Study of Schedule D (Capital Gains)

and

Schedule E (Rents, Royalties, Partnership)

Income Reported on

Individual Income Tax Returns

Tax Years 2002 - 2006

Montana Department of Revenue
Office of Tax Policy and Research

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Schedule D and Schedule E Income Study
History and Background

PART A – CAPITAL GAINS

Introduction

In fiscal year 2007, individual income taxes contributed nearly half (45%) of Montana's total general fund revenue. For tax year 2006, Montanans reported over $2 billion of income from capital gains; that's just over 10% of all income reported on tax forms in that year. One-quarter of all taxpayers reported capital gains income.

Notwithstanding the significant role of capital gains in state revenues and taxpayers' incomes, little is known about the composition of assets from which capital gains income arises, how this composition changes over time, and the relationships between capital gains income and the state's economy. This study hopes to shed light on these and other matters surrounding capital gains income, and provide a base of information for subsequent research. While capital gains also play a role in the state's corporation license tax, the focus here is entirely on the individual income tax.

What are Capital Assets and Capital Gains? How are They Taxed?[1]

Generally speaking, capital gains refers to the net income received from the sale of capital assets. For tax purposes, an asset is considered a "capital asset" unless it is specifically identified as not being a capital asset. Supplies and inventories, accounts receivable related to inventory, depreciable business property, real property used in a trade or business, and certain copyrights comprise the bulk of assets not considered to be capital assets.[2] Among other things, capital assets include land; a taxpayer's principal residence; stocks, bonds, and other securities; livestock and timber; and collectibles, including art, antiques, and historical artifacts. The sale of an ownership interest in a partnership also could result in a capital gain.

While most people refer generically to capital "gains" income, calculating net income from the sale of a capital asset can also result in a net loss of income. The tax treatment of capital gains income depends on whether the gain associated with the sale of a capital asset is actually "realized" as opposed to "recognized", and whether the gain is a "short-term" gain or a "long-term" gain.

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[1] The discussion in this, and the following sections on recent legislation, is intended to provide the reader with a very general overview of the taxation of capital gains income. The specifics of federal law in this area are complex; nothing in these sections should be construed as providing professional legal advice. Taxpayers with complex capital gains taxation issues or questions should consult a professional advisor.

[2] While business real estate or any depreciable business property technically is excluded from the definition of "capital assets", gains from the sale of business property that qualifies as Code Sec. 1231 property (most depreciable and real business property) are treated as though they were from the sale of long-term capital assets.

For tax purposes, capital gain and loss provisions do not apply until there is a *sale or exchange* of property. For example, strictly speaking, any increase in the value of corporate stock above its purchase price (gain) is *recognized* as income. That income is not subject to tax, however, until the stock is actually sold and the income is *realized*.

Generally speaking, "short-term" gains and losses arise from the sale of capital assets held by the taxpayer for 12 months or less, while "long-term" gains and losses arise from the sale of assets held for more than 12 months. The distinction is important because long-term gains are subject to lower tax rates than those applied to short-term gains, which are considered "ordinary" income.

In determining the tax on net capital gains or losses, taxpayers must adhere to a complicated netting process in which any short-term losses are applied to reduce any short-term gains, if any, that otherwise would be taxable at ordinary income tax rates. Any net short-term loss may then be applied against long-term gains before long-term losses are netted against long-term gains to arrive at a final net gain or loss. Any net gain is taxed in full at rates prescribed by law; any resulting net loss may be applied as an offset against other ordinary income, with this offset limited to $3,000 for the tax year. Any unused net capital loss may be carried over to subsequent tax years, again subject to the $3,000 annual limitation, until the net loss is completely used.

For tax purposes, capital gains income has a long history of receiving preferential treatment relative to other types of income. Prior to the Tax Reform Act of 1986, individuals could deduct 60% of their net capital gains from income. That act repealed this preferential deduction, essentially subjecting capital gains income to the same tax treatment as ordinary income.

Recent Legislation – Federal

The *Taxpayer Relief Act of 1997 (TRA1997)* significantly reduced the tax rates applied to certain net gains from the sale, exchange or conversion of capital assets. The maximum federal tax rate applied to most capital gains sold after July 28, 1997 was reduced from 28% to 20%; for taxpayers whose ordinary income would otherwise be subject to the 15% federal tax bracket the top rate was reduced to 10%.

This act further provided that beginning in 2001, the top rate would drop to 18% for assets acquired after January 1, 2001 and held for five years. The 10% capital gains rate for taxpayers in the 15% ordinary income bracket dropped to 8% for assets held for five years or more, with no requirement that the asset be purchased after January 1, 2001.

These rate reductions applied to most capital assets with the exceptions of section 1250 gains (gains derived from unrecaptured depreciation of business assets) and gains from real estate investment trusts, for which the top rate was reduced from 28% to 25%; and to gains from collectibles such as fine art and jewelry, which continued to be subject to a top tax rate of 28%. In addition, the new lower tax rates did not apply to assets held for more than one year, but less than 18 months ("mid-term" gain).[3]

In addition, TRA1997 provided that taxpayers could exclude from income up to $250,000 ($500,000 for a married couple) in capital gains from the sale of a principal residence, regardless of whether the gain is reinvested in another primary residence. This provision replaced the previous "one-time" exclusion for taxpayers over age 55. The new exclusion was made available each time a taxpayer sold a principal residence, but not more than once in any two-year period.

The *Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA03)* acted to reduce even further the maximum tax rates applied to capital gains, albeit temporarily. For sales or exchanges completed after May 5, 2003 the 20% rate was reduced to 15% and the 10% rate was reduced to 5%. In 2008, the 15% rate remains in place, but the 5% rate drops to 0% for just that year. JGTRRA03 provided that both of these lower rates revert to the previous rates of 20% and 10% beginning with tax year 2009.

The *Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA05)* extended the tax year 2008 reduced tax rates provided for in JGTRRA03 through December 31, 2010.

Recent Legislation – State

Senate Bill 407 (SB407), passed by the 2003 Legislature and signed into law by then Governor Judy Martz, is clearly the most singular piece of state legislation affecting the taxation of capital gains income. Like the federal legislation discussed above, it also acted to reduce significantly the marginal tax rate applied to capital gains income.

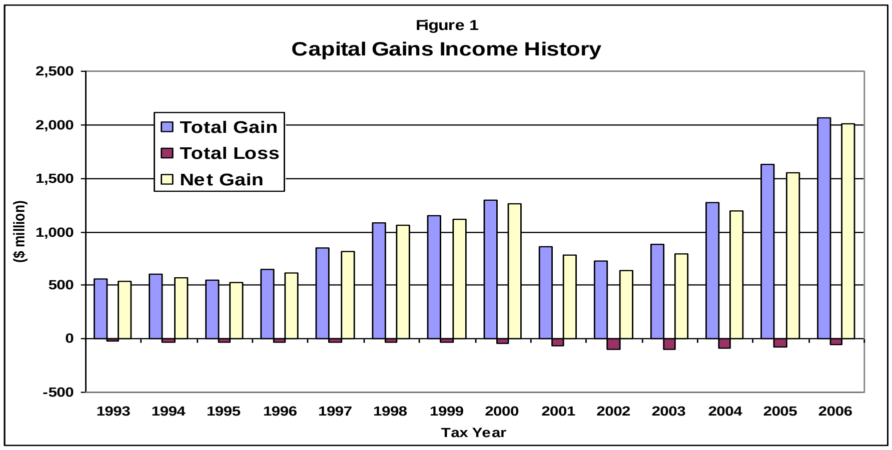
Prior to SB407, individual income tax rates ranged from 2% to a high of 11% in Montana. SB407 reduced these rates to range from 1% to a top marginal rate of 6.9%. This rate reduction was paid for largely by capping the previously unrestricted itemized deduction for federal income taxes paid during the tax year at $5,000 ($10,000 for married couples filing jointly).

In addition, SB407 provided for a new capital gains tax credit equal to 1% of net capital gains for tax years 2005 and 2006, effectively reducing the top marginal tax rate applied to capital gains to 5.9%. SB407 further provided that this credit increases to 2% of net capital gains beginning with tax year 2007, effectively reducing the top marginal tax rate applied to capital gains income to 4.9% for that and subsequent years.

Capital Gains - Trends

[3] The 18-month holding period for qualifying for long-term rates was short lived, however. The *Internal Revenue Service Restructuring and Reform Act of 1998* re-established the 12-month holding period for preferential long-term capital gain tax treatment.

