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An Analysis of the Tax Treatment of Capital Losses

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Summary

Several reasons have been advanced for increasing the net capital loss limit against ordinary income: as part of an economic stimulus plan, as a means of restoring confidence in the stock market, and to restore the value of the loss limitation to its 1978 level. A number of bills increasing the limit have been introduced, and the President has proposed an increase as well.

Under current law, long term and short term losses are netted against their respective gains and then against each other, but if any net loss remains it can offset up to \$3,000 of ordinary income each year. Capital loss limits are imposed because individuals who own stock directly decide when to realize gains and losses. The limit constrains individuals from reducing their taxes by realizing losses while holding assets with gains until death when taxes are avoided completely.

Current treatment of gains and losses exhibits an asymmetry because long term gains are taxed at lower rates, but net long term losses can offset income taxed at full rates. Individuals can game the system and minimize taxes by selectively realizing gains and losses, and for that reason the historical development of capital gains rules contains numerous instances of tax revisions directed at addressing asymmetry. The current asymmetry has grown as successive tax changes introduced increasingly favorable treatment of gains. Expansion of the loss limit would increase “gaming” opportunities. In most cases, this asymmetry makes current treatment more generous than it was in the past, although the capital loss limit has not increased since 1978.

Capital loss limit expansions, like capital gains tax benefits, would primarily favor higher income individuals who are more likely to hold stock. Most stock shares held by moderate income individuals are in retirement savings plans (such as pensions and individual retirement accounts) that are not affected by the loss limit. Statistics also suggest that only a tiny fraction of individuals in most income classes experience a loss and that the loss can usually be deducted relatively quickly.

One reason for proposing an increase in the loss limit is to stimulate the economy, by increasing the value of the stock market and investor confidence. Economic theory, however, suggests that the most certain method of stimulus is to increase spending directly or cut taxes of those with the highest marginal propensity to consume, generally lower income individuals. Expanding the capital loss limit is an indirect method, and is uncertain as well. Increased capital loss limits could reduce stock market values in the short run by encouraging individuals to sell.

Adjusting the limit to reflect inflation since 1978 would result in an increase in the dollar limit to about \$8,000. However, most people are better off now than they would be if the \$3,000 had been indexed for inflation if capital losses were excludable to the same extent as long-term capital gains were taxable. For higher income individuals, restoring symmetry would require using about \$2 in long term loss to offset each dollar of ordinary income. Fully symmetric treatment would also require the same adjustment when offsetting short term gains with long term losses. This report will be updated to reflect legislative developments.

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An Analysis of the Tax Treatment of Capital Losses

Introduction

Given the recent downturn in the stock market, interest has been expressed in increasing the net capital loss limitation. In the 107th Congress several bills have been introduced that would affect the tax treatment of capital losses. An increase in the capital loss limitation to \$5,000 was part of the original economic stimulus package, H.R. 3090, that passed the House in October 2001. This provision, however, did not make it into the final version of the stimulus package.

On October 8, 2002, the House Ways and Means Committee passed H.R. 1619, a bill that would increase the net capital loss deduction to \$8,250 and would index that amount for inflation. Another bill, H.R. 5212 would increase the net capital loss deduction to \$20,000 and index the amount for inflation. In the Senate, S. 784 would increase the net capital loss deduction to \$20,000 and allow a three-year carryback. S. 818 would increase the net capital loss deduction to \$10,000 and index the amount for inflation.

In addition to these pending bills in the 107th Congress, President Bush has indicated that he favors increasing the net capital loss deduction to \$20,000 as part of a tax plan to stimulate the economy.

A limit on the deductibility of capital losses against ordinary income has long been imposed, in part because gains and losses are taxed or deducted only when realized. An individual who is actually earning money on his portfolio can achieve tax benefits by realizing losses and not gains (and can hold assets with gains until death when no tax will ever be paid). The loss limit prevents this selective realization of losses from being a significant problem.

