vagaries of domestic politics at the inception of the cold war may have hastened the enactment of the rollover rule, without an adequate discussion of its potential to dominate land-use patterns and community structure. Parts V and VI argue that the rollover rule may have had three unintended consequences: (a) over-investment in housing, (b) the inflation of housing prices, and (c) the conversion of farmland into suburban housing. The Article tests these three hypotheses through case studies of the housing markets of Santa Clara County, California, and Boulder County, Colorado. Part VII elaborates upon the third hypothesis by describing the negative effects of suburbanization, including the hidden economic, social, and environmental costs of sprawl development. Part VIII outlines the demise of the rollover rule, as Congress expanded the home sale preference in 1997 by repealing § 1034 of the Code.

II. The "American Dream" Narrative: Tax Preferences for Home Owners

Two diverse forces – one philosophical, one economic – facilitated the 1951 enactment of the predecessor to § 1034. First, the home sale preference created by § 1034 was but one of many federal policies favoring home ownership, all supported by our national reverence for the sanctity of the family dwelling. Second, the tax advantage for home sellers was expressed as a capital gains preference, justified by the same economic arguments that have prevailed in maintaining a general preference for long-term capital gains almost continuously since 1921. This Part addresses two questions basic to an understanding of § 1034: Why does the law favor home owners? Further, why does the law favor capital gains over ordinary income?

The family hearth has long been a treasured icon of our society, with home ownership at the heart of the American Dream.¹⁹ The vision of a nation of home owners is perceived as far more than a luxury or convenience – it is seen as the "foundation of all society."²⁰ Federal policy reflects this respect for home ownership through tax preferences such as the home mortgage interest deduction,²¹ the real property tax deduction,²² and the home sale preference of § 121²³ and § 1034 of the Code,²⁴ as well as through nontax benefits such as federally insured home mortgages.²⁵

The preferences have been the subject of a fairly substantial body of critical literature. Commentators have criticized the home mortgage interest deduction as potentially inequitable,²⁶ racially skewed,²⁷ and as an incentive for the destruction of wetlands, other sensitive landscapes, and endangered

19. See, e.g., Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 374 n.1 (1994) (quoting Radio Address to the Nation on the Economic Plan, 29 WEEKLY COMP. PRES. DOC. 331, 332 (Feb. 27, 1993) (President William J. Clinton) (stating that home ownership is "an essential part of the American dream we're working hard to restore"); President Lyndon Johnson, Message to Congress on the Crisis of the Cities (Feb. 22, 1968) ("Home ownership is a cherished dream and achievement of most Americans."), reprinted in 114 CONG. REC. 3956, 3957 (1968); President Franklin Roosevelt, Address to the United States Savings and Loan League (Nov. 16, 1942) ("[A] nation of home owners, of people who own a real share in their own land, is unconquerable."), in N.Y. TIMES, Nov. 17, 1942, at 35).

20. 78 CONG. REC. 11,182 (1934) (statement of Rep. Sirovich), quoted in Forrester, *supra* note 19, at 374-75 n.1.

21. I.R.C. § 163(h) (1994) (allowing deduction of interest on up to one million dollars of debt incurred to acquire taxpayer's principal residence and one other residence). The deduction was projected to cost the U.S. Treasury \$253.9 billion for the period 1994-98. Oliver A. Houck, *On the Law of Biodiversity and Ecosystem Management*, 81 MINN. L. REV. 869, 881 n.36 (1997) (citing STAFF OF JOINT COMM. ON TAXATION, 103D CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1994-1998, at 13 (Comm. Print 1993)).

22. I.R.C. § 164(a)(1) (allowing for deduction of state and local property taxes).

23. See discussion *infra* Part VIII.A.

24. Although § 1034 was repealed in 1997, an expanded version of the home sale preference now appears in I.R.C. § 121. See discussion *infra* Part VIII.B.

25. See National Housing Act, ch. 847, § 203, 48 Stat. 1246, 1248-49 (1934) (codified as amended at 12 U.S.C. § 1709 (1994)).

26. See CHIRELSTEIN, *supra* note 18, ¶ 7.04, at 166-68 (noting that deduction exacerbates mortgagors' financial advantage over renters caused by "inconsistency in the law . . . [whereby] the imputed rental value of owner-occupancy is not taxable, while cash rental payments are not deductible").

27. See Beverly I. Moran & William Whitford, *A Black Critique of the Internal Revenue Code*, 1996 WIS. L. REV. 751, 774-75 (arguing that "the tax benefits of deductions are always a function of income bracket [and,] . . . [therefore,] [i]f homeowning blacks, on average, have a lower income than homeowning whites, this principle alone assures that the tax benefits of deducting mortgage interest and property taxes are racially skewed").

species.²⁸ Despite these criticisms, home owners have maintained their favored status for well over half a century.²⁹ For example, in 1986 Congress eliminated deductions of "personal interest," but retained a major exception for the deduction of home mortgage interest.³⁰ Similarly, flat-tax proposals may garner a certain measure of popular support but "hit the political wall when they consider eliminating deductions for home-mortgage interest."³¹

Political support for these home owner preferences is buttressed by pious rhetoric as much as by careful logic. The language emphasizes the sacrosanct nature of the family home, couched in terms of the American Dream or, more recently, in terms of "family values."³² One senator described the home mortgage interest deduction as "one of the most sacred parts of the Tax Code,"³³ even though commentators cannot precisely identify the deduction's effect upon the affordability of housing.³⁴ Likewise, legislators touted a recent package of tax reform measures, including the expansion of the home sale preference,³⁵ as changes that would promote the future of the family: "By letting hard-working Americans keep more of their own money, we allow them to preserve their family, prepare for their own future, and invest in the nation's economy."³⁶ In a nation where home owners comprise over 60% of

28. See Houck, *supra* note 21, at 880-81 (arguing that federal subsidies encourage development of sensitive natural areas); Oliver A. Houck, *Reflections on the Endangered Species Act*, 25 ENVTL. L. 689, 696-97 (1995) (arguing that mortgage interest deduction and other federal subsidies support development projects, some of which impact endangered species).

29. Beginning in 1934, for example, Congress provided for federally insured home mortgages. See *supra* note 25 and accompanying text.

30. Tax Reform Act of 1986, Pub. L. No. 99-514, § 511(b), 100 Stat. 2085, 2246 (codified as amended in scattered sections of 26 U.S.C.).

31. Erik M. Jensen, *Frontiers of Tax Reform*, 47 CASE W. RES. L. REV. 253, 256 (1996) (book review).

32. For an essay on the use of the family values motif in the 1992 presidential campaign, see Lance Morrow, *Family Values: The Republican Pitch Seems Cynical, But It Goes to the Soul of What Kind of Country Americans Want*, TIME, Aug. 31, 1992, at 22, 27. "The Republican meaning of family values tends to point toward a cultural ideal (two-parent heterosexual households, hard work, no pornography, a minimal tolerance of the aberrant)." *Id.*

33. 132 CONG. REC. 14,824 (1986) (statement of Sen. Pryor) (supporting home mortgage interest deduction during debate over Tax Reform Act of 1986).

34. The Honorable Leslie B. Samuels, Remarks at the Federal Bar Association Annual Tax Law Conference (March 6, 1996), in Section of Tax'n Rep., July 1989, at 1, 7 (Summer 1996) (noting that elimination of home mortgage interest and property tax deductions "could have a significant effect on housing prices, although it is difficult to predict precisely how such effects would play out").

35. See discussion *infra* Part VIII.B.

36. 143 CONG. REC. S8405 (daily ed. July 31, 1997) (statement of Sen. Smith); see also *id.* at S6716 (daily ed. June 27, 1997) (statement of Sen. Graham) (discussing reduction of capital gains tax rate). Senator Graham stated: "In particular, I would like to draw your

the population,³⁷ the emotionally charged family values language has a superficial appeal that may tempt legislators to support home preferences as politically expedient measures, without a rigorous analysis of the subtle consequences of the preferences. The home sale preference of former § 1034 was subject to just such an infirmity. Congress enacted the provision without substantial controversy in 1951 and without careful inquiry into precisely how to delineate the contours of the preference. As a result, the poorly conceived rollover rule governed over a generation of home sales.

A. *The Home Sale Preference of Former § 1034*

Since 1951, the Code has provided a consistent preference for the sale of personal residences.³⁸ Suppose *X* purchased a home in 1940 for \$10,000. If *X* sells the residence in 1951 for \$15,000, then *X* has realized a gain of \$5,000.³⁹ But should the gain from the home sale be taxed just like any other capital gain? As a matter of social policy, is it fair or wise to tax that \$5,000 "profit"? If *X* buys a replacement home of similar size and quality, then *X* may need to spend the entire \$15,000 from the sale of the old home. In essence, *X* has simply traded one home for another. The profit may be illusory and temporary, providing no source of funds from which *X* can draw to pay a tax on the so-called gain. Therefore, if a capital gains tax is imposed on the sale, *X*'s net worth will be decreased by the amount of the tax. Congress feared that imposing a capital gains tax upon such home sales made it "harder for [tax-

attention to a provision that will have considerable impact on our Nation's families: the capital gains exclusion for homeowners who sell their primary residence." *Id.* For other references to the linkage of family values and federal policy, see Forrester, *supra* note 19, at 374 n.1 ("I believe that those on welfare, what they really want is a piece of the American dream: homeownership, a good job, opportunities for their children, and strong, loving families.") (quoting Remarks on Arrival in Appleton, Wisconsin, 1992-93 PUB. PAPERS 1188 (July 27, 1992) (President George Bush)); Jerome Kurtz, *The Interest Deduction Under our Hybrid Tax System: Muddling Toward Accommodation*, 50 TAX L. REV. 153, 189 (1995) (stating that "the tax law has always treated the deduction for home mortgage interest with a rare degree of deference").

37. BUREAU OF THE CENSUS, U.S. DEP'T OF COM., HOMEOWNERSHIP (last modified Mar. 31, 1997) <<http://www.census.gov/hhes/housing/census/owner.html>> [hereinafter HOMEOWNERSHIP]; see also BUREAU OF THE CENSUS, U.S. DEP'T OF COM., CENSUS OF HOUSING 1 (1990); Peter Passell, *The Easy One in Tax Breaks: Who's Against Homeowners?*, N.Y. TIMES, Aug. 31, 1996, at 33 (discussing proposed legislation that would eliminate capital gains taxes on most home sales).

38. See Revenue Act of 1951, Pub. L. No. 82-183, § 318, 65 Stat. 452, 494 (codified as amended at I.R.C. § 1034).

39. A similar hypothetical was posed during the debate over the Revenue Act of 1951. See H.R. REP. NO. 82-586, at 28, 111-13 (1951), reprinted in 1951 U.S.C.C.A.N. 1781, 1808-09, 1898-1900.

payers] to maintain [their] former standard of living,"⁴⁰ forcing home sellers to "dip into [their] savings" in order to pay the tax.⁴¹

In 1951, Congress provided relief from this perceived hardship by enacting the predecessor to § 1034 of the Internal Revenue Code.⁴² The relief provided to home sellers, however, was contingent upon the satisfaction of several conditions. Perhaps the least debated of those conditions – the buy-up requirement of the rollover rule – required taxpayers to purchase a replacement home of greater or equal value than the former residence to defer taxation. That is, gain from the sale of the old residence was recognized only to the extent that the sale price of the old residence (minus various sales-related expenses) exceeded the cost of the new residence.⁴³ The net effect of this provision was to encourage home sellers to buy up to defer taxation.

The political groundwork for this home sale provision had been laid thirty years earlier when Congress enacted the first general capital gains preference in 1921.⁴⁴ The same reluctance to tax capital gains that prevailed during that early debate played a role in the 1951 passage of the home sale preference. Although the preferential treatment of capital gains had been firmly established by mid-century, a lingering ambivalence toward the relative merits of earned and unearned income retained sufficient currency to prompt continuing debate. It was during this time, for example, that Professor Walter Blum wrote his now-classic article, *A Handy Summary of the Capital Gains Arguments*.⁴⁵ An examination of the larger historical context of capital gains taxation is an indispensable prelude to an understanding of the home sale preference.

B. *The Ambivalent Taxation of Capital Gains*

The taxation of home sale profits is only part of the larger issue of the proper tax treatment of capital gains in general. For almost a decade after the

40. 97 CONG. REC. 6961 (1951) (statement of Rep. Forand).

41. *Id.* (citation omitted). "Payment of a capital gains tax when an individual switches homes may be a real hardship, because ordinarily [the individual] needs as much cash as he can lay his hands on." *Id.* at 6962.

42. H.R. REP. NO. 82-586, at 27, reprinted in 1951 U.S.C.C.A.N. 1781, 1808; see I.R.C. § 1034 (1994) (repealed 1997).

43. For the purpose of determining whether or not gain was deferred, the sales price of the old residence was adjusted to reflect "the amount realized, reduced by the aggregate of the expenses for work performed on the old residence in order to assist in its sale." I.R.C. § 1034(b)(1) (1994) (repealed 1997).

44. Revenue Act of 1921, ch. 136, § 206(b), 42 Stat. 227, 233.

45. Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247 (1957).

enactment of the sixteenth amendment,⁴⁶ it remained unclear as a constitutional matter whether Congress could tax capital gains. In the early 1920s, the Supreme Court decided several issues that cleared the way for the full taxation of capital gains. Nevertheless, Congress continued to demonstrate a reluctance to tax capital gains, at least at the same level as ordinary income.

In *Eisner v. Macomber*,⁴⁷ the Supreme Court considered whether Congress could tax stock dividends as income.⁴⁸ In deciding that Congress lacked such authority, the Court stated that "[t]he essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit."⁴⁹ In language that led to the now-familiar requirement that income is not taxable until it has been realized,⁵⁰ the Court observed that despite the fact that the stockholder "is the richer because of an increase of his capital, at the same time . . . he has not realized or received any income in the transaction."⁵¹ Although the Court's opinion implied that the realization requirement is one of constitutional dimension, many subsequent commentators have agreed that the requirement is simply a rule of administrative convenience rather than a constitutional mandate.⁵²

Stated in the affirmative, *Macomber* might have been construed to stand for the proposition that capital gains were constitutionally taxable, at least where a realization event has occurred. Instead of resolving the taxability of capital gains, however, the decision created more uncertainty and provoked congressional outrage⁵³ against the Court's intrusion into Congress's authority in the

46. "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. CONST. amend. XVI.

47. 252 U.S. 189 (1920).

48. *Eisner v. Macomber*, 252 U.S. 189, 199 (1920). The Standard Oil Company had distributed surplus profits to defendant-stockholder in the form of additional shares of stock. *Id.* at 200-01.

49. *Id.* at 211.

50. In its purest form, the Haig-Simons definition of income would call for the imposition of an income tax on annual increases in wealth. Due primarily to the administrative difficulties inherent in that approach, such a regime has been eschewed in favor of an approach under which income is not taxed until gains have been realized. See generally JOSEPH BANKMAN ET AL., FEDERAL INCOME TAX 123-94 (1996).

51. *Macomber*, 252 U.S. at 212.

52. See CHIRELSTEIN, *supra* note 18, ¶ 5.01, at 71; see also Marjorie E. Kornhauser, *The Origins of Capital Gains Taxation: What's Law Got to Do With It?*, 39 SW. L.J. 869, 874 n.23 (1985) (stating that, although *Macomber* was "generally understood [at the time] to constitutionally mandate realization[,] . . . [t]oday, the realization requirement is generally adhered to for administrative convenience since the taxation of unrealized gain would require complex annual valuations").

53. See Kornhauser, *supra* note 52, at 922-23 (noting that *Macomber* decision caused "an

tax arena.⁵⁴ The issue was not resolved until the following year when the Court, in *Merchants' Loan & Trust Co. v. Smetanka*,⁵⁵ held that capital gains were indeed taxable "income" within the meaning of the Sixteenth Amendment.⁵⁶ *Merchants' Loan* signaled a retreat from judicial activism with respect to the congressional taxing power.⁵⁷ The decision freed Congress to base its tax treatment of capital gains upon pragmatic, rather than constitutional, concerns.

In 1921, within months after the Court rendered its decision in *Merchants' Loan*, Congress retreated from its newly confirmed constitutional authority by enacting the first capital gains preference.⁵⁸ Although Congress did not articulate a comprehensive rationale for the preference,⁵⁹ commentators generally cite at least two arguments in its support. First, the preference may counteract the adverse effects of the phenomenon called "bunching," under which gains that have accrued over many years (such as the appreciation in value of a personal residence) are taxed only in the year that a profit has been realized.⁶⁰ Consistent with this rationale, one can understand the

outpouring of protest in Congress, which did not abate for years and which included proposals for constitutional amendments to permit the taxation of stock dividends and state and local income").

54. *Id.* at 921-22 ("Congress and the public perceived the *Macomber* case as severely disturbing the balance of power [between Congress and the Court].").

55. 255 U.S. 509 (1921).

56. *Merchants' Loan & Trust Co. v. Smetanka*, 255 U.S. 509, 517-21 (1921). For an interesting discussion of the Court's cursory treatment of the issue, despite diverse and impassioned contemporary opinion, see Kornhauser, *supra* note 52, at 879.

57. See Kornhauser, *supra* note 52, at 923-25 (arguing that *Merchants' Loan* and other capital gains cases decided contemporaneously reflected "the Court's acceptance of [Congress's] power in the income tax area").

58. Revenue Act of 1921, ch. 136, § 206(b), 42 Stat. 227, 233 (taxing capital gains at maximum rate of 12.5%); see Kornhauser, *supra* note 52, at 928 ("[T]he existence of a broad power to tax, however, did not mean that the power had to be exercised. Congress retained legislative discretion to fashion complex revenue-producing statutes to meet changing needs and conditions.").

59. See CHIRELSTEIN, *supra* note 18, ¶ 16.02, at 301 ("Curiously in view of its significance to the revenues, the capital gain preference has never received a systematic exposition in any official source. Congressional committee reports, debates, etc., contain little on the subject of underlying policy, apart from occasional references to 'fairness,' 'incentives,' and the like.").

60. One commentator provides the following illustration:

If stock is purchased at \$100 a share in Year 1 and is finally sold in Year 5 for \$150, the \$50 gain then realized may be the sum of a series of unrealized gains which accrued over the five-year period. Since, historically, our rate-structure has been progressive, if we include the entire \$50 in Year 5 just because the stock happened to be sold in that year, the investor's tax could be considerably greater than if the gain had been taken into account ratably over the five-year holding period.

first preference as a congressional reaction to the *Macomber* realization requirement that served to mitigate the perceived harsh effect of the realization rule.⁶¹ A second argument asserts that the capital gains preference preserves the mobility of capital from existing assets into more profitable investments. Under this view, taxpayers may be "locked in" to existing investments if the sale of current assets triggers a tax of sufficient magnitude to make the transaction too expensive to undertake.⁶² As a result, a capital gains preference may remove the disincentive against capital mobility, giving investors freedom to make efficient investment decisions without fear of negative tax consequences.

Although experts continue to debate the merits of the general capital gains preference,⁶³ it has been a persistent part of the tax landscape for over seventy-five years.⁶⁴ Capital gains have not escaped taxation altogether, however, and a variety of mechanisms have limited the preference since 1921.⁶⁵ The next Part considers how and why Congress chose to limit the preference and focuses on the specific home preference of § 1034.

III. *The Restrictive Subtext: The Rollover Rule*

Why did Congress create a special preference for home sales, only to limit its applicability to cases in which taxpayers bought more expensive

CHIRELSTEIN, *supra* note 18, ¶ 16.02, at 302; *see also* Blum, *supra* note 45, at 253. Professor Blum argues that the bunching justification is weak because "while the prescription fits the disease, the disease itself is unnecessary." *Id.* Instead of a preference, he suggests that the obvious solution for the bunching problem is to adopt an averaging mechanism to spread out capital gains over a block of years. *Id.*

61. CHIRELSTEIN, *supra* note 18, ¶ 16.02, at 302 (stating that "preferential treatment can be seen as a rough-and-ready way of mitigating the impact of progressive rates on income that is 'bunched' into a single taxable year"); *see also* Anita Wells, *Legislative History of Treatment of Capital Gains Under the Federal Income Tax, 1913-1948*, 2 NAT'L TAX J. 12, 15 (1949) (citing H.R. REP. NO. 67-350, 10-11 (1921) for the proposition that the sale of capital assets has been "seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized").