Figure 1 shows the growth in total capital gains, total capital losses, and net capital gains income from 1993 through 2006. Generally, the amount of capital gains income reported on Montana individual income tax returns has grown over time, with periods of increasing and decreasing net gains. From 1993 through 1996 net gains were fairly stable, averaging around $560 million per year. Between 1996 and 2000, reported net capital gains income increased from $616 million to $1.26 billion during the period often referred to as the *dot-com bubble*. Net capital gains income plunged in 2001 and 2002 as the dot-com bubble burst, as the events of September 11, 2001 unfolded, and in the wake of a series of corporate malfeasance scandals, only to rebound once again, climbing from $637 million in 2002 to just over $2 billion in 2006. Not surprisingly, over this time frame capital losses were most prevalent in the period 2001-2004, but never rose above $95 million, in large part due to the loss limitation rules discussed earlier.



The variability in growth of capital gains income is further illustrated in Figure 2, which shows the annual percentage change in net capital gains income over the period 1994-2006. Net gains dropped in three years, falling by as much as 38% in 2001; and rose in the remaining years increasing by as much as 51% in 2004.

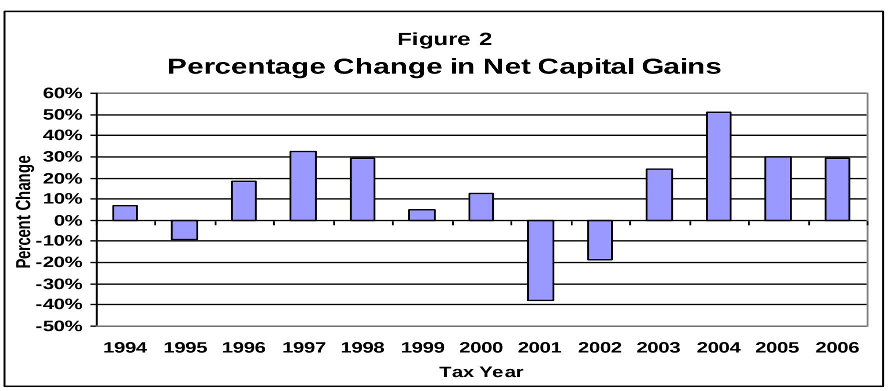


Table 1 shows total Montana Adjusted Gross Income (MAGI), total net capital gains income, net gains as a share of MAGI, the number of taxpayers reporting capital gains income, and average capital gains income.

Over the period 1992 to 2006, total adjusted gross income increased steadily, with the exception of tax years 2001 and 2002. It's apparent that the precipitous drop in capital gains income in these two years contributed in large part to the decreases in MAGI in these years.

Over the period 1992-2006, capital gains income, on average, comprised 7.6% of total adjusted gross income. Capital gains income as a share of total income was below this average in the 1992-1996 period, increased to a high of 9.6% of gross income during the run up in net gains in the mid- to late-1990's; dropped to 5-6% of total income in the 2001-2002 period; and has since grown to nearly 11% of total income in 2006.

Table 1
Montana Adjusted Gross Income, Net Capital Gains Income, and Average Capital Gains Income
Full-Year Resident Filers, Tax Years 1992 - 2006

Calendar Year	Total MAGI	Net Capital Gains Income	Capital Gains Share of Total MAGI	Number of Taxpayers With Capital Gains	Average Capital Gains Income
1992	8,116,405,540	416,698,117	5.1%	90,106	$4,625
1993	8,545,134,968	536,271,361	6.3%	98,575	$5,440
1994	9,034,909,731	573,636,916	6.3%	101,984	$5,625
1995	9,415,826,925	521,183,204	5.5%	106,118	$4,911
1996	10,013,110,001	616,452,540	6.2%	113,669	$5,423
1997	10,655,088,396	818,544,248	7.7%	118,853	$6,887
1998	11,553,140,475	1,060,173,721	9.2%	124,800	$8,495
1999	12,167,306,419	1,115,780,493	9.2%	131,877	$8,461
2000	13,118,511,822	1,259,719,705	9.6%	139,010	$9,062
2001	13,039,447,584	785,759,218	6.0%	123,285	$6,374
2002	13,034,812,578	637,443,506	4.9%	112,243	$5,679
2003	13,572,279,532	790,912,922	5.8%	111,022	$7,124
2004	15,011,177,190	1,193,177,168	7.9%	121,190	$9,846
2005	16,773,601,215	1,554,054,359	9.3%	125,354	$12,397
2006	18,659,287,966	2,006,020,579	10.8%	131,954	$15,202

The number of taxpayers with capital gains income increased steadily from 90,106 to 139,010 over the period 1992 to 2000. The number of taxpayers with capital gains income dropped significantly in the 2001-2003 period, totaling just 111,022 in 2003, before climbing again to a total of 131,954 in tax year 2006.

Over the period 1992-2006 net capital gains income averaged $7,935. Average gains were well below this level from 1992 through 1997, before increasing to an average of just over $9,000 in tax year 2000. Average net gains dropped again during the 2001-2003 period before increasing rapidly to $15,202 in 2006.

Table 2 shows the relationship between total tax liability and tax liability from capital gains, and the average marginal tax rate on capital gains income over the period 1992 to 2006.

Once again, the bursting of the dot-com bubble is evident in tax years 2001 and 2002. These are the only two years in which total tax liability fell, again attributable in large part to the large drop in capital gains income in those years.

Total tax from capital gains income increased steadily from $30.6 million in 1992 to $96.6 million in 2000. Following the 2001-2003 period, during which net tax from capital gains income averaged $54 million, tax from capital gains again rebounded to nearly $100 million by 2006.

Table 2
Total Tax Liability, Tax From Capital Gains, and Effective Tax Rate
Full-Year Residents, Tax Years 1992 - 2006

Calendar Year	Total Tax Liability Before Credits	Total Tax From Capital Gains[1]	% of Total Tax From Cap Gains	Average Marginal Tax Rate[2]
1992	307,944,888	30,643,869	10.0%	7.35%
1993	330,730,153	39,437,253	11.9%	7.35%
1994	338,409,572	42,185,106	12.5%	7.35%
1995	346,530,045	38,327,674	11.1%	7.35%
1996	368,446,552	45,333,756	12.3%	7.35%
1997	399,069,118	60,195,526	15.1%	7.35%
1998	449,965,886	78,062,000	17.3%	7.36%
1999	478,811,343	81,952,000	17.1%	7.34%
2000	518,279,456	96,628,000	18.6%	7.67%
2001	498,294,819	58,761,743	11.8%	7.48%
2002	494,137,275	45,315,460	9.2%	7.11%
2003	538,203,804	57,775,813	10.7%	7.30%
2004	620,917,791	92,318,485	14.9%	7.74%
2005	667,849,230	75,843,568	11.4%	4.88%
2006	751,040,039	99,002,437	13.2%	4.94%

[1]For tax years 2005 and 2006, total tax from capital gains is net of the 1% capital gains tax credit, which totaled $15.4 million in TY2005 and $19.6 million in TY2006.

[2]Defined as the ratio of total tax from capital gains to total capital gains income. Total tax from capital gains for tax years 1992-1997 is estimated by applying the average tax rate on capital gains for tax years 1998 and 1999 (7.354%) to capital gains income for each of these years.

Over the period 1992-2006 tax from capital gains income averaged 13.2% of total individual income tax liability. The share of total tax from capital gains was lower than average from 1992 to 1996, and significantly higher that the average from 1997 to 2000. Since 2000, the share of total tax from capital gains has exceeded the total period average only once, in 2004, even though total tax from net gains approached $100 million in 2006.

From 1992 through 2004, the average marginal tax rate on capital gains income ranged between 7% and 8%. The average marginal tax rate dropped to less than 5% in both 2005 and 2006 in response to the legislative changes discussed earlier, which reduced the top marginal tax rate from 11% to 6.9% and instituted a new capital gains tax credit equal to 1% of capital gains income. The average marginal tax rate on capital gains income likely will drop again in 2007 when the capital gains tax credit increases to 2% of net capital gains income.

Capital Gains - Distribution by Income Brackets

Table 3 shows the distribution of all households filing income taxes along with all capital gains, capital losses, and net capital gains, by total household income bracket, for tax year 2006.[4] As Table 3 shows, the distribution of net capital gains is concentrated largely among higher income households.