The problem of losses is further exacerbated by the current tax system, where the treatment of capital gains and losses is asymmetrical. Long term gains are taxed at a maximum rate of 20%. Long term losses are deductible without limit against short term capital gains and net long term losses are deductible against \$3,000 of ordinary income. Both short term capital gains and ordinary income can be taxed at rates of up to 38.6%. This differential allows taxpayers to time their gains and losses so as to minimize income taxes. (For example, by realizing and deducting losses in one tax year at 38.6% while waiting until the next tax year to realize and pay taxes on gains at 20%). Increasing the net capital loss deduction would increase the rewards of gaming the system.

The empirical evidence indicates that capital gains income is heavily concentrated in the upper income ranges. It is probable that large capital losses are also concentrated in the same income ranges. Taxpayers in the middle income ranges tend to hold capital gains producing assets as part of tax favored retirement savings plans. The assets in these plans are not affected by the net loss restrictions. As a consequence, the benefits of increasing the net loss deduction would tend to accrue to taxpayers in the upper income ranges.

It is also unclear whether increasing the net loss deduction would stimulate the economy. Economic analysis suggests that measures to stimulate the economy should focus on spending or on tax cuts likely to be spent, that will directly increase aggregate demand. An expanded deduction for capital losses has a tenuous connection to expanded spending; thus, presumably, the argument is that such a tax benefit will benefit the stock market. However, it is not at all certain that an increase in loss deduction would increase the stock market; it might increase sales of poorly performing stocks and depress these markets further.

This report provides an overview of these issues related to the tax treatment of capital losses. It explains the current income tax treatment of losses, describes the historical treatment of losses, provides examples of the tax gaming opportunities associated with the net loss deduction, examines the distributional issues, and discusses the possible stimulative effects of an increase in the net loss deduction.

Current Income Tax Law

Under current income tax law, a capital gain or loss is the result of a sale or exchange of a capital asset (such as corporate stock or real estate). If the asset is sold for a higher price than its acquisition price, then the sale produces a capital gain. If the asset is sold for a lower price than its acquisition price, then the sale produces a capital loss.

Capital assets held longer than 12 months are considered long-term assets while assets held 12 months or less are considered short-term assets. Capital gains on short-term assets are taxed at regular income tax rates. Gains on long-term assets are taxed at a maximum tax rate of 20% (10% for taxpayers in the 15% marginal tax rate bracket). For any gain from the sale of assets held longer than five years and whose holding period began after December 31, 2000, the maximum tax rate is 18% (for taxable years beginning after December 31, 2000, any gain on assets held more than five years which would otherwise be taxed at 10% will be taxed at 8%).

Losses on the sales of capital assets are fully deductible against the gains from the sales of capital assets. (Losses on the sale of a principal residence are not deductible and losses on business assets are treated as ordinary losses and deductible against business income.) However, when losses exceed gains, there is a \$3,000 annual limit on the amount of capital losses that may be deducted against other types of income.

Determining the amount of capital losses under the federal individual income tax involves a multi-step process. First, short-term capital losses (on assets held less than 12 months) are deducted from short-term capital gains. Second, long-term capital losses (on assets held for more than 12 months) are deducted from long-term capital gains. Next, net short-term gains or losses are combined with net long-term gains or losses.

If the combination of short-term and long-term gains and losses produces a net loss, then that net loss is deductible against other types of income up to a limit of \$3,000. Net losses in excess of this \$3,000 limit may be carried forward indefinitely and deducted in future years, again subject to the \$3,000 annual limit.

Historical Treatment of Capital Losses

Historically, Congress has repeatedly grappled with the problem of how to tax capital gains and losses. Ideally, a tax consistent with a theoretically correct measure of income would be assessed on real (inflation-adjusted) income when that income accrues to the taxpayer. Conversely, real losses should be deducted as they accrue to the taxpayer. However, putting theory into practice has been a difficult exercise.

Since 1913, there has been considerable legislative change in the tax treatment of capital gains income and loss. To provide perspective for the current debate, a brief overview of the major legislative changes affecting capital losses follows.

1913 to World War II

Between 1913 and 1916, capital losses were deductible only if the losses were associated with a taxpayer's trade or business. Between 1916 and 1918, capital losses were deductible up to the amount of any capital gains, regardless of whether the gains or losses were associated with a taxpayer's trade or business. From 1918 to 1921, capital losses in excess of capital gains were deductible against ordinary income.