62. *See* Blum, *supra* note 45, at 256-58 (describing this effect as "probably the most widely publicized argument against taxing capital gains").

63. *See generally* *Colloquium on Capital Gains*, 48 TAXL. REV. 315 (1993) (presenting colloquium on issue of desirability of capital gains preference).

64. The general capital gains preference disappeared briefly between 1986 (preference eliminated by the Tax Reform Act of 1986) and 1990 (modest preference reinstated by the Revenue Reconciliation Act of 1990). *See* CHIRELSTEIN, *supra* note 18, ¶ 16.01, at 298-301; I.R.C. § 1 (1994) (as amended by Revenue Reconciliation Act of 1990, Pub.L. No. 101-508 § 11101, 104 Stat. 400, 404-05).

65. *See infra* Part III.

replacement homes? An obvious response suggests that Congress wanted to ensure that the income tax would generate sufficient federal revenues to meet the nation's financial needs. That response, however, is unsatisfying. It does not explain, for example, why Congress amended the home sale preference in 1997 to exclude all but 0.25% of home sale gains from taxable income.⁶⁶ The taxation of an insignificant percentage of home sellers appears tailored to goals of a philosophical rather than economic nature.

Such symbolic qualifications on tax relief may be the product of our inconsistent national attitudes toward wealth.⁶⁷ In one sense, the wealthy are regarded with disdain because "Americans imbue earned income with an aura of morality and virtuousness that unearned income, particularly inherited income, does not have."⁶⁸ At the same time, however, the wealthy represent the "apotheosis of the American dream" by proving that "anyone can achieve anything by dint of merit, rather than by class or privilege."⁶⁹ In the political sphere, these competing philosophical views play out as a battle of rich against poor. For example, 1997 tax reform measures reduced the maximum tax rate on capital gains from 28% to 20%.⁷⁰ The legislative debate highlighted the philosophical schism in our views of wealth. Opponents of the reduction questioned whether investment is of greater merit than work and argued that there must be some "reasonable limitation" on the capital gains tax benefit.⁷¹ They noted that the benefit provides a disproportionate advantage to the wealthy and that 0.5% of taxpayers receive 50% of the nation's capital gains.⁷² In contrast, proponents of the expanded preference emphasized the admirable qualities of the wealthy, arguing that "millionaires come from risk-taking, millionaires come from [job-creating] entrepreneurial activity."⁷³

66. See *infra* Part VIII.B.

67. See generally Marjorie E. Kornhauser, *The Morality of Money: American Attitudes Toward Wealth and the Income Tax*, 70 IND. L.J. 119 (1994).

68. *Id.* at 119.

69. *Id.* at 169.

70. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 311, 111 Stat. 788, 831-32.

71. See 143 CONG. REC. S6397 (daily ed. June 26, 1997) (statement of Sen. Dorgan) (describing investor as one who "takes a shower in the morning, does not get dirty during the day, does not sweat, sits in a chair someplace and invests").

72. *Id.*

73. *Id.* at S6398 (statement of Sen. Bennett). The distinction between the wealthy and the nonwealthy is fluid, potentially changing during the course of one's lifetime:

Most Americans do not start off in a high income bracket. They work up to it over the years and reach a peak somewhere in their 50s or 60s. . . . Census statistics for 1990 show families headed by someone in the 45- to 64-year-old bracket earning nearly double the income of families headed by someone in the 25- to 34-year-old bracket.

The attitude that tax breaks for home owners – however deserving – must have some "reasonable limitation" may have influenced the buy-up requirement of § 1034. Beyond that, the limitation on the home sale preference may have been simply an administrative convenience, as Congress borrowed the rollover mechanism from the existing involuntary conversion provision.⁷⁴

A. The Rollover Mechanism

With little fanfare, Congress enacted the rollover rule as a brief clause at the end of the home sale preference, itself almost an afterthought to the Revenue Act of 1951.⁷⁵ Although Congress could have excluded all home sale profits from taxation, it adopted a more limited approach. Through the mechanism of a qualified tax deferral – expressed through the rollover rule – Congress restricted the preference to those transactions in which taxpayers replaced their old homes with new residences that cost at least as much as the adjusted sale price of the old. On its face, the rollover rule created a temporary tax deferral. In practical effect, in connection with other Code provisions, that deferral often functioned as a permanent tax exclusion.⁷⁶

Capital gains are not taxed until they are both realized and recognized, concepts that postpone taxation from the year in which a taxpayer has enjoyed an increase in wealth until some later point in time.⁷⁷ As with other gains, those associated with personal residences are not realized until the year the property is sold rather than in the years that appreciation occurs.⁷⁸ After realization, most gains are recognized as taxable unless otherwise provided by the Code.⁷⁹ Certain transactions, however, are entitled to postponement of taxation under various "nonrecognition" rules such as former § 1034.

When taxation of the gain from a home sale was deferred, the cost or basis of the second residence was adjusted downward to reflect the nonrecog-

....

Most of the people who are called rich could more accurately be called middle-aged or elderly. They are not a class. They are an age bracket. When they were younger, they were usually in a lower income bracket.

143 CONG. REC. H6656 (daily ed. July 31, 1997) (statement of Rep. Crane) (quoting Thomas Sowell, *Liberals Are Mighty Generous with Definition of 'the Rich,'* CHI. SUN-TIMES, July 26, 1997).

74. See *infra* Part III.B.

75. Revenue Act of 1951, Pub. L. No. 82-183, § 318, 65 Stat. 452, 494.

76. See *infra* notes 85-87 and accompanying text.

77. See CHIRELSTEIN, *supra* note 18, ¶ 16.02, at 302-05.

78. See generally *Eisner v. Macomber*, 252 U.S. 189 (1920).

79. See I.R.C. § 1001(c) (1994) (stating that realized gains and losses are recognized unless otherwise provided in Code).

nized gain. Thus, if *X* purchased a personal residence in 1975 for \$100,000 and sold it in 1985 for an adjusted sales price of \$150,000,⁸⁰ *X* realized a gain of \$50,000. That gain qualified for nonrecognition under § 1034 if, within two years of the sale, *X* purchased a replacement home for at least \$150,000.⁸¹ The adjusted basis of the second home (if purchased for \$150,000) was \$100,000, reflecting *X*'s entire unrecovered investment in both homes.⁸² Suppose *X* (age 45) then sold the second home in 1995 for an adjusted sales price of \$200,000 and moved into an apartment. Because no nonrecognition rule applied to this second sale, *X* would have been taxed on a \$100,000 gain, the amount by which the sales price of the second residence exceeded its adjusted basis.⁸³ Thus, after a period of deferral, *X* finally paid a tax upon the \$50,000 gain from the sale of the first home, as well as upon the \$50,000 gain from the sale of the second home.

In theory, § 1034 postponed – but did not forgive – the obligation to pay tax on the gain from the sale of a residence. That postponement could be justified under the theory that the taxpayer's investment had been uninterrupted, even though the form of the investment had changed as one home was substituted for another.⁸⁴ In practice, however, home owners often avoided taxation altogether by continuously "buying up" until the taxpayer reached age 55 and qualified for a permanent exclusion from taxation of up to \$125,000 of gain.⁸⁵ Furthermore, if the taxpayer held the home until death, the heirs were taxed only to the extent that gains occurred after the taxpayer's death.⁸⁶ Thus, although § 1034 specifically provided only for the deferral of taxation, in many instances the relief it provided was the functional equivalent of a permanent exclusion of gain from the home seller's taxable income.⁸⁷

Mere deferral, however, also provided a significant benefit to the taxpayer. In the previous example *X* realized a \$50,000 gain from the sale of the first residence in 1985, but it was not recognized until 1995. Thus, *X*'s tax obligation had been deferred for a period of ten years. If the gain had been

80. See I.R.C. § 1034(b)(1) (1994) (repealed 1997) (defining adjusted sales price).

81. See I.R.C. § 1034(a) (1994) (repealed 1997) (stating how to qualify for nonrecognition of gain).

82. The adjusted basis of the second home equals its cost (\$150,000) minus unrecognized gain from the sale of the first home (\$50,000).

83. See I.R.C. § 1001(a) (1994) (discussing computation of gain for appreciated property).

84. See CHIRELSTEIN, *supra* note 18, ¶ 15, at 289.

85. See I.R.C. § 121 (1994) (amended 1997). For a discussion of § 121 and the 1997 amendment thereof, see *infra* Part VIII.

86. See I.R.C. § 1014 (1994) (stating general rule that basis of property acquired from decedent is fair market value of such property at date of decedent's death).

87. See CHIRELSTEIN, *supra* note 18, ¶ 15.02, at 296-97.

taxable at the rate of 28%,⁸⁸ then the ten-year deferral amounted to a tax-free government loan of \$14,000, the amount of tax. Assuming an interest rate of 8%, the 1985 value to X of the tax deferral would be \$6,485.⁸⁹

From its inception, the rollover rule's buy-up requirement limited the home sale preference. However, since 1921, Congress has limited other capital gains preferences by at least three mechanisms. First, preferences may be expressed as rate differentials. Under the Revenue Act of 1921,⁹⁰ taxpayers had the option of paying a flat tax of 12.5% on long-term capital gains, rather than normal and surtax rates well in excess of 70%.⁹¹ Today's Code continues to implement a rate differential, taxing long-term capital gains at a maximum rate of 20% as compared to a maximum rate of 39.6% for ordinary income.⁹²

Second, Congress created a partial exclusion of gain from taxable income in response to the potential inequitable results of the rate differential. In 1929, one congressional committee observed that under the income tax rates in effect at the time, only 1.5% of all taxpayers benefitted from the rate differential and only 0.25% received a substantial benefit from the differential.⁹³ Subsequently, the Revenue Act of 1934 adopted a "step-scale plan" under which up to 70% of capital gains could be excluded from ordinary income, with the percentage varying in accordance with the length of time the taxpayer had held assets.⁹⁴ More recently, the partial exclusion mechanism of § 1202 (prior to amendment in 1993) allowed taxpayers to deduct 60% of certain long-term capital gains from gross income.⁹⁵ Yet another variation of the partial exclusion mechanism applied to older home sellers from 1964 to 1997, allowing them to exclude up to \$125,000 of gain from their gross incomes.⁹⁶

88. See I.R.C. § 1(h) (1994) (imposing 28% maximum tax rate on capital gains prior to amendment in 1997).

89. See CHIRELSTEIN, *supra* note 18, at 368. The present value (pv) of \$ A deferred t years from today at an interest rate of $r\%$ is computed according to the formula: $pv = A/(1+r)^t$. Thus, the present value of the tax owed by X is: $pv = \$14,000/(1.08)^{10} = \$6,485$.

90. Revenue Act of 1921, ch. 136, § 206(b), 42 Stat. 227, 233.

91. See Wells, *supra* note 61, at 14-15 (stating that during World War I, combined normal and surtax rates peaked at 77% for 1918, falling slightly to 73% for 1919 and 1920).

92. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 311, 111 Stat. 788, 831-32 (codified as amended in scattered sections of 26 U.S.C.).

93. See Wells, *supra* note 61, at 20 n.36 (citing JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, SUPPLEMENTAL REPORT ON CAPITAL GAINS AND LOSSES (Comm. Print 1929)).

94. *Id.* at 21.

95. See I.R.C. § 1202 (1985) (repealed in 1986 and reinstated in different form in 1993). See generally CHIRELSTEIN, *supra* note 18, ¶ 16.01, at 298-301.

96. See I.R.C. § 121 (1994) (amended 1997) (illustrating variation of partial exclusion of gain mechanism applied to older homesellers); see also *infra* Part VIII.A.

In 1997, Congress expanded the partial exclusion to include home sellers of all ages, finally replacing the rollover rule.⁹⁷

Yet a third mechanism provides for the qualified deferral or postponement of taxation. Congress first applied this mechanism in 1921 to the special case in which the sale of assets was deemed an "involuntary conversion" rather than a voluntary sale.⁹⁸ Under that provision, gain resulting from the involuntary conversion of property into cash due to theft, fire, or condemnation was not recognized as taxable if it satisfied one important requirement. That qualification – the prototype for the rollover rule of § 1034 – required that the proceeds be reinvested in property of a similar character to the original property.⁹⁹

Was the buy-up requirement of the rollover rule an appropriate mechanism for limiting the home sale preference of § 1034? Recall first the broader issue of whether or not capital gains in general should be taxed preferentially.¹⁰⁰ If taxation of capital gains indeed creates an impediment to the mobility of capital,¹⁰¹ then tax deferral under the rollover rule might be a good solution to the problem.¹⁰² This justification for the rollover rule, however, loses its force in the specific context of home sales. In that case, Congress was concerned primarily about preventing hardship to home owners, rather than promoting efficient investment choices.¹⁰³ As an intuitive matter, a tax levied on home sales appears more likely to reduce a family's standard of living than a tax on the sale of profitable investments.

Ironically, as demonstrated later in this Article, Congress applied the rollover rule in the context where it was least desirable – to home sales – thus

97. See *infra* Part VIII.B.

98. See *infra* Part III.B. In 1921, the original involuntary conversion provision allowed for reinvested sale proceeds to be excluded permanently from taxation. Revenue Act of 1921, ch. 136, § 214(a)(12), 42 Stat. 227, 241-42. Three years later the provision was amended, providing that taxation would be deferred rather than permanently forgiven, for qualifying taxpayers. See Revenue Act of 1924, ch. 234, § 203, 43 Stat. 253, 256-57. See generally Dettmers v. Commissioner of Internal Revenue, 430 F.2d 1019, 1022 (6th Cir. 1970).

99. See I.R.C. § 1033 (1994). The "conversion" occurs typically when the taxpayer receives insurance proceeds or a condemnation award as compensation for lost property. See generally Marjorie E. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 S. CAL. L. REV. 397 (1987). The "like-kind exchange" provision of I.R.C. § 1031, originally enacted in 1921, was also an antecedent of the rollover rule of § 1034.

100. See *supra* Part II.B.

101. See *supra* note 62 and accompanying text.

102. See CHIRELSTEIN, *supra* note 18, ¶ 16.02, at 304-05 (citing C. Blum, *Rollover: An Alternative Treatment of Capital Gains*, 41 TAX L. REV. 383 (1986)).

103. See H.R. REP. NO. 82-586, at 27 (1951), reprinted in 1951 U.S.C.C.A.N. 1781, 1808; *infra* Part IV.C.

creating the potential for great harm to the natural environment.¹⁰⁴ At the same time, the buy-up requirement produced no significant countervailing benefit to the national fisc. In actual operation, most home sellers enjoy something akin to a permanent exclusion of gain from taxable income,¹⁰⁵ with only 4% of home sales generating tax revenues for the federal treasury.¹⁰⁶ The legislative history of the Revenue Act of 1951¹⁰⁷ provides no definitive explanation why Congress linked tax relief for home sellers to the price of the replacement home. Although the Act generated some four hundred pages of legislative history,¹⁰⁸ the home sale preference evoked a scant nine pages of consideration,¹⁰⁹ and the rollover rule was the subject of virtually no congressional debate.¹¹⁰ Despite the silence of the legislative record, one can make certain inferences of congressional intent by referring back to the Revenue Act of 1921,¹¹¹ under which Congress enacted the first capital gains preferences.

B. *Converting the Involuntary Conversion Provision*

The sparse legislative history of § 1034, as well as its text, suggest that it was patterned after the involuntary conversion provision of § 1033. First enacted in 1921, the precursor to § 1033 provided tax relief to those who had suffered an "involuntary conversion" of capital assets into cash proceeds.¹¹² Congress had enacted the provision in response to the government requisition or condemnation of ships during World War I.¹¹³ If ship owners were taxed on the resultant "gain" – the difference between the government condemnation award and the original purchase price – they would not have sufficient funds with which to purchase replacement ships. In a letter to the Ways and Means Com-

104. See *infra* Part VII.B.

105. See *supra* notes 85-87 and accompanying text.

106. *Education Hearings*, *supra* note 9 (statement of Donald C. Lubick).

107. Revenue Act of 1951, Pub. L. No. 82-183, § 318, 65 Stat. 452, 494.

108. See H.R. CONF. REP. NO. 82-1179 (1951), *reprinted in* 1951 U.S.C.C.A.N. 2121, 2121-2170; S. REP. NO. 82-781 (1951), *reprinted in* 1951 U.S.C.C.A.N. 1969, 1969-2098; H.R. REP. NO. 82-586 (1951), *reprinted in* 1951 U.S.C.C.A.N. 1781, 1781-1942. If one includes transcripts of congressional debate in the legislative history, then the record is even more voluminous.

109. See S. REP. NO. 82-781, pt. 1 at 34-37, *reprinted in* 1951 U.S.C.C.A.N. 1969, 2004-06; H.R. REP. NO. 82-586, at 27-29, *reprinted in* 1951 U.S.C.C.A.N. 1781, 1808-10; 97 CONG. REC. 11603 (1951) (statement of Sen. George), *reprinted in* 1951 U.S.C.C.A.N. 2099, 2118-19; 97 CONG. REC. 6891 (1951) (statement of Rep. Doughton), *reprinted in* 1951 U.S.C.C.A.N. 1943, 1947.

110. See *generally* 97 CONG. REC. 6889-98, 11,597-12,383 (1951).

111. Revenue Act of 1921, ch. 136, 42 Stat. 227.

112. See *generally* *Filippini v. United States*, 200 F. Supp. 286 (N.D. Cal. 1961), *aff'd*, 318 F.2d 841 (9th Cir. 1963).

113. See *American Natural Gas Co. v. United States*, 279 F.2d 220, 225-26 (Ct. Cl.) (citing in part letter from Secretary of the Treasury to Committee on Ways and Means).

mittee, the Secretary of the Treasury described the hardship created by the taxation of gains resulting from such forced sales.¹¹⁴ The Secretary concluded that,

[t]o require the taxpayer to pay income and war profits and excess profits taxes upon the difference between the cost . . . and the compensation received at the time of requisition or loss would have been to take such a large proportion of the amount received for the vessel that, although the owner desired to replace the same, the taking of the tax by the Government would have made it impossible in practically every instance.¹¹⁵

Thirty years later, Congress was well aware of the involuntary conversion provision as it drafted the new home sale preference. Representative Forand, a Rhode Island Democrat and member of the Ways and Means Committee, introduced the home sale preference.¹¹⁶ The Congressman justified his committee's proposal as hardship relief, necessitated in large part by the national defense crisis.¹¹⁷ The exigencies of war permeated the analysis, suggesting that taxpayer moves were prompted by the labor needs of the World War II and post-World War II defense industry rather than by personal choice.¹¹⁸

Congressman Forand emphasized two points in support of the provision. First, he argued that many home sales were "involuntary" – Americans moved from one city to another to satisfy the labor needs of the defense industry.¹¹⁹ In fact, he compared home sales to involuntary conversions. In support of this analogy, he discussed a hypothetical Mr. Smith who worked for the government in Washington for thirty years until he "was ordered" to move to Chicago.¹²⁰ In arguing that it was unfair to tax the capital gain resulting from the sale of Mr. Smith's home in Washington, the Congressman concluded that "[i]n practical fact, although not technically under the law, Mr. Smith had an involuntary conversion."¹²¹

Second, Congressman Forand emphasized the lack of a subjective profit motive.¹²² That is, home owners generally sell their property out of necessity, rather than out of a desire to generate a profit.¹²³ The congressman stated,

114. *Id.* at 226.

