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Housing capital-gains taxation and homeowner mobility: Evidence from the Taxpayer Relief Act of 1997

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Abstract

We provide new evidence on the impact of housing capital-gains taxation on homeowner behavior by examining residential mobility before and after the Taxpayer Relief Act of 1997 (TRA97), which generated the most sweeping reform of capital-gains taxation in the last two decades. In addition to lowering marginal tax rates on long-term capital gains for all assets, TRA97 also eliminated any differential treatment of housing gains above and below age 55, allowing all homeowners to qualify for capital-gains exclusions. Utilizing data drawn from the Current Population Survey (CPS) on either side of the law change (1996 and 1998) on homeowners just above (56–58 year olds) and below (52–54 year olds) the age-55 threshold and a reduced-form, difference-in-difference empirical approach, our estimates suggest that the repeal of the differential capital-gains tax treatment by age embodied in TRA97 had an economically important and statistically significant impact on the residential mobility of under-55 homeowners. Across a variety of specifications, the repeal raised the mobility rate by around 1–1.4 percentage points, which, for a mean mobility rate of 4 percentage points, represented an increase in the mobility rate of homeowners in their early 50s by 22–31%. Furthermore, the bulk of this effect was concentrated among highly mobile homeowners who *a priori* were more likely to have wanted to trade down (e.g., divorced, empty nesters), those facing higher capital gains tax rates, and those living in states that had experienced higher rates of nominal appreciation.
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1. Introduction

As has been long recognized in the urban and public economics literatures, the US tax code subsidizes owner-occupied housing through the non-taxation of imputed rents and the favorable treatment of capital gains. Prior to 1997, gains arising from the sale of a home were treated differently if the seller went on to buy a more (rather than a less) expensive home. In addition, preferential treatment was given based on age: homeowners age 55 or older qualified for a one-time exclusion of \$125,000 in calculating taxable gains, while younger homeowners did not qualify for this exclusion. Both of these provisions have led other researchers to

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conclude that, *de facto,* most gains for those over 55 went untaxed (Rosen, 1985; Burman et al., 1996) and to consider the possibility that those under 55 who desired to trade down, buying a less expensive house, might have been effectively "locked-in" to their existing homes by the differential treatment according to age. This would result in a reduction in residential mobility, much as capital-gains taxes on appreciated stocks might reduce realizations, a topic of considerable interest in public and financial economics.[1]

However, there is only limited empirical evidence on the extent to which housing capital-gains taxation affects homeowner mobility in the United States. In particular, existing studies that have employed older cross-sectional household survey data (Hoyt and Rosenthal, 1990) may have had difficulty separately identifying the impact of the tax treatment from other, unobserved factors that generate cross-sectional differences in outcomes. At the same time, studies that used panel data exploited now distant legislative changes, primarily from the 1970s (Newman and Reschovsky, 1987; Sinai, 1998).

In this paper, we provide new evidence of the impact of housing capital-gains taxation on mobility by examining homeowner behavior before and after the Taxpayer Relief Act of 1997 (TRA97), which generated the most sweeping reform of capital-gains taxation in the last two decades. In addition to lowering marginal tax rates on long-term capital gains for all assets, TRA97 also eliminated any differential treatment of housing gains above and below age 55, allowing all homeowners to qualify for capital-gains exclusions. We utilize data drawn from the Current Population Survey (CPS) on either side of the law change (1996 and 1998) on homeowners just above (56–58 year-olds) and below (52–54 year-olds) the age-55 threshold in a reduced-form, difference-in-difference approach to estimate the impact of the repeal of the age-55 rule on the relative mobility of these two groups of homeowners.

Overall, the empirical evidence we present suggests that the repeal of the age-specific capital-gains tax treatment embodied in TRA97 had an economically important and statistically significant impact on the residential mobility of under-55 homeowners. Across a variety of specifications, the repeal raised the mobility rate by around 1–1.4 percentage points, which, for a mean mobility rate of 4 percentage points, implies that TRA97 raised the mobility rate of homeowners in their early 50s by 22–31%. Furthermore, the bulk of this effect was concentrated among highly mobile homeowners who *a priori* were more likely to have wanted to trade down (e.g., divorced, empty nesters), those facing higher capital gains tax rates, and those living in states that had experienced higher rates of nominal appreciation. Interestingly, these findings are generally consistent in magnitude with the estimates of Newman and Reschovsky (1987) and Sinai (1998), who relied on more modest reforms in the 1970s and early 1980s. In combination, these three studies suggest that capital-gains taxation of owner-occupied housing prior to 1997 likely resulted in substantial housing lock-in effects.

The paper is organized as follows. Section 2 gives background on the tax treatment of housing capital gains before and after the Taxpayer Relief Act of 1997 and a brief review of key existing studies of gains taxation on housing behavior. Section 3 describes the regression framework, CPS, and the construction of the analysis dataset. Section 4 discusses the estimation results. There is a brief conclusion.

2. Background

A capital gain for tax purposes on the primary residence is calculated as the difference between the sale price net of transactions cost and the adjusted tax basis, the latter of which is the purchase price plus the value of tax-qualified improvements. Prior to TRA97, a homeowner was expected to postpone paying capital-gains tax on a sale if the subsequent home, purchased within two years, was of equal or greater value. Postponed gains were subtracted from the tax basis in the new home. This had the effect of increasing the taxable gain on the new home, should it ever be sold. For example, if an owner sold a home for \$200,000 that had been purchased for \$150,000, with no improvements, and bought a new home for \$225,000, the adjusted tax basis in the new home would be \$175,000 (i.e., \$225,000 − \$50,000 = \$175,000), so that effectively the \$50,000 gain in the previous home was transferred to the new home, deferring the tax. Alternatively, if the homeowner traded down, buying a less expensive home, then the difference between the sale price of the previous home and the purchase price of the new home was treated as a taxable gain and taxed in the year of sale.[2] Adapting the example above, suppose the seller instead bought a new home for \$185,000. The immediate taxable gain would have been \$15,000 (\$200,000 − \$185,000 = \$15,000) and the balance of

[1] See Blouin et al. (2000), Shackelford (2000), and Sinai and Gyourko (2004), among others, for recent research.

[2] A home seller who moved into rental housing and did not buy a new home within two years paid tax on the entire gain.

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