The Revenue Act of 1921 significantly changed the tax treatment of capital gains and losses. Assets were divided into short and long term assets. Short term gains were taxed at regular income tax rates and excess short term losses were deductible against ordinary income. Long-term gains were eligible for tax at a flat rate of 12.5%. Net excess long term losses were deductible against other types of income at ordinary income tax rates which, including surtax rates, went as high as 56%.

This system created an asymmetrical treatment of long term gains and losses. Excess long term losses could be deducted at much higher tax rates than the rates applied to long term gains. This asymmetry was rectified by the Revenue Act of 1924, which instituted a tax credit of 12.5% for net long term losses.

This approach remained in effect, with only minor modifications, between 1924 and 1938. The Revenue Act of 1938, however, introduced changes in the tax

treatment of gains and losses from the sale of capital assets. Gains and losses were classified as short-term if the capital asset had been held 18 months or less and long-term if the asset had been held for longer than 18 months.

Short-term losses were deductible up to the amount of short-term gains. Short-term losses in excess of short-term gains could be carried forward for one year and used as an offset to short-term gains in that succeeding year. The carryover could not exceed net income in the taxable year the loss was incurred. Net short-term gains were included in taxable income and taxed at regular tax rates.

For assets held more than 18 months but less than 24 months, 66.66% of the gain or loss was recognized. For assets held longer than 24 months, 50% of the gain from the sale of that asset was recognized and included in taxable income. Net recognized long-term losses could be deducted against other forms of income without limit. This treatment, however, introduced a new inconsistency into the tax system because while only 50% of any long term capital gain was included in the tax base, 100% of any net long term loss was deductible from the tax base.

World War II through the 1950s

The next significant change in the tax treatment of capital losses occurred during World War II. The Revenue Act of 1942 changed the tax treatment of capital losses in two significant ways. First, it consolidated the tax treatment of short- and long-term losses. Second, it established a \$1,000 limit on the amount of ordinary income that could be offset by combined short- and long-term net capital loss. Finally, it created a five-year carry forward for net-capital losses that could be used to offset capital gains and up to \$1,000 of ordinary income in succeeding years.

Once again, this change introduced an inconsistency into the tax treatment of gains and losses because it allowed taxpayers to use \$1 in net long-term losses to offset \$1 in net short-term gains. Since only 50% of a net long-term gain was included in taxable income, including 100% of a net long-term loss created an asymmetry. For instance, if a taxpayer had a net long-term loss of \$100, then it could be used to offset \$100 of net short-term gains. Symmetrical treatment of long-term gains and losses, however, would allow only 50% of a net long-term loss to be deducted against net short-term gains (\$100 of net long-term loss could only offset \$50 of net short-term gain). This asymmetry was corrected in the Revenue Act of 1951 which eliminated the double counting of net long-term losses.

The 1960s through the 1970s

The Revenue Act of 1964 repealed the five-year loss carryover for capital losses and replaced it with a unlimited loss carryover. Net losses, however, were still deductible against only \$1,000 of ordinary income in any given year.

The Tax Reform Act of 1969 also removed a dichotomy in the tax treatment of long term gains and losses that had existed since 1938 by imposing a 50% limitation on the amount of net long-term losses that could be used to offset ordinary income. Under prior law, even though only 50% of net long-term gains were subject to tax,

net long-term losses could be deducted in full and used to offset up to \$1,000 of ordinary income. The 1969 Act repealed this provision and established a new 50% limit on the deductibility of net long-term losses, subject to the same \$1,000 limit on ordinary income (hence, it took \$2 of long term loss to offset \$1 of ordinary income). In addition, the law specified that the nondeductible portion of net long-term losses could not be carried forward to be deducted in succeeding years.

The Tax Reform Act of 1976 increased the capital loss offset against ordinary income. Under prior law, net capital losses could offset up to \$1,000 of ordinary income. The 1976 Act increased the capital loss offset limit to \$2,000 in 1977 and \$3,000 for tax years starting after 1977.