Table 3
Distribution of Capital Gains, Capital Losses, and Net Gains and Average Gain
Tax Year 2006; All Full-Year Resident Households

Total Household Income Bracket	No. of Hshlds.	Capital Gains	Capital Losses	Net Capital Gains	Share of Net Gains	Cumulative Share	Ave. Gain Per Hshld.
$<0	4,883	17,682,955	(3,605,586)	14,077,369	0.7%	0.7%	2,883
$ 0 - $ 9,999	81,332	14,659,006	(7,550,279)	7,108,727	0.4%	1.1%	87
$ 10,000 - $ 19,999	74,410	26,116,424	(6,755,740)	19,360,684	1.0%	2.0%	260
$ 20,000 - $ 29,999	56,433	31,394,710	(5,407,637)	25,987,073	1.3%	3.3%	460
$ 30,000 - $ 39,999	41,177	34,379,606	(4,651,229)	29,728,377	1.5%	4.8%	722
$ 40,000 - $ 49,999	32,834	40,712,733	(4,391,008)	36,321,725	1.8%	6.6%	1,106
$ 50,000 - $ 59,999	27,078	42,347,125	(3,904,098)	38,443,027	1.9%	8.5%	1,420
$ 60,000 - $ 69,999	22,588	47,243,141	(3,750,419)	43,492,722	2.2%	10.7%	1,925
$ 70,000 - $ 79,999	17,968	48,195,778	(3,390,679)	44,805,099	2.2%	12.9%	2,494
$ 80,000 - $ 89,999	13,615	43,434,335	(2,773,207)	40,661,128	2.0%	15.0%	2,986
$ 90,000 - $ 99,999	9,980	45,364,185	(2,174,110)	43,190,075	2.2%	17.1%	4,328
$100,000 - $109,999	6,904	43,530,273	(1,519,891)	42,010,382	2.1%	19.2%	6,085
$110,000 - $119,999	5,126	37,935,523	(1,205,572)	36,729,951	1.8%	21.0%	7,165
$120,000 - $129,999	3,711	36,437,179	(1,019,137)	35,418,042	1.8%	22.8%	9,544
$130,000 - $139,999	2,752	36,922,065	(808,168)	36,113,897	1.8%	24.6%	13,123
$140,000 - $149,999	1,983	27,897,255	(637,471)	27,259,784	1.4%	26.0%	13,747
$150,000 - $174,999	3,546	65,665,342	(1,129,453)	64,535,889	3.2%	29.2%	18,200
$175,000 - $199,999	2,265	63,424,034	(796,769)	62,627,265	3.1%	32.3%	27,650
$200,000 - $299,999	4,289	184,509,328	(1,717,776)	182,791,552	9.1%	41.4%	42,619
$300,000 - $399,999	1,584	121,917,345	(637,771)	121,279,574	6.0%	47.5%	76,565
$400,000 - $499,999	848	100,090,521	(333,605)	99,756,916	5.0%	52.4%	117,638
$500,000+	1,979	955,201,259	(879,938)	954,321,321	47.6%	100.0%	482,224
TOTALS	417,285	2,065,060,122	(59,039,543)	2,006,020,579	100.0%		4,807

In TY 2006, 17% of all net gains accrued to households with less than $100,000 of total income; just slightly over a quarter of all net gains accrued to households with less than $150,000 of income, while nearly half of all net gains accrued to the 1,979 households with incomes of $500,000 or more.

Households with negative *total* household income had an average positive net gain of $2,883. Average net gains for households with positive total income ranged from $87

[4] Total household income is total income for federal income tax purposes, plus Montana additions to income.

for households with incomes of less than $10,000 to $482,224 for households in the highest income bracket.

Figure 3 further illustrates that the preponderance of net capital gains income accrues to higher income households. As illustrated in Figure 3, this skewing of net capital gains income towards higher income households has become more pronounced over the course of the past several years, as total net capital gains income increased from a recent low of $637 million in 2002 to just over $2 billion in 2006.

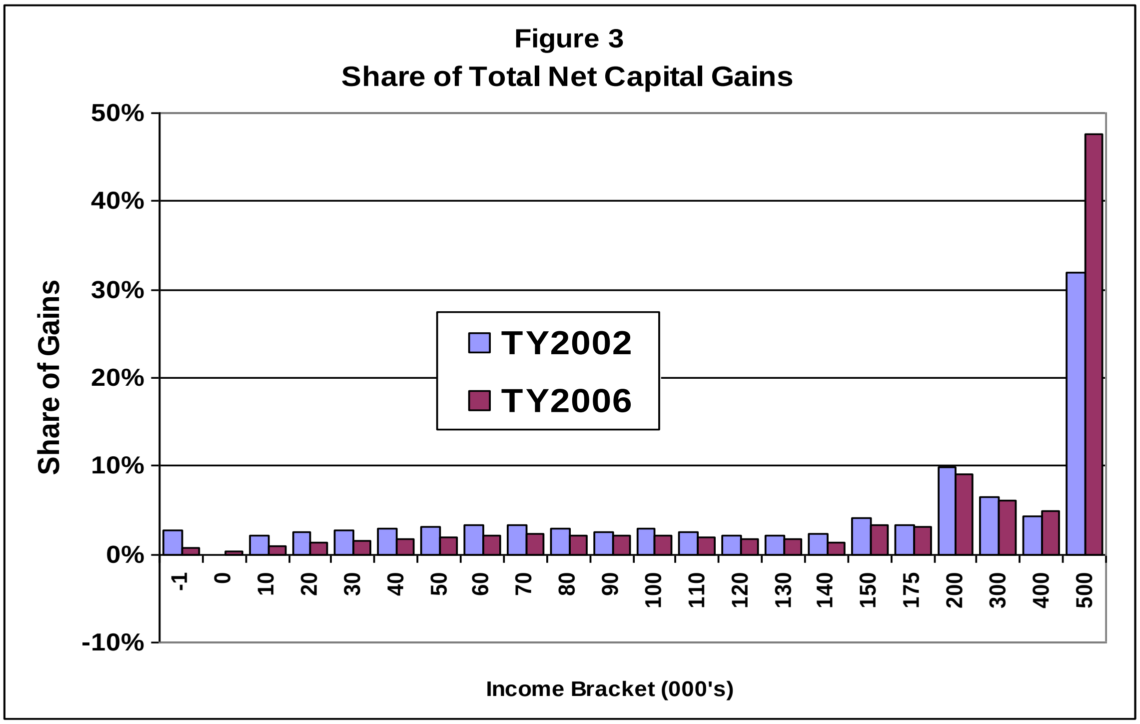


Figure 3 shows the share of total net capital gains income accruing to households in each income bracket for tax years 2002 and 2006. Between these two years, the share of total net capital gains income accruing to the highest income households (households with $500,000 or more of total income) increased from 31.9% to 47.6%; the share of net gains accruing to households with incomes between $400,000 and $500,000 increased from 4.3% to 5%. The share of net gains decreased in all other income brackets, with the largest percentage decreases in share generally occurring in households with incomes up to $90,000.

To put this in perspective, in 2002, households with $150,000 or more of income received 60% of all net capital gains income; by 2006 this had increased to 74% of all net gains. Households with $150,000 or more of total income received 81% of the total *change* in net capital gains income between 2002 and 2006, while households with less than $150,000 received the remaining 19% of the total increase in net gains. Clearly, the run up in net gains between these two years acted to benefit high income households substantially more than lower income households.

Table 4 shows the relationship between total household income and net capital gains income, for all households and for households with capital gains income.
The first three columns show the total household income bracket, the total number of households filing income tax returns, and their total household income.

