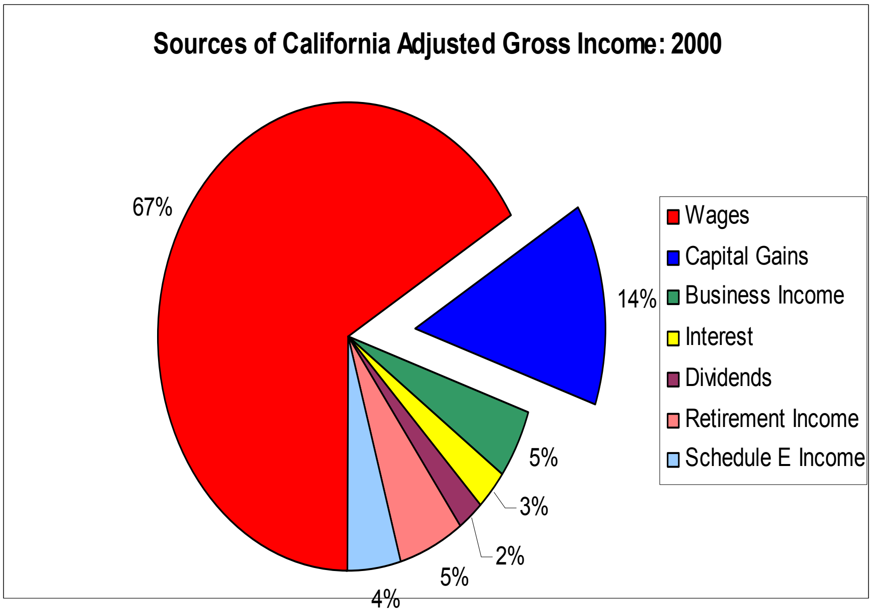
Capital Gains,
Now You See Them, Now You Don't

Phil Spilberg

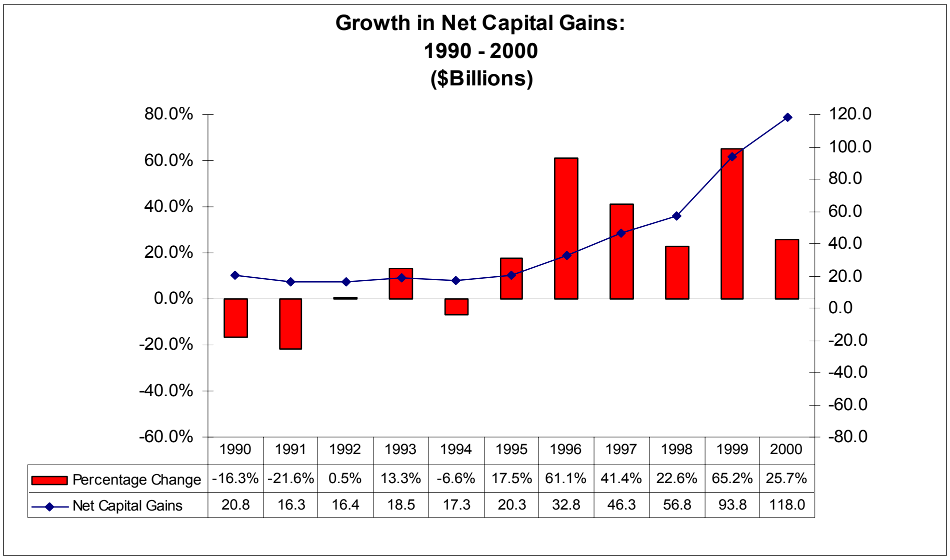
Economic and Statistical Research Bureau