The Revenue Act of 1978 reduced the tax rate on long term capital gains income by increasing the exclusion from tax for long term capital gains from 50% to 60%. The 1978 Act, however, did not reduce the limit on the deductibility of net long term losses. Hence, while only 40% of long term gains were included in the tax base, 50% of losses were excluded from the tax base.

The Tax Reform Act of 1986 to the Present

The Tax Reform Act of 1986 repealed the net capital gain deduction for individuals. Both short-term and long-term capital gains income were included in taxable income and taxed in full at regular income tax rates. Regular statutory income rates under the Act were reduced from a maximum of 50% to 33% (28% statutory rate plus a 5% surcharge).

The tax treatment of capital losses was changed by eliminating the 50% limitation on deductibility of net long term losses. Losses could be netted against gains and any excess losses, whether short or long term, could be deducted in full against up to \$3,000 of ordinary income. Net losses in excess of this amount could be carried forward indefinitely.

Gradually changes were made that caused capital gains to be tax favored again. When tax rates were revised in 1990 to eliminate the “bubble” arising from the surcharge, a maximum rate of 28% was set for capital gains, slightly lower than the top rate of 31%. When tax rates were increased in 1993 for very high income individuals (adding a 36% and 39.6% rate), this 28% top tax rate on long term gains was maintained, causing a wider gap between taxation of ordinary income and capital gains income. The growing asymmetry between taxes on capital gains and losses was not addressed.

The Taxpayer Relief Act of 1997 was the latest major change in the tax treatment of capital gains and losses. It established the current law treatment of gains by lowering the maximum tax rate on long term capital gains income to 20% (and creating a 10% maximum capital gains tax rate for individuals in the 15% tax bracket). The Act did not change the tax treatment of capital losses.

Analysis of the Treatment of Capital Losses Under Current Law

As the previous section demonstrated, the tax treatment of capital gains and losses has changed repeatedly over the years. Some of the legislative changes that occurred in the past were attempts to reestablish symmetry between the tax treatment of capital gains and capital losses.

Under current law, asymmetries between the tax treatment of capital gains and losses remain. Currently, net long term losses are deductible against net short term gains without limit. This rule introduces inconsistencies because net long term gains are taxed at a maximum rate of 20% while net long term losses can be deducted against short term gains which can be taxed at rates up to 38.6%. Additionally, net long term losses can be deducted against up to \$3,000 of ordinary income even though the maximum rate on ordinary income is 38.6% while the maximum rate on long term gains is 20%.

The recent downturn in the stock market has prompted some analysts to suggest increasing the net capital loss limitation as a means of softening the downturn for some investors. However, simply increasing the loss limitation would tend to increase the dichotomy between the tax treatment of gains and losses. Given these suggestions, a review of the rationale behind the net loss limitation may prove valuable.

The loss limitation was originally enacted because taxpayers have control over the timing of the realization of their capital gains and losses. They can elect to sell assets with losses and hold assets with gains, thus minimizing their capital income tax liabilities. When capital gains income is taxed more lightly than other types of income, allowing capital losses to offset other income without limit increases a taxpayer's ability to minimize income taxes by altering the timing of the realization of gains and losses.

For example, consider the case of a taxpayer who, on the last day of a tax year, wishes to sell two assets. The sale of the first asset would produce a long-term gain of \$20,000 while the sale of the second asset would produce a long-term loss of \$20,000. If the taxpayer sold both assets in the same tax year, then the two sales would net to zero and there would be no taxes owed on the transactions.

However, if there were no loss limitation, then the taxpayer could significantly reduce his taxes by realizing the gain this tax year and postponing the realization of the loss until the next tax year (or vice versa). Realization of the \$20,000 long-term gain in the current tax year would cost the taxpayer \$4,000 in federal income taxes (20% maximum long-term capital gains tax rate times the \$20,000 capital gain). By waiting and taking the loss the next tax year, the taxpayer could reduce his federal income taxes by \$7,720 (38.6% maximum tax rate on ordinary income times the \$20,000 long-term loss).

Hence, with no capital gains loss limitation, the taxpayer could reduce his net federal income taxes by \$3,720 simply by changing the timing of the realizations of gains and losses.