115. *Id.*

116. 97 CONG. REC. 6960 (1951) (statement of Rep. Forand).

117. *Id.*

118. See, e.g., H.R. REP. NO. 82-586, at 27 (1951), reprinted in 1951 U.S.C.C.A.N. 1781, 1808 (stating that involuntary moves are "particularly numerous in periods of rapid change such as mobilization or reconversion").

119. 97 CONG. REC. 6960 (1951) (statement of Rep. Forand).

120. *Id.* at 6961.

121. *Id.*

122. *Id.*

123. *Id.*

"Gains resulting from switches of personal residences are . . . not in the same category as gains from the sale of other capital assets since they are ordinarily not obtained as a result of a desire to make profit in the usual sense of the word."¹²⁴

The statutory text of § 1033 and § 1034 further supports the inference that the rollover rule was adapted from the involuntary conversion provision. Both provide for the deferral of gain, but only to the extent that the taxpayer replaces the original property or home with an equally expensive substitute. At the time of the 1951 legislative debate, the involuntary conversion provision provided:

Involuntary Conversion. If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith . . . expended in the acquisition of other property similar or related in service or use to the property so converted, . . . no gain shall be recognized, but loss shall be recognized. *If any part of the money is not so expended, the gain, if any, shall be recognized, to the extent of the money which is not so expended.*¹²⁵

Thirty years after the enactment of the involuntary conversion provision, Congress revisited the same issue: how to provide relief from the capital gains tax when wartime circumstances resulted in the forced liquidation of assets. Congress's 1951 response, the rollover rule, relied heavily upon the earlier legislation:

[G]ain (if any) from such [home] sale shall be recognized only to the extent that the taxpayer's selling price of the old residence exceeds the taxpayer's cost of purchasing the new residence. . . .¹²⁶

The justifiability of such an adaptation depends upon whether homes and ships are functionally equivalent as capital assets.

C. A Case of Mistaken Identity: Is a Home Like a Ship?

Although convenient, the analogy between ship condemnations and home sales proves inapt. Admittedly, there is at least a superficial similarity be-

124. *Id.*

125. I.R.C. §112(f) (1939) (emphasis added).

126. Revenue Act of 1951, Pub. L. No. 82-183, § 318, 65 Stat. 452, 494; *see also* 97 CONG. REC. 6961 (1951). As an additional rationale supporting the deferral of the capital gains tax, Congressman Forand noted that capital losses from home sales were not deductible from net income, even though losses from the sale of other capital assets were deductible "against capital gains or against ordinary income." *Id.* He suggested that this anomaly was inequitable and should be corrected. *Id.*

tween the two provisions. Both involve transactions that generally are not profit-driven, and both provide a sympathetic case in which taxation seems to impose an unfair hardship upon the property owner. In both cases, Congress claimed that certain sales or exchanges of assets should not be recognized as taxable events if the status quo were restored within a reasonable time and the investment continued. One important difference overshadows these similarities: Ships are movable, whereas homes are fixed in a specific geographic location. As a result, ship owners can search a national market for replacement property. In contrast, family or work constraints generally confine home shoppers to a particular region.

Why does this difference matter? The answer turns upon the identification of those who are deserving of tax relief.¹²⁷ If Congress wanted to single out involuntary transactions for special relief, then continuity of investment might be a useful surrogate for the measurement of merit. That is, if taxpayers expeditiously replace their lost assets, then perhaps we can assume that they never freely parted with those assets in the first instance. But, how should we measure continuity of investment? Should we require that assets be replaced with property of similar kind or similar cost? By applying the latter test to both homes and ships, Congress failed to recognize the difference between movable and immovable property. In the case of home sales, the rollover rule's cost-based analysis may be a clumsy test for identifying those involuntary sellers who are entitled to tax relief.

For example, suppose that *Y* owned a modest two bedroom, one bath, 1000 square foot home in Honolulu, Hawaii. *Y* had purchased the home in 1950 for \$150,000, but it had appreciated in value to \$350,000.¹²⁸ Assume also that an accident seriously injured *Y*'s adult child. *Y* reluctantly sells the Hawaii home to care for the child in Des Moines, Iowa, where the median home price was \$50,000.¹²⁹ If *Y* buys a two bedroom, one bath, 1000 square foot home in Des Moines for \$50,000, does *Y* deserve the protection of the home sale preference? If we take Congress at its word,¹³⁰ then *Y* would seem to be a deserving candidate for tax relief. After all, the sale of *Y*'s home was not truly voluntary, nor was it prompted by a profit-motive. On the other hand *Y* clearly does not qualify for rollover treatment under § 1034 even though *Y* replaced the Hawaii home with a virtually identical property in Iowa.

127. See *supra* notes 67-69 and accompanying text (discussing Americans' complex attitudes about wealth and taxation).

128. See BUREAU OF THE CENSUS, U.S. DEP'T OF COM., COUNTY AND CITY DATA BOOK 716 (12th ed. 1994) (stating that in 1990 median value of homes in Honolulu was \$353,900).

129. *Id.* at 740 (stating that in 1990 median value of homes in Des Moines was \$49,500).

130. The home sale preference was introduced as a measure to prevent hardship to those who sold their homes unwillingly and without profit-motivation. See *supra* Part III.B.

Suppose instead that *Y* parted involuntarily with a ship, rather than a home. Assume that *Y*'s ship had been destroyed by a submarine during World War I.¹³¹ *Y* had purchased the ship for \$150,000, but it was worth \$350,000 at the time of its destruction.¹³² In compensation for the loss, *Y* received a check for \$350,000.¹³³ *Y* searched throughout the country for a similar ship, and purchased a replacement for \$350,000.¹³⁴ In this case, *Y* is clearly entitled to tax relief.¹³⁵ Not only has *Y* replaced the lost ship with virtually identical property, but *Y* has expended the full \$350,000 in so doing.¹³⁶ Thus, *Y* deserves relief under both the replacement-in-kind and replacement-cost tests of merit.¹³⁷

Why does the rollover rule appear to be an adequate test of merit for the conversion of ships, but not homes? Two explanations are possible. First, perhaps the rule *is* adequate in both cases. If there is a potential discontinuity between articulated legislative purpose and the statutory mechanism chosen to implement that purpose, then one could argue that the latter should prevail. Thus, we might conclude – despite legislative pronouncements to the contrary – that the purpose of the home sale preference was simply to reward those who buy up, without regard to hardship or subjective motivation. Alternatively, we might conclude that the rollover rule *is not* adequate in the context of the home sale preference because it encourages overspending beyond that necessary to replace the original home. Through its repeal of the rollover rule in 1997, Congress implicitly endorsed the second explanation.¹³⁸

IV. The Revenue Act of 1951

As discussed in the previous Part, there was a poor fit between the rollover rule and the goals of the home sale preference. The rule was at cross-purposes with the preference, measuring the subjective motivation of the seller (involuntary sale lacking a profit motive) with an objective ruler (cost of new residence). Why did Congress do such a poor job of providing the desired relief? The political context against which Congress enacted the preference provides a partial explanation for the apparent lapse in reason.

131. See *Hearings Before the Comm. on Finance, U.S. Senate, 67th Cong. 55* (1921) (statement of Dr. T.S. Adams, Tax Adviser, Treasury Department) (explaining similar example).

132. See *id.*

133. See *id.*

134. See *id.*

135. See *id.*

136. See *id.*

137. See *id.*

138. See *infra* Part VIII.B.

Congress acted against a unique political backdrop, poised between the eras of traditional war and cold war. The post-war mood of the 1951 Congress suggests three reasons why the predecessor to § 1034 may have received inadequate legislative scrutiny and attention to detail. First, the home sale preference was subsumed in the larger debate of how to balance a federal budget burdened by past war debts while simultaneously preparing for the uncertain defense needs of the new cold-war era. As a result, Congress was concerned more with protecting federal revenues than providing tax relief. Second, the preference garnered a surprising, widespread support in the midst of an otherwise hostile debate. In 1951, the dream of home ownership finally appeared within the reach of many Americans.¹³⁹ Due to its broad appeal, the preference may have passed too easily, without the checks and balances inherent in vigorous bipartisan debate.¹⁴⁰ Third, the ubiquitous political grandstanding common to every era may have prompted legislators to articulate noble policies incapable of realization. The promise to protect the seller who is pure of heart (untainted by profit-seeking) was reduced, perhaps inevitably, to the mathematical precision of the rollover rule.

A. War and Taxes

One can best understand the Revenue Act of 1951¹⁴¹ in the context of the historical relationship between war and taxes. By mid-century, Congress had firmly established the pattern of raising war revenues through increases in the federal income tax.¹⁴² Prior to World War I, the federal income tax was of relatively minor importance to the national treasury, providing less than 10% of federal funds.¹⁴³ The financial needs of the war, however, provided the impetus for a significant increase in the income tax.¹⁴⁴ During the period 1913

139. A Census Bureau publication states that "[o]wning one's home has long been considered a part of the American Dream." HOMEOWNERSHIP, *supra* note 37. The article notes that "The post-World War II surge was remarkable. A booming economy, favorable tax laws, a rejuvenated home building industry, and easier financing saw homeownership explode nationally, topping 60 percent in just two decades." *Id.*

140. The home seller preference continues to generate bipartisan support. During the 1996 presidential campaign, both candidates endorsed an expanded tax break for home sales. See Passell, *supra* note 37, at 33 ("[B]roadening the capital gains exemption [for home sales is] a deficit-conscious Presidential candidate's dream. Here, after all, is a tax break with great popular appeal that requires only modest offsetting revenues.").

141. Revenue Act of 1951, Pub. L. No. 82-183, 65 Stat. 452.

142. JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 79 (1985) (describing war periods as "the single most important influence on the formation and structure of the [income and general] tax code").

143. *Id.* Excise and customs taxes provided the remaining 90% of federal revenues. *Id.*

144. The modern income tax was not adopted until 1913, after the passage of the Sixteenth

to 1915, the highest marginal tax rate on individual income was 7%.¹⁴⁵ By 1918, marginal rates had increased more than tenfold, to a maximum of 77%.¹⁴⁶ As a result, the tax generated almost 60% of federal revenues.¹⁴⁷ Thus, the income tax had been discovered as a bountiful source of revenue to finance the war effort.

During World War II, Congress again raised taxes to support the military budget. By 1944, the maximum marginal rate on individual income had reached a staggering 94%.¹⁴⁸ In addition, Congress broadened the tax base to include a greater percentage of Americans.¹⁴⁹ In the decade before the war, fewer than 5% of Americans were required to pay income tax.¹⁵⁰ Between 1940 and 1945, however, the income tax burden spread from approximately 7 million to 42 million Americans.¹⁵¹

In sum, both world wars enjoyed considerable popular and congressional support, with concomitant increases in the rate of taxation.¹⁵² But even during those relatively popular wars, congressional willingness to accommodate executive budget requests was short-lived. One tax historian explains:

In considering the financing of the major wars in this century, Congress began in each case with quick, decisive, and bipartisan action, granting most of what the president requested. As the wars progressed, however, revenue increases became much more controversial, and Congress strongly asserted itself in rewriting administrative proposals. . . . What this progression demonstrates is that only in those early months of almost hysterical reaction to crisis can revenues easily be raised in the United States. At all other times, gains will be traded only for losses granted elsewhere in the

Amendment resolved constitutional issues. *Id.* at 75-78.

145. The surtax ranged from 1% (on taxable income up to \$20,000) to 7% (on taxable income over \$500,000). JOSEPH A. PECHMAN, *FEDERAL TAX POLICY* 243 (1987). In addition, a modest "normal tax" was also imposed upon individual income. JACOB MERTENS, *LAW OF FEDERAL INCOME TAXATION* § 2.02 (1989).

146. The tax ranged from 6% (on taxable income up to \$4000) to 77% (on taxable income over \$1,000,000). PECHMAN, *supra* note 145, at 243.

147. WITTE, *supra* note 142.

148. Individual Income Tax Act of 1944, Pub. L. No. 78-315, §§ 3, 4(a), 58 Stat. 231, 231-32 (establishing marginal rates that ranged from 22% of income over \$2000 to 91% of income over \$200,000); *see* PECHMAN, *supra* note 145, at 301 (stating maximum marginal rate reached 94% during World War II).

149. Carolyn C. Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 *BUFF. L. REV.* 685, 685 (1989).

150. *Id.* (citing LAWRENCE H. SELTZER, *THE PERSONAL EXEMPTIONS IN THE INCOME TAX* 62 (1968)).

151. Jones, *supra* note 149, at 686 (citing BUREAU OF THE CENSUS, U.S. DEP'T OF COM., SER. NO. Y 402-411, *HISTORICAL STATISTICS OF AMERICA* 1110 (1975)).

152. WITTE, *supra* note 142, at 83.

code, and the trading seems to continue to the point where no one is satisfied but few can afford to see the bill defeated.¹⁵³

In 1951, President Truman faced two obstacles as he submitted his cold-war budget to Congress. First, the current "war" in Korea was of a new kind, one unlikely to trigger widespread public fervor. Second, the war-induced momentum in support of tax increases – if it had ever existed – had dissipated long before the passage of the Revenue Act of 1951.

B. From Hot War to Cold War

Congressional discomfort with the emerging cold war contributed to the bitter tone of the 1951 debate. On June 25, 1950, North Korea invaded South Korea.¹⁵⁴ Four days later, after communist troops reached Seoul, President Truman sent U.S. forces to defend the southern republic.¹⁵⁵ Based upon the nation's past experience, one might expect that Congress would willingly increase taxes to support the President's military expenditures. In fact, such a spirit of cooperation did exist, but only for a limited period of time prior to the debate over the 1951 Act. On September 23, 1950, Congress increased revenues by \$6.1 billion, and on January 3, 1951, Congress provided for an additional \$3.9 billion revenue increase.¹⁵⁶

The bipartisan momentum had dissipated by the time President Truman submitted his annual budget to Congress on January 15, 1951.¹⁵⁷ The projected defense expenditures for 1952 were \$41 billion – more than twice the amount spent for defense in 1951.¹⁵⁸ The prevailing antideficit philosophy was "pay as you go."¹⁵⁹ Accordingly, Truman's budget sought to raise \$10 billion in new federal revenues from a variety of sources, including a \$4 billion increase in the personal income tax.¹⁶⁰ Congress criticized the Presi-

153. *Id.* at 143-44.

154. 3 COUNCIL ON FOREIGN RELATIONS, ENCYCLOPEDIA OF U.S. FOREIGN RELATIONS 30 (Bruce W. Jentleson & Thomas G. Paterson eds., 1997). After World War II, Korea had been divided informally along the 38th parallel, with the northern portion under the administration of the Soviet Union and the southern portion under the administration of the United States. *Id.* at 25. Following elections sponsored by the United Nations in southern Korea, the Republic of Korea (ROK) was formed on August 15, 1948. *Id.* The Soviet Union responded by supporting the formation of the communist Democratic People's Republic of Korea in the north. *Id.*

155. *Id.* at 31.

156. See S. REP. NO. 82-781, at 1 (1951), reprinted in 1951 U.S.C.C.A.N. 1969, 1969; see also WITTE, *supra* note 142, at 137-41 (describing how Finance Committee acted "quickly in the bipartisan spirit typical of previous early wartime legislation").

157. See 97 CONG. REC. 11,721-22 (1951); 97 CONG. REC. 6956 (1951).

158. WITTE, *supra* note 142, at 140.

159. *Id.*

160. *Id.*

dent's budget as excessive, and the battle over the 1951 Act was protracted and bitter.

What caused Congress to abandon its historical attitude of wartime cooperation with the executive branch? Several factors may help to explain this failure to support the Korean war effort enthusiastically. First, the President had ordered U.S. troops to Korea without a declaration of war by Congress.¹⁶¹ A Congress that had not been part of the decision to engage in war might be disinclined to authorize funding for such a war. As one historical account noted wryly, "Truman saw little need to consult Congress – except when he wanted the \$69.5 billion Korean War bill paid."¹⁶²

Second, the United States had not developed clear foreign policy goals with respect to Korea. The United States had a long history of ambivalence toward the Korean peninsula, approving Japanese control over the peninsula from 1905 to 1940.¹⁶³ When World War II ended nearly a half-century of Japanese domination, the United States suddenly found itself responsible for the administration of South Korea.¹⁶⁴ The United States was a reluctant protector at best.¹⁶⁵ Only six months before the outbreak of hostilities in Korea, for example, the Secretary of State had declared that South Korea was not within the U.S. defense perimeter.¹⁶⁶ Thus, Congress may not have been willing to increase taxes to protect a nation that had traditionally been considered peripheral to the United States' security interests.

An examination of domestic politics supplies a third explanation of why the 1951 tax debates were polarized rather than cooperative. The Democratic party had held the presidency for nearly two decades.¹⁶⁷ By mid-century, the

161. See Louis Fisher, *The Korean War: On What Legal Basis Did Truman Act?*, 89 AM. J. INT'L L. 21, 21 (1995); 3 COUNCIL ON FOREIGN RELATIONS, *supra* note 154, at 32; see also JOHN W. SPANIER, *THE TRUMAN-MACARTHUR CONTROVERSY AND THE KOREAN WAR* 44-48, 58-64 (1965).

162. 3 COUNCIL ON FOREIGN RELATIONS, *supra* note 154, at 32.

163. Through the Taft-Katsura Agreement of 1905, the United States acknowledged Japanese domination over Korea in exchange for Japanese recognition of the American presence in the Philippines. *Id.* at 24.

164. After World War II, the United States and the Soviet Union agreed to a division of the peninsula, with the United States occupying the territory south of the 38th parallel and the Soviets occupying the area north of that parallel. See ROBERT J. DONOVAN, NEMESIS, TRUMAN AND JOHNSON IN THE COILS OF WAR IN ASIA 15-16 (1984).

165. See 3 COUNCIL ON FOREIGN RELATIONS, *supra* note 154, at 25 ("In the early postwar years the United States's policy toward Korea . . . was half-hearted. Washington's main purpose was to shed the responsibilities for Korea it inherited as a consequence of victory over Japan.").

166. *Id.*

167. Franklin D. Roosevelt held the presidency for twelve years before Truman took office in 1945. See 1 COUNCIL ON FOREIGN RELATIONS, *supra* note 154, at 277.

Republicans were eager to recapture the office. As one newspaper editorial stated in late 1949, there was a "rising revolt" in the Republican party that could have led to "junking the bipartisan foreign policy in the hope that some partisan advantage could be salvaged from the resulting discord."¹⁶⁸ The debate over the 1951 Revenue Act illustrates the disintegration of bipartisanship, with the Republicans accusing the Democratic administration of promoting taxing and spending policies that were not in the best interests of the nation.

Finally – and perhaps most importantly – the fundamental nature of war changed as the "cold war" era began.¹⁶⁹ Typical of the new breed of conflict, the Korean War was a frustrating experience for the United States. Unlike World War II, there was no decisive military victory but simply a containment of Soviet communist influence to the northern portion of the Korean peninsula.¹⁷⁰ There was no formal end to the war because South Korea never signed the truce agreement.¹⁷¹ Indeed, there was not even a clear acknowledgment that the United States had been at "war," for President Truman insisted that the conflict was simply a "police action."¹⁷²

Taken together, these factors set the stage for a protracted budget battle between the political parties. Republicans and Democrats were locked in a deadly embrace because both shared the "pay-as-you-go" philosophy.¹⁷³ As a result, both were determined to balance the federal budget by offsetting federal expenditures with federal tax revenues.¹⁷⁴ The parties disagreed, however, about how to structure that balance. In particular, the issue of how to treat capital gains was a divisive topic, cast primarily in terms of rich against poor.¹⁷⁵

168. SPANIER, *supra* note 161, at 44-45 (quoting uncited 1949 *Washington Star* editorial).

169. See 1 COUNCIL ON FOREIGN RELATIONS, *supra* note 154, at 273.

170. 3 COUNCIL ON FOREIGN RELATIONS, *supra* note 154, at 32.

