Issue Brief

A Publication of the Institute for Policy Innovation

April 15, 1998

250 South Stemmons, Suite 215 Lewisville, Texas 75067 (972) 219-0811

The New Schedule D—As In "Disaster"

New Capital Gains Holding Periods Needlessly Complicate Tax Code

By Gary Robbins, Senior Research Fellow and
Aldona Robbins, Senior Research Fellow

Lower tax rates on capital gains were one of the few pro-growth elements in the "Taxpayer Relief Act of 1997." But the bill further complicated the tax code by adding more *holding periods*, that is, the time between when an asset is bought and sold. Previously, tax treatment of capital gains distinguished between only short or long-term gains (or losses).

Media accounts already report confusion over the new capital gains rules. Support for proposals to fix the problem is likely to grow as the April 15th tax filing deadline nears. This issue brief looks at the implications of added holding periods for taxpayers, federal coffers, and the economy.

How Last Year's Tax Bill Changed Capital Gains Rules

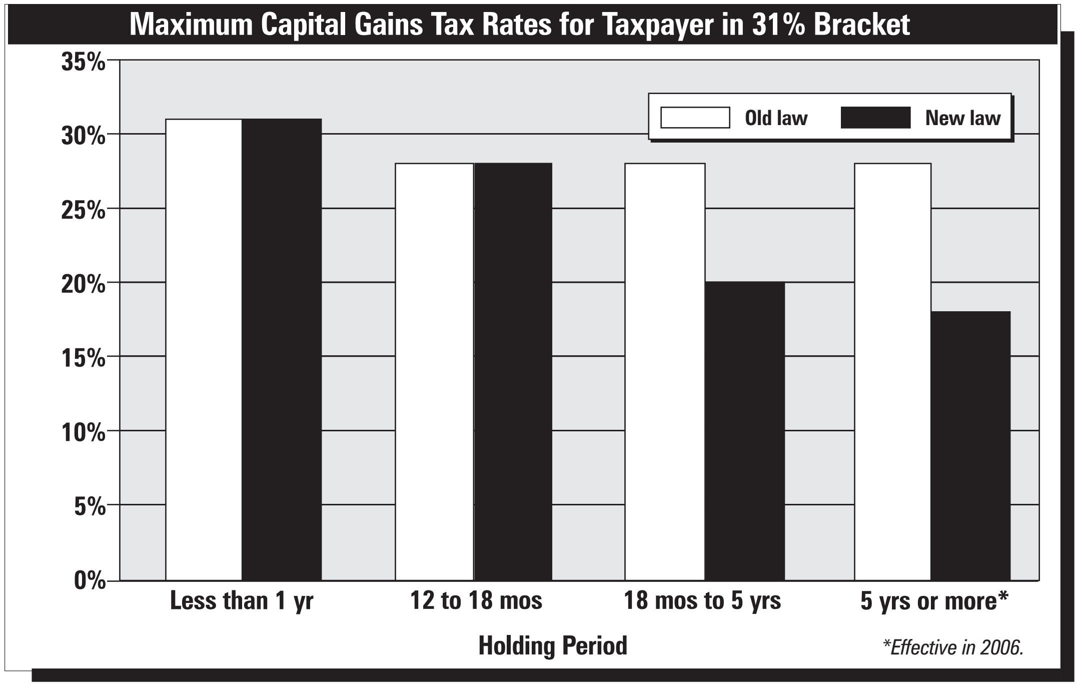
A *capital gain* occurs when an investor sells an asset, like stock or real estate, for more than the purchase price.[1] Conversely, a *capital loss* occurs when the seller receives less than he or she paid. Until last year, capital gains and losses fell into two categories: short-term and long-term. The designation "short-term" referred to gains (losses) on assets held less than one year while "long-term" referred to assets held more than one year.

Schedule D, part of the form 1040 package, requires taxpayers to segregate their short- and long-term gains. *Net short-term gains* (the difference between short-term gains and losses) are taxed at the same rate as ordinary income. Since the Tax Reform Act of 1986, net long-term capital gains have been taxed at a maximum rate of 28%.