Table 4
Relationship Between Total Household Income and Net Capital Gains Income
All Households and All Households with Capital Gains, Tax Year 2006

	ALL HOUSEHOLDS		HOUSEHOLDS WITH CAPITAL GAINS INCOME					
Total Household Income Bracket	Number	Total Income	Number	% of All Hshlds.	Total Income	Capital Gains Income	% of Total Inc. (CG Hshlds.)	% of Total Inc. (All Hshlds.)
$<0	4,883	(133,892,757)	2,528	52%	(74,313,089)	14,077,369	-19%	-11%
$ 0 - $ 1,999	13,425	14,450,199	1,918	14%	2,164,147	(111,307)	-5%	-1%
$ 2,000 - $ 3,999	17,118	51,509,913	2,303	13%	6,932,882	933,547	13%	2%
$ 4,000 - $ 5,999	17,598	87,863,821	2,357	13%	11,798,044	1,406,544	12%	2%
$ 6,000 - $ 7,999	16,817	117,499,380	2,308	14%	16,166,460	1,977,495	12%	2%
$ 8,000 - $ 9,999	16,374	147,269,296	2,275	14%	20,510,421	2,902,448	14%	2%
$ 10,000 - $ 11,999	15,611	171,500,483	2,217	14%	24,390,920	2,714,358	11%	2%
$ 12,000 - $ 13,999	15,133	196,493,158	2,164	14%	28,112,903	4,056,147	14%	2%
$ 14,000 - $ 15,999	14,929	223,825,072	2,154	14%	32,313,876	3,840,974	12%	2%
$ 16,000 - $ 17,999	14,588	248,024,414	2,144	15%	36,493,778	4,046,196	11%	2%
$ 18,000 - $ 19,999	14,149	268,690,488	2,095	15%	39,753,453	4,703,009	12%	2%
$ 20,000 - $ 24,999	30,540	684,867,437	4,827	16%	108,478,059	12,311,230	11%	2%
$ 25,000 - $ 29,999	25,893	710,393,944	4,594	18%	126,185,157	13,675,843	11%	2%
$ 30,000 - $ 34,999	22,133	717,720,811	4,433	20%	143,909,981	13,954,431	10%	2%
$ 35,000 - $ 39,999	19,044	712,957,918	4,101	22%	153,801,483	15,773,946	10%	2%
$ 40,000 - $ 44,999	17,016	722,321,733	4,118	24%	174,797,841	17,357,740	10%	2%
$ 45,000 - $ 49,999	15,818	750,745,548	4,220	27%	200,388,716	18,963,985	9%	3%
$ 50,000 - $ 54,999	14,238	747,054,861	3,951	28%	207,428,950	18,794,938	9%	3%
$ 55,000 - $ 59,999	12,840	737,696,081	3,756	29%	215,929,868	19,648,089	9%	3%
$ 60,000 - $ 64,999	11,894	742,983,426	3,636	31%	227,164,194	21,145,055	9%	3%
$ 65,000 - $ 69,999	10,694	721,637,487	3,543	33%	239,159,181	22,347,667	9%	3%
$ 70,000 - $ 74,999	9,600	695,389,781	3,367	35%	243,941,735	21,525,738	9%	3%
$ 75,000 - $ 79,999	8,368	648,051,494	3,158	38%	244,674,931	23,279,361	10%	4%
$ 80,000 - $ 89,999	13,615	1,153,848,189	5,427	40%	460,537,929	40,661,128	9%	4%
$ 90,000 - $ 99,999	9,980	945,094,211	4,327	43%	410,059,542	43,190,075	11%	5%
$100,000 - $109,999	6,904	723,299,763	3,255	47%	341,554,835	42,010,382	12%	6%
$110,000 - $119,999	5,126	588,710,147	2,562	50%	294,511,069	36,729,951	12%	6%
$120,000 - $129,999	3,711	462,864,098	2,027	55%	252,916,337	35,418,042	14%	8%
$130,000 - $139,999	2,752	370,661,303	1,631	59%	219,823,982	36,113,897	16%	10%
$140,000 - $149,999	1,983	287,015,307	1,204	61%	174,413,173	27,259,784	16%	9%
$150,000 - $174,999	3,546	573,581,338	2,260	64%	366,000,402	64,535,889	18%	11%
$175,000 - $199,999	2,265	422,726,439	1,651	73%	308,224,265	62,627,265	20%	15%
$200,000 - $299,999	4,289	1,035,225,933	3,244	76%	784,641,908	182,791,552	23%	18%
$300,000 - $399,999	1,584	546,406,834	1,287	81%	444,650,817	121,279,574	27%	22%
$400,000 - $499,999	848	377,460,643	729	86%	324,795,924	99,756,916	31%	26%
$500,000+	1,979	2,683,581,801	1,802	91%	2,533,459,579	954,321,321	38%	36%
TOTALS	**417,285**	**20,155,529,994**	**103,573**	**25%**	**9,345,773,653**	**2,006,020,579**	**21%**	**10%**

The next two columns show the number of households with capital gains income, and the percentage of households with capital gains income. Up to $25,000 of income, the percentage of households with capital gains income remains very stable, averaging around 14% of all households. After that, this percentage increases steadily to where 91% of all households in the highest income bracket have capital gains income. Overall, one-quarter of all households have capital gains income, but the higher the total income bracket, the greater the chance that households will have capital gains income.

The next two columns show total household income, and net capital gains income, for all households with capital gains income. The final two columns of Table 4 show, first, the percentage that net capital gains income is of total income for all households with capital gains income; and, second, the percentage that net capital gains income is of total income for *all* households.

With respect to households that have capital gains income, net gains comprise 11-14% of total income for households with total income up to $30,000. For households whose total income ranges between $30,000 and $90,000 the percentage of total income comprised of capital gains actually drops to around 9-10%. Above $90,000 the percent of total income made up of capital gains income increases steadily to where capital gains comprise 38% of total income for households in the highest income bracket. Overall, capital gains comprise 21% of total income for all households with capital gains income.

With respect to *all* households, net capital gains represent just 1-3% of total income for households with incomes up to $75,000. Net gains as a share of total income increases to around 10% for households with incomes between $130,000 and $175,000; and above that rapidly increases to 36% of total income for households in the highest income bracket. Overall, capital gains comprise 10% of total income for all households.

Capital Gains – Household Profiles

This section draws on information reported on individual income tax forms to make some general comparisons between households with capital gains income and all other households. All full-year resident households filing income tax forms for tax year 2006 were segregated into the following six groups:

Group 1: All households
Group 2: "Negative" capital gains households (all households with negative capital gains).
Group 3: "Small" capital gains households (all households with positive capital gains of less than $10,000).
Group 4: "Median" capital gains households (all households with positive capital gains between $10,000 and $50,000).
Group 5: "Large" capital gains households (all households with positive capital gains of $50,000 or more).
Group 6: "All other" households (all households with no capital gains income).

Table 5 provides information on selected household characteristics for each of these groups. The first two lines of Table 5 show the total number of households filing in each group, and the percentage of total households in each group. Of the 417,285 households filing in 2006, about one-quarter (103,573) had capital gains income, while three-quarters (313,712 households) had no capital gains income.

Section A of Table 5 shows the distribution of households across filing types for each group. Overall, 46% of all households were "single" filers.[5] This percentage was lower for all capital gains household groups, and declined as capital gains income increased.

[5] "Single" filers include children who file income tax returns but are either living with their parents or in institutional environments such as university dormitories.

Single filers represented just 22% of households in the highest capital gains income group; single filers made up 50% of all households with no capital gains income.

Table 5
Household Profiles - Capital Gains Households v. Other Households

Household Characteristic	All Hshlds.	CAP GAIN HSLD. GROUPS				All Oth. Hshlds.
		Neg	Low	Med	High	
Number in Group	417,285	27,635	55,730	13,718	6,490	313,712
Percent in Group	100%	6.6%	13.4%	3.3%	1.6%	75.2%
A. Percent of Households, by Filing Type						
Single Households	46%	39%	39%	28%	22%	50%
Married; Filing Jointly	20%	29%	24%	23%	21%	18%
Married; Filing Separately	25%	30%	35%	46%	54%	21%
Head of Household	9%	3%	3%	2%	2%	11%
B. Percent of Total Income, by Income Type						
Wages and salaries	60%	51%	56%	32%	9%	80%
Interest and dividends	6%	12%	8%	14%	12%	2%
Capital gains	10%	-3%	4%	23%	59%	0%
Business income	14%	25%	18%	21%	20%	9%
Retirement income	11%	18%	16%	13%	3%	10%
Farm income	-1%	-1%	-1%	-2%	-2%	0%
Other income	0%	-2%	-1%	-1%	-1%	0%
C. Percent Taking Standard/Itemized Deductions						
Itemized Deduction	54%	79%	74%	85%	91%	46%
Standard Deduction	46%	21%	26%	15%	9%	54%
D. Percent of Total Itemized Deductions, by Deduction Type						
Medical-related deductions	16%	21%	20%	21%	9%	14%
Federal income tax (capped amount)	27%	24%	29%	23%	14%	29%
Other taxes	11%	12%	12%	11%	9%	10%
Home mortgage interest	26%	22%	23%	19%	14%	31%
Investment interest	1%	2%	1%	4%	10%	0%
Contributions	12%	14%	13%	16%	37%	8%
Other deductions	6%	5%	4%	6%	7%	6%

One-fifth of all households are married couples who file a joint return. This percentage is higher for all capital gain household groups, and again declines from 29% for households with negative capital gains to 21% for households with the largest capital gains.

