How Sales of Capital Assets Were Affected by the Tax Reform Act of 1986

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What follows is the first attempt by employees of the Internal Revenue Service's Statistics of Income (SOI) function to analyze data from the 1985-based Sales of Capital Assets (SOCA) Panel. This paper focuses on the first three years of the panel, 1985 through 1987. These years are particularly interesting because they span a period immediately before and after the Tax Reform Act (TRA) of 1986 -- a major tax law change affecting the treatment of sales of capital assets (which hereafter will be called "capital gains"). Tax Year 1985 is the base year, representing taxpayer behavior before TRA. Tax Year 1986 shows what taxpayers did to prepare themselves for Tax Year 1987, when TRA took effect.

This paper will do the following:

- Provide SOCA Study background information;
- Present capital assets background information;
- Describe sales of capital assets data which have traditionally been available in the annual Statistics of Income reports issued by the IRS;
- Show some preliminary SOCA Panel data; and
- Introduce plans for further development of the SOCA study.

SOCA Study Background

Beginning with Tax Year 1985, a longitudinal SOCA panel was developed to complement the annual cross-sectional series of SOI data (Holik, Hostetter, and Labate, 1989). The plan was to follow a sample of taxpayers for as long as ten years to study their reactions to tax law changes and economic conditions. A sample of 12,980 tax returns was selected; these returns were highly skewed towards high-income taxpayers with dividend and interest income (Hostetter, 1993). Information from Schedule D and other IRS forms with SOCA data have been edited for 1985 and each subsequent year. (Note that the weights used for the SOCA data are still preliminary.)

Historical Background

Two major events affecting the sales of capital assets happened during the 1985-through-1987 time period. The first was the passage of the Tax Reform Act of 1986. The second was the stock market crash of October 19, 1987, which caused a sudden loss in value of many taxpayers' stock portfolios (as well as a panic about possible future losses).

The essence of TRA was to keep revenues constant while lowering the tax rates. In order to accomplish this, many exclusions, deductions, adjustments, and special tax treatments were eliminated. Among the sources of income that had received particularly favorable treatment under prior law was long-term capital gains -- i.e., gains on property held for six months or more.

Prior to 1987, short-term gains were taxed as ordinary income and ordinary income had a maximum tax rate of 50 percent. The maximum tax rate on long-term gains, prior to 1987, was only 20 percent. This is because 60 percent of long-term capital gains could be excluded from taxable income, which left only 40 percent of long-term capital gains to be taxed at the 50 percent tax rate. Under TRA, long-term gains became fully taxable, just as short term gains had been. For the phase-in year of 1987, there was a maximum tax rate of 28 percent on long-term gains and a maximum tax rate of 38.5 percent on short-term gains. In 1988, both short-term and long-term gains were treated as ordinary income. Table 1 illustrates how TRA affected the capital gains tax rates.

Table 1
Capital Gains Tax Rates
Before and After Tax Reform Act of 1986

Tax Year	Max Tax on Long-Term Gains	Max Tax on Short-Term Gains	Max Tax on Ordinary Income
1985 and 1986	20%	50%	50%
TRA 1986			
1987	28%	38.5%	38.5%
1988	33%	33%	33%

TRA took effect January 1987, but was passed by Congress in September 1986. This gave taxpayers several months to prepare for the upcoming tax law changes. During this time period, there was an incentive to accelerate sales of long-term capital assets in order to take advantage of the soon-to-expire low 20 percent tax rate.

■ Data Traditionally Available

Information Provided

The IRS releases annual reports of cross-sectional data on the operation of the income tax law. Table 2 displays the cross-sectional data on capital assets obtained from Schedule D, Capital Gains and Losses, filed with the IRS Form 1040, Individual Income Tax Return. These data show that long-term gains increased nearly two and one-half times between 1985 and 1986 -- from 139.7 to 335.9 billion dollars. For 1987, the TRA transitional year, long-term gains were cut in half from 1986, to 167.3 billion dollars. Long-term losses, as well as short-term gains and losses, show more orderly increases over the three-year period.

The two bottom lines in Table 2 represent the amount of capital gains carried from Schedule D to Form 1040, and included in total income. They represent combined long-term and short-term gains and losses. In the case of net capital gains, the amount shown is after the 60% capital gains exclusion allowed in 1985 and 1986. In the case of net capital losses, the amount has been limited to $3,000 per filing unit. In spite of the drop in the amount of long-term capital gains from 1986 to 1987, the amount of capital gains included in total income rose. This is due to the abolition of the 60 percent long-term exclusion.