171. Although a truce was declared on July 27, 1953, South Korea never signed the agreement. *Id.* at 26.

172. See Fisher, *supra* note 161, at 33-34.

173. WITTE, *supra* note 142, at 140.

174. For example, one Senator stated:

Inflation is our greatest danger. . . . For the first time in the history of the United States the Federal debt exceeded the national income in a single year in 1942. Until 1942, when we were in the middle of World War II, the national income of all the people of the United States far exceeded the national debt. . . . [T]hrough all the wars of this country, through all its crises, even through the great depression of 1929, our national income was far greater than our national debt.

97 CONG. REC. 11,830 (1951) (statement of Sen. O'Mahoney).

175. *Id.* at 11,723 (statement of Sen. Humphrey) ("It would violate every test of equal sacrifice to ask the man in the street to pay higher excise and income taxes when the rich

The Republican minority asserted that the budget should be balanced by reducing expenditures, not by increasing taxes. The Republicans reacted strongly against President Truman's budget requests and claimed that his proposed expenditures were excessive.¹⁷⁶ Republican congressmen claimed that they were "stunned"¹⁷⁷ by the President's "spending orgy"¹⁷⁸ that would propel the nation into socialism and "a most dangerous situation" of inflation.¹⁷⁹ Using terminology that is still popular today, the Republicans criticized the President's "tax and spend" philosophy.¹⁸⁰ In particular, the minority representatives argued that the President's excessive tax increases would unduly penalize wealthy¹⁸¹ and corporate¹⁸² taxpayers. The Republicans opposed any increase in the rate of capital gains taxation, claiming that an increase would deter capital investments and ultimately would reduce federal revenues.¹⁸³

become richer through our failure to close loopholes.").

176. One Republican congressman stated that he was "stunned by the size of President Truman's budget for 1952," under which proposed federal spending for 1952 exceeded "the total Federal spending for any 10 successive years added together in the history of our Nation up to the beginning of the fiscal year 1942." *Id.* at 6956 (statement of Rep. Martin); *see also id.* at 6956 (statement of Rep. Simpson) ("We have scraped the bottom of the tax barrel . . . [and] are now in the wood.").

177. *Id.* at 6956 (statement of Rep. Martin).

178. *Id.* at 6957 (statement of Rep. Martin) ("High taxes cannot offset the inflationary impact of such a governmental spending orgy as we have witnessed during the past 20 years."); *see also id.* at 6952 (statement of Rep. Simpson) (complaining that "the job of balancing the budget is an almost impossible job when those in charge of spending are on a spending spree" and that "if this administration is given a dollar it will spend a dollar and twenty cents or more").

179. *Id.* at 6952 (statement of Rep. Simpson); *see also id.* at 6952 (statement of Rep. Fulton) (complaining that increased taxes will "cut down the incentive to hustle, to work, and to produce, which is inflationary").

180. *Id.* at 6954 (statement of Rep. Simpson) ("But the thing I am worried about is the fact the more we tax the more they are going to continue to spend and I say we cannot continue indefinitely doing that.").

181. *Id.* at 6953 (statement of Rep. Simpson) (complaining that past "soak-the-rich" tax policies have "wiped out that group of taxpayers who have in the past been paying a large share of our tax burden").

182. *Id.* (statement of Rep. Simpson) (favoring special corporate tax concessions because "our tax laws so penalize our corporations that they do not have the money with which to expand" and asserting that business must expand "if the industrial might of America is to help us win this war in Korea").

183. *Id.* at 11,722 (statement of Sen. Millikin) ("If [we] want to get revenue out of capital gains, the way to get it is to . . . decrease the rate."); *id.* at 11,722-23 (statement of Sen. Millikin). Senator Milliken noted:

If [we] were to lengthen the time and increase the rate, and thus sterilize the movement of capital . . . [we] would not be helping the income base with greater income, and thus we would not be collecting any more income taxes. . . . [T]he

In response, the Democrats favored balancing the budget by raising the tax on income generally and on capital gains in particular. They labeled their Republican counterparts "calamity howlers" and "gloomy Jeremiahs scream[ing] socialism."¹⁸⁴ In a poignant appeal, one congressman argued that willingness to sacrifice and pay higher taxes was necessary to preserve democracy for centuries to come:

This Nation and all free nations are now engaged in another struggle, a struggle not merely of armies but of ideologies, a struggle, the outcome of which may determine for centuries to come whether freemen shall live in peace under free governments of their own choosing. . . . And although heavy taxes are necessary, the sacrifices we shall have to make to pay them is small indeed compared to the sacrifices made by the youth of our Nation who defend us. Let us have faith in our country, faith in our people, and do our simple duty.¹⁸⁵

The Democrats supported an increase in the maximum capital gain tax rate from 25% to 37.5%.¹⁸⁶ They contended that capital gain preferences were nothing more than "class legislation" favoring the wealthy at the expense of progressive taxation.¹⁸⁷ One Senator noted that increasing the rate differential between capital gains and ordinary income through preferences for the former would encourage circumvention of the tax code. The senator compared this transformation of earned income into capital gain to the efforts of feudal alchemists to transform base metals into gold.¹⁸⁸ In addition, the Democrats

lower the rate and the shorter the period of time, the greater the amount of capital transactions, and therefore the greater the amount of capital gains will be.

Id. (statement of Sen. Millikin).

184. *Id.* at 6955-56 (statement of Rep. Combs).

185. *Id.* (statement of Rep. Combs).

186. *See, e.g., id.* at 11,720-21 (statement of Sen. Humphrey) (supporting increase in maximum capital gains tax from 25% to 37.5% and asking why Finance Committee did not "believe in increasing tax burdens of recipients of capital gains, even in the slightest degree, as the burdens on wages and other incomes are increased").

187. *Id.* (statement of Sen. Humphrey). Senator Humphrey claimed that capital gains rates must be raised to keep pace with the increases in other income taxes "to protect the basic equity of the individual income tax." *Id.* At the time, there was a fragile consensus that the federal tax system should be progressive, imposing a proportionately greater burden upon those with greater incomes. *See* Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905 (1987); Walter J. Blum & Harry Kalven, *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952); Edwin S. Cohen, *Reflections on the U.S. Progressive Income Tax: Its Past and Present*, 62 VA. L. REV. 1317 (1976).

188. 97 CONG. REC. 11,720 (1951) (statement of Sen. Humphrey).

[A]fter four hundred or five hundred years of fruitless searching on the part of the scientists of those days, they never did convert base metal into gold. We had to

feared that capital gain preferences would erode the tax base and reduce federal revenues generally.¹⁸⁹

The mood of Congress in 1951 was, therefore, highly contentious. Consensus on any tax reform measure appeared unlikely. In particular, one could not have predicted that the home sale provision could survive the Democratic hostility toward capital gain preferences. Nevertheless, the preference transcended economic and political lines and attracted bipartisan support.

C. A Bipartisan Oasis: The Home Sale Preference

The House debated the 1951 Act for almost two days before turning the discussion to the home sale preference. The proposal received broad support from both Democratic and Republican legislators.¹⁹⁰ In fact, not a single Congressman spoke out against the provision in the published floor debates.

What political factors could account for this oasis of bipartisan agreement within an otherwise hostile deliberation? Why would Congress agree to a tax relief measure in a bill whose purpose was primarily to raise federal revenues? Particularly surprising was the fact that the home sale provision had been drafted at the initiative of the Democrats.¹⁹¹ After all, they had argued strenuously against expanding the general preference for capital gains, claiming that such tax breaks were simply "class legislation" that relieved the wealthy of the obligation to pay their fair share of the national tax burden.¹⁹² The Democrats attempted to explain this apparent inconsistency by identifying the expected beneficiaries of the proposal. As he introduced the provision, Representative Forand¹⁹³ entered two tables into the record which he purported would demonstrate that the personal residence provision would particularly assist low-income taxpayers.¹⁹⁴ His data suggested that a large majority

wait for the modern tax lawyer to do that. . . . He has an ever-increasing productive program of how to convert earned income [always taxed at higher rates] into capital gains.

Id.

189. Senator Humphrey argued, "[I]f we keep whacking away at this ordinary income base, even though we have high rates, we will find that we shall have nothing to draw from, because ordinary income is being converted into capital gains, which are being given the preferential type of treatment." *Id.* at 11,721.

190. In the House of Representatives, Congressmen Simpson and Mills spoke in favor of the provision. *Id.* at 6952-56. In the Senate, Republican Long spoke in favor of the bill. *Id.* at 11,721.

191. See *supra* note 116 and accompanying text.

192. See *supra* note 187 and accompanying text.

193. See *supra* note 116 and accompanying text.

194. 97 CONG. REC. 6961-62 (1951).

of home owners in the United States were of low income.¹⁹⁵ Thus, the Democrats could join the Republicans in supporting a capital gain preference without abandoning their nonwealthy constituents. The Republicans also welcomed the home sale provision as legislation that would promote the interests of their party. The special deferral of taxation of the gain resulting from home sales was consistent with their support of the capital gains preference in general.¹⁹⁶ At the same time, wealthy home sellers would certainly benefit from the provision along with their poorer counterparts.

An even more basic explanation can account for this bipartisan agreement: The home sale provision may have provided relief to weary congressmen as well as to arguably over-taxed home owners. That is, after the rancorous debate over other provisions of the 1951 Act, the legislators may have embraced this opportunity for congenial consensus.¹⁹⁷ Furthermore, the cost was relatively minor. Compared to the President's proposal to generate over four billion dollars in new revenues through increased taxation,¹⁹⁸ the personal residence provision was projected to result in a revenue loss of only \$112 million.¹⁹⁹

V. The Unintended Consequences of the Rollover Rule: Three Hypotheses

As discussed in the previous Part, Congress failed to analyze carefully or to debate thoroughly the purpose of the rollover rule.²⁰⁰ Instead, the legislators simply assumed that the limited home sale preference would provide hardship relief to otherwise over-taxed home owners. It would not be surprising, therefore, if over time the actual effects of the rule deviated substantially from those anticipated by Congress in 1951. In particular, § 1034 may have relieved one type of hardship, but only by placing several new burdens upon the taxpayer and the landscape. These potential, unexpected consequences include: (1) over-investment in housing, (2) inflated housing prices in certain geographic areas, and (3) the conversion of farmland into suburban housing developments.

Part V examines the expected behavior of "rational taxpayers," those whose housing choices are influenced by a desire to maximize their economic

195. Representative Forand stated that in 1949, buyers with incomes below \$5000 accounted for 71% of all home purchases (excluding farms). *Id.*

196. *See supra* note 183 and accompanying text.

197. When the home sale provision was introduced in the House, the mood changed abruptly from one of mud-slinging to one of congenial back-slapping. *See* 97 CONG. REC. 6961 (1951).

198. *See supra* note 160 and accompanying text.

199. 97 CONG. REC. 6962 (statement of Rep. Forand).

200. *See supra* Part IV.

well-being. This Part describes how the buy-up requirement of the rollover rule may have influenced their behavior, unintentionally leading to the three results outlined above. Part VI moves from the realm of the hypothetical to the actual by presenting data on the sale of homes in Santa Clara County, California, and on the purchase of homes in Boulder County, Colorado. Through the case studies, numerous individual choices coalesce into a broader pattern of the collective. The goals of Parts V and VI are quite modest. They do not purport to prove that the rollover rule caused specific effects. Rather, they simply describe three potential, unanticipated consequences of the rule and present data that are consistent with those hypotheses.

A. Over-Investment in Housing

The rollover rule may have distorted the choice of home buyers, creating a strong incentive for over-investment in housing. Profit from the sale of a home – like any other capital asset – is taxed as capital gain in the absence of special relief provisions. For over seventy-five years, the Code has offered various preferences for capital gains in general, in part to assuage the fear that excessive taxation might lock capital into undesirable investments.²⁰¹

However, the generalized preference for capital gains has not provided adequate protection for home sellers. The family home differs in significant respects from other capital assets. Many view the home primarily as shelter and sanctuary rather than as a profit-making investment. Taxing home sales, therefore, has an aura of unfairness, particularly when the tax burden forces home sellers to "trade down" on each successive move into less desirable living quarters. Congress enacted the rollover rule in 1951 in an effort to relieve this perceived hardship.²⁰²

The rule, which remained in effect until 1997,²⁰³ provided only a partial cure for the home seller's financial woes. Congress could have excluded all gains on personal residences from income. Instead it simply deferred taxation

201. See *supra* note 62 and accompanying text. For a recent articulation of the "lock-in" argument in the context of the Taxpayer Relief Act of 1997, see 143 CONG. REC. S6397-98 (daily ed. June 26, 1997) (statement of Sen. Roth).

We are trying to free up hundreds of millions, if not billions, of dollars to the best investment available to help ensure that we are creating in this country an environment of growth, jobs, and opportunity . . . [and] in this competitive world of today and in this global economy, it is critically important that we [encourage more investment and] make the best utilization of the capital we have so that we are in a strong competitive position.

Id.

202. See *supra* Part IV.C.

203. See *infra* Part VIII.B.

for home owners who continued to purchase ever more expensive homes.²⁰⁴ With such a tempting option, the rational taxpayer would continue to buy up. In fact, taxpayers did exhibit this rational behavior, with only 4% of all home sales resulting in a taxed gain.²⁰⁵ This tax benefit was not without its costs, however. The rule encouraged people to buy more expensive homes than they needed or wanted, particularly when they moved from high-cost regions to low-cost areas. The rule may also have discouraged home sellers from moving into less expensive quarters and transferring a portion of their assets into higher-yield investments.²⁰⁶ Finally, those who encountered financial difficulties would incur a substantial tax penalty if they sold their homes because they needed cash for urgent expenditures.²⁰⁷ The net result of this compliance with the rollover rule may be a national over-investment in housing, locking investments into the housing market.²⁰⁸

How – if at all – did the rollover rule influence the housing choices of taxpayers? Consider the example of *X*, a taxpayer who sold a principal residence in Boston in order to take a new job in another city. *X* purchased the home twenty years ago for \$100,000 and sold it in 1994 for an adjusted sales price of \$150,000.²⁰⁹ The home was an ideal size to accommodate *X*'s family comfortably, and *X* wanted to buy or rent a similar residence in the new city. Suppose *X*'s new job was in San Francisco, where the cost of housing was generally higher than that of Boston.²¹⁰ While shopping for a new home,

204. See *supra* Part III.A.

205. See *supra* note 106 and accompanying text.

206. During the last two decades, the stock market has outperformed the real estate market. Funds invested in the stock market increased an average of 400% during that period of time, while assets invested in the real estate market increased at a rate less than that of inflation. *FY 98 Budget: Hearings Before the House Comm. on Ways and Means*, 105th Cong. (1997) (statement of Richard Woodbury, National Assoc. of Realtors), available in 1997 WL 8220306.

207. For many Americans, the home represents the family's most valuable asset, accounting for approximately one-fifth of individuals' total net worth. Jerome Kurtz, *The Interest Deduction Under Our Hybrid Tax System: Muddling Toward Accommodation*, 50 *TAXL. REV.* 153, 188 (1995) (citing BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *BALANCE SHEETS FOR THE U.S. ECONOMY 1945-1992*, at 25 (1993)); see also Erik M. Jensen, Book Note, 47 *CASE W. RES. L. REV.* 253, 256 n.17 (1996) ("The largest asset for a majority of American families is home equity.") (citing Michael J. Boskin, *A Framework for the Tax Reform Debate*, in *FRONTIERS OF TAX REFORM* 11, 24 (Michael J. Boskin ed. 1996)).

208. At the end of 1992, the value of all owner-occupied housing in the United States was \$6,671.1 billion. Kurtz, *supra* note 207, at 188.

209. After subtracting various expenses for work performed on the old residence in order to prepare it for sale, *X* has realized \$150,000 from the transaction. Using the terminology of § 1034, \$150,000 represents the adjusted sales price of *X*'s home. See I.R.C. § 1034(b) (1994) (repealed 1997) (defining adjusted sales price).

210. The 1990 median value of Boston homes was \$161,400. BUREAU OF THE CENSUS,

X realized that the \$150,000 proceeds from the sale of the old home would not go very far in the San Francisco housing market. In fact, that sum was sufficient to purchase only a smaller home of inferior quality in a less attractive neighborhood. What were *X*'s options? Ignoring tax consequences, *X* might have chosen to rent an apartment, at least for a sufficient period of time during which to accumulate savings toward the purchase of a more suitable home. Under § 1034, however, *X* was forced to reinvest the \$150,000 proceeds in a new home within two years or be subject to a tax liability of up to \$14,000.²¹¹ When facing such a choice, *X* might well have decided to purchase a home in San Francisco, even though at the time *X* could only afford a cramped and inferior replacement of the Boston residence. In sum, *X* would have "over-invested" in a home, even though renting would better have suited *X*'s needs.

Now, suppose instead that *X*'s new job was in Albany, New York, where housing was generally less expensive than in Boston.²¹² For \$100,000, *X* could purchase a home in Albany of similar size and quality to the former residence in Boston. Again, ignoring tax consequences, *X* might have chosen to purchase the \$100,000 home. The remaining \$50,000 from the Boston proceeds could have been applied to any one of a number of saving or spending options, such as purchasing a new car, investing in the stock market, financing the children's college education, or caring for elderly parents. Once again, though, § 1034 guided *X*'s decision. If *X* did not spend at least \$150,000 on a replacement residence, then *X* would owe tax on every dollar of gain that *X* did not reinvest in a new home. Thus, if *X* purchased a home in Albany for \$100,000, *X* would have owed \$14,000 in taxes on the remaining \$50,000,²¹³ leaving *X* with \$36,000 cash. Alternatively, *X* could have spent at least \$150,000 on a new home and paid no tax. In sum, *X* could have converted the \$150,000 Boston proceeds into either (1) a \$100,000 home plus \$36,000 cash or (2) a \$150,000 home. Under those circumstances, it is likely that *X* would have spent at least \$150,000 on a new home rather than give \$14,000 to the government in taxes. As a result, *X* bought "more house" than desirable simply to qualify for rollover treatment.

Every year, approximately four million homes are purchased in the

supra note 128, at 752. The 1990 median value of San Francisco homes was \$298,900. *Id.* at 692.

211. Capital gains are taxed at a lower rate than ordinary income. In the hypothetical, *X* has realized a gain of \$50,000 (the difference between the \$100,000 *X* paid for the house and the \$150,000 *X* realized from the sale of the house). Under I.R.C. § 1(h) prior to 1997, long-term capital gains were taxed at a maximum rate of 28%. See *infra* note 359 and accompanying text. Therefore, the maximum capital gains tax imposed on the proceeds from *X*'s sale of the Boston home would be $(.28) (\$50,000) = \$14,000$.

212. The 1990 median value of Albany, New York, homes was \$101,800. U.S. BUREAU OF THE CENSUS, *supra* note 128, at 788.

213. See *supra* note 211.

United States.²¹⁴ In each instance prior to 1997, § 1034 distorted individual investment decisions in at least two important ways. First, home owners were inclined to reinvest all the proceeds from home sales into replacement homes, thus skewing investment decisions in favor of housing over all other types of investments. As the San Francisco hypothetical illustrates, taxpayers became locked into home ownership, unable to move capital from housing to other investments without adverse tax consequences. Second, in the case where a taxpayer moved to a less expensive region, § 1034 again provided a strong incentive for home owners to over-invest in housing by forcing taxpayers into a larger home than they needed or wanted.

B. Inflation of Housing Prices

The rollover rule may also have contributed to the inflation of housing prices in certain geographic regions of the United States. This phenomenon is a function of at least two factors: (1) domestic population migration and (2) inter-regional disparity of home values. With respect to the first factor, the population of the United States has been shifting generally toward the "sunbelt" areas of the country. Between 1990 and 1995, for example, the South region²¹⁵ experienced a net domestic migration²¹⁶ of 2.09 million, and the Mountain division of the West²¹⁷ region showed a net domestic migration of 1.06 million domestic residents.²¹⁸ During that same period, in contrast, the Northeast

214. NATIONAL ASSOCIATION OF REALTORS, *supra* note 9, at 13; *see also Education Hearings*, *supra* note 9 (statement of Donald C. Lubick).