Franchise Tax Board

Sacramento, CA

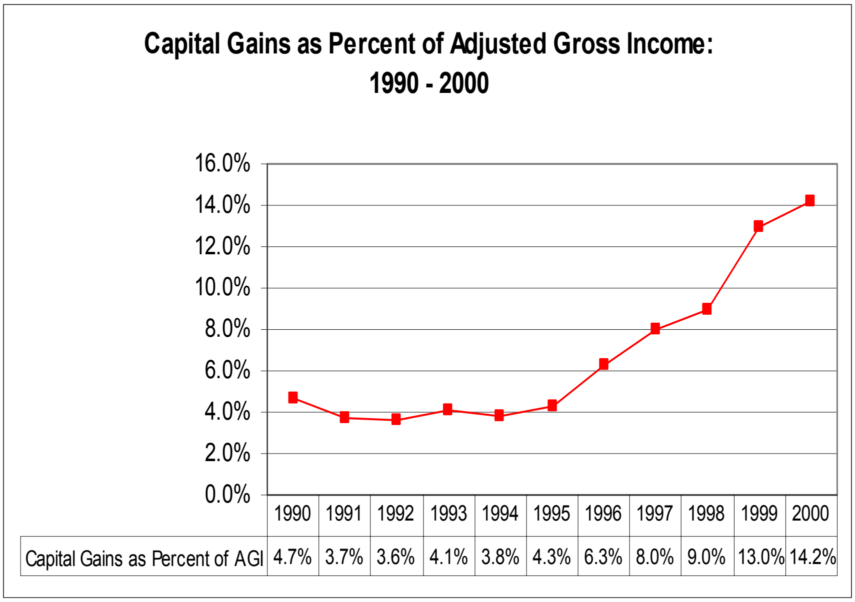


In 2000, CG represented 14% of CA AGI. It was, by far the second largest source of income after wage and salaries, followed by business (schedule c) income and retirement income, both at 5%.



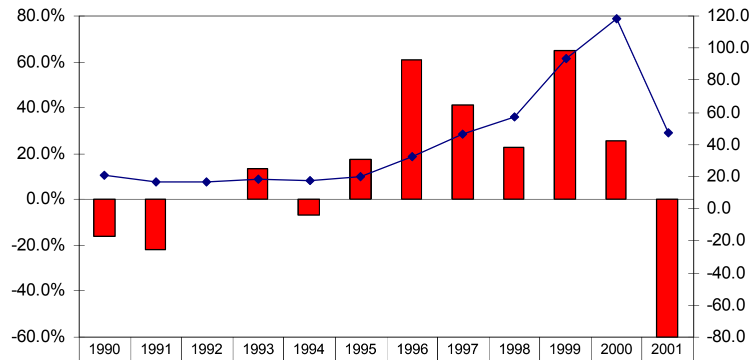
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Percentage Change	-16.3%	-21.6%	0.5%	13.3%	-6.6%	17.5%	61.1%	41.4%	22.6%	65.2%	25.7%
Net Capital Gains	20.8	16.3	16.4	18.5	17.3	20.3	32.8	46.3	56.8	93.8	118.0

Growth in capital gains in the several years preceding 2000 has been nothing short of amazing. Starting in 1995, growth rates have been …, resulting with an increase in CG from $20.3 billion in 1995 to $118 billion in 2000, nearly a 6 fold increase in 5 years.



From 1995 on, CG grew from 4.3% of AGI to 14.2% in 2000. So, even with the growth of stock options, its representation, during that time period, grew by more than a factor of 3.

Growth in Net Capital Gains:
1990 - 2001*
(Billions of Dollars)



	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Percentage Change	-16.3%	-21.6%	0.5%	13.3%	-6.6%	17.5%	61.1%	41.4%	22.6%	65.2%	25.7%	-60.0%
Net Capital Gains	20.8	16.3	16.4	18.5	17.3	20.3	32.8	46.3	56.8	93.8	118.0	47.2

*** 2001 is an estimate**

Of course, what goes up can fall down. Our DOF has estimated that CG fell by 60% in 2001, to roughly their level in 1997.