One-quarter of all households include married couples who file separate income tax returns. This percentage is substantially higher for all capital gains households increasing from 30% for households with negative gains to 54% for households with the highest capital gains. Only 21% of all households with no capital gains use this filing status.

Heads of households comprised 9% of all households; but only 2-3% of households with capital gains income were of this filing type.

Section B shows the percent of total income that is contributed from various sources of income for each of the groups. For all households, 60% of total income is from wages and salaries. This percentage is lower for households with capital gains income, ranging from 56% for households with low capital gains income to just 9% for households with the highest capital gains income.

Interest and dividend income comprises just 6% of total income for all households, but comprises around 12% of income for capital gains households. For households with no capital gains, interest and dividend income comprises just 2% of total income.

For all households, capital gains makes up 10% of total income. Capital gains make up relatively small portions of total income for households with net capital losses (-3%) and low positive gains (4%); but nearly a quarter of total income is from capital gains for households with medium gains, and 59% of total income is from capital gains for those households with gains of $50,000 or more.

“Business income” includes net business income from Schedule C; rent, royalty, partnership and other income from Schedule E; and other net gains from the sale of business property. Overall, business income is 14% of total income. For the three groups with positive capital gains income, business income averages close to 19% of total income; but jumps to 25% for households with negative capital gains. After wage and salary income, business income is the largest source of income for households with negative capital gains. For all households with no capital gains income, business income represents just 9% of total income.

Retirement income averages around 10-11% for all households, and for households with no capital gains. For households with capital gains income, the share of total income from retirement income sources decreases from 18% for households with negative capital gains to just 3% for households with the highest capital gains. Retirement income represents the third largest source of income for households with negative capital gains.

Farm income and other income play relatively minor roles for all of the groups.

Section C of Table 5 shows the percentage of each group that takes either the standard deduction or itemizes their deductions. Overall, 54% of households itemize deductions while 46% take the standard deduction. These percentages are reversed for all households that have no capital gains income because most households with capital gains income, regardless of the nature or size of that income, itemize deductions. Overall, 78% of all households with capital gains income itemize their deductions.

Section D of Table 5 shows the distribution of itemized deductions, by deduction type, for each of the groups, for households within each group that itemize their deductions.

Medical-related deductions include deductions for medical expenses, and premiums paid for medical care and long-term care insurance. These deductions make up 16% of all deductions for all households. Generally, these deductions make up a larger share of deductions (21%) for all capital gains households, except for households with the largest capital gains where medical deductions make up just 9% of total itemized deductions.

Taxpayers are allowed to itemize their federal income tax paid during the tax year, but only up to $5,000 ($10,000 if married and filing a joint return). This deduction averaged 27% of all itemized deductions for all households. For capital gains households, this percentage ranged from a high of 29% for households with low capital gains, to a low of 14% for households with high capital gains. Because total itemized deductions tend to grow with income, and because households with large capital gains also tend to be households with high incomes, it's not surprising that the capped amount of this deduction represents a smaller share of total deductions for these households. For households with no capital gains income this deduction represents 29% of all itemized deductions.

The itemized deduction for other taxes averages around 11% for all groups.

Home mortgage interest represents 26% of total itemized deductions for all households. This percentage is somewhat lower for households with capital gains in general, but drops to just 14% for households with large capital gains.

The deduction for investment interest averages around 1-2% of total deductions for all households, including most households with capital gains income, but increases to 10% for households with the highest capital gains income. This may reflect a higher level of activity in these households whereby taxpayers borrow funds to purchase property held for investment, such as stocks and bonds, and deduct the interest on the borrowed funds.

Charitable contributions make up 12% of total itemized deductions for all households who itemize deductions. Again, this percentage is similar for most capital gains households, but jumps to 37% for households with the highest capital gains. Just 8% of total deductions is from charitable contributions for all households with no capital gains.

"Other" deductions, which include child and dependent care expenses, casualty and theft losses, unreimbursed employee business expenses, political contributions, gambling losses and other miscellaneous deductions average around 6% for all groups.

In summary, households with the highest capital gains income tend to be households in which married couples file separate tax returns; itemize their deductions, and have a much larger share of their deductions in investment interest and charitable contributions; and where a very small share of total household income is in the form of wages and salaries.

PART B – SCHEDULE "E" INCOME

Introduction

In contrast with Schedule D, which is used to report income from a single source, i.e., capital gains; taxpayers may report income from a wide variety of sources on Schedule E. These sources include net gain or loss from:

1) rental real estate;
2) mineral and other royalties;
3) partnerships and S corporations;
4) estates and trusts;
5) residual interests in Real Estate Mortgage Investment Conduits (REMICs); and
6) rental of farm property.

In fiscal year 2007, individual income taxes contributed nearly half (45%) of Montana's total general fund revenue. For tax year 2006, Montanans reported nearly $2 billion of income from Schedule E; that's 10% of all income reported on tax forms in that year. Nearly one-fifth of all taxpayers reported income from Schedule E.

Notwithstanding the significant role of Schedule E income in state revenues and taxpayers' incomes, little is known about the distribution of income across the above listed types of income reported on Schedule E, how this distribution changes over time, and the relationship between income reported on Schedule E and the state's economy. This study hopes to shed light on these and other matters surrounding Schedule E income, and provide a base of information for subsequent research.

Description and Taxation of Incomes Reported on Schedule E

As noted above, Schedule E is used to report several different types of income. Following sections provide a brief description of those income types and their treatment for tax purposes.

Rental Income. Taxpayers who receive income from rental real estate, and who are not in the real estate business, must report the net income from their rental activities on Schedule E. Generally, taxpayers are allowed to deduct a variety of expenses (e.g., advertising, insurance, repairs, taxes, utilities paid, etc.) related to the business of renting property, including depreciation, from gross rents received to determine net gain or loss on the rental property.[6]

Royalty Income. Taxpayers must report royalty income from oil, gas, or mineral properties, as well as from copyrights and patents, on Schedule E. Business expenses, including in some cases a deduction for depletion, are subtracted from gross royalties to determine net gain or loss from royalty income.[7]

Partnership and S Corporation Income. Taxpayers who are members of a partnership, or who are shareholders of an S corporation, must report any net gain or loss from these entities during the tax year on Schedule E. The partnership or S corporation is required to report to each partner or shareholder their share of enterprise income on Schedule K-1. Special "at-risk" and/or "passive activity" rules may limit the partnership or S corporation loss that may be claimed by an individual taxpayer.

Estate and Trust Income. Beneficiaries of estates and/or trusts must report their share of any gain or loss (whether received or not) from estate and trust activities during the tax year. Beneficiaries should receive a Schedule K-1 showing the amount of gain or loss to report, and where to report the income on the taxpayer's tax return.

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[6] The amount of loss that may be claimed from rental real estate activity may be limited by applicable "at-risk" and/or "passive activity" rules. Generally, these rules limit losses to the amount a taxpayer could actually lose in an activity, or to the amount of income derived from passive activities. A detailed, technical description of these rules is beyond the scope of this paper.

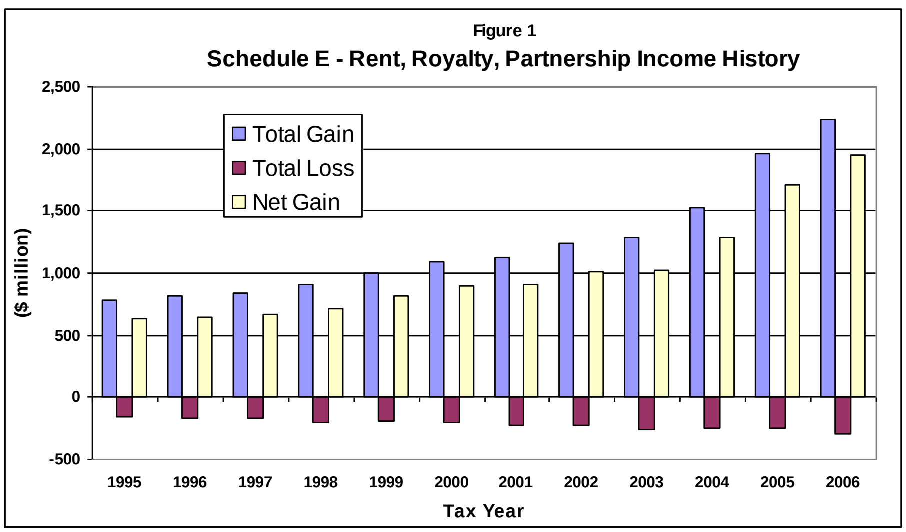
[7] Taxpayers with royalty income who also are subject to "at-risk" rules are required to submit Form 6198 to determine the amount of their allowable loss from royalty activities. Royalty income is not subject to the "passive-activity" rules that rental activity may be subject to.