It should be noted that current law allows for an unlimited carry forward of excess losses. Hence, taxpayers do not forfeit the full value of excess losses because they can deduct those losses in future years. The actual cost to the taxpayer of forgoing the full loss in the current year is the interest that would have been earned on the additional tax reduction that would have been realized had there been no excess loss limitation.

For example, consider a scenario where a taxpayer has a net long term capital loss of \$20,000. If there were no loss limitation, the taxpayer could deduct the entire loss against other income in the first year and, assuming the highest marginal tax rate of 38.6%, reduce his income tax liability by \$7,720 (\$20,000 times 0.386).

Now consider the situation with a \$3,000 annual loss limitation. If the taxpayer had no net capital gains in any subsequent year, then it would take the taxpayer seven years to deduct the full \$20,000 capital loss (\$3,000 loss deduction for six years and a \$2,000 loss deduction in the seventh year). Once again assuming the taxpayer faces the highest marginal tax rate of 38.6% (and that the rate does not change over the seven year period) the taxpayer will reduce his taxes over the period by \$7,720.

Since money has a time value, however, the \$7,720 in tax savings taken over seven years is not as valuable as the \$7,720 in tax savings taken in the first year when there was no loss limitation. If an interest rate of 5% is assumed, then the present value of the \$7,720 in tax savings over seven years is \$6,747. So under this worst case scenario, in present value terms, the annual capital loss limitation would reduce the tax savings in this example by approximately \$973.

It is also worth noting that if the tax rate on long term gains and losses were symmetrical at 20%, then the full deduction of a \$20,000 net long term loss would reduce the taxpayer's income tax liability by only \$4,000 (\$20,000 loss times 20% tax rate). Hence, even with the \$3,000 annual loss limitation, taxpayers with net long term capital losses receive more tax savings under the current system than if there were a symmetrical tax rate on long term gains and losses. In most cases, the current system, even without indexing the \$3,000 loss for inflation, is more generous than the system that existed in 1978.

Distributional Effects

The empirical evidence establishes that capital gains are concentrated at the higher end of the income range. In 1999, the last year that tax statistics were available, the top 2% of taxpayers with over \$200,000 in adjusted gross income earned 73% of capital gains, and the 7.5% of taxpayers with adjusted gross incomes

over \$100,000 earned 85% of gains¹. It has also long been recognized that these concentrations are somewhat overstated because large capital gains realizations tend to push individuals into higher brackets and an annual snapshot can overstate the concentration. One way to correct for this effect is to sort individuals by long term average incomes which requires special tax tabulations. The most recent study to do so (using a somewhat different measure of income, but reporting by population share) indicated that the top 1% who earned over \$200,000 from 1979-1988 received 57% of gains, and the top 3% who earned over \$100,000 received 73% of the gains.² By interpolation, we can see that about two-thirds of gains are received by the top 2% of the income distribution.

The distortion relating to gains works in the opposite direction in the case of losses, understates the share of losses going to high income individuals, and may be much more serious. Thus, looking at losses by income class may not be very meaningful. For example, the top 2% accounted for about 36% of losses.³ However, there are significant losses in very low income classes that are almost certainly people whose incomes are normally high. For example, another 6% of losses are realized by individuals with no adjusted gross income. Since gains are normally much larger than losses, this distortion can be quite serious and calculations such as these probably do not tell us very much. A better calculation is the permanent capital gains share, which suggests, as noted above, that about two-thirds of gains are realized by individuals in the top 2% of the permanent income distribution, and a similar finding is probably appropriate for losses.

There are other reasons to expect that lower and middle income taxpayers are unlikely to be much affected by the expansion of capital losses. First, many of their assets are held (and are increasingly being held) in tax favored forms. In 2001, 29% of equities held by individuals were held in pensions (either private or state and local); moreover somewhere in the neighborhood of 7.5% of stock is held in individual retirement accounts. Assets held in these accounts are not affected by loss restrictions because in the case of traditional IRAs and pension plans the original contributions have already been deducted from income. Hence, any possible loss on the original investment has been pre-deducted from taxable income. In the case of ROTH IRAs, since gains on investments are not subject to tax upon withdrawal, losses on investments should not be deducted from income.