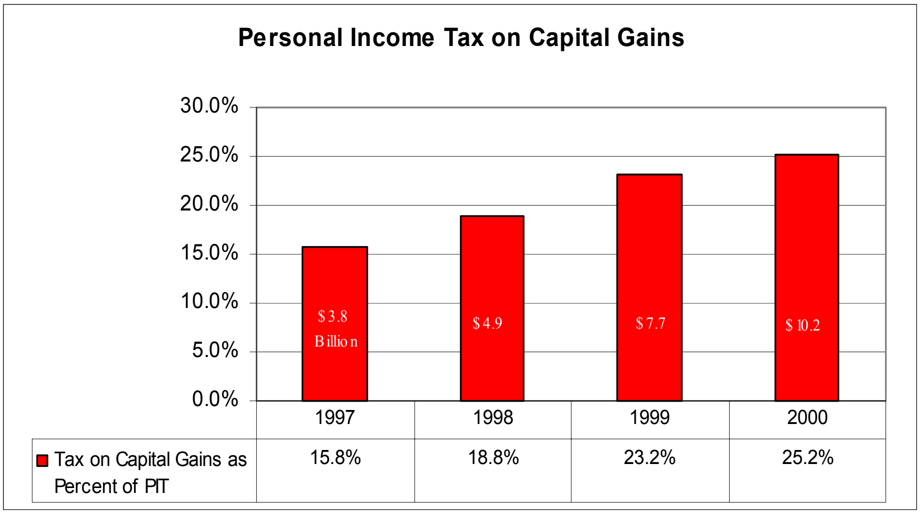
Income Distribution for Capital Gains					
Adjusted Gross Income Class	Capital Gains ($ in Millions)	Captital Gains Percentage Distribution	Capital Gains Tax ($ in Millions)	Adjusted Gross Income ($ in Millions)	Capital Gains as a Percentage of AGI
Negative to $0	$ 652	0.5%	-$ 1	-$ 5,197	
$1 to $10,000	218	0.2%	0	11,388	1.9%
$10,001 to $30,000	1,111	0.9%	12	84,039	1.3%
$30,001 to $50,000	1,600	1.3%	54	103,114	1.6%
$50,001 to $75,000	2,552	2.1%	136	107,778	2.4%
$75,001 to $100,000	2,683	2.2%	181	82,945	3.2%
$100,001 to $200,000	8,475	7.1%	680	141,758	6.0%
$200,001 to $500,000	12,495	10.4%	1,078	89,942	13.9%
$500,001 and over	90,189	75.2%	8,052	216,556	41.6%
TOTAL	$ 119,975	100.0%	$ 10,192	$ 832,323	14.4%

Who earns CGs? Well, not surprising, it is largely the rich.

In 2000, over 75% of CGs were earned by taxpayers with AGI over $500,000. Over 85% came from taxpayers with AGI over $200,000.

So, the talk about a CG exclusion helping the little guy is overstated. Only 15% of CG is earned by taxpayers with income under 100 grand.

Also, what is interesting is that if you look all taxpayers with income above $500,000, over 40% of that income is from CGs.



Because CGs are so highly concentrated, in CA, which does not exclude a portion of CGs from income, or provide a preferential CG tax rate, by 2000 more than ¼ of our PIT came from CGs.

Recall that CGs were only 14% of AGI.