REMIC Residual Income. Taxpayers who hold a residual interest in a Real Estate Mortgage Investment Conduit (REMIC)[8] must report their share of the REMIC's net gain or loss for the tax year. The REMIC should provide the taxpayer with a Schedule Q and instructions detailing the amount of gain or loss to report, and how and where to report this information on the taxpayer's tax return. This income is not subject to passive activity loss rules.

Farm Rental Income. A landowner (or sub-lessor) of farm land who did not materially participate in the operation or management of a leased farm must report net farm rental income (gross farm rental income less farm rental property expenses), based on crops or livestock produced by the tenant, on Schedule E. The amount of net gain or loss to report is calculated using Form 4835. Any net gain is carried over to Schedule E. Any net loss is subject to "at-risk" and "passive activity" rules, and may be limited by these rules.

Total Income from Schedule E - Trends

Figure 1 shows the growth in Schedule E total gain, total loss, and net gain, as reported on full-year resident individual income tax returns for tax years 1995 through 2006.



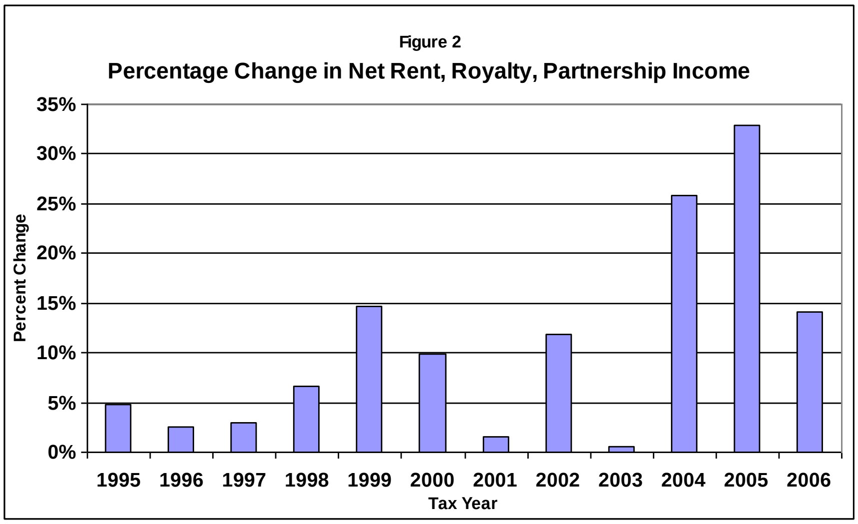
Total gain increased relatively modestly over the period 1995-2003, growing at an average annual rate of 6.4%. Schedule E total gains even grew over the 2001-2003 period, a period during which income from capital gains declined sharply, although

[8] A REMIC is an entity that holds a fixed pool of residential and/or commercial mortgages and issues multiple classes of interests in itself to investors.

growth in Schedule E income grew at very slow rates in 2001 and 2003. Growth in total gains has increased considerably since 2003.

Total losses reported on Schedule E also continued to grow over this time period, but at much slower rates than growth in total gains. As a result, while total losses as a percent of net gains remained fairly steady, at around 20%, over the period 1995-2003, this percentage declined to around 13% in both 2005 and 2006.

Figure 2 shows the percentage change in net gains over the period 1995-2006.



As Figure 2 indicates, growth was relatively modest in the middle 1990's, increased in the late 1990's and in 2000, and was relatively slow again over the 2001-2003 period. Growth in recent years has been very rapid, averaging around 24% over the 2004-2006 period. Over the entire period 1995-2006, however, growth was never negative.

Table 1 shows total Montana Adjusted Gross Income (MAGI), total net Schedule E income, Schedule E net income as a share of MAGI, the number of taxpayers reporting Schedule E income, and average Schedule E income.

Table 1
Montana Adjusted Gross Income, Schedule E Income, and Average Schedule E Income
Full-Year Resident Filers, Tax Years 1995 - 2006

Calendar Year	Total MAGI	Schedule E Net Gain	Schedule E Share of Total MAGI	Number of Taxpayers With Sch. E Income	Average Schedule E Income
1995	9,415,826,925	629,646,678	6.7%	82,868	$7,598
1996	10,013,110,001	645,596,435	6.4%	85,022	$7,593
1997	10,655,088,396	664,946,777	6.2%	84,610	$7,859
1998	11,553,140,475	709,340,064	6.1%	85,866	$8,261
1999	12,167,306,419	813,249,932	6.7%	86,496	$9,402
2000	13,118,511,822	894,050,325	6.8%	85,362	$10,474
2001	13,039,447,584	907,393,972	7.0%	85,107	$10,662
2002	13,034,812,578	1,014,593,070	7.8%	85,241	$11,903
2003	13,572,279,532	1,019,724,460	7.5%	86,402	$11,802
2004	15,011,177,190	1,283,270,778	8.5%	88,436	$14,511
2005	16,773,601,215	1,704,629,493	10.2%	89,947	$18,951
2006	18,659,287,966	1,944,998,907	10.4%	91,792	$21,189

Schedule E income has continued to increase every year over the 1995-2006 period. Schedule E income as a share of total MAGI remained fairly stable over the period 1995-2001, ranging between 6% and 7%. Beginning with tax year 2002, Schedule E income as a share of total MAGI has been increasing quickly to where it comprises 10.4% of MAGI in tax year 2006.

The number of taxpayers reporting Schedule E income also was very stable between 1996 and 2003, ranging from 84,610 in 1997 to 86,496 in 1999. Beginning with tax year 2004, the number of taxpayers reporting Schedule E income also has increased rapidly growing to 91,792 in 2006.

Schedule E income per taxpayer has increased almost three fold over time, from a low of $7,593 in 1996 to a high of $21,189 in 2006. Again, this increase in average Schedule E income has been particularly pronounced over the 2004-2006 period.

Table 2 shows the relationship between total tax liability and tax liability from Schedule E income, and the average marginal tax rate on Schedule E income over the period 1998 to 2006.

Total tax from Schedule E income grew every year, with the exception of tax year 2001 where total tax from all sources as well as from Schedule E income declined. Whereas total tax from all sources again declined in tax year 2002, tax from Schedule E income increased by 15%. Since 2002, total tax from Schedule E income has continued to grow, reaching nearly $120 million by tax year 2006. Of note, total tax from Schedule E has exceeded total tax from capital gains in every year since tax year 2000.

Table 2
Total Tax Liability, Tax From Schedule E Income, and Effective Tax Rate
Full-Year Residents, Tax Years 1998 - 2006

Calendar Year	Total Tax Liability Before Credits	Total Tax From Sch. E Income	% of Total Tax From Sch. E Inc.	Average Marginal Tax Rate[1]
1998	449,965,886	49,021,855	10.9%	6.91%
1999	478,811,343	56,901,458	11.9%	7.00%
2000	518,279,456	62,764,458	12.1%	7.02%
2001	498,294,819	59,788,894	12.0%	6.59%
2002	494,137,275	68,809,562	13.9%	6.78%
2003	538,203,804	72,849,891	13.5%	7.14%
2004	620,917,791	92,855,367	15.0%	7.24%
2005	667,849,230	104,447,561	15.6%	6.13%
2006	751,040,039	119,548,771	15.9%	6.15%

[1]Defined as the ratio of total tax from Schedule E income to total Schedule E income. The average marginal tax rate drops in 2005 and subsequent years, as a result of reducing the top marginal income tax rate from 11% to 6.9% under SB407, 2003 Legislative Session.

Tax attributable to Schedule E income as a share of total tax liability was around 11-12% over the period 1998-2001. Then, in 2002, as total tax liability fell and tax from Schedule E income grew, this percentage increased to almost 14%. In recent years, this percentage has continued to grow and now ranges between 15% and 16%.

Over the period 1998-2004, the average marginal tax rate on Schedule E income was distributed very tightly around the average for the period of 7%. Beginning in 2005, this average dropped to something closer to 6% as the top marginal individual income tax rate was reduced from 11% to 6.9% by Senate Bill 407 (2003).