The Taxpayer Relief Act of 1997 lowered the maximum tax rate on net long-term gains from 28% to 20% (10% for taxpayers in the 15% bracket) as of May 7, 1997. But the bill also specified that, beginning July 29, 1997, the maximum rate would continue to be 28% for assets sold after July 28, 1997 and held between one year and 18 months.[2]

Beginning in 2001, taxpayers will have to contend with a *fourth* holding period. Those in the 15% bracket will pay an 8% capital gains rate on assets held at least five years. Taxpayers in higher brackets will have to wait until 2006 for a maximum 18% rate on capital gains for 5-year assets. [See Table 1 and Figure 1 for comparisons of holding periods and tax rates between old and new law.]

Figure 1
Maximum Capital Gains Tax Rates for Taxpayer in 31% Bracket



More Taxpayers Will Have to File Schedule D

Of the 118 million taxpayers who filed Form 1040 in 1995, 15.3 million, or one in eight, filled out Schedule D. Because taxpayers with income from capital gains are growing 2.6 times faster than 1040 filers in general, higher percentages of taxpayers will file Schedule D in the years to come. Based on this trend, almost one in seven of this year's 122 million tax returns will include Schedule D. By 2003, that proportion should increase to one in six.[3] [See Table 2 and Figure 2 for 1995 returns filing Schedule D by income.]

Consequently, the need to track of capital gains holding periods is not confined to the "rich." According to Internal Revenue Service data, almost 53 percent of taxpayers filing Schedule D report less than $50,000 in adjusted gross income (AGI) while another 28 percent have AGIs between $50,000 and $100,000. [See Table 2 and Figure 3 for Schedule D filers by income.]

Both the growth in Schedule D filers and their income distribution stem from changing patterns of saving and investment. Data from the Federal Reserve shows that 41.7 percent of American families owned stock, either directly or indirectly, in 1995, up from 31.7 percent in 1989. And the median value of those holdings increased by 30 percent, from $10,400 to $13,500 (expressed in 1995 dollars).[4] As retirement for baby boomers draws ever nearer, even more small investors should enter the stock market, accelerating the importance of capital gains for the middle class.

Table 1
Capital Gains Holding Periods and Tax Rates

[1] Tax Reform Act of 1986.

[2] Taxpayer Relief Act of 1997.

[3] Short-term gains are taxed at ordinary rates.

[4] Effective 2001, taxpayers in the 15% bracket will pay 8%. The 18% rate will begin in 2006 for other taxpayers.

Capital Gains Holding Periods and Tax Rates

Holding Period	Maximum Tax Rate			
	15% Bracket		28% Bracket and above	
	Old Law[1]	New Law[2]	Old Law[1]	New Law[2]
Less than 1 year[3]	15.0%	15.0%	39.6%	39.6%
Between 1 year and 18 months	15.0%	15.0%	28.0%	28.0%
Between 18 months and 5 years	15.0%	10.0%	28.0%	20.0%
5 years or more[4]	15.0%	8.0%	28.0%	18.0%

Table 2
Individual Tax Returns with Schedule D Capital Gains and Losses, 1995

Source: Internal Revenue Service, *Statistics of Income Bulletin, Fall 1997*, Washington, DC, Table 1, pp. 22-23.

Individual Tax Returns with Schedule D Capital Gains and Losses, 1995
(Returns in thousands)

Adjusted Gross Income	Total Individual Returns	Total Schedule D Returns	Schedule D Returns with:	
			Taxable net gain	Taxable net loss
All Returns	118,218	15,285	10,151	5,134
No adjusted gross income	944	320	123	197
$1 under $5,000	14,646	793	456	337
$5,000 under $10,000	13,982	866	551	315
$10,000 under $15,000	13,562	896	566	330
$15,000 under $20,000	11,386	863	539	323
$20,000 under $25,000	9,970	852	544	307
$25,000 under $30,000	7,848	763	488	275
$30,000 under $40,000	12,380	1,460	975	486
$40,000 under $50,000	9,099	1,275	846	429
$50,000 under $75,000	13,679	2,683	1,871	812
$75,000 under $100,000	5,374	1,578	1,118	460
$100,000 under $200,000	4,075	1,985	1,383	601
$200,000 under $500,000	1,007	720	517	203
$500,000 under $1,000,000	178	151	111	40
$1,000,000 or more	87	80	63	17