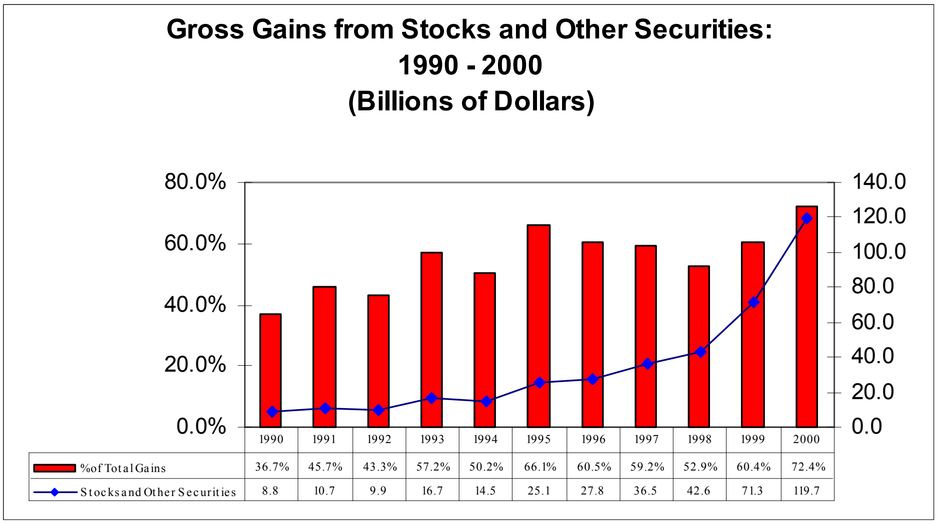
Gross Capital Gains and Its Components: 1988 - 2000						
Tax Year	Stocks /a	Other securities	Residential Real Estate /b	Non-Residential Real Estate	Other	Total
1988	10,928	897	6,253	2,720	10,313	31,111
1989	9,478	838	6,675	3,332	10,633	30,956
1990	7,895	901	5,103	2,672	7,373	23,944
1991	9,413	1,249	3,514	2,446	6,710	23,331
1992	8,412	1,516	2,775	1,620	8,627	22,949
1993	14,792	1,924	3,394	1,791	7,344	29,245
1994	12,897	1,553	3,680	1,906	8,771	28,807
1996	25,742	2,065	2,517	1,289	14,359	45,973
1997	32,715	3,823	3,493	2,916	18,781	61,728
1998	37,724	4,883	6,837	2,334	28,826	80,604
1999	66,254	5,075	5,969	4,258	36,481	118,037
2000	$ 113,426	$ 6,235	$ 12,499	$ 2,625	$ 30,561	$ 165,347

/a Includes capital gain distributions
/b For years prior to 1998, capital gains for sale of primary residences were excluded because they were largely rolled forward.
Source: California Franchise Tax Board: Capital Assets Study
Detail may not add to totals due to rounding

Now let me get to the sources of CGs from our capital asset studies. These studies are similar to the Wisconsin study and we have them going back to 1988.

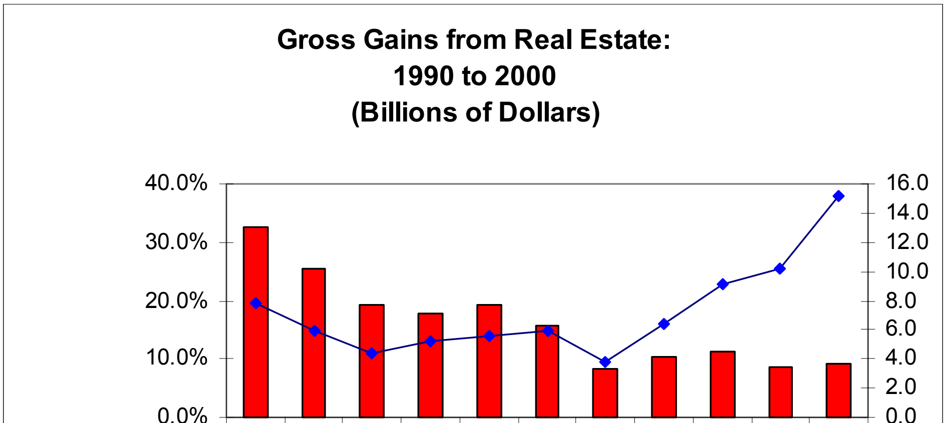
This table focuses on gross gains; in other words, there is no netting of gains against losses.

In 2000, as we can see, stocks, by far is the largest CG asset type. A distant second is “other”, that is largely made up of pass through income from S-Corps, partnerships, LLCs and LLPs. That is followed by real estate.