Table 2
Cross-Sectional Data on Sales of Capital Assets
(Amounts in billions of dollars)

Type of Capital Asset	1985	1986	1987
Long-Term Gains	139.7	335.9	167.3
Long-Term Losses	17.5	33.9	43.7
Short-Term Gains	9.1	12.7	16.0
Short-Term Losses	10.1	22.0	31.2
Net Capital Gains*	71.6	135.0	144.2
Net Capital Losses*	3.9	3.5	6.8

Note: These data came from the annual series Statistics of Income--Individual Income Tax Returns, Pub. 1304.
* Amount included in adjusted gross Income.

Questions Unanswered

While this type of "bottom line" cross-sectional information sheds some light on the effects of TRA, it leaves many questions unanswered, such as:

- Were the reduced long-term capital gains in 1987 really the result of fewer sales, or were taxpayers selling just as many assets but earning less money?
- Were the huge increases in long-term gains in 1986 due to the same people selling more assets, or were sales being made by people who didn't have capital transactions in 1985?
- What types of assets were sold in each year?
- When were assets sold?
- How long had the assets been held?

These are the types of questions that the SOCA Panel was designed to answer.

SOCA Panel Data

Using data, from the SOCA panel, we have begun to study the first three questions posed above.

What Caused the Decrease in Long-term Capital Gains in 1987?

The SOCA Panel data in Table 3 show that although total gains decreased in 1987, there were plenty of assets being sold. Some economists warned that increasing the capital gains rates would lock people into holding their assets, since the higher tax rates associated with a sale would wipe out the expected profits associated with a new investment. Of course, a year when there is a stock market crash is not the best one to test this hypothesis, but, at least for 1987, the new tax law does not appear to have suppressed asset transactions. In fact, the number of tax returns showing transactions rose from 7.6 to 9.9 million between 1986 and 1987. The number of transactions also rose during this same period from 36.6 to 40.2 million. And this is a panel study, so we are counting only taxpayers who were already filing in 1985. Any new filers after 1985 are excluded from the data.

Table 3
SOCA Panel Capital Gains Transactions From 1985-1987
(Numbers in thousands, amounts in billions of dollars)

Capital Assets Transactions	1985	1986	1987
Number of Returns with Transactions	7,651	7,635	9,894
Number of Transactions	25,903	36,569	40,188
Total Sales Price	$481.1	$733.5	$748.1
Total Basis (Cost)	$308.6	$454.0	$629.8
Total Gains*	$191.1	$308.2	$174.4
Total Losses*	$18.4	$28.7	$56.0

*Whether or not included in adjusted gross income.

Even more impressively, the value of the assets sold, as measured by the basis (which is generally their cost at the time of acquisition) increased by 39 percent, from 454 to 629.8 billion dollars. On the other hand, the total amount received from these sales increased only modestly, from 733.5 to 748.1 billion dollars. This large increase in basis and small increase in sales price led to a substantial decrease in total gains (before any exclusions) and a substantial increase in total losses (before any limitations). The bottom two rows of Table 3 illustrate these results.

Who is Selling Assets?

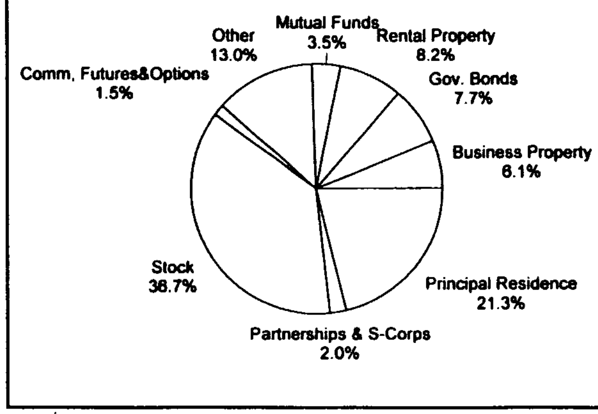
Table 3 also shows that there was a very dramatic increase in the value of the assets sold between 1985 and 1986. That figure rose 47 percent, from 308.6 to 454 billion dollars. This increase is generally attributed to people timing their sales to occur prior to the increase in the capital gains tax rates. Interestingly, the number of individuals with capital transactions was practically unchanged from 1985 to 1986, actually dropping very slightly from 7.65 to 7.64 million. It is tempting to assume that the same taxpayers who sold assets in 1985 sold assets in 1986, but that they sold more valuable assets in 1986. Table 4 illustrates that this assumption is wrong.