Percentage Distribution of Schedule D Returns by AGI

Adjusted Gross Income	All Schedule D Returns	Schedule D Returns with:	
		Taxable net gain	Taxable net loss
All Returns	100.0%	100.0%	100.0%
No adjusted gross income	2.1%	1.2%	3.8%
$1 under $5,000	5.2%	4.5%	6.6%
$5,000 under $10,000	5.7%	5.4%	6.1%
$10,000 under $15,000	5.9%	5.6%	6.4%
$15,000 under $20,000	5.6%	5.3%	6.3%
$20,000 under $25,000	5.6%	5.4%	6.0%
$25,000 under $30,000	5.0%	4.8%	5.4%
$30,000 under $40,000	9.6%	9.6%	9.5%
$40,000 under $50,000	8.3%	8.3%	8.4%
$50,000 under $75,000	17.6%	18.4%	15.8%
$75,000 under $100,000	10.3%	11.0%	9.0%
$100,000 under $200,000	13.0%	13.6%	11.7%
$200,000 under $500,000	4.7%	5.1%	4.0%
$500,000 under $1,000,000	1.0%	1.1%	0.8%
$1,000,000 or more	0.5%	0.6%	0.3%

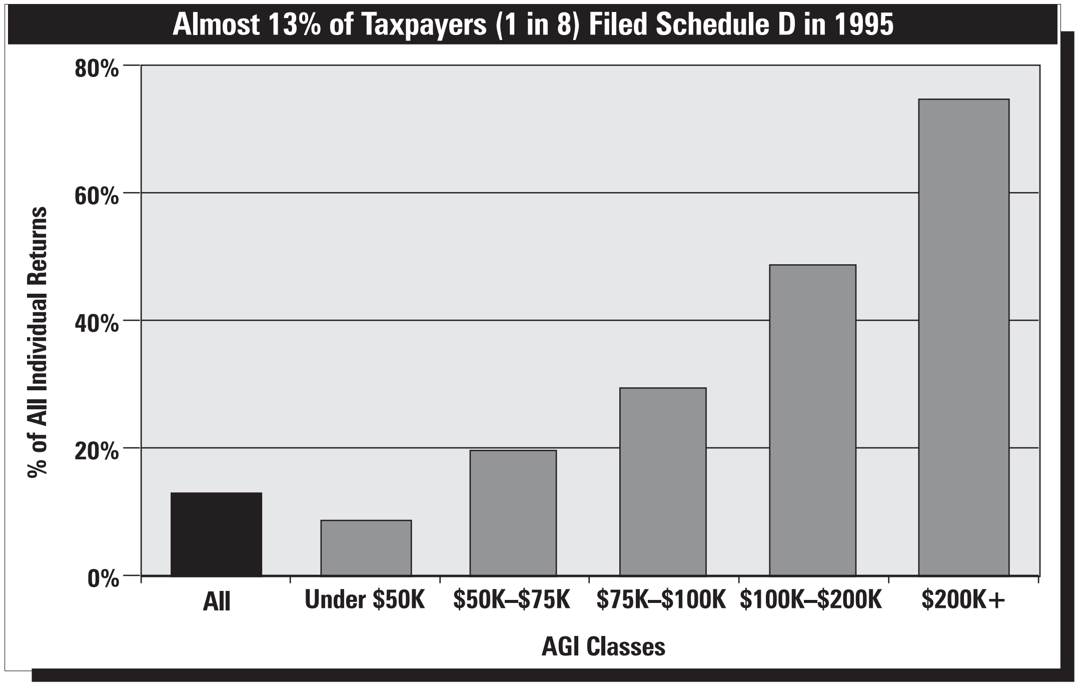
Return to Two Capital Gains Holding Periods

Congress is already having second thoughts about adding more holding periods. Chairman Bill Archer of the House Ways and Means Committee has talked about returning to a two-tiered system in this year's tax bill. There are at least three reasons that favor a rollback: (1) reduced recordkeeping and filing complexity for taxpayers; (2) minimal budgetary effects; and (3) positive economic effects.

Extra Holding Period Adds Complexity

Adding one more holding period greatly complicates Schedule D filing. Instead of two categories of assets, there are now three (and eventually four) that taxpayers must track. And, computing the taxes owed on capital gains has become much more burdensome.