	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
% of Total Gains	36.7%	45.7%	43.3%	57.2%	50.2%	66.1%	60.5%	59.2%	52.9%	60.4%	72.4%
Stocks and Other Securities	8.8	10.7	9.9	16.7	14.5	25.1	27.8	36.5	42.6	71.3	119.7

Focusing on stocks – which I have combined with other securities – we see the growth in their importance. In 1990 stocks and other securities constituted less than 40% of gross gains. By 2000, this % grew to over 70%



	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
% of Total Gains	32.5%	25.5%	19.2%	17.7%	19.4%	15.7%	8.3%	10.4%	11.4%	8.7%	9.1%
Real Estate	7.8	6.0	4.4	5.2	5.6	6.0	3.8	6.4	9.2	10.2	15.1

Over the same period of time, real estate has lost much influence, dropping from around 30% of gross gains to less than 10%. This is even though, in absolute terms real estate gains have grown dramatically since the mid 90s, raising from about $6 billion to over $15 billion in 2000.

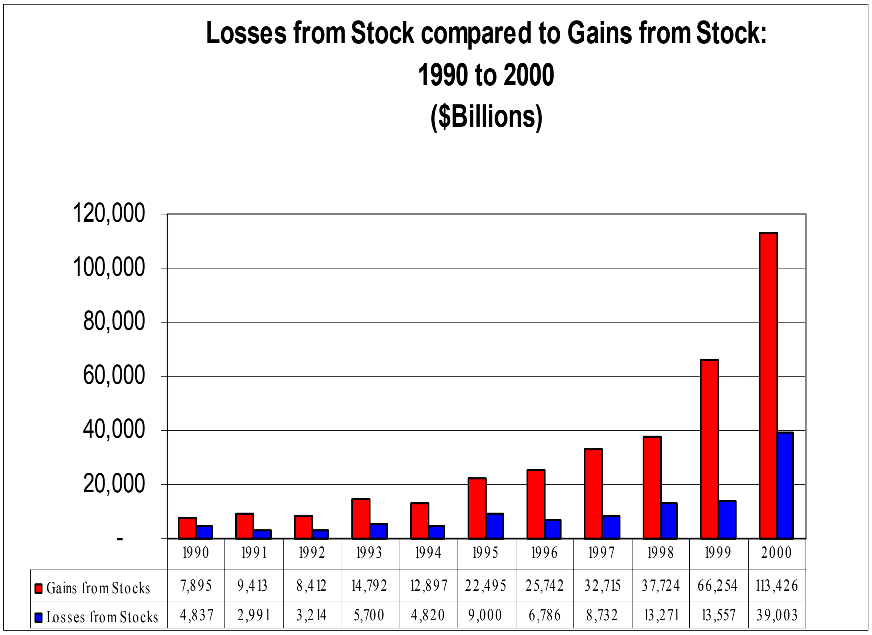
Gross Capital Losses and Its Components: 1988 - 2000 /a						
Tax Year	Stocks	Other securities	Residential Real Estate	Non-Residential Real Estate	Other	Total
1988	3,522	1,111	362	178	2,633	7,806
1989	4,136	1,117	510	145	4,428	10,336
1990	4,837	1,225	363	470	1,944	8,839
1991	2,991	2,716	314	218	3,305	9,544
1992	3,214	1,063	738	283	3,486	8,784
1993	5,700	1,385	1,136	946	3,293	12,459
1994	4,820	2,696	1,527	561	4,392	13,996
1995	9,000	2,562	1,859	176	7,117	20,714
1996	6,786	1,379	444	830	5,603	15,041
1997	8,732	1,897	1,001	603	2,710	14,943
1998	13,271	4,319	674	1,061	4,788	24,112
1999	13,557	4,488	430	279	5,865	24,619
2000	$ 39,003	$ 4,209	$ 438	$ 771	$ 6,466	$ 50,887

/a Excludes capital loss carryovers.
Source: California Franchise Tax Board: Capital Assets Study
Detail may not add to totals due to rounding

Let's look at gross losses. Again, this is before any netting with gains.

From 1999 to 2000, losses more than doubled, from less than $25 billion to more than $50 billion.