215. The United States Bureau of the Census includes the following states in its South census region: Alabama, Arkansas, Delaware, District of Columbia, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, Oklahoma, South Carolina, Virginia, West Virginia, Tennessee, and Texas. POPULATION DIVISION, BUREAU OF THE CENSUS, DEMOGRAPHIC COMPONENTS OF POPULATION CHANGE: JULY 1, 1995 TO JULY 1, 1996 (1996).

216. Net domestic migration is "the difference between domestic immigration to an area and domestic outmigration from it during the period." BUREAU OF THE CENSUS, *supra* note 215. Under that definition, the *actual* number of people entering an area might be substantially higher than the *net* immigrants. In addition, a region's actual population may grow due to births and international migration, even though its net domestic migration is negative. "Immigrants" are "those persons who entered a specified area by crossing its boundary from some point outside the area." BUREAU OF THE CENSUS, U.S. DEPT' OF COM., 1990 CENSUS OF POPULATION AND HOUSING, at B-32 <<www.census.gov/prod/1/90dec/cph4/appdxb.pdf>> "Outmigrants" are persons who depart from a specific area by crossing its boundary to a point outside it, but without leaving the United States." *Id.*

217. The United States Bureau of the Census includes the following states in its West census region, Mountain division: Arizona, Colorado, Idaho, Montana, Nevada, New Mexico, Utah, and Wyoming. BUREAU OF THE CENSUS, *supra* note 215.

218. BUREAU OF THE CENSUS, U.S. DEP'T OF COMM., STATISTICAL ABSTRACT OF THE UNITED STATES 30 (1996). Those statistics measure population change from April 1, 1990 to July 1, 1995. *Id.*

region²¹⁹ and the Pacific division of the West²²⁰ region experienced significant losses, with net domestic migrations of -1.7 million and -1.1 million, respectively.²²¹

The price of homes demonstrates significant variation from region to region. This interregional price disparity, coupled with domestic migration, created the potential for the rollover rule to contribute to the inflation of housing costs. Consistent with national migration patterns, consider a person who moved from San Francisco, California (Pacific division of the West region), to Houston, Texas (South region). In 1996, the average value of existing homes in San Francisco was \$259,082.²²² Under the rollover rule, the rational taxpayer would shop for a comparably priced home in Houston, even though the average price of a home in Houston was only \$78,444.²²³ Thus, the rollover rule would encourage overspending by more than 300% in order to avoid taxation. Over time, as millions of people migrated from one region to another, the cost of housing would increase in those locations that experienced a significant influx of home buyers from high-cost areas. Although many factors may have contributed to the inflation of housing costs, the rollover rule clearly exacerbated the problem.²²⁴

C. Conversion of Farmland into Suburban Housing

Finally, the rollover rule may have served as an incentive to accelerate the conversion of farmland into new suburban housing developments. Within many metropolitan areas, the population has been shifting from the central cities to the suburbs. Between 1985 and 1994, for example, the suburbs gained an annual average of 2.5 million persons due to domestic migration, while the cities lost an average of 2.4 million persons annually.²²⁵ As the population has migrated, it has spread out to occupy more land. Between

219. The Census Bureau's Northeast region includes Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, and Vermont. BUREAU OF THE CENSUS, *supra* note 215.

220. The Pacific division of the West region includes Alaska, California, Hawaii, Oregon, and Washington. *Id.*

221. BUREAU OF THE CENSUS, *supra* note 218, at 30. California alone suffered a net domestic migration of -1.5 million. *Id.*

222. Timothy M. Ito, *The Hottest Markets*, U.S. NEWS & WORLD REP., Apr. 1, 1996, at 67.

223. *Id.*

224. See, e.g., Louise Lee, *Flashy Homes Overrun Wal-Mart's Town*, WALL ST. J., June 27, 1997, at B12 (describing migration of wealthy Wal-Mart vendors from expensive areas such as Danville, California, to once-overlooked Bentonville, Arkansas; noting that longtime residents "blame Wal-Mart's suppliers for jacking up local housing prices"; and citing rollover rule as an incentive for new residents to buy expensive homes).

225. BUREAU OF THE CENSUS, U.S. DEP'T OF COM., TABLE A3 ANNUAL INMIGRATION, OUTMIGRATION, AND NET MIGRATION FOR METROPOLITAN AREAS (released December 1996) <<http://www.census.gov/population/socdemo/migration/tab-a-3.txt>>.

1970 and 1990, urban population density decreased by 23%.²²⁶ To accommodate this massive expansion, new homes have been built on open space or farmland surrounding the central cities, causing negative economic, social, and environmental impacts.²²⁷ Overall, the United States lost 153,217 farms between 1982 and 1987.²²⁸

This loss of farmland, to a large extent, may be a function of free-market forces and individual choice. But, it may also have been an unintended consequence of the rollover rule. To defer taxation under the old rule, the rational taxpayer who sold a personal residence would invest all of the gain from the sale into a replacement home. This may have been difficult to accomplish, particularly for those who moved from high-cost areas to less expensive regions.²²⁹ In that case, the new location may have had a scarcity of existing homes expensive enough to satisfy the rollover rule. As a result, the taxpayer would be most likely to purchase a new suburban home, often the most expensive housing in an area.²³⁰

Although commentators have attributed farmland loss to numerous federal laws and policies,²³¹ few have blamed the rollover rule. Most notably among those few, a Cleveland study concluded that "in metropolitan areas where values increase in an outward direction, [the rollover rule] contributes to urban decline by encouraging outmigration and obstructing movement inward."²³² The next Part presents two case studies that support the three hypotheses described above.

VI. *A Tale of Two Counties: A Case Study*

As this Part explains, California experienced a serious economic depression in the early 1990s. Many left the state in search of a better place to live, often choosing Colorado and other western states as their destination. As they moved, Californians sold some of the nation's most expensive

226. OREGON'S DEPARTMENT OF LAND CONSERVATION AND DEVELOPMENT, INDICATORS OF URBAN SPRAWL (May 1992) (citing *Census: Cities Take Over U.S.*, STATESMAN J., Dec. 18, 1991, at 5A) <<http://darkwing.uoregon.edu/~pppm/anduse/sprawl.html>>.

227. See *infra* Part VII.B.

228. *Farms, Net Change 1982-1987* (visited July 21, 1997) <<ftp://ftp.lib.virginia.edu/ssdc/ccdb/ccdb.32572/table14.html>>.

229. See *infra* Part VI.B.

230. *Id.*

231. See *infra* Part VII.A.

232. Thomas E. Bier & Ivan Maric, *IRS Homeseller Provision and Urban Decline*, 16 J. URB. AFF. 141, 141 (1994); see also Robert H. Freilich & Bruce G. Peshoff, *The Social Costs of Sprawl*, 29 URB. LAW. 183, 187-88 (1997) (explaining that capital gains home sale provision "effectively requires reinvestment in a more expensive home, typically located in suburban areas"); Jerry Frug, *The Geography of Community*, 48 STAN. L. REV. 1047, 1098 (1996) (describing Bier's Cleveland research as most careful study of decline of central cities and inner suburbs); *infra* note 310 and accompanying text.

homes.²³³ This California exodus – which reached a peak in 1993 and 1994 – offers an opportunity to test the hypotheses of the previous Part, providing a case study of a significant migration from high-cost to lower-cost areas of the country. To provide a manageable snapshot of the larger migratory picture, the study focuses on Santa Clara County, California, and Boulder County, Colorado.²³⁴ California in general, and Santa Clara in particular, supplied a substantial number of new residents to Boulder County, with the potential to exert a measurable influence upon the Boulder housing market:

Table 1: Number of California Immigrants v. Boulder County Home Sales

<i>Year</i>	<i>Santa Clara to Boulder Migration</i> ²³⁵	<i>California to Boulder Migration</i> ²³⁶	<i>Boulder County: Number of Home Sales</i> ²³⁷
1990	279	1113	2451
1991	218	1763	3409
1992	260	2065	4768
1993	295	2584	5547
1994	304	2742	4867
1995	240	2455	4390
1996	261	2335	4691

233. See *infra* note 241 and accompanying text.

234. The author chose Boulder County for the case study because it had been the author's home for many years, during which time the California migration to Colorado had been a popular topic of news and conversation. The author selected Santa Clara County for study because (1) each year between 1990 and 1996, it had been among the top four California counties whose residents moved to Boulder (including also Los Angeles, Orange, and San Diego Counties), see *infra* Part VI.B, and (2) of those four counties, Santa Clara provided the best comparison to Boulder in terms of the size of its population. See BUREAU OF THE CENSUS, *supra* note 128, at 46, 60 (showing selected 1990 county populations as 8.8 million for Los Angeles, 2.4 million for Orange, 2.4 million for San Diego, 1.4 million for Santa Clara, and 225,339 for Boulder).

235. Internal Revenue Service, County to County Migration Flows from Administrative Recordings (1990-1996) (providing unpublished data estimating county to county migration based upon the number of exemptions claimed by taxpayers) (on file with author).

236. *Id.*

237. Sales statistics were computed by the author from data supplied by Stefanie K. Schroeder, Computer Programmer, Boulder County Assessor. See Boulder County Assessor, Single Family and Condo/TWNHS Sales (New) for 1990-96 (July 29, 1997) [hereinafter Boulder County New Homes Sales] (unpublished data, on file with author) (providing data for new noncondominium homes in Boulder County); Boulder County Assessor, Single Family and Condo/TWNHS Sales (Existing Homes) for 1990-96 (July 31, 1997) [hereinafter Boulder County Existing Homes Sales] (unpublished data, on file with author) (providing data for existing noncondominium homes in Boulder County).

Data from this case study support the three hypotheses discussed in Part V, suggesting that the rollover rule (1) encouraged new Boulder residents to overspend on housing, (2) contributed to a dramatic increase in the cost of Boulder housing, and (3) stimulated the demand for the construction of new, suburban housing on farmland and open space.

A. Santa Clara County, California: 1990-96

It was the worst of times in California.²³⁸ Increasing unemployment, inflation, and costs of living had combined with devastating effect upon the state's economy, producing its most serious recession since the depression of the 1930s.²³⁹ In 1991, for example, the state's average unemployment rate was 7.7%, with some California counties staggering under unemployment rates as high as 21.3%.²⁴⁰ In 1990, California was the second most expensive state in the nation for housing, with a median home value of \$195,500.²⁴¹ In that year, only 55% of the state's residents owned their own homes, a rate considerably lower than the national average of 64%.²⁴² One county responded dramatically to these and other negative economic conditions: On December 6, 1994, Orange County declared bankruptcy.²⁴³ More commonly, Californians simply left the state in vast numbers in search of a more favorable economic climate. From 1992 through 1996, California's net domestic outmigration²⁴⁴ exceeded that of all other states,²⁴⁵ with an average net domestic migration exceeding -200,000.²⁴⁶ Other western states were the most

238. The title of Part VI and introductory sentences of Part VI.A are inspired by CHARLES DICKENS, *A TALE OF TWO CITIES* 3 (Dodd, Mead & Co. 1942) (1859).

239. Alex Berenson, *California's Problem is Growth*, DENV. POST, Feb. 26, 1995, at D1.

240. BUREAU OF THE CENSUS, *supra* note 128, at 67. The state's highest rate of unemployment (21.3%) occurred in Imperial county. *Id.*

241. *Id.* at 8 (providing median value of specified owner-occupied housing units, excluding mobile homes, houses with business or medical office, houses on 10 or more acres, and housing units in multi-unit buildings).

242. BUREAU OF THE CENSUS, U.S. DEP'T OF COM., CENSUS OF HOUSING (noting that California reached its 58.4% "high water mark" in 1960).

243. See Dennis J. Aigner, *Orange County: Pre and Post-Bankruptcy*, UC INSIGHT (Spring 1995) <<http://www.gsm.uci.edu/whatsnew/springucinsight95/uc4.html>>. Commentators blamed both the county's managers and the economic climate. See *id.* (calling Orange County a "laboratory, [sic] of financial mismanagement"); see also *Debt Issuance and Investment Practices of State and Local Governments: Hearings Before the Subcomm. on Capital Mkts., Sec., and Gov't Sponsored Enterprises of the House Comm. on Banking and Fin. Servs.*, 104th Cong. 12 (1995) (statement of Kurt Sjoborg, Auditor, State of California) (finding that Orange County employed high risk investment strategies that "reacted . . . with the 300 basis point increase in interest" to reach "a critical flashpoint").

244. See *supra* note 216.

245. See Paul Larmer & Ray Ring, *Can Planning Rein in a Stampede?*, HIGH COUNTRY NEWS, Sept. 5, 1994, at 6.

246. DEMOGRAPHIC RESEARCH UNIT, CALIFORNIA STATE DEP'T OF FINANCE, HISTORICAL

popular destinations, becoming the new homes of more than 150,000 Californians between 1992 and 1993.²⁴⁷ Colorado alone was the target of approximately 23,500 California outmigrants during that two-year period.²⁴⁸

If any California county could be immune from the state's financial difficulties, it might be Santa Clara. Situated at the southern tip of San Francisco Bay, the county begins less than 30 miles south of the city of San Francisco.²⁴⁹ Santa Clara boasts of a well-educated population²⁵⁰ and is the home of prestigious Stanford University.²⁵¹ In addition, the county has spawned a sophisticated high-technology center known as Silicon Valley.²⁵² Despite its advantages, however, Santa Clara also suffered from the California recession. The county's unemployment rate rose from 5.5% in 1991²⁵³ to

COUNTY POPULATION ESTIMATES AND COMPONENTS OF CHANGE JULY 1, 1990-1996 (1997) [hereinafter DEMOGRAPHIC RESEARCH]. California's net domestic migration figures are as follows:

Year	Net Domestic Migration
1992	-54,082
1993	-317,194
1994	-318,735
1995	-264,093
1996	-237,257

Id. Overall, however, the state's population increased during the 1991-1996 period from 30.5 million to 32.3 million. *Id.* The increase was due to immigration from other countries and to a natural population increase (the amount by which births exceed deaths). *Id.*

247. Larmer & Ring, *supra* note 245, at 6. Between 1992 and 1993, Californians moved to the following western states in the following numbers (rounded off to the nearest hundred): Nevada (29,200), Washington (27,100), Oregon (25,400), Colorado (23,500), Arizona (20,900), Idaho (11,300), Utah (9,400), New Mexico (4,600), Montana (2,000), and Wyoming (800). *Id.* Larmer & Ring's statistics are derived from driver's license transfers recorded by the California Department of Motor Vehicles and may underestimate the actual number of people moving from state to state by excluding nondrivers and those who failed to surrender their California licenses after leaving the state. *Id.*

248. *Id.*

249. See RAND McNALLY ROAD ATLAS 11 (1997).

250. In 1990, of the county's residents 25 years of age and older, 82% were high school graduates and 32.6% were college graduates (compared to a national average of 20.3%). Bureau of the Census, U.S. Dep't of Com., *USA Counties 1996 CD-ROM* [hereinafter *USA Counties*].

251. In 1997, Stanford University ranked fifth among 228 national universities. AMERICA'S BEST COLLEGES 1998, U.S. NEWS & WORLD REP. 70-71 (defining national universities based on categories established by Carnegie Foundation for the Advancement of Teaching).

252. See generally *Silicon Valley Online* (visited Feb. 16, 1998) <<http://www.silvalonline.com/history.html>> (providing area profile).

253. BUREAU OF THE CENSUS, *supra* note 128, at 67.

6.8% in 1993,²⁵⁴ and, like the rest of the state, Santa Clara suffered a dramatic exodus. From 1991 through 1996, the county had an average annual net loss of 11,155 domestic residents, approximately 7% of the county's population during that period.²⁵⁵

B. Boulder County, Colorado: 1990-96

Meanwhile, it was the best of times in Colorado. In 1991, the state's unemployment rate was 5%,²⁵⁶ with employment growing steadily from 1990 through 1995 at an annual rate of 3.9%.²⁵⁷ The cost of living was reasonable: In 1990, the median value of a Colorado home was \$82,700,²⁵⁸ less than half the cost of a home in California.²⁵⁹ In response to the state's strong economy, Colorado's population grew dramatically. Between 1990 and 1995, Colorado was the fourth fastest-growing state in the nation, with a 13.7% increase in total population.²⁶⁰ Many of the new residents were outmigrants from Cali-

254. CALIFORNIA DEP'T OF FINANCE, EMPLOYMENT AND UNEMPLOYMENT, CALIFORNIA AND METROPOLITAN AREAS (last modified Nov. 6, 1996) <http://www.dof.ca.gov/html/fs_data/stat-ab5/table5/cl.htm>.

255. DEMOGRAPHIC RESEARCH, *supra* note 246. Santa Clara County's net domestic migration figures are as follows:

<i>Year</i>	<i>Net Domestic Migration</i>
1991	-12,732
1992	-10,426
1993	-10,591
1994	-18,622
1995	-13,892
1996	-671

256. BUREAU OF THE CENSUS, *supra* note 128, at 67.

257. Doris Drury & Wilson Kendall, *Colorado's Economy*, DENV. BUS. J., May 17, 1996, available in 1996 WL 10036242 (explaining that Colorado's economy in the 1990s was rebounding "from the agricultural, oil and gas, and mining bust of the early 1980s"). During 1993, 68,600 new jobs were created in Colorado, the highest increase since 1984. *Boom With a View*, SUNDAY TIMES (Longmont), Mar. 27, 1994, at A1.

258. BUREAU OF THE CENSUS, *supra* note 128, at 66 (providing median value of owner-occupied housing, excluding mobile homes, houses with business or medical office, houses on 10 or more acres, and housing units in multi-unit buildings).

259. See *supra* note 241 and accompanying text. In 1990, the Colorado rate of home ownership was 62.2%. BUREAU OF THE CENSUS, *supra* note 242.

260. BUREAU OF THE CENSUS, *supra* note 218, at 7 (measuring state population change from April 1, 1990, to July 1, 1995). With the exception of Georgia and Texas, eight of the ten fastest-growing states for the period 1990 to 1995 were located in the West. Colorado's growth for the 1990-95 period was exceeded only by that of Nevada (27.3%), Idaho (15.5%) and Arizona (15.1%). *Id.* The annual growth rates in the West were comparable to that of Africa (2.93%), which has experienced the highest annual population growth of any continent in the

fornia. From 1991 through 1996, over 140,000 Californians moved to Colorado.²⁶¹

Boulder County shared in the state's economic boom, with a 1991 unemployment rate of only 3.5%.²⁶² The favorable economy was well-publicized. *Money* magazine named Boulder as one of the nation's top twenty areas in which to live.²⁶³ Similarly, *Entrepreneur* magazine listed the Boulder/Longmont area²⁶⁴ as one of the nation's top "entrepreneurial hot spots," citing its stable business climate, well-known university, high-technology employers, and "atmosphere of innovation and experimentation."²⁶⁵ The area attracted recognition for noneconomic reasons as well. Nestled against the foothills of the Rocky Mountains, the Boulder area contains 65,000 acres of parks and open space.²⁶⁶ In 1989, *Outside* magazine proclaimed the city of Boulder "the

world. See Richard D. Lamm, *The Real Bind Is Too Many People Everywhere*, HIGH COUNTRY NEWS, Sept. 5, 1994, at 19. In 1993, for example, annual western growth rates were as follows: Nevada (3.9%), Idaho (3.1%), Colorado (2.9%), Utah and Arizona (2.7%), New Mexico (2.2%), and Montana (2.1%). See *id.*

261. Telephone Interview with Susan Woods, Office Manager II, Driver Services, Colo. Dep't of Motor Vehicles (July 29, 1997). The estimated annual number of persons moving from California to Colorado are as follows:

Year	California to Colorado Migration
1991	18,123
1992	20,819
1993	25,188
1994	34,795
1995	19,608
1996	21,886
Total	140,419

Id. The above figures are based upon the annual number of California driver's licenses surrendered in Colorado and therefore may underestimate the total number of immigrants to Colorado. A Boulder County Commissioner estimated that about one-third of the state's newcomers were from California. Erik Wilmsen, *Will Quake Send People to Colorado?*, COLO. DAILY, Jan. 19, 1994, at 1.