Figure 2
Almost 13% of Taxpayers (1 in 8) Filed Schedule D in 1995



Last year's thirteen-step procedure, required only for taxpayers in the 31% bracket and above, has tripled to 36 steps for *all* Schedule D filers. Basically, the computation in Part IV of Schedule D has the taxpayer do the following: [See Table 3 for an example.]

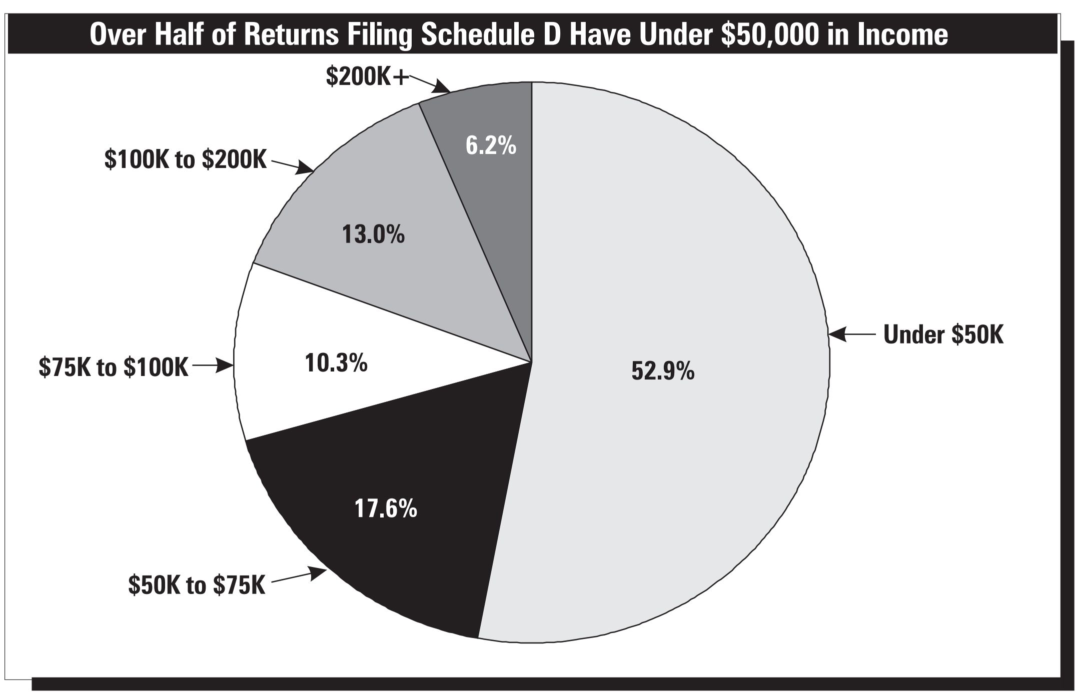
① compute regular tax on taxable income including capital gains;

② subtract capital gains from taxable income and recompute the regular tax;

③ compute tax on capital gains using the appropriate tax rate and;

④ add the capital gains tax to the tax on income without gains [② above], compare to regular tax [① above] and use the smaller amount.