Another 6.6% are held in life insurance plans which are also not subject to tax. Altogether, these assets forms account for over 40% of equities and they are likely to be proportionally much more important for the middle class.⁴ In addition, moderate income taxpayers are more likely to hold equities in mutual funds that have mixed portfolios and typically do not report losses because they hold so many types

¹ Internal Revenue Service Statistics of Income, *Individual Income Tax Returns*, 1999.

² Leonard E. Burman. *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed*. (Washington D.C., The Brookings Institution, 1999).

³ Internal Revenue Service, op cit.

⁴ Data from the Board of Governors of the Federal Reserve, Flow of Funds Accounts, June 6, 2002.

of stocks. Only about 25% of distributions from mutual funds are reported on tax returns because the remainder of distributions occur in pension and retirement accounts.⁵

Direct evidence from tax returns does suggest, as shown in Table 1, that only a small fraction of most taxpayers experience a net capital loss. Excluding the “No Income” class, for over half the population arrayed by income, less than 3% have any loss at all and for three-quarters of individuals less than 5% have a loss. These shares would probably be even smaller for population arrayed according to lifetime income.

Table 1. Capital Losses by Income Class, 1999

Adjusted Gross Income (\$thousands)	Cumulative Share of Returns	Percent in Each Class With Loss	Average Schedule D Loss	Average Loss Deducted	Percentage of Loss Deducted
none	1	20.1	\$18,122	\$2,200	21
under 5	11	1.8	3,146	1,636	53
5-10	22	2.1	4,461	1,602	50
10-15	31	1.8	4,847	1,941	59
15-20	40	2.1	4,248	1,951	54
20-25	48	2.5	3,898	1,714	60
25-30	55	2.3	5,180	2,077	51
30-40	65	3.2	5,144	1,775	43
40-50	73	4.3	4,248	1,695	50
50-75	86	5.7	5,417	1,792	44
75-100	92	8.4	5,519	1,896	38
100-200	98	10.2	7,718	2,069	25
200-500	99.6	15.4	15,175	2,253	14
500-1000	99.8	14.9	28,600	2,576	6
1000+	100.	13.1	113,181	2,703	1

Source: CRS calculations based on Internal Revenue Service Statistics of Income, Individual Income Tax Returns, 1999.

⁵ Congressional Budget Office, The Contribution of Mutual Funds to Taxable Capital Gains, CBO Memorandum, Oct. 1999.

Moreover, most of these individuals are probably able to deduct losses, because the average loss (which in income distributions is normally well above the median loss) is still not much higher than \$3,000. More than 50% of losses are deducted immediately. Other evidence indicates that of individuals who could not deduct their losses in full, two thirds were able to fully deduct losses within two years and more than 90% in six years.⁶ A recent study concluded that in 2003 more than half of the benefit of raising the exclusion to \$6,000 would be received by tax filers with incomes over \$100,000, who account for 11% of tax filers.⁷

Thus, the evidence suggests that raising the capital loss limit would benefit a small share of largely higher income individuals.

Economic Effects

One of the objectives of recent economic proposals, especially those proposed by the President, is to stimulate the economy. Normally a tax benefit that favors individuals with high permanent incomes (as does a capital gains tax cut) is a relatively ineffective way to stimulate the economy because these individuals tend to have a higher propensity to save, and it is spending, not saving, that stimulates the economy. The most effective economic stimulus is one that most closely translates dollar for dollar into spending.⁸ Direct government spending on goods and services would tend to rank as the most effective, followed by transfers and tax cuts for lower income individuals.

One argument that might be made for providing capital gains tax relief is that it would increase the value of the stock market and thus investor confidence. Indeed, such an argument has been made for a capital gains tax cut in the past. Such a link is weaker and more uncertain than a direct stimulus to the economy via spending increases or cuts in taxes aimed at lower income individuals. Indeed, it is not altogether certain that capital gains tax relief would increase stock market values. Stock markets rise when increases in offers to buy exceed increases in offers to sell. Capital gains tax revisions may be more likely to increase sales than purchases in the short run through an unlocking effect, and this effect could be particularly pronounced in the case of an expanded capital loss deduction.⁹ Although these

⁶Burman, *The Labyrinth of Capital Gains*, op cit.