Schedule E – Distribution by Income Brackets

Table 3 shows the distribution of all households filing income taxes along with total Schedule E gains, Schedule E losses, and net Schedule E income, by total household income bracket, for tax year 2006.[9] As Table 3 shows, the distribution of net Schedule E income is concentrated largely among higher income households.

[9] Total household income is total income for federal income tax purposes, plus Montana additions to income.

Table 3
Distribution of Schedule E Gains, Losses, Net Gains and Average Gain
Tax Year 2006; All Full-Year Resident Households

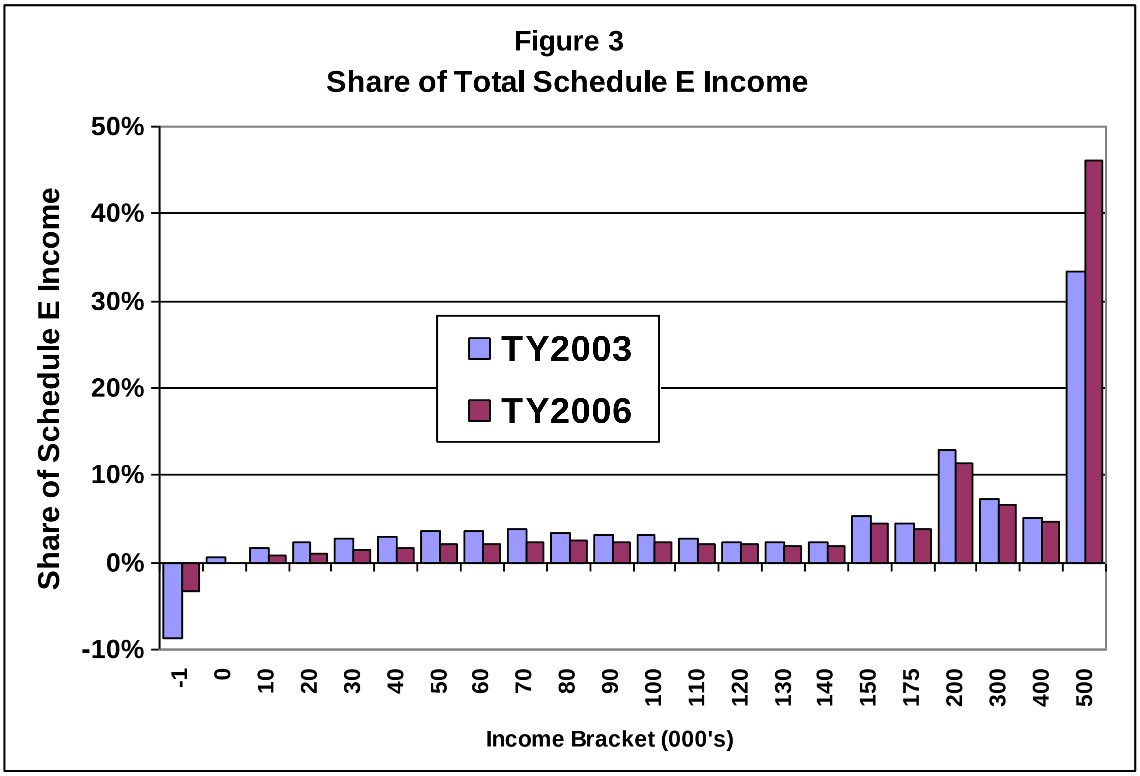
Total Household Income Bracket	No. of Hshlds.	Schedule E Gains	Schedule E Losses	Net Sch E Gains	Share of Net Gains	Cumulative Share	Ave. Gain Per Hshld.
$<0	4,883	6,528,185	(69,112,311)	(62,584,126)	-3.2%	-3.2%	(12,817)
$ 0 - $ 9,999	81,332	11,985,309	(11,297,762)	687,547	0.0%	-3.2%	8
$ 10,000 - $ 19,999	74,410	27,729,857	(13,980,144)	13,749,713	0.7%	-2.5%	185
$ 20,000 - $ 29,999	56,433	36,205,199	(15,201,747)	21,003,452	1.1%	-1.4%	372
$ 30,000 - $ 39,999	41,177	41,205,033	(15,008,786)	26,196,247	1.3%	0.0%	636
$ 40,000 - $ 49,999	32,834	46,531,334	(14,517,474)	32,013,860	1.6%	1.6%	975
$ 50,000 - $ 59,999	27,078	52,765,066	(13,025,280)	39,739,786	2.0%	3.6%	1,468
$ 60,000 - $ 69,999	22,588	53,988,277	(12,612,766)	41,375,511	2.1%	5.8%	1,832
$ 70,000 - $ 79,999	17,968	55,814,964	(11,033,022)	44,781,942	2.3%	8.1%	2,492
$ 80,000 - $ 89,999	13,615	56,999,083	(7,639,481)	49,359,602	2.5%	10.6%	3,625
$ 90,000 - $ 99,999	9,980	52,597,689	(7,724,379)	44,873,310	2.3%	12.9%	4,496
$100,000 - $109,999	6,904	51,259,704	(5,645,566)	45,614,138	2.3%	15.3%	6,607
$110,000 - $119,999	5,126	44,079,605	(4,656,472)	39,423,133	2.0%	17.3%	7,691
$120,000 - $129,999	3,711	44,966,297	(5,090,005)	39,876,292	2.1%	19.3%	10,745
$130,000 - $139,999	2,752	39,100,880	(3,986,535)	35,114,345	1.8%	21.1%	12,760
$140,000 - $149,999	1,983	39,345,985	(3,108,298)	36,237,687	1.9%	23.0%	18,274
$150,000 - $174,999	3,546	95,206,207	(6,745,885)	88,460,322	4.5%	27.6%	24,947
$175,000 - $199,999	2,265	79,707,360	(6,479,402)	73,227,958	3.8%	31.3%	32,330
$200,000 - $299,999	4,289	234,143,812	(11,484,410)	222,659,402	11.4%	42.8%	51,914
$300,000 - $399,999	1,584	134,077,674	(6,396,103)	127,681,571	6.6%	49.3%	80,607
$400,000 - $499,999	848	97,044,377	(7,067,259)	89,977,118	4.6%	54.0%	106,105
$500,000+	1,979	936,558,240	(41,028,143)	895,530,097	46.0%	100.0%	452,516
TOTALS	417,285	2,237,840,137	(292,841,230)	1,944,998,907	100.0%		4,661

In TY2006, just 13% of all net Schedule E income accrued to households with less than $100,000 of total income; less than a quarter (23%) of total Schedule E income accrued to households with less than $150,000 of income, while 46% of all Schedule E income accrued to the 1,979 households with incomes of $500,000 or more.

Households with negative total household income had average net Schedule E income of $(12,817). Average net Schedule E income for households with positive net income ranged from $8 for households with incomes of less than $10,000 to $452,516 for households in the highest income bracket.

As Table 1 showed, net income from Schedule E grew very rapidly between tax years 2003 and 2006, nearly doubling from $1 billion to almost $2 billion. This rapid growth in Schedule E income benefitted the highest income households proportionally more than lower income households.

Figure 3 shows the share of total net Schedule E income accruing to households in each income bracket for tax years 2003 and 2006. Between these two years, the share of total net Schedule E income accruing to the highest income households (households with $500,000 or more of total income) increased from 33.4% to 46.0%; the share of net Schedule E income decreased in all other brackets where total household income is positive, with the largest percentage decreases in share generally occurring in households with incomes up to around $150,000.



To put this in perspective, in 2003, households with $150,000 or more of income received 68% of all Schedule E income; by 2006 this had increased to 77% of all Schedule E income. Households with $150,000 or more of total income received 87% of the total *change* in net Schedule E income between 2003 and 2006, while households with less than $150,000 received the remaining 13% of the total increase in Schedule E income. Clearly, the run up in net Schedule E income between these two years acted to benefit high income households substantially more than lower income households.

Table 4 shows the relationship between total household income and Schedule E income in relation to all households that filed an income tax return in TY2006, and just those households that had some form of income from Schedule E.

Overall, of the 417,285 households filing income tax returns, a total of 74,920 households (18%) had Schedule E income. The percentage of households with Schedule E income grows as incomes rise. Only 13% of households with incomes of less than $75,000 reported any form of Schedule E income. On the other hand, 72% of all households with incomes of $175,000 or more reported Schedule E income, with 86% of all households with income of $500,000 or more reporting Schedule E income.