Figure 3
Over Half of Returns Filing Schedule D Have Under $50,000 in Income



Line	Sample 1997 Schedule D Capital Gains Tax Computation	
Line	Capital Gains Information on Hypothetical Taxpayer Filing Joint Return	
7	Net short-term (held less than one year) capital gain or (loss)	500
15	Net 12-to-18 month capital gain or (loss)	1,000
16	Net long-term (held over one year) capital gain or (loss)	3,000
17	Sum of short- and long-term capital gains [add lines 7 & 16]	3,500
	Part IV: Tax Computation Using Maximum Capital Gains Rates	
19	Taxable income, 1040 line 38	75,000
20	Long-term capital gains less short-term losses [lesser of line 16 or 17]	3,000
21	Investment Interest Expense Deduction, Form 4952, line 4e	0
22	Subtract line 21 from line 20. If zero or less, enter 0.	3,000
23	Sum of short-term and 12-to-18-month capital gains [add lines 7 and 15]. If zero or less, enter 0.	1,500
24	Lesser of 12-to-18-month capital gains or short-term plus 12-to-18-month capital gains [lines 15 & 23]. If zero or less, enter 0.	1,000
25	Unrecaptured 1250 gain[1]	0
26	Add lines 24 and 25	1,000
27	Capital gains held over 18 months [line 22 minus line 26]. If zero or less, enter 0.	2,000
28	Taxable income from 1040 without capital gains held over 18 months [line 19 minus line 27]. If zero or less, enter 0.	73,000
29	Smaller of taxable income from 1040 [line 19] or $41,200 (the point at which taxable income is taxed at 28% for joint returns)	41,200
30	Smaller of line 28 or line 29	41,200
31	Taxable income from 1040 less long-term capital gains [line 19 minus line 22]. If zero or less, enter 0.	72,000
32	Larger of line 30 or line 31	72,000
33	Tax on amount in line 32 using Tax Table or Tax Rate Schedules	14,811
34	Enter amount from line 29	41,200
35	Enter amount from line 28	73,000
36	Amount of capital gains in 15% bracket [line 34 minus line 35]. If zero or less, enter 0.	0
37	Tax on capital gains held over 18 months in 15% bracket [line 36 times 0.1]	0
38	Smaller of taxable income from 1040 [line 19] or capital gains held over 18 months [line 27]	2,000
39	Amount of capital gains in 15% bracket [line 36]	0
40	Amount of capital gains held over 18 months subject to 20% rate [line 38 minus line 39]. If zero or less, enter 0.	2,000
41	Alternate 20% tax on capital gains held over 18 months [line 40 times 0.2]	400
42	Smaller of line 22 or line 25	0
43	Taxable income including long-term gains [line 22 plus line 32]	75,000
44	Taxable income from 1040 [line 19]	75,000
45	Uncaptured 1250 gains without short-term losses [line 43 from line 44]. If zero or less, enter 0.	0
46	Uncaptured 1250 gains adjusted for losses [line 42 minus line 45]. If zero or less, enter 0.	0
47	Tax on uncaptured 1250 gains [line 46 times 0.25]	0
48	Taxable income from 1040 [line 19]	75,000
49	Taxable income less capital gains plus capital gains taxed at 10%, 20% and 25% [Sum of lines 32, 36, 40 and 46]	74,000
50	Capital gains to be taxed at 28% [line 49 minus line 48]	1,000
51	Tax on capital gains taxed at 28% [line 50 times 0.28]	280
52	Tax on taxable income without capital gains plus the tax on capital gains taxed at 10%, 20%, 25% and 28% [Sum of lines 33, 37, 41, 47 and 51]	15,491
53	Tax on taxable income from 1040 [line 19] using Tax Table or Tax Rate Schedules	15,651
54	Tax [smaller of line 52 or 53]	15,491

Table 3
Sample 1997 Schedule D Capital Gains Tax Computation

[1] 1250 gains refers to depreciable property.

The reason the calculation takes 36 steps is because there are currently four possible, alternate tax rates on capital gains:

- 10% if taxable income is in the 15% bracket and the asset is held over 18 months;
- 20% if taxable income is in the 28% bracket or above and the holding period was 18 months or more;
- 28% if taxable income is in the 28% bracket or above and the holding period was 12 to 18 months; and
- 25% if property was depreciated (Section 1250).

These steps will expand even more when the fourth holding period becomes effective starting in 2001.

According to the Internal Revenue Service (IRS), taxpayers spent an average 3 hours and 41 minutes filling out Schedule D in 1996.[5] IRS expects taxpayers to spend an extra 30 minutes keeping records and preparing returns under the new capital gains rules.[6] Valuing tax preparation time at $50 an hour, even IRS' very conservative estimate means that the new Schedule D will add $415 million a year to taxpayer compliance costs.[7] Because compliance adds nothing to the production of goods and services, these costs are a deadweight loss to society.

Returning to two holding periods would reduce, but not eliminate, this complexity. Recordkeeping becomes simpler without the 12-to-18-month category, and steps to compute the 28% tax on these gains would no longer be needed. However, steps to compute tax at the 10%, 20% and 25% rates would remain for all Schedule D filers. *Only a capital gains exclusion, as was the case before 1986, avoids the need for a separate capital gains tax calculation.*[8]

Little Budgetary Consequences

The price tag on the original capital gains proposal coming out of the House Ways and Means Committee last year was $35 billion over eleven years (1997 to 2007).[9] However, the final tax bill dropped inflation-indexing of capital gains and added two holding periods, paring back that revenue loss to $21.2 billion.[10]

"…even IRS' very conservative estimate means that the new Schedule D will add $415 million a year to taxpayer compliance costs."