262. BUREAU OF THE CENSUS, *supra* note 128, at 67.

263. Carla Fried, *The Best Places to Live in America*, MONEY, July 1997, at 132, 140 (ranking top 20 metropolitan areas of United States).

264. Boulder County includes a city of the same name. All references to "Boulder" refer to the county, unless clearly specified otherwise.

265. Karen Axelton et al., *The Nation's Entrepreneurial Hot Spots*, ENTREPRENEUR, Oct. 1996, at 122, 139-40 (listing city of Boulder as second-best small city in nation for small business).

266. BOULDER CHAMBER OF COM., BOULDER, COLORADO DEMOGRAPHICS 2 (1997) (listing recreational amenities of park land (6970 acres), city open space (25,000 acres), and county open space (33,000 acres)).

sports town" of the nation.²⁶⁷ Due in part to such favorable publicity, the county grew rapidly. From 1990 through 1996, the county's population increased approximately 16%,²⁶⁸ gaining an average of almost 2,900 more domestic residents each year than it lost.²⁶⁹ By far, the largest source of newcomers was California, supplying the county with an average of over two thousand new residents annually.²⁷⁰ By 1995, 10% of the population of the county's largest city (Boulder) consisted of immigrants from California.²⁷¹ In an effort to understand the effects of the rollover rule, the following sections

267. Stu Stuller, *15 Sporting Towns*, OUTSIDE, May 1989, at 85, 85.

268. The county's annual population was as follows:

<i>Year</i>	<i>Boulder County Population</i>
1990	224,950
1991	228,644
1992	234,350
1993	239,400
1994	247,500
1995	257,675
1996	260,950

Telephone Interview with Larry Mugler, Director, Development Services Division, Denver Regional Council of Governments (July 22, 1997).

269. *USA Counties*, *supra* note 250 (recording net domestic migration of 14,333 for 5-year period 1990 to 1995). The *actual* number of new domestic residents would be significantly larger than the *net* domestic migration of 14,333.

270. *See supra* note 236 and accompanying text. Almost half of the California to Boulder migrants were supplied by the four counties of Los Angeles, Orange, San Diego, and Santa Clara. The following table shows the total annual migration to Boulder County from those four California counties:

<i>Year</i>	<i>Four-County Immigration</i>
1990	1018
1991	1044
1992	1288
1993	1455
1994	1565
1995	1336
1996	1264

See Internal Revenue Service, *supra* note 235.

271. CENTER FOR POLICY AND PROGRAM ANALYSIS, CITY OF BOULDER, BOULDER CITIZEN SURVEY 30 (1995).

discuss the Boulder County housing market during the 1990-96 California migration.

1. *Over-Investment in Housing*

The first hypothesis suggests that the rollover rule would encourage over-investment in housing, particularly by those who moved to Boulder County from more expensive areas of the country. Survey results provide some support for this prediction. Residents of a large-lot, luxury development in Boulder County were polled by mail concerning the factors that influenced them to purchase homes in that development.²⁷² Virtually all respondents had complied with the buy-up requirement of the rollover rule, and only one household had paid a capital gains tax on the profit from the sale of its former residence. Approximately half of those responding stated that tax considerations had influenced their home purchase decisions. In particular, those respondents indicated that they wanted to buy a home at least as expensive as their former home to avoid taxation or that they would have considered buying a smaller or less expensive home but for the potential tax penalty.²⁷³ One respondent exclaimed, "[The tax laws have] driven our lives. It took building a custom home to buy one expensive enough to avoid the [capital gains tax]."²⁷⁴ The remaining half of the respondents stated that tax considerations had not influenced their choice of home.²⁷⁵ Anecdotal data supplied by Boulder real estate agents confirmed that tax avoidance may have been a significant motivation for those who chose to "trade up" to more expensive homes.²⁷⁶

272. Surveys were mailed to 73 households in the Somerset development in Boulder County, with 23 responses returned to the author. The survey is reproduced as Appendix A, *infra* p. 468. A 1997 promotional brochure described the development as "Boulder County's most elegant executive community" with home prices ranging from \$800,000 to \$1,000,000.

273. The survey asked, "Did the tax laws have any influence on your decision to buy your current home?" Appendix A, *infra* p. 468. Of 23 responses, 11 checked one or both of the following answers: (a) "Yes, we wanted to buy a home at least as expensive as our former home so that we wouldn't have to pay the capital gains tax," and/or (b) "Yes, if it weren't for the capital gains tax, we might have considered buying a smaller or less expensive home." Responses to Home Purchase Survey conducted by the author (1997) (unpublished data, on file with author).

274. Responses to Home Purchase Survey, *supra* note 273.

275. Twelve respondents indicated that tax considerations had not influenced their housing decision. Perhaps these respondents simply wanted to purchase their dream homes, without regard to tax avoidance. A 1993 housing survey conducted by the Census Bureau suggested that 25% of recent movers cited their desire for a better or larger home as the reason for leaving their previous unit. CENSUS BUREAU, U.S. DEP'T OF COM., AMERICAN HOUSING SURVEY, 1993 AHS-N DATA CHART (1993).

276. The author conducted telephone interviews of five Boulder County real estate agents for luxury developments. All agreed that the capital gains tax potentially influenced buyers to

2. Inflation of Housing Prices

In 1990, the average Santa Clara home cost more than twice as much as a home in Boulder County, with prices remaining well above their Boulder counterparts through 1996:

Table 2: Average Value of Noncondominium Homes in Santa Clara and Boulder

Year	Santa Clara County ²⁷⁷	Boulder County ²⁷⁸
1990	\$260,500	\$128,500
1991	251,500	133,000
1992	250,000	148,000
1993	247,000	169,500
1994	245,000	195,500
1995	251,500	201,500
1996	264,000	212,000

Consistent with the second hypothesis, one would expect newcomers from Santa Clara to over-invest in housing, contributing to an inflation of home prices in Boulder County.

Data derived from actual home sales support that prediction. Boulder housing prices increased sharply, particularly during 1992 to 1994 when the migration from California and Santa Clara County reached its peak. As the price of Boulder housing approached that of Santa Clara, the rate of increase diminished:

purchase more expensive homes than they might otherwise have purchased. Telephone Interview with Vicki Moselle, Colorado Landmark Realtors (Aug. 1997) (noting that people bought more house than they wanted under rollover provision, and some will probably scale down after rule is no longer in effect); Telephone Interview with Tracie Thede, Griffin Mktg., Inc. (Aug. 1997) (claiming that buyers from northern California, in particular, were interested in spending all of proceeds from sale of their former residences); Telephone Interview with Terri Johnson, RE/MAX of Boulder, Inc. (Aug. 1997) (asserting that capital gains tax may have helped to create luxury home market, causing people to reinvest all of their sale proceeds in replacement home, even if they would prefer to buy smaller home); Telephone Interview with Stan Meade, Wild View Land Co. (Aug. 1997) (stating that capital gains tax induced some people, particularly those from California, to buy up); Telephone Interview with Bets Sholten, Perry & Butler Realty, Inc. (Aug. 1997) (noting that 1997 changes in capital gains tax may induce some home owners to "trade down").

277. Telephone Interview with John Karevoll, Financial Editor, DataQuick Info. Sys., La Jolla, California (Sept. 25, 1997) (providing median value).

278. Boulder County New Homes Sales, *supra* note 237 (providing mean values, rounded to nearest \$500); Boulder County Existing Homes Sales, *supra* note 237 (same).

Table 3: Annual Change in Boulder County Home Sale Prices²⁷⁹

Year	% Change From Previous Year
1991	3.5
1992	11.3
1993	14.5
1994	15.3
1995	3.0
1996	5.2

Anecdotal evidence also supports the prediction, consistent with the view that California migrants drove up the price of housing throughout the West. In a whimsical essay, one western newspaper defined the term "Californian" as an "imprudent spender single-handedly responsible for inflated values of real property."²⁸⁰

3. Conversion of Farmland into Suburban Housing

As a third unintended consequence, the rollover rule may have accelerated the conversion of Boulder County farmland into suburban housing developments. To minimize their tax liability, newcomers from California needed to purchase homes of value greater than or equal to the value of their former residences. But – at least in the early years of the California migration – the average Boulder County home simply did not cost enough to satisfy this requirement. As a result, the rollover rule limited the new residents' housing choices in two important ways.

First, the rule discouraged the immigrants from moving into neighborhoods within the city limits²⁸¹ because the average city home cost far less than the average home in Santa Clara County:

279. *Id.*

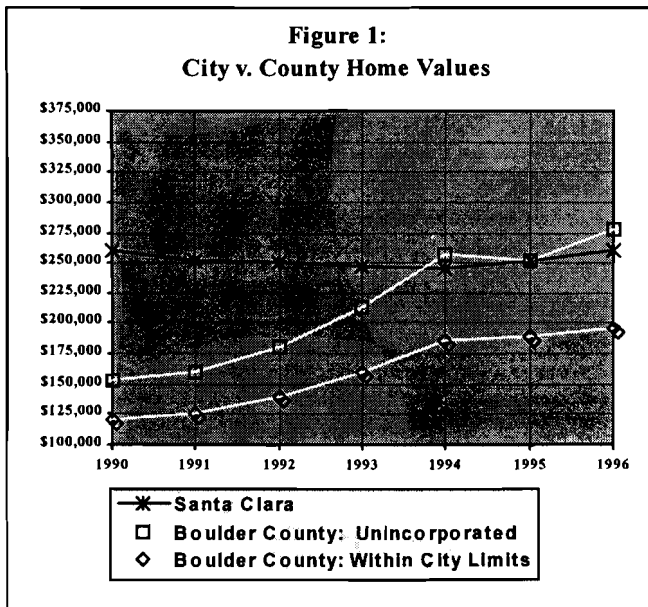
280. John Walker, *Excerpts From a New West Dictionary*, HIGH COUNTRY NEWS, Sept. 29, 1997, at 16. Another article, published by the same newspaper, described the influx of Californians into Montana as creating a "demand on real estate [that] has shot home prices up." See Cindy Wehling, *Montana Town Puts Out Unwelcome Mat*, HIGH COUNTRY NEWS, Jan. 24, 1994 <<http://www.hcn.org/1994/jan24/dir/wr2.html>>. The article also noted a growing animosity toward the wealthy new residents, citing the T-shirt slogan, "Beautify Montana: Put a Californian on a bus." *Id.*

281. Boulder County includes the following incorporated cities and towns: Boulder, Broomfield, Erie, Lafayette, Longmont, Louisville, Lyons, and Superior. BOULDER COUNTY COMMISSIONERS' OFFICE, GROWTH WATCH 6-7 (Summer 1997) [hereinafter GROWTH WATCH].

Table 4: Average Sale Price of Noncondominium Homes – City v. County

Year	Santa Clara County ²⁸²	Boulder County ²⁸³	
		Unincorporated County	Within City Limits
1990	\$260,500	\$152,500	\$120,500
1991	251,500	159,000	125,500
1992	250,000	179,500	139,500
1993	247,000	212,500	159,500
1994	245,000	257,000	186,000
1995	251,500	252,500	189,000
1996	264,000	277,000	196,000

Instead, the new residents would tend to search for housing in the unincorporated county, where prices more closely approximated those of Santa Clara County:



Second, beyond forcing the new residents into the county, the rollover rule required them to purchase new rather than existing county homes. Even

282. See *supra* note 277 and accompanying text.

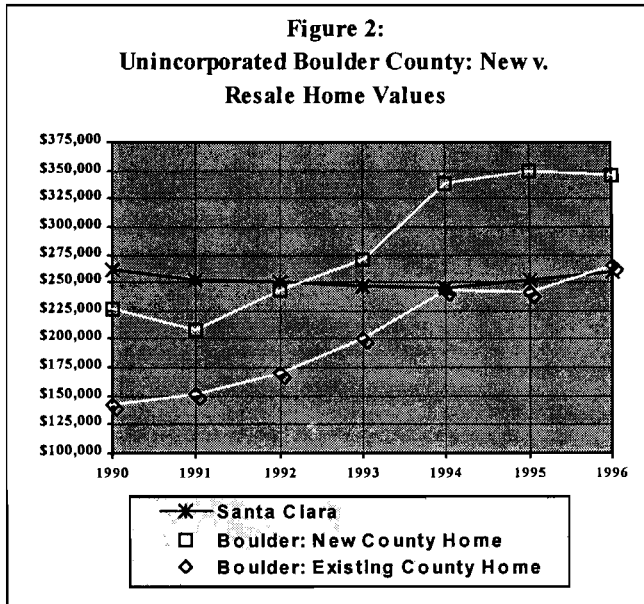
283. Boulder County New Homes Sales, *supra* note 237 (mean sale price of noncondominium homes); Boulder County Existing Homes Sales, *supra* note 237 (same).

in unincorporated Boulder County, the average county resale did not cost enough to avoid taxation until sometime in 1994:

Table 5: Average Sale Price of Noncondominium County Homes – New v. Resale

Year	Santa Clara County ²⁸⁴	Unincorporated Boulder County ²⁸⁵	
		New	Resale
1990	\$260,500	\$226,500	\$141,500
1991	251,500	208,500	151,500
1992	250,000	243,000	170,500
1993	247,000	270,000	201,500
1994	245,000	337,500	243,000
1995	251,500	350,000	240,500
1996	264,000	346,500	265,000

Thus, to satisfy the rollover rule and minimize their tax liability, the new residents needed to purchase new homes located in unincorporated county areas:



284. See *supra* note 277 and accompanying text.

285. Boulder County New Homes Sales, *supra* note 237 (providing mean sale price of noncondominium homes, rounded to nearest \$500); Boulder County Existing Homes Sales, *supra* note 237 (same).

Throughout the peak of the California migration period, only new homes in unincorporated Boulder county were of equal or greater value than Santa Clara homes. Therefore, as predicted by the third hypothesis, compliance with the rollover rule by new residents from Santa Clara and other expensive areas would lead to the conversion of farmland and open space into new housing developments.²⁸⁶ Construction data support this prediction, as the peak California migration period coincides with an increase in new residential construction in Boulder County:

Table 6: *New Homes Sales in Boulder County*²⁸⁷

Year	New Sales
1990	399
1991	702
1992	1122
1993	1663
1994	1184
1995	827
1996	975

Many of the new homes were built on rural or agricultural lands. Between 1959 and 1987 – the generation during which the rollover rule was in effect – Boulder County experienced a 46% decline in total farmland and rangeland, a 38% decline in total cropland, and a 47% decline in irrigated land.²⁸⁸ Between 1975 and 1997, the area of cities and towns in Boulder County more than doubled from thirty-nine square miles to eighty-one square miles, expanding into the farmlands of the county.²⁸⁹ On a statewide level, Colorado agricultural land is now converted to housing and suburban services at an average rate of ten acres per hour, 250 acres per day, or 90,000 acres per

286. The construction of new homes *within* the city limits might also lead to the destruction of farmland, particularly if constructed upon newly annexed land along the city/county periphery. Due to Boulder County’s land use regulations, property must be annexed to an adjacent city or town prior to high-density development. See GROWTH WATCH, *supra* note 281, at 1 (noting that “annexations result in the bulk of Boulder County’s growth” and that “[s]ince 1984, Boulder County communities have annexed more than 12,800 acres, or 20 square miles of land, for development”).

287. Boulder County New Homes Sales, *supra* note 237 (providing sales data for non-condominium homes).

288. RESOURCE ANALYSIS SECTION, COLORADO DEP’T OF AGRIC., COLORADO AGRICULTURAL LAND TRENDS (1994).

289. GROWTH WATCH, *supra* note 281, at 3.

year.²⁹⁰ This loss of farmland is difficult to justify, particularly if it was simply the unanticipated consequence of a poorly understood provision of the tax code.

Thus, this case study supports the hypothesis that the rollover rule caused serious, unintended consequences to the American taxpayer and to the American landscape. The tax incentive for the destruction of farmland was primarily a function of increasing residential prices as one moves out of the central cities and into the county. As this study illustrates, the phenomenon of expensive suburbs surrounding a less expensive city center was not confined to aging, industrial cities.²⁹¹ Rather, the rollover rule acted as a magnet to deter investment from vibrant cities²⁹² as well as those in decline.

VII. Rethinking Suburbia: The American Dream Becomes the American Nightmare

The American landscape is vast and startling in its beauty. The Founders treasured this seemingly inexhaustible supply of land, envisioning a nation of yeoman-farmers as the pillar of a democratic society.²⁹³ Thomas Jefferson proclaimed passionately that "[t]hose who labor in the earth are the chosen people of God. . . . Corruption of morals in the mass of cultivators is a phenomenon of which no nation has furnished an example."²⁹⁴ The post-industrial vision is a variation of the Jeffersonian ideal, recognizing that most

290. COLORADO DEP'T OF AGRIC. & THE GOVERNOR'S TASK FORCE ON AGRICULTURAL LANDS, A REPORT ON THE CONVERSION OF AGRICULTURAL LAND IN COLORADO (1995).

291. See *supra* Part VI.B.III.

292. Despite the rollover rule, the city of Boulder's population continues to increase:

Year	<i>City of Boulder Population</i>
1993	90,987
1994	94,346
1995	95,665
1996	95,442
1997	95,662 (estimated)

1997 *Boulder County Almanac*, BOULDER DAILY CAMERA, June 22, 1997, Special Section, at 23.

293. See JAMES HOWARD KUNSTLER, *HOME FROM NOWHERE* 28 (1996) (noting that American desire for individual dwelling place in natural landscape developed, in part, as response to European system under which "[o]rdinary people not already in possession of land as yeomen had little hope of acquiring a scrap [of land] of their own").

294. Steven C. Bahls, *Preservation of Family Farms - The Way Ahead*, 45 DRAKE L. REV. 311, 323 (1997) (citing BASIC WRITINGS OF THOMAS JEFFERSON 161 (Philip S. Foner ed., 1944)).

Americans will toil as employees rather than as farmers.²⁹⁵ Nevertheless, a romanticized image of country living continues to inform our collective vision of the ideal life. The modern American Dream, perhaps, can be described generally as the desire to live in a single-family home on a large suburban lot, tucked away in a wooded cul-de-sac neighborhood a secure distance from the crime and turmoil of the city.

A splendid ideal, the dream has persisted, in one form or another, for over two hundred years. Nevertheless, one can characterize the modern incarnation of the Jeffersonian vision as an American nightmare. The dream of suburban home ownership is woefully inadequate in at least two respects. First, it has remained an elusive goal, unattainable for many Americans. And second, the dream has many hidden economic, social, and environmental costs that are not borne by those who enjoy suburban life. In short, the dream celebrates a nonsustainable lifestyle, available only to an increasingly elite segment of the population.²⁹⁶

A. *The Causes of Sprawl*

The pursuit of suburban life has led to what many commentators describe as "suburban sprawl." In 1974, a landmark study on residential development patterns – *The Costs of Sprawl* – used the term "sprawl" to describe low-density, single-family homes sited at the urban fringe of metropolitan areas.²⁹⁷ Over time, the definition has generally been stated in a less neutral fashion, recognizing the negative impacts of sprawl development: It is "poorly-planned, land-consumptive, automobile-dependent [and] designed without regard to its surroundings."²⁹⁸ Two features are particularly striking as depart-

295. By 1995, less than 3% of the population engaged in farming. Bahls, *supra* note 294, at 323 (citing BUREAU OF THE CENSUS, U.S. DEP'T OF COM., STATISTICAL ABSTRACT OF THE UNITED STATES 417 (1995)).