As it turns out, only 4.5 million of the 7.6 million taxpayers with capital transactions in 1986 also had transactions in 1985. That is, there were 3.1 million taxpayers who had no transactions in 1985 but sold capital assets in 1986; a comparable number of taxpayers made sales only in 1985 and sat out the selling frenzy of 1986. The new 1986 sellers did quite well in the market; their total sales price of 218 billion dollars was 62 percent higher than their total cost or basis of 134.6 billion. This is a rate of return which is comparable to that of those taxpayers who sold in both years.

What Types of Assets Were Sold?

The SOCA Panel Study contains codes for 20 asset types; for purposes of this analysis, they have been consolidated into nine categories. As Figure 1 shows, stocks account for the highest proportion of sales. In 1985, stocks accounted for 37 percent of the total sales. Sales of principal residences came in second. It should be noted, however, that most sales of residences do not affect total income. The gain from these sales can be postponed indefinitely if the house sold is replaced with another one of equal or greater value within a two-year period.

Figure 1
Amount of Sales by Asset Type
Tax Year 1985



Sales of government bonds ranked only fifth in 1985, but Table 5 demonstrates that, by 1987, this asset type moved into third place -- a reflection of rapidly falling interest rates. The huge rise in the sale of stocks in 1986 is undoubtedly related to anticipation of the effects of TRA. Research done with the SOCA panel study by Burman, Clausing, and O'Hare shows that sales of stocks rose and fell in 1986, as Congress debated the proposed drastic increase in the capital gains tax (Burman, 1994). Other fluctuations that are probably related to TRA are in the area of rental property, partnerships, and S-Corporations. An ever-rising trend prior to TRA was the formation of partnerships for the purpose of generating large losses to off-

Table 4
1986 Capital Gains Transactions by 1985 Taxpayers

(Numbers in thousands, amounts in billions of dollars)

	Total 1986 Transactions	Transactions in Both 1985 and 1986	Transactions Only in 1986
Number of Returns with Transactions	7,635	4,505	3,130
Number of Transactions	36,569	24,355	12,214
Total Sales Price	$733.5	$515.4	$218.1
Total Basis (Cost)	$454.0	$319.4	$134.6
Total Gains	$308.2	$213.7	$94.5
Total Losses	$28.7	$20.4	$8.3

Table 5
Amount of Sales by Asset Type
(Amounts in billions of dollars)

Asset Type	1985	1986	1987
Stocks	174.3	331.7	291.5
Principal Residence	99.9	119.3	147.2
Other	61.6	66.2	70.8
Rental Property	38.4	53.5	45.3
Government Bonds*	35.4	50.4	75.3
Business Property	28.8	21.7	21.4
Partnerships & S-Corps	19.2	45.2	28.8
Mutual Funds	16.6	40.1	41.3
Commodities, Futures & Options	6.9	5.3	26.4
TOTALS	$481.1	$733.4	$748.0

*Includes Federal, state, and local obligations.

set large current incomes, or the direct investment in rental property for the same purpose (Petska and Nelson, 1990; Nelson and Petska, 1989; and Petska, 1991). TRA, with its limitation on the deductibility of passive losses, made these real estate ventures much less attractive; therefore, taxpayers had an incentive to sell these properties.

Futures and options jumped dramatically from 1986 to 1987. The amount of sales in 1987 is four times greater than the amount in 1986. It will be interesting to see whether this jump is sustained in later years or whether it is related to the volatile markets of 1987.

■ Conclusions and Future Plans

We have a wonderful research tool for studying sales of capital assets. Some of the research we hope to do in the near future involves an analysis of the timing of sales and an examination of how long assets are typically held prior to sale.

We also plan to add data already edited for 1988 through 1992 to the file. This will make the data much more interesting but also more difficult to analyze. Final weights are being developed. Use of base-year weights becomes more and more problematical the further you get from the year the sample was drawn. The unintentional, but also unavoidable, addition of people who marry panel members and file joint returns must be addressed. There also appears to be a high propensity for the taxpayers in our panel to do very well over the years. Transition matrices for the sample and the population may have to be developed to adjust for these occurrences. In conclusion, we are confident that in the near future we will have some interesting developments.

■ Acknowledgments

The authors wish to extend a special thanks to John Czajka and Robert Cohen, for developing the tables, and Wendy Alvey, for reviewing the manuscript.

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