Most of the $13.8 billion revenue difference was due to indexing, not holding periods. We estimate a small, static revenue loss from eliminating the 12-to-18-month holding period. After picking up a little revenue during the first five years ($82 million), it would cost only $1.5 billion over ten years (1998 to 2007).[11] The main reason for the low price tag is that we estimate only about 6 percent of capital gains fall into the new holding period.

Economy Would Benefit

Eliminating the 12-to-18 month holding period would help the economy by giving a boost to capital markets. One component of the cost of capital is the return paid to investors. Because equity investors must now factor in more rates of return based on how long the asset is held, the investment decision is much more complex. Evaluating the expected rate of return on a prospective new investment requires estimating the likelihood of holding an investment for each of the three periods. The higher tax rate on gains held between 12 and 18 months (a maximum 28% versus 20%) reduces the return, lowering the price an investor is willing to pay for the asset. Lower asset prices hurt those trying to put new investments in place, resulting in less capital formation and slower growth.

Though a small percentage of capital gains (6 percent) fall into this intermediate period, the reach of this "small" tax is much longer. Why? Because even an investor expecting to hold more than 18 months must build in the possibility that he or she will have to sell early and pay the higher tax rate. In this way, the taint on expected returns extends to most capital gains, thereby magnifying the economic effects.

By 2007, we estimate that eliminating the 12-to-18-month holding period would:[12] [See Table 4 for simulation results.]

- Increase gross domestic product by $15.4 billion;
- Add $12.5 billion to the stock of U.S. capital and
- Create 6,145 new jobs.

Economic and Budgetary Effects of Eliminating the 12 to 18 Month Capital Gains Holding Period, Revised Base (Change Relative to Baseline)				
Economic Effects				
By Calendar Year	Change from Baseline			
	GDP[1] ($bil. nom.)		Jobs	Capital ($bil. nom.)
2002	4.9		2,923	4.8
2007	15.4		6,145	12.5
Revenue Effects (in $millions)				
Calendar Year	Static Federal Tax Change	Dynamic Federal Tax Change	Net to Federal Government	Net to All Governments
1998-2002	81.8	972.6	1,054.5	1,709.0
1998-2007	(1,506.7)	4,409.5	2,902.8	4,915.0
Per $ of Static Loss, 1998-2007			$1.93	$3.26

Table 4
Economic and Budgetary Effects of Eliminating the 12 to 18 Month Capital Gains Holding Period, Revised Base

Source: Fiscal Associates Inc. Model.

[1] Cumulative increase in GDP over baseline.

Government forecasting methods would show eliminating the intermediate holding period as a revenue loser over the long run. But this prediction would be wrong. In fact, government would pick up revenue at the federal, state and local levels because higher growth means a larger tax base and higher income, payroll, excise, sales and property taxes for federal, state and local governments.

We estimate that: [See Table 4.]

- Economic effects would turn a static revenue loss of $1.5 billion over ten years into a net gain of $2.9 billion for the federal government.
- State and local revenues would increase by $2 billion over the same period.

Put another way, giving up a dollar in static revenue loss through elimination of the 12-to-18-month holding period would yield almost $2 in dynamic revenue gains to the federal government and over $3 including state and local governments.

What About Speculation?

Press reports claim the Clinton administration will likely oppose any attempt to revert to two holding periods. In the face of minimal revenue effects, opposition will most likely rely on the mistaken belief that a rollback would encourage stock market speculation. This argument is wrong for the following reasons.

First, speculative gains (or losses) generally occur on sales of assets held less than a year and quite often held only a few days. As such, they receive no special treatment and are taxed as ordinary income.

In addition, speculation plays an important economic role that government should not discourage. Despite sometimes negative connotations, speculators are simply people who trade based on information they believe either others do not know or have not correctly evaluated. Armed with this knowledge, the speculator is willing to assume greater risk in the hopes of greater reward. In the process, speculation helps to stabilize the market by dampening supply fluctuations.