296. See Frug, *supra* note 232, at 1073 (arguing that prevailing urban and zoning policies have had "enormously destructive consequences for American life," including the "simultaneous creation of poor African American neighborhoods and of privileged, mostly white, suburbs"). For suggested alternatives to modern sprawl, see KUNSTLER, *supra* note 293, at 29; Andres Duany & Elizabeth Plater-Zyberk, *The Second Coming of the Small Town*, UTNE READER, May-June 1992, at 97. See generally PETER CALTHORPE, *THE NEXT AMERICAN METROPOLIS: ECOLOGY, COMMUNITY, AND THE AMERICAN DREAM* (1991); PETER KATZ, *THE NEW URBANISM: TOWARD AN ARCHITECTURE OF COMMUNITY* (1991). For legislative attempts to control sprawl, see OR. REV. STAT. §§ 197.005-.860 (1991) (leading to establishment of "urban growth boundaries" that geographically contain urban development from encroachment upon rural land).

297. REAL ESTATE RESEARCH CORP., *THE COSTS OF SPRAWL, EXECUTIVE SUMMARY 2* (1974) [hereinafter *THE COSTS OF SPRAWL*]. The study was prepared by the Real Estate Research Corporation for the Council on Environmental Quality, the Department of Housing and Urban Development, and the Environmental Protection Agency.

298. Freilich & Peshoff, *supra* note 232, at 185, *quoted in* LINCOLN INSTITUTE OF PUBLIC

ures from the traditional town or city. First, residential uses are segregated from industrial and commercial uses, with the result that people do not live within convenient proximity to work, retail businesses, and community meeting places such as libraries and coffee shops. And second, development is spread out over large tracts of land, making it virtually impossible for residents to walk to their destinations. In sum, sprawl developments contain all of the elements of the traditional town – such as housing communities, office parks, and shopping centers – but those elements have been combined poorly.²⁹⁹

What causes sprawl? Contrary to what intuition might suggest, population growth probably has not been a direct cause of this phenomenon. In the Chicago metropolitan area, for example, land use increased by 46% in a twenty-year period, even though the population increased by only 4%.³⁰⁰ Similarly, in the Kansas City metropolitan region, land development increased by 110% between 1960 and 1990, although urban and suburban population increased by only 29%.³⁰¹ Thus, factors other than population growth contribute to sprawl.

Originally, sprawling development patterns may have been a rational response to the industrial revolution. As late-nineteenth century cities became polluted and overcrowded, people sought refuge in the surrounding countryside just outside the urban boundaries.³⁰² As one commentator explains, "Americans' historical experience of city life has been of a bleak, relentless, noisy, squalid, smoky, smelly, explosively expanding, socially unstable, dehumanizing sinkhole of industrial foulness congested with ragtag hordes of gabbling foreigners."³⁰³ The urban exodus gained momentum in the 1920s as the increased availability of the automobile made suburban life a feasible alternative for many urban dwellers.³⁰⁴ The suburban migration gained addi-

POLICY, ALTERNATIVES TO SPRAWL 4 (1995).

299. Richmond, *supra* note 3, at 331 n.23 (citing Duany & Plater-Zyberk, *supra* note 296, at 97) ("These elements have the makings of a great cuisine, but they have never been properly combined.").

300. Frug, *supra* note 232, at 1097 (citing Paul Glasstis, *A Tale of Two Suburbias*, U.S. NEWS & WORLD REP., Nov. 9, 1992, at 34).

301. As a result, average density declined from approximately 3,500 people per square mile to about 2,150 per square mile. Freilich & Peshoff, *supra* note 232, at 185 (citing Chris Lester & Jeffrey Spivak, *Divided We Sprawl: Suburbs Can't Escape the Cost of Separation*, K.C. STAR, Dec. 17, 1995, at A-1; Jeffrey Spivak & Chris Lester, *Divided We Sprawl: U.S. Fosters Society of Separation*, K.C. STAR, Dec. 18, 1995, at A-10); see also OREGON DEP'T OF LAND CONSERVATION & DEV., INDICATORS OF URBAN SPRAWL (May 1992) <<http://darkwing.uoregon.edu/~pppm/landuse/sprawl.html>> (noting that land use in Portland metropolitan area increased by 300% between 1940 and 1970, even though region's population increased by only 100% during that same time period).

302. See Richmond, *supra* note 3, at 328.

303. KUNSTLER, *supra* note 293, at 25.

304. See Richmond, *supra* note 3, at 329.

tional force during the economic boom that followed World War II.³⁰⁵

At least in the beginning, sprawl reflected the free will of the American people: It was the cumulative manifestation of numerous individual choices of where to live. Over time, however, those choices became more a product of government policy than of free market forces, as numerous laws created incentives for the continuation of sprawl development. Commentators have identified a panoply of federal policies that have promoted sprawl, generally in the name of the American Dream:³⁰⁶ Home mortgages secured by the Federal Housing Administration and the Veterans Administration generally favored buyers who purchased new suburban homes;³⁰⁷ the Federal Aid Highway Act funded an interstate highway system that made suburban fringe areas accessible and developable;³⁰⁸ and the home mortgage interest deduction of the federal tax code provided an incentive for taxpayers to purchase expensive suburban homes in order to maximize the benefit of the deduction.³⁰⁹ Conspicuously missing from the traditional litany, however, is § 1034 of the Code.³¹⁰ Local governments, too, have been blamed for promoting sprawl, by

305. *Id.* (describing post-World War II migration as "dramatic, extraordinarily consistent, four-decade process characterized by a massive shift in the location and design of housing, shopping, work places and jobs, which is projected to continue for the foreseeable future").

306. See generally KENNETH T. JACKSON, *CRABGRASS FRONTIERS: THE SUBURBANIZATION OF THE UNITED STATES* (1985); Lee R. Epstein, *Where Yards are Wide: Have Land Use Planning and Law Gone Astray?*, 21 WM. & MARY ENVTL. L. & POL'Y REV. 345, 353-66 (1997); James A. Kushner, *The Reagan Urban Policy: Centrifugal Force in the Empire*, 2 UCLA J. ENVTL. L. 209 (1982).

307. Freilich & Peshoff, *supra* note 232, at 186-87 (citing NATIONAL COMM'N ON URBAN PROBLEMS - FEDERAL INCOME TAXATION AND URBAN HOUSING, *BUILDING THE AMERICAN CITY* 399-407 (1968)); see also JAMES HOWARD KUNSTLER, *THE GEOGRAPHY OF NOWHERE* 102 (1993); Richmond, *supra* note 3, at 330 (citing HOUSING FOR ALL UNDER LAW 17 (Richard P. Fishman ed., 1978)).

308. Freilich & Peschoff, *supra* note 232, at 187 (citing Larry Bourne, *A Hennakie Perspective on Urb. Decline and Population Deconcentration*, 1 URB. GEOGRAPHY 39 (1980); NATIONAL COMM'N ON URB. PROBS., *BUILDING THE AMERICAN CITY* 231 (1968)); see also Richmond, *supra* note 3, at 329-30.

309. Freilich & Peshoff, *supra* note 232, at 187; see also Bier & Maric, *supra* note 232, at 142.

310. See Stephen Gurko, *Federal Income Taxes and Urban Sprawl*, 48 DENV. L.J. 329 (1972) (omitting § 1034 from list of federal income tax provisions that promote sprawl). Three noteworthy exceptions are Bier & Maric, *supra* note 232, at 153 (concluding from their case study of the Cleveland metropolitan area that § 1034 "encourages outmigration [from central cities into surrounding suburbs] and obstructs movement inward in metro areas like Cleveland where home values increase in an outward direction"); Freilich & Peshoff, *supra* note 232, at 187-88 (briefly stating that capital gains provision "effectively requires reinvestment in a more expensive home, typically located in suburban areas"); and Oliver A. Houck, *The Water, the Trees, and the Land: Three Nearly Forgotten Cases that Changed the American Landscape*, 70 TUL. L.REV. 2279, 2309 n.176 (1996) (linking suburban sprawl to "real estate sale rollovers").

failing to manage growth aggressively and by permitting new developments that do not pay their own capital infrastructure costs.³¹¹

The common law, as well as federal and local policies, has contributed to the development of open land. Justices of the Supreme Court – like federal legislators – have been captivated by the American Dream and have been moved to near-poetic rhetoric in defense of suburbia. In 1974, Justice Douglas eloquently defended the suburban landscape, describing it as:

[a] quiet place where yards are wide, people few, and motor vehicles restricted. . . . The police power is not confined to elimination of filth, stench, and unhealthy places. It is ample to lay out zones where family values, youth values, and the blessings of quiet seclusion and clean air make the area a sanctuary for people.³¹²

Although Justice Douglas may have intended to protect rural sanctuaries from the encroachments of urban life, his opinion has had the opposite result by upholding sprawl-producing single-family zoning ordinances.

In sum, as numerous laws and policies institutionalized sprawl, individual choice was restricted. As a result, future generations may be unable to choose alternatives to sprawl without paying a substantial price in terms of lost subsidies and tax benefits.

B. *The Hidden Costs of Sprawl*

Despite the appeal of suburban housing developments, they impose formidable – often hidden – costs upon society. The problem is difficult to resolve, however, because, from the perspective of the individual home owner, sprawl development is often an economically efficient means of providing housing.³¹³ New homes built upon former farmland can provide "more home for the money" because land prices generally decrease as one moves farther from the core of the metropolitan area.³¹⁴

311. Freilich & Peshoff, *supra* note 232, at 188 (citing JOINT ECON. COMM., U.S. CONGRESS, HARD CHOICES, SUMMARY REPORT OF THE NATIONAL INFRASTRUCTURE STUDY (Feb. 1984); NANCY S. RUTLEGE, PUBLIC INFRASTRUCTURE AS A NATIONAL CONCERN: REPORT OF THE NATIONAL COUNCIL ON PUBLIC WORKS IMPROVEMENT 17-18 (1987)).

312. *Village of Belle Terre v. Boraas*, 416 U.S. 1, 9 (1974) (upholding under state police power zoning ordinance that limited certain areas to single-family, large-lot homes); *see also* Epstein, *supra* note 306, at 345 (discussing *Boraas*).

313. *See* Robert W. Burchell, *Economic and Fiscal Costs (and Benefits) of Sprawl*, 29 URB. LAW. 159, 163 (1997).

314. *Id.* at 162. As a rule of thumb, the cost ratio of an acre of developed land compared to an acre of farmland is about 100:1. Telephone interview with David L. Carlson, Resource Analyst, Colorado Dep't of Agric. (July 30, 1997). Suburban developments featuring large homes on large lots may nevertheless cost more *per home* than their smaller counterparts within

However, from a long-term social perspective, sprawl calls for an economically inefficient use of resources. Sprawl responds to a sort of centrifugal force by which development moves continuously outward from the urban center. New "edge cities" are created as commercial and industrial developments are lured to the periphery of the metropolitan region by inexpensive land and convenient highway access.³¹⁵ In response, new bedroom communities spring up even farther from the urban center.³¹⁶ This "leapfrog" development is inefficient and expensive, particularly in regions where the population does not increase but simply spreads outward to occupy a greater land area.³¹⁷ The community must now maintain an ever-expanding network of roads, public utilities, schools, and other infrastructure even as commercial enterprises evacuate the metropolitan core area, abandoning it to the area's poorer citizens. How can a region pay its expanding costs with a finite supply of money? The residents have a choice of evils: They can accept increasing taxes and development costs, or the older core areas can be sacrificed by allocating a decreasing share of tax revenues to them.³¹⁸ One study concluded that the development costs of traditional, relatively compact communities are approximately 44% below the costs associated with sprawl.³¹⁹ In addition, the study found that sprawl alternatives tend to bear an increased share of their

the city limits. See *infra* Part VI.B.

315. Burchell, *supra* note 313, at 161-62 (citing ROBERT CERVERO, SUBURBAN GRIDLOCK (1986); JOEL GARREAU, EDGE CITY: LIFE ON THE NEW FRONTIER (1991)).

316. Burchell, *supra* note 313, at 162.

317. See *supra* notes 226-27, 300-01 and accompanying text.

318. *Supra* note 313 and accompanying text.

319. THE COSTS OF SPRAWL, *supra* note 297, at 3-4. The study compared the costs of constructing three types of communities: (1) low density sprawl (representing the typical pattern of single-family suburban development), (2) high density planned communities (clustered residential housing and dedicated public open space), and (3) combination (an area composed of the previous two types of housing in equal measure). *Id.* at 2. "Development costs" exclude land costs, but include the costs of constructing homes, utilities, transportation, schools, public facilities, and public open space. *Id.* at 3. Similarly, another study concluded that:

streets, utilities, and schools for a suburban single family development with 3 dwelling units per acre built 5 miles from sewage and water treatment plants in a leapfrog pattern would cost \$43,381 per dwelling in 1987 dollars. Building the same development adjacent to existing development and near central facilities would reduce costs by \$11,597 per dwelling unit, a 27 percent reduction.

OREGON DEP'T OF LAND CONSERVATION & DEVELOPMENT, *supra* note 301 (citing CENTER FOR URB. STUD. (PSU) AND REG'L FIN. ADVISORS, INC., DLCD'S LOCAL GOVERNMENT INFRASTRUCTURE FUNDING IN OREGON (1990)); see also Richmond, *supra* note 3, at 327 n.44 (citing Kevin Kasowski, *The Costs of Sprawl, Revisited*, DEVELOPMENTS, Sept. 1992, at 1 (presenting conclusion of Rutgers University study that sprawl development costs approximately \$7-8 billion dollars over twenty-year period)).

own costs rather than shifting them onto the government and, ultimately, upon taxpayers who may not desire or benefit from the new sprawl development.³²⁰

Sprawl also imposes environmental costs upon the metropolitan region. Low density suburban communities are typically auto-dependent, with employment and commercial centers located beyond the reach of the pedestrian.³²¹ Between 1970 and 1990, for example, sprawl proliferated as the urban population density decreased by 23%.³²² During that same period, automobile usage increased by 98.4%, even though the population increased by only 22.5%.³²³ Resulting primarily from this increased auto usage, sprawl generates about 80% more air pollution than does high density development.³²⁴ Further, sprawl has a voracious appetite for open space and wildlife habitat, consuming over four times as much residential land as high density development.³²⁵ In contrast, in the high density community, over half of the land can remain completely undeveloped while still accommodating the same number of residents.³²⁶

In addition to its economic and environmental costs, sprawl also exacts a social price. Farm communities are destroyed to make way for new suburban housing.³²⁷ The unique character of individual towns dissolves into a homogeneous mass of look-alike homes and strip malls.³²⁸ Residents must

320. THE COSTS OF SPRAWL, *supra* note 297, at 3-4.

321. In suburban neighborhoods, walking or public transportation generally are not viable alternatives to the private automobile; a typical suburbanite, therefore, drives about three times as many miles as someone who lives in a high density, mixed use neighborhood. *See* Alan Thein Durning, *Pedestrian Paradise*, SIERRA, May-June 1997, at 36, 38-39 ("[P]eople in typical households in Northwestern suburbs own one car per driver and get in their cars ten times a day."). For a very readable and lively argument that "[a]nybody who thinks we're going to be using cars twenty-five years from now the way we've *been* accustomed to using them in the recent past ought to have his head examined," see KUNSTLER, *supra* note 293, at 58-80 (chapter entitled "Car Crazy").

322. OREGON DEP'T OF LAND CONSERVATION & DEV., *supra* note 301.

323. *Id.* (citing FEDERAL HIGHWAY ADMIN., SELECTED HIGHWAY STATISTICS AND CHARTS (1989)).

324. THE COSTS OF SPRAWL, *supra* note 297, at 4-5. Additional air pollution is also generated by residential heating units because heating efficiency increases with the density of development. *Id.*

325. *Id.* at 2.

326. *Id.* If one counts the suburban backyard as a type of open space, then the typical suburban neighborhood provides twice as much public and private land dedicated to open space. *Id.* However, *all* of the suburban land is typically developed to some degree (bisected by roads and serviced by public utilities) and disturbed by human presence (including pesticide use and destruction of natural vegetation), and may therefore be of less value as wildlife habitat than completely undisturbed land. *Id.*

327. *See supra* Parts V.C and VI.B.3.

328. *See* THE COSTS OF SPRAWL, *supra* note 297, at 13 (noting that sprawl results in

spend significantly more time in their automobiles commuting to work, school, and social activities, creating the late twentieth-century phenomenon of the harried "soccer mom" driving her children from place to place in the family minivan.³²⁹ This automobile dependence isolates those who cannot drive – children and the elderly – confining them to their homes or making them reliant upon others.³³⁰ It also isolates neighbor from neighbor, minimizing the social interaction generated by foot traffic and casual encounters with other members of the community.³³¹ Beyond that, sprawl causes more subtle, negative social impacts by reducing the visual delight of our communities. Few would argue that the drive to the local strip mall is as enjoyable as the stroll through the neighborhood to a traditional downtown shopping district.

VIII. *The Demise of the Rollover Rule*

The rollover rule remained in effect for almost half a century, serving as vigilant gatekeeper to the home sale preference. In theory, relief was limited to those sellers who were able or willing to reinvest the proceeds in another home of greater or equal value. In practice, the rule provided no meaningful limitation on tax relief because the vast majority of home owners conformed their behavior to its rigid strictures.³³²

"haphazard spreading of urban uses in a manner which lowers the visual quality of the community" and housing demonstrates "little design variation").

329. See Gary S. Becker, *Gender Politics: You Ain't Seen Nothin' Yet*, BUS. WK., Feb. 17, 1997, at 20.

[T]he Republican Party tried to appeal during the past campaign to the traditional married household by emphasizing family values, opposing abortion, and supporting middle-class tax cuts and larger deductions for children. They did succeed reasonably well with members of intact families, including "soccer moms."

Id.

330. See Epstein, *supra* note 306, at 347-48 (1997) (referring to "suburban chauffeur syndrome" under which it is impossible for suburban children to participate in community life without the assistance of a family "chauffeur"). Similarly, other commentators argue that:

fresh air and open spaces *are* good for [children]. Suburban sprawl is not. Children in the postwar suburbs are kept in an unnaturally extended state of isolation and dependence because they live in places designed for cars rather than people. . . . Imagine how the lives of children would change if the suburban house and yard were assembled in the form of a traditional neighborhood so that kids could visit friends, go out for a hamburger, or walk to a library on their own.

Frug, *supra* note 232, at 1097 (quoting Andres Duany & Elizabeth Plater-Zyberk, *The Second Coming of the American Small Town*, WILSON Q., Winter 1992, at 19).

331. See Frug, *supra* note 232, at 1095 (asserting that suburban developments perpetuate "cult of domesticity," under which wife was expected to be full-time homemaker who needed protection of "safe" community that was economically and racially homogeneous) (citing GWENDOLYN WRIGHT, *BUILDING THE DREAM: A SOCIAL HISTORY OF HOUSING IN AMERICA* 269-74 (1981)).

332. See *supra* note 106 and accompanying text.

As a product of the post-war years, the rule reflected an overly optimistic vision that upward mobility was within the reach of most Americans. At that time, the dominant paradigm of the American family was reflected by television shows such as *Leave it to Beaver*, depicting a stable, two-parent family living in a comfortable suburban home purchased by the steady paycheck of the dutiful patriarch.³³³ To such a stereotypical family, able to buy up as the family expanded, the rollover rule would pose no hardship. But, that one-size-fits-all conception of the American family no longer describes today's society,³³⁴ if indeed it ever reflected the majority of taxpayers.³³⁵ The rule ignores many who would like to "move down" into smaller homes or rental quarters, including single adults, single parents,³³⁶ early retirees,³³⁷ the unemployed,³³⁸ and those who prefer a simple lifestyle.³³⁹

As explained below, the rule was dismantled in three phases spread over a period of forty-six years. In each phase, an expansion of the home sale preference was marked by a corresponding restriction of the applicability of the rollover limitation. There is a rough symmetry between the enactment and the repeal of the rollover rule: In each case, both the home sale preference and its limiting rollover rule were but minor actors in the larger drama of balancing the budget and tax reform. As a result, Congress both enacted and repealed the rule with a minimum of debate. Congress was largely silent on the important issues of who should benefit from the personal residence provision, why

333. See Jo Ann Tooley et al., *A Lifetime of Lucy and the Beaver*, U.S. NEWS & WORLD REP., Aug. 7, 1989, at 62 (stating that there were 234 syndicated episodes of show between 1957 and 1963).