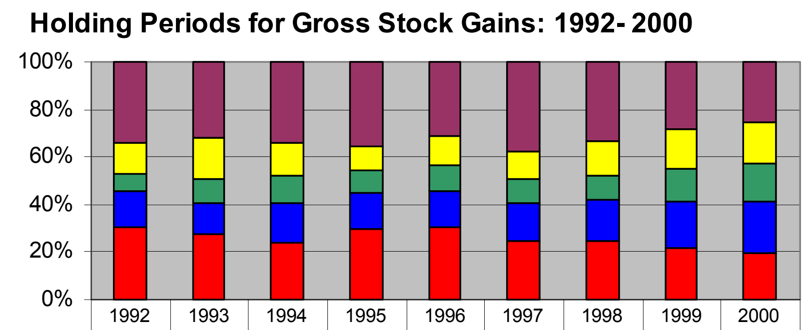
Most of this increase came from stocks, which almost tripled.



	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Gains from Stocks	7,895	9,413	8,412	14,792	12,897	22,495	25,742	32,715	37,724	66,254	113,426
Losses from Stocks	4,837	2,991	3,214	5,700	4,820	9,000	6,786	8,732	13,271	13,557	39,003

In fact, looking at stock gross losses relative to stock gains, in 2000 stock losses were greater than stock gains in all years but 1999 and 2000.

For example, in 1998 stock gains were about $38 billion, which compares to the $39 billion loss in 2000.

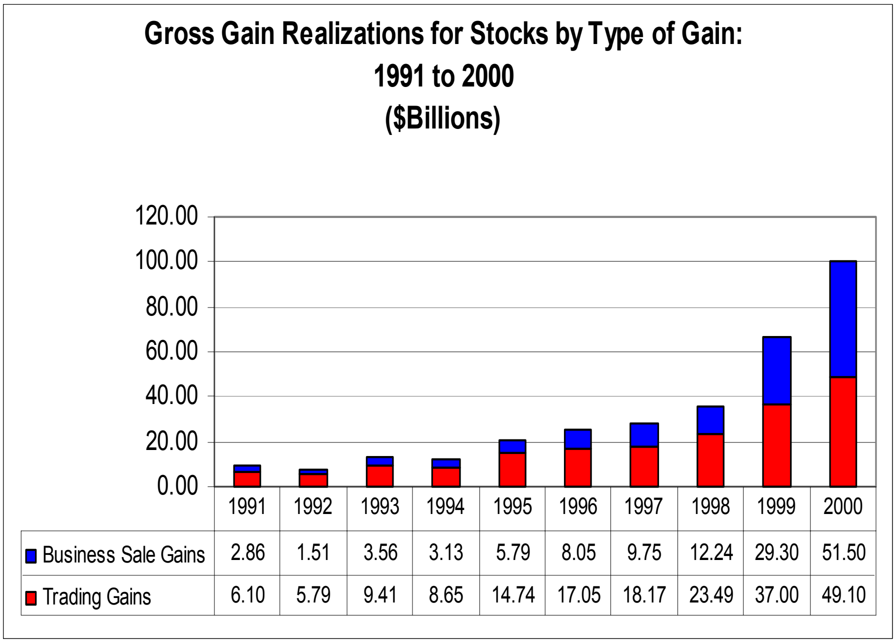


	1992	1993	1994	1995	1996	1997	1998	1999	2000
More than 5 years	34.0%	31.6%	34.3%	35.7%	31.0%	37.7%	33.3%	28.6%	25.1%
3 to 5 years	13.3%	17.8%	13.8%	10.1%	12.4%	11.8%	14.3%	16.4%	17.6%
2 to 3 years	7.1%	9.9%	11.0%	9.6%	10.8%	9.7%	10.5%	14.0%	15.6%
1 to 2 years	15.5%	12.7%	16.9%	15.1%	15.6%	15.8%	17.1%	19.0%	22.1%
1 Year or Less	30.1%	27.9%	24.0%	29.6%	30.2%	24.9%	24.8%	22.0%	19.5%

As for holding periods for stocks…

I found our holding periods a bit shorter than in the Wisconsin study.

In 2000, over 40% of the stocks sold were held less than 2 years, over 55% were held under 3 years. And these ratios have been fairly steady.