⁷William G. Gale and Peter Orszag, "A New Round of Tax Cuts?" Brookings Institution, 2002.

⁸For a further discussion of this issue, see CRS Report RS21136, *Government Spending or Tax Reduction: Which Might Add More Stimulus to the Economy?*, by Marc LaBonte; CRS Report RS21126, *Tax Cuts and Economic Stimulus: How Effective are the Alternatives?*, by Jane G. Gravelle; and CRS Report RS21014, *Economic Effects of Permanent and Temporary Capital Gains Tax Cuts*, by Jane G. Gravelle.

⁹Increases in capital loss limits increase the expected rate of return on stocks and would therefore eventually be expected to push up demand and raise prices, although the extent to which tax benefits on future losses actually affect the investment decision is not certain.

(continued...)

benefits may stimulate the stock market because they make stocks more attractive investments, they also create a short term incentive to sell— and an incentive to sell the most depressed stocks. Thus, if the method of stimulating the economy is expected to work via an increase in stock prices, such a tax revision whose effect is expected via a boost in the stock market could easily depress stock prices further. Overall, it is a uncertain method of stimulating the economy.

Policy Options

Several reasons have been advanced to increase the net capital loss limit against ordinary income: as part of an economic stimulus plan, as a means of restoring confidence in the stock market, and to restore the value of the loss limitation to its 1978 level.

An increase in the net capital loss limit may not be an effective device to stimulate aggregate demand. In the short run, an increase in the loss limitation could produce an incentive to sell stock, which could depress stock prices and erode confidence even further.

In addition, the empirical evidence suggests that the tax benefits of an increase in the net capital loss limitation would be received by a relatively small number of higher income individuals.

The restoration of the value of the loss limitation to its 1978 level is more complicated to address, but two important comments may be made.

First, there is no way to determine that a particular time period had achieved the optimal net capital lost limitation, although historically, the loss limit has been quite small.

Second, while correcting the \$3,000 loss limit to reflect price changes since 1978 would increase its value to about \$8,000 in 2002 dollars, net long term capital losses are generally treated more preferentially than they were prior to 1978 because of the asymmetry between loss and gain, which was never addressed during recent tax changes. Restoration of historical treatment would also require an adjustment for asymmetry. This problem with asymmetry has been growing increasingly important through the tax changes of 1990, 1993, and 1997. Raising the limit on losses without addressing asymmetry will expand opportunities to game the system.

Achieving full symmetry in the system requires that the tax rate differential between short and long term gains and losses be accounted for during the netting process. The current rate differential is approximately two to one (38.6% maximum tax rate on ordinary income and short term capital gains versus an 18% or 20%

⁹(...continued)

Note, however, that any price effects would be temporary; in the long run, investment and rates of return would adjust and stock prices should reflect the value of underlying assets.

maximum tax rate on long term capital gains). Given this rate differential, symmetry could be achieved in the netting process through the following steps:

- ! In the case of a net short term gain and a net long term loss, \$2 of net long term losses should be required to offset \$1 of short term gain. If a net loss position remains, \$2 of long term losses should be required to offset \$1 of ordinary income up to the net loss limitation. Any remaining net loss would be carried forward.

- ! In the case of a net short term loss and a net long term loss the simplest way is to begin with short term losses which can be used on a dollar for dollar basis to offset ordinary income. If short term losses exceed the limit they would be carried forward along with all long term losses. If net short term losses are less than the loss limitation, then \$2 of net long term loss can be used to offset each \$1 remaining in the net loss limitation. Any remaining net long term loss would be carried forward.

- ! In the case of a net short term loss and a net long term gain each \$1 of net short term loss should offset \$2 of net long term gain. Any net loss remaining should offset ordinary income on a dollar for dollar basis up to the net loss limitation. Any remaining net loss would be carried forward.

Although the netting principles outlined above may appear complicated, they are no more complicated to implement on tax forms than the current netting procedures.