A classic example occurs daily in the commodity markets. Farmers face the problem of deciding how much to produce without knowing what price their crops will bring at the time of harvest, usually months into the future. Enter the speculator who is willing to buy the farmer's crop at a given price (say $3 a bushel for 10,000 bushels of wheat in six months). By selling this *futures contract*, the farmer transfers the risk of price fluctuations to the speculator and can set about to produce and deliver 10,000 bushels of wheat.[13]

Similar transfers of risk from other wheat farmers to speculators further assure the supply of wheat to the market. A more predictable supply, in turn, will lead to fewer and smaller fluctuations in the price of wheat.

Conclusion

It is hard to argue against a return to two holding periods for capital gains. Doing so would make tax return filing much easier for one out of seven taxpayers. Even small budgetary effects would be more than offset through the boost to capital markets. Economic gains would ultimately bring in $2 in revenue to federal coffers for every dollar that government forecasts predict would be lost.

Concern over increased speculation is a red herring. Speculative gains, which are generally short-term, receive no special treatment and are taxed as ordinary income. Further, speculation serves a positive economic purpose, dampening market fluctuations and providing a way to transfer risk from producers to speculators.

Finally, to those budget hawks who doubt there would be any economic benefits to offset the average $150 million annual revenue loss, perhaps 16.6 million Schedule D filers would be willing to pay $10 each to only have to track whether they held a stock or mutual fund under or over a year.

Endnotes

1 For tax purposes, a capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; (2) depreciable or real property used in the taxpayer's trade or business; (3) specified literary or artistic property; (4) business accounts or notes receivable; or (5) certain U.S. publications.

2 Assets sold before May 7, 1997, regardless of how long they were held, are also taxed at 28%. Real estate depreciation recapture will generally be taxed at maximum rate of 25% while collectibles will be continue to be taxed at a maximum rate of 28%. The bill also included a $250,000 exclusion ($500,000 for a joint return) for the sale of a principal residence effective May 7, 1997.

3 Between 1993 and 1995, 1040 returns grew at an annual rate of 1.6 percent while returns reporting capital gains or losses (including non-Schedule D) increased at 4.1 percent.

4 "Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, Vol. 83, No. 1, January 1997, Table 6. Indirect stock ownership refers to mutual funds or part of a retirement account.

5 Internal Revenue Service, 1996 1040 Forms and Instructions, p.7.

6 Robert D. Hershey, Jr., "Taxpayers, Defeated by Schedule D, Surrender to the Experts," *The New York Times*, March 29, 1998, Section 3, p. 11.

7 16.6 million taxpayers should file Schedule D in 1998.

8 Prior to 1986, there was a 60-percent capital gains exclusion which meant that only 40 percent of capital gains were included in income for tax purposes.

9 Joint Committee on Taxation, "Estimates of Chairman's Mark Relating to Revenue Reconciliation Provisions," June 9, 1997.

10 Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement on the Revenue Provisions of H.R. 2014, The 'Taxpayer Relief Act of 1997,'" July 30, 1997.

11 Our estimate is consistent with a report in Richard W. Stevenson, "How to Spend a Windfall," *The New York Times*, March 1, 1998 that cited a revenue pick up of $100 million over five years and a small decline over 10 years.

12 Simulation was done using the Fiscal Associates Inc. Model, a neoclassical, general equilibrium model of the U.S. economy which incorporates taxes through their effects on the returns to labor and capital. Economic effects are expressed as a change from a baseline forecast that describes how the economy would perform without any change in policy. The Model baseline, which currently has the U.S. economy growing at a long-run, real rate of 2.5 percent a year, is similar to those used by the Congressional Budget Office and the Office of Management and Budget. For more on the Model see Gary and Aldona Robbins, *Accounting for Growth: Incorporating Dynamic Analysis into Revenue Estimation*, Lewisville, TX: Institute for Policy Innovation, Policy Report No. 138, July 1996.

13 Of course, commodity and futures markets are far more complicated. For more discussion see William F. Sharpe, *Investments*, Englewood Cliffs, NJ: Prentice-Hall, Inc., 1985, Ch. 17.