In this chart, I try to separate out the stock gains from trading from the stock gains from sale of businesses.

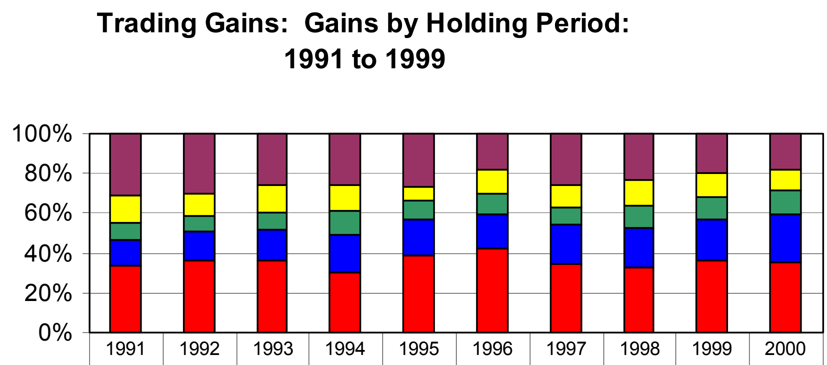
We tend to associate stock gains with financial portfolio adjustments, but we found that a significant portion of gains appear to come from taxpayers selling their businesses.

This happens when a startup or long established firm is sold to an acquiring firm for cash or the stock of the acquirer.

We have assumed a business sale to occur when the gain on the sale is at least equal to 95% of the sale price or if the sale price is over $5 million. As it turns out, the results are insensitive to the $5 million sale price parameter.

As this chart shows, business sale gains are a significant and raising portion of all stock gains over this time period, raising from about $3 billion in 1991 to over $51 billion in 2000.

In fact, in 2000, business sale gains were more than ½ of all stock gains.



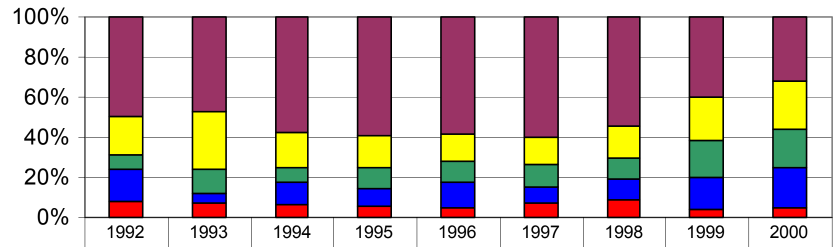
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
more than 5 years	30.7%	30.0%	25.8%	26.0%	26.4%	18.0%	26.0%	23.4%	20.0%	17.8%
3 to 5 years	14.0%	11.6%	13.6%	12.4%	7.6%	12.1%	10.8%	13.2%	11.8%	10.9%
2 to 3 years	9.1%	7.1%	9.3%	12.4%	9.4%	10.7%	9.0%	10.7%	11.1%	11.8%
1 to 2 years	12.5%	15.3%	15.5%	18.9%	17.5%	17.2%	20.1%	20.1%	21.0%	24.5%
less than 1 year	33.7%	36.0%	35.8%	30.4%	39.1%	42.0%	34.2%	32.5%	36.1%	35.0%

Lets take a look at the holding periods of trading gains.

In 2000, 35% of the stocks sold were held less than 1 year, almost 60% less than 2 years, over 70% less than 3 years.

So, the holding periods are quite short.

Business Sale Gains: Gross Gains by Holding Period: 1992 to 2000



	1992	1993	1994	1995	1996	1997	1998	1999	2000
More than 5 years	49.5%	47.0%	57.4%	59.2%	58.5%	59.6%	54.1%	39.6%	32.1%
3 to 5 years	19.7%	29.1%	17.6%	16.4%	13.2%	13.7%	16.6%	22.3%	24.0%
2 to 3 years	7.0%	11.6%	7.2%	10.2%	10.9%	11.2%	10.0%	17.8%	19.3%
1 to 2 years	16.2%	5.4%	11.4%	8.8%	12.3%	8.0%	10.7%	16.4%	19.9%
less than 1 year	7.7%	6.9%	6.5%	5.4%	5.2%	7.5%	8.6%	3.9%	4.7%

If trading gains are short relative to all stock gains than business sale gains must be long. And they are.