334. See *Something Happened*, ECONOMIST, Oct. 26, 1991, at 6, 7 ("The post-war image of a secure family . . . with real incomes rising strongly, is now a useless way of thinking about America. Nor is it any use to think of America as a place where [sic] poverty axiomatically shrinks each decade.").

335. See Sandra D. Atchison, *Ward and June - Not*, BUS. WK., Nov. 23, 1992, at 15 (reviewing and explaining Stephanie Coontz, *THE WAY WE NEVER WERE: AMERICAN FAMILIES AND THE NOSTALGIA TRAP* (1992)). During the reign of *Leave it to Beaver*, one in three American children was poor, 60% of the elderly had incomes of less than \$1000, and illegitimate births increased 80% between 1944 and 1955. *Id.*

336. *Id.*

337. See Christopher J. Farrell, *The Labor Pool Is Deeper than It Looks*, BUS. WK., Nov. 24, 1997, at 39 (noting that "labor-force participation rate of men 55 to 64 started flattening out about a decade ago" but that it has "sharply risen since 1994").

338. See Gene Koretz, *The Downside of Downsizing*, BUS. WK., Apr. 28, 1997, at 26 (describing "devastating impact on employee morale" of corporate restructuring and job-cutting, and noting that 50,182 job cuts were announced in March 1997).

339. See Connie Lauerman, *Breaking Away: Voluntary Simplicity Is a New Way of Thinking About an Old Problem - Too Many Things, Too Little Time*, CHI. TRIB., June 7, 1996, at 1 (citing report by Trends Research Institute identifying "voluntary simplicity" as major trend of 1990s).

the benefits should be limited to that select group of home sellers who bought up, and, most importantly, whether the rollover rule was the best mechanism by which to achieve those goals with a minimum of adverse side effects.

A. Retreat from the Rollover Rule: § 121

For the first decade of its existence, the rollover rule remained substantially intact. Its demise began in 1964 with the enactment of § 121 of the Code.³⁴⁰ Under the new provision, the rollover rule did not apply to those who had attained the age of sixty-five.³⁴¹ Instead, qualified older home sellers were granted an exclusion of gain from taxable income.³⁴² If their homes sold for \$20,000 or less, the sellers were entitled to a full exclusion and owed no tax on the transaction.³⁴³ Alternatively, if their residences sold for more than \$20,000, the sellers were entitled to a partial exclusion of gain in the ratio of \$20,000 to the actual sales price.³⁴⁴ The anticipated revenue loss under § 121 was a modest ten million dollars,³⁴⁵ positioned in a larger package of tax cuts expected to reduce federal revenues by up to \$3.5 billion dollars.³⁴⁶

The \$20,000 limitation reflected a congressional judgment that only the "average and smaller homestead" seller merited a full tax exemption.³⁴⁷ The provision also reflected a growing congressional awareness that the buy-up requirement of the § 1034 rollover rule was not appropriate for all taxpayers. Nevertheless, Congress fell short of acknowledging that the desire to buy a smaller home was not necessarily dependent upon the age of the taxpayer:

While present law generally provides adequately for the younger individual who is for one reason or another changing residences, it does not do so for the elderly person whose family has grown and who no longer has need for

340. Revenue Act of 1964, Pub. L. No. 88-272, § 206, 78 Stat. 19, 38-40.

341. *Id.*

342. To qualify for the exclusion under the original version of § 121, three requirements had to be satisfied: (a) the seller must be age 65 or older, (b) the seller must have owned and used the property as a principal residence for five out of the last eight years prior to the sale, and (c) the exclusion was available to a taxpayer and spouse only once in their lifetimes. *Id.*

343. *Id.*

344. For example, if *X* sold her home for an adjusted sales price of \$60,000 and realized a gain of \$10,000, only one-third of the gain ($1/3 \times \$10,000 = \$3,333$) could be excluded from income (based upon the ratio of \$20,000 to \$60,000 sales price). See H. Rep. No. 88-749, at 46 (1963), reprinted in 1964 U.S.C.C.A.N. 1313, 1354. For a discussion of the partial exclusion and other limitations upon tax relief, see *supra* notes 90-99 and accompanying text.

345. H.R. REP. NO. 88-749 at 48 (1963), reprinted in 1964 U.S.C.C.A.N. 1313, 1356. By 1994, however, the exemption cost the federal treasury \$4.7 billion. Houck, *supra* note 28, at 697 (citing JOINT COMM. ON TAX'N, U.S. CONGRESS, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1994-98, at 24 (1993)).

346. H.R. REP. NO. 88-749 at 48 (1963), reprinted in 1964 U.S.C.C.A.N. 1313, 1356.

347. *Id.* at 44, reprinted in 1964 U.S.C.C.A.N. 1313, 1354.

the family homestead. Such an individual may desire to purchase a less expensive home or move to an apartment or to a rental property at another location. He may also require some or all of the funds obtained from the sale of the old residence to meet his and his wife's living expenses. Nevertheless, under present law, such an individual must tie up all of his investment from the old residence in a new residence, if he is to avoid taxation on any of the gain which may be involved.³⁴⁸

Thus, Congress began to question the stereotype that taxpayers would enjoy upward mobility throughout their lifetimes.³⁴⁹ Nevertheless, it continued to adhere to a rigid vision of the American family under which the typical couple would have several children and need to buy up to keep pace with the growing family. After the children had grown, the taxpayer and spouse would remain in the "empty nest" until they retired at age sixty-five. At that point, the taxpayer would "buy down" and move into an apartment or less expensive home, presumably remaining there until death.³⁵⁰ Although that stylized conception may have described many American families, it undoubtedly excluded many other taxpayers by making numerous assumptions that no longer fit – and may never have fit – the majority of American taxpayers.

In 1978, Congress took a second step toward dismantling the rollover rule by amending § 121 in two relevant respects.³⁵¹ First, Congress expanded the class of taxpayers qualifying for § 121 benefits to include all those who had attained the age of fifty-five prior to selling their primary residences.³⁵² Second, sellers could exclude up to \$100,000 (later increased to \$125,000) of gain from gross income.³⁵³ Thus, the amendment substituted an absolute dollar limitation on tax relief for the prior limitation based upon the sales price of the residence. This substitution had a subtle effect upon the determination of those who could qualify for the full benefit of § 121, changing the focus from the value of the home to the amount the value had appreciated

348. *Id.*

349. *See supra* notes 333-39 and accompanying text.

350. Congress did not provide for the taxpayer who would like to move more than once after age sixty-five, but limited the § 121 exclusion to one sale per lifetime. Revenue Act of 1964, Pub. L. No. 88-272, § 206, 78 Stat. 19, 38-40.

351. *See generally* Revenue Act of 1978, Pub. L. No. 95-600, § 404, 92 Stat. 2763, 2869.

352. § 404, 92 Stat. at 2869 (codified at I.R.C. § 121(a)(1) (prior to amendment in 1997)).

353. *Id.* (allowing exclusion of up to \$100,000, or \$50,000 of gain in case of separate return by a married individual). These changes were prompted by the recognition that the previous "dollar limits and age restriction [were] unrealistic in view of increasing housing costs and decreasing retirement ages." S. REP. NO. 95-1263, at 196 (1978), *reprinted in* 1978 U.S.C.C.A.N. 6959, 6959. Subsequently, the amount of excludable gain was increased to \$125,000 (\$62,500 in the case of a separate return by a married individual). I.R.C. § 121(b)(1) (1994) (prior to amendment in 1997).

during the seller's residence. As a result, the amended provision created the potential for discrimination against those who had remained in their homes for long periods of time, generating inflationary gains in excess of the statutory limit. This result is in apparent contradistinction from the original intent of § 121 to provide tax relief to those of average and below-average means.³⁵⁴

B. Repeal of the Rule: The Taxpayer Relief Act of 1997

In 1997, Congress finally removed the rollover rule from the Code by repealing § 1034.³⁵⁵ In its place, Congress amended § 121 to allow qualified taxpayers of all ages to exclude from gross income the gain from the sale of their homes.³⁵⁶ Gone are both the rollover rule of former § 1034 and the age limitations of former § 121. Instead, the Code retains a dollar limitation upon nontaxable gain, but increases the exclusion from \$125,000 to \$500,000.³⁵⁷

The repeal of § 1034 and the rollover rule was part of a larger tax reform package designed to implement a bipartisan balanced budget agreement.³⁵⁸ Among other things, Congress approved a plan to balance the federal budget by the year 2002, implemented a \$94 billion tax cut, and reduced the top rate of taxation on capital gains from 28% to 20%.³⁵⁹ The record is replete, however, with partisan disagreement over precisely which Americans would benefit from the reform. The Republicans claimed that their proposal would benefit primarily the middle class and that taxpayers earning less than \$75,000 would enjoy 76% of its benefits.³⁶⁰ The Democrats, in response, argued that 50% of

354. See *supra* note 347 and accompanying text.

355. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 312, 111 Stat. 788, 836-839.

356. *Id.*

357. The amount of gain excluded from gross income is limited to \$250,000. I.R.C. § 121(b)(1) (1994), as amended by Taxpayer Relief Act of 1997, I.R.C. § 121(b)(1) (West Supp. 1998). In the case of qualifying couples filing joint returns, the ceiling is \$500,000. I.R.C. § 121(b)(2) (1994), as amended by Taxpayer Relief Act of 1997, I.R.C. § 121(b)(2) (West Supp. 1998). In addition, to qualify for the full tax benefits of new § 121, the property must have been owned by the taxpayer and used by the taxpayer as a principal residence during the five-year period preceding the sale for periods aggregating two years or more. I.R.C. § 121(a) (1994), as amended by Taxpayer Relief Act of 1997, I.R.C. § 121(a) (West Supp. 1998). An additional limitation provides that the exclusion applies to only one sale or exchange every two years. I.R.C. § 121(b)(3) (1994), as amended by Taxpayer Relief Act of 1997, I.R.C. § 121(b)(3) (West Supp. 1998).

358. See 143 CONG. REC. S6782 (daily ed. June 27, 1997) (statement of Sen. Murray). To implement the agreement, Congress passed companion bills that would cut taxes and reduce spending, respectively. See Janet Hook & Sam Fulwood III, *Congress Passes Tax Cut, Spending Bills Easily*, L.A. TIMES, Aug. 1, 1997, at A16.

359. See Hook & Fulwood, *supra* note 358.

360. See, e.g., 143 CONG. REC. H4659 (daily ed. June 26, 1997) (statement of Rep. Dreier) ("So the fact is, we are there trying desperately to help those struggling middle-income wage

the benefits of the Republican tax proposal would go to the wealthiest 5% of Americans.³⁶¹ Despite such political posturing, the Taxpayer Relief Act of 1997 passed easily by votes of 389-43 and 92-8 in the House of Representatives and in the Senate, respectively.³⁶² The projected revenue loss was \$200-300 million annually.³⁶³

The legislative history reveals three primary rationales supporting the repeal of the rollover rule. First, Congress stated that the amendment would simplify the record-keeping and capital gains calculations required of home sellers.³⁶⁴ Second, Congress claimed that the repeal would remove the tax incentive for over-investment in housing:

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.³⁶⁵

earners create greater opportunities, improve their quality of life, and things like a capital gains tax rate reduction will do just that.").

361. 143 CONG. REC. H 4608 (daily ed. June 25, 1997) (statement of Rep. Fazio) ("Who gets the benefits? On that there is a clear difference. The Democratic bill helps working families. The Republican bill, I regret, caters to the wealthy and special interests.").

362. *Id.* The *Washington Post* noted that Congress passed both the balanced budget and tax cut plans "[w]ith stunning speed and little dissent." Eric Pianin, *Budget, Tax Plans Pass with Few Dissenters*, WASH. POST, Aug. 1, 1997, at A14. The speed was attributed to history: "Republicans and Democrats who spent 2½ years bitterly feuding over spending and tax policies giddily celebrated passage of the two bills that blended conflicting philosophies and political agendas." *Id.* The members were "exhausted and eager to depart for the August recess." *Id.*

363. *FY 98 Budget: Hearing on Savings & Investment Provisions Before the House Comm. on Ways and Means*, 105th Cong. (1997) (statement of Jane G. Gravelle, Senior Specialist in Economic Policy, Congressional Research Service), available in 1997 WL 149061.

364. H. REP. NO. 105-148, at 347 (1997); S. REP. NO. 105-33, at 36 (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."). Contrary to those expectations, however, the amendment may not accomplish fully the goal of simplification. Those on the "borderline" – sellers of expensive homes as well as those who have owned the same residence for a long period – will still need to keep detailed records in order to determine whether they qualify for the \$500,000 exemption. See Albert B. Crenshaw, *New Tax Laws Still Require Religious Record-Keeping*, WASH. POST, Nov. 16, 1997, at H1 ("Houses . . . can be very long-term investments, and while \$500,000 may seem like a lot today, inflation will certainly erode it over the years.").

365. H. REP. NO. 105-148, at 347 (1997). This rationale is consistent with this article's first hypothesis relating to the unintended consequences of the rollover rule. See *supra* Part V.A. The special case of those who move from high- to low-cost housing areas is explored

Finally, Congress wished to remove the "constraint [on] the mobility of the elderly" imposed by the rollover requirement.³⁶⁶ Thus, almost half a century after it enacted the rollover rule, Congress has acknowledged at least one important unintended consequence of the rule: stimulation of national over-investment in housing. Conspicuously absent, however, is an awareness that the rule also promoted the inflation of housing prices and accelerated the conversion of farmland into suburban housing.³⁶⁷

During the recent tax reform process, our national mistrust of unearned income³⁶⁸ collided with our ideal of the home as a sacred family refuge.³⁶⁹ Although the new legislation boldly repealed the rollover rule, it bears the mark of the lingering congressional impulse to provide some limit – even if only symbolic – upon tax preferences for capital gains.³⁷⁰ Prior to the 1997 reform, fewer than 4% of all home sales resulted in taxable gains.³⁷¹ By expanding the home sale preference to allow up to \$500,000 of nontaxable gain,³⁷² experts estimate that only 0.25% of all home sales will be taxed annually.³⁷³ Why did Congress exempt 99.75% of home sellers from taxation, but stop short of providing a full tax exemption for home sale profits? When questioned, the Secretary of the Treasury was unable to identify clearly the rationale for retaining the tax for a small percentage of home sellers.³⁷⁴ The

supra Part VI.B. See also Jon Newberry, *Tax Code Fixer-Upper*, 83 A.B.A. J. 97, 97 (1997) (noting that tax change will particularly benefit people from high-cost areas such as New York City or California who relocate to less expensive areas and who would otherwise have to buy "more house than they really want, particularly if children are now older").

366. H. REP. NO. 105-148, at 347 (1997) ("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.").

367. See *supra* Parts V.B.-C.

368. See *supra* notes 67-73 and accompanying text.

369. See *supra* notes 19-25 and accompanying text.

370. See *supra* note 67 and accompanying text.

371. *Education Hearings, supra* note 9 (statement of Donald C. Lubick).

372. See *supra* note 357 and accompanying text.

373. *Education Hearings, supra* note 9 (statement of Donald C. Lubick).

374. Representative Xavier Becerra asked "why you decided to have a ceiling that provides a shield for \$500,000 in profits for the sale of a home?" Secretary Rubin responded,

[B]y having as high a number as we did have, we've eliminated virtually all need for people who own homes, not – and there are people with very high priced homes it does not apply to – but almost all homeowners will no longer have to keep records of all the little changes they make every year that then go ultimately into determining what their basis is when they sell their home. . . . There's no way of knowing with inflation rates and all the rest what that home, on a nominal base, would be worth 40 years from now. We wanted it to be a situation where that person didn't have to keep records and do all the kinds of things that would be

general tenor of the debate, however, indicates a continuing ambivalence toward capital gains. A complete tax break for capital gains remains politically and distributionally imprudent, even where the goal is to assist non-profit-seeking home sellers.

In sum, although Congress stopped short of creating a complete tax exclusion for home sale profits, the repeal of the rollover rule was nevertheless a tremendously important accomplishment. Not only will the repeal restore the free choice of home owners to purchase whatever accommodations best suit their needs, but it removes an insidious and unrecognized federal incentive for the unnecessary destruction of farmland.

IX. Conclusion

In 1997, Congress ended the forty-six year life of the rollover rule by repealing § 1034 of the Internal Revenue Code, thus expanding the home sale preference. Congress had created the predecessor of §1034 with the noble aspiration of making the American Dream of home ownership more affordable for deserving taxpayers, but the preference was severely weakened by the rollover rule which required home sellers to buy increasingly expensive homes to be eligible for the tax break.

The rollover rule bears the mark of its 1951 birth. Congress perceived § 1034 as simple tax relief, preventing hardship to those whose service to the defense industry required them to move from one area of the country to another.³⁷⁵ Influenced by the post-war economic boom, Congress no doubt believed that the typical American couple would naturally buy larger homes as their family expanded, and that the rollover rule's buy-up requirement was well-tailored to the life of the ordinary taxpayer.³⁷⁶ In practice, however, the rollover rule served as a powerful tax incentive that forced taxpayer behavior into a rigid mold for almost half a century. That is, the congressional assumption that families would purchase increasingly expensive homes became a self-fulfilling prophecy that changed, rather than reflected, the home purchase decisions of potentially hundreds of millions of taxpayers since 1951.³⁷⁷

This confusion between tax relief and tax incentive had profound and unintended consequences. Contrary to Congress's probable expectations, the

necessary to ultimately have to determine basis. And that was part of what led to the choice of that number [\$500,000 exclusion for married taxpayers filing joint returns].

FY 98 Budget Proposal: Hearings Before the House Comm. on Ways and Means, 105th Cong. (1997) (statement of Robert Rubin, Secretary of the Treasury), available in 1997 WL 57072.

375. See *supra* note 119 and accompanying text.

376. See *supra* notes 333-39 and accompanying text.

377. See *supra* note 9 and accompanying text.

rule encouraged taxpayers to over-invest in housing and led to the inflation of housing prices, particularly in regions experiencing a substantial influx of new residents from more expensive areas of the country. Decades later, Congress recognized the first of these two detrimental effects of the rollover rule, citing it as a factor motivating its 1997 repeal of § 1034.³⁷⁸ The third and most devastating consequence of the rollover rule – the destruction of farmland at the fringe of metropolitan areas – has not yet been widely recognized as a direct consequence of the rule. This article is offered to remedy that deficiency.

The story of the rollover rule provides several important lessons. First, it demonstrates that seemingly innocuous legislation may have serious, hidden flaws. Second, it reinforces the value of vigorous partisan debate. Tax reduction measures of all types have tremendous superficial appeal and tend to generate short-term political benefits to legislators.³⁷⁹ Nevertheless, such appealing measures may have undesirable long-term consequences, such as those caused by the rollover limitation of the home sale preference.³⁸⁰

The rollover story has a happy ending. Congress repealed § 1034 in 1997 as part of a broader package of tax reform measures designed to promote "family values." Just as the enactment of the rollover rule had unintended consequences, so also does its repeal. The unexpected beneficiary may well be the American landscape – perhaps the greatest value that we can preserve for future generations.

378. See *supra* Part VIII.B.

379. See Passell, *supra* note 37, at 33.

380. See *supra* Part V.