54% of CG from business sales relate to assets held more than 3 years.

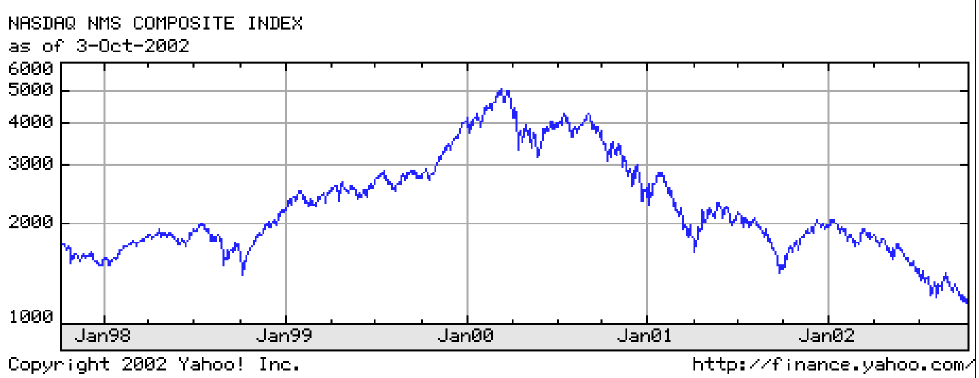
OK, so this is a lot of data and, you may say, so what?

So What?

- Stock Losses
- Business Sale Stock Gains
- Trading Stock Gains
- Partnerships, LLCs, LLPs, S-corporations
- Real Estate

Stock losses are now an important part of the equation (look at index data)

… and they are likely to grow substantially for 2001 and 2002. Indeed, in 2000 almost all losses were used to offset gains. I believe, 2001 and 2002 will generate substantial loss carryovers.


NASDAQ NMS COMPOSITE INDEX
as of 3-Oct-2002
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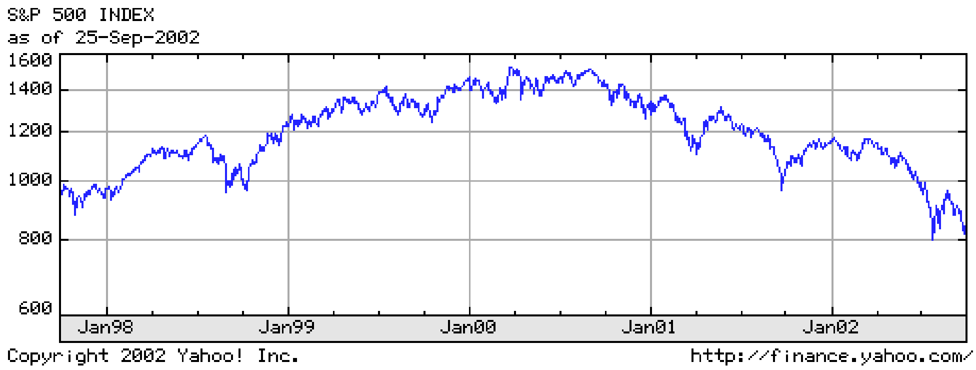
S&P 500 INDEX
as of 25-Sep-2002
1600
1400
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Jan02
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Business sale stock gains can fall dramatically, especially if they were due to tech startups.

Keep in mind that trading gain holding periods are quite short; over 70% are less than 3 years. Because of this, gains are likely to fall dramatically in 2001 and 2002. Indeed, it is likely that trading losses in both years will be greater than gains.

I believe that gains from pass-throughs may hold up, because they are more likely to be associated with real estate, ether through direct holdings or trusts. However, if a significant portion comes from hedge funds, this too can fall.

Real estate is the one bright spot, which I expect to grow dramatically into 2001 and 2002.