Table 4
Relationship Between Total Household Income and Schedule E Income
All Households, and All Households with Schedule E Income, Tax Year 2006

	ALL HOUSEHOLDS		HOUSEHOLDS WITH SCHEDULE "E" INCOME					
Total Household Income Bracket	Number	Total Income	Number	% of All Hshlds.	Total Income	Net Schedule E Income	Sch E Inc as % of Total Inc. (Sch E Hshlds.)	Sch E Inc as % of Total Inc. (All Hshlds.)
$<0	4,883	(133,892,757)	2,127	44%	(82,837,127)	(62,584,126)	76%	47%
$ 0 - $ 1,999	13,425	14,450,199	599	4%	657,538	(1,139,583)	-173%	-8%
$ 2,000 - $ 3,999	17,118	51,509,913	793	5%	2,399,813	(1,032,005)	-43%	-2%
$ 4,000 - $ 5,999	17,598	87,863,821	929	5%	4,703,100	427,663	9%	0%
$ 6,000 - $ 7,999	16,817	117,499,380	1,124	7%	7,847,653	581,048	7%	0%
$ 8,000 - $ 9,999	16,374	147,269,296	1,276	8%	11,494,249	1,850,424	16%	1%
$ 10,000 - $ 11,999	15,611	171,500,483	1,320	8%	14,551,131	1,782,283	12%	1%
$ 12,000 - $ 13,999	15,133	196,493,158	1,326	9%	17,223,651	2,241,255	13%	1%
$ 14,000 - $ 15,999	14,929	223,825,072	1,382	9%	20,677,500	2,839,075	14%	1%
$ 16,000 - $ 17,999	14,588	248,024,414	1,360	9%	23,148,908	3,424,971	15%	1%
$ 18,000 - $ 19,999	14,149	268,690,488	1,383	10%	26,286,768	3,462,129	13%	1%
$ 20,000 - $ 24,999	30,540	684,867,437	3,482	11%	78,370,222	9,773,554	12%	1%
$ 25,000 - $ 29,999	25,893	710,393,944	3,318	13%	91,116,346	11,229,898	12%	2%
$ 30,000 - $ 34,999	22,133	717,720,811	3,293	15%	106,898,209	12,606,604	12%	2%
$ 35,000 - $ 39,999	19,044	712,957,918	3,140	16%	117,668,696	13,589,643	12%	2%
$ 40,000 - $ 44,999	17,016	722,321,733	3,165	19%	134,339,707	14,845,623	11%	2%
$ 45,000 - $ 49,999	15,818	750,745,548	3,132	20%	148,795,831	17,168,237	12%	2%
$ 50,000 - $ 54,999	14,238	747,054,861	3,007	21%	157,821,996	19,787,196	13%	3%
$ 55,000 - $ 59,999	12,840	737,696,081	2,859	22%	164,288,926	19,952,590	12%	3%
$ 60,000 - $ 64,999	11,894	742,983,426	2,793	23%	174,447,656	19,940,961	11%	3%
$ 65,000 - $ 69,999	10,694	721,637,487	2,636	25%	177,896,915	21,434,550	12%	3%
$ 70,000 - $ 74,999	9,600	695,389,781	2,422	25%	175,422,980	20,456,154	12%	3%
$ 75,000 - $ 79,999	8,368	648,051,494	2,309	28%	178,827,491	24,325,788	14%	4%
$ 80,000 - $ 89,999	13,615	1,153,848,189	4,040	30%	342,761,885	49,359,602	14%	4%
$ 90,000 - $ 99,999	9,980	945,094,211	3,259	33%	308,866,010	44,873,310	15%	5%
$100,000 - $109,999	6,904	723,299,763	2,549	37%	267,436,271	45,614,138	17%	6%
$110,000 - $119,999	5,126	588,710,147	1,999	39%	229,937,536	39,423,133	17%	7%
$120,000 - $129,999	3,711	462,864,098	1,714	46%	214,009,259	39,876,292	19%	9%
$130,000 - $139,999	2,752	370,661,303	1,307	47%	176,043,259	35,114,345	20%	9%
$140,000 - $149,999	1,983	287,015,307	1,054	53%	152,696,408	36,237,687	24%	13%
$150,000 - $174,999	3,546	573,581,338	1,974	56%	320,308,122	88,460,322	28%	15%
$175,000 - $199,999	2,265	422,726,439	1,374	61%	256,516,862	73,227,958	29%	17%
$200,000 - $299,999	4,289	1,035,225,933	2,926	68%	711,067,975	222,659,402	31%	22%
$300,000 - $399,999	1,584	546,406,834	1,192	75%	411,193,719	127,681,571	31%	23%
$400,000 - $499,999	848	377,460,643	664	78%	295,793,468	89,977,118	30%	24%
$500,000+	1,979	2,683,581,801	1,693	86%	2,429,893,910	895,530,097	37%	33%
TOTALS	**417,285**	**20,155,529,994**	**74,920**	**18%**	**7,868,572,843**	**1,944,998,907**	**25%**	**10%**

Households with Schedule E income reported total household income of $7.869 billion, which represents 39% of total household income of $20.156 billion reported by all households.

Of the $7.869 billion of total household income reported by Schedule E households, Schedule E income comprised $1.945 billion, or 25% of total income. For households with Schedule E income that have negative total income, Schedule E losses accounted for 76% of total household income; Schedule E losses accounted for 47% of total income for all households reporting negative net income in tax year 2006.

For Schedule E income households, income from Schedule E comprises 14% of total income for households with positive income of less than $150,000; for households with incomes of $150,000 or more, Schedule E income comprises 34% of all income.

For all households filing tax returns, income from Schedule E comprises 3% of total income for households with positive income of less than $150,000; for households with incomes of $150,000 or more, Schedule E income comprises 27% of all income, with Schedule E income comprising 33% of total income for all households in the highest income bracket of $500,000 or more.

The following section provides a more detailed discussion of how Schedule E households are distinguished from all other households filing income tax returns.

Schedule E - Household Profiles

This section draws on information reported on individual income tax forms to make some comparisons between households with Schedule E income and all other households. All full-year resident households filing income tax forms for tax year 2006 were segregated into the following six groups:

Group 1: All households
Group 2: “Negative” Schedule E income households (all households with negative Schedule E income).
Group 3: “Small” Schedule E income households (all households with positive Schedule E income of less than $10,000).
Group 4: “Median” Schedule E income households (all households with positive Schedule E income between $10,000 and $50,000).
Group 5: “Large” Schedule E income households (all households with positive Schedule E income of $50,000 or more).
Group 6: “All other” households (all households with no Schedule E income).

Table 5 provides information on selected household characteristics for each of these groups. The first two lines of Table 5 show the total number of households filing in each group, and the percentage of total households in each group. Of the 417,285 total households filing in 2006, a total of 74,920 (18%) had Schedule E income, while 313,712 households (82%) had no Schedule E income.

Section A of Table 5 shows the distribution of households across filing types for each group. Overall, 46% of all households were “single” filers.[10] This percentage was lower for all Schedule E household groups, and declined as Schedule E income increased. Single filers comprised just 15% of households in the highest Schedule E income group; whereas single filers made up 51% of all households with no Schedule E income.

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[10] “Single” filers include children who file income tax returns but are either living with their parents or in institutional environments such as university dormitories.

Table 5
Household Profiles - Schedule E Income Households v. Other Households

Household Characteristic	All Hshlds.	SCHEDULE "E" GROUPS Neg	Low	Med	High	All Oth. Hshlds.
Number in Group	417,285	21,735	29,165	15,809	8,211	342,365
Percent in Group	100%	5.2%	7.0%	3.8%	2.0%	82.0%
A. Percent of Households, by Filing Type						
Single Households	46%	27%	32%	24%	15%	51%
Married; Filing Jointly	20%	38%	27%	22%	25%	18%
Married; Filing Separately	25%	31%	37%	50%	58%	21%
Head of Household	9%	4%	3%	3%	3%	10%
B. Percent of Total Income, by Income Type						
Wages and salaries	60%	53%	48%	36%	17%	76%
Interest and dividends	6%	12%	10%	9%	8%	4%
Capital gains	10%	40%	17%	16%	12%	4%
Business income	4%	8%	7%	5%	2%	4%
Schedule E income	10%	-18%	5%	28%	61%	0%
Retirement income	11%	11%	15%	9%	2%	12%
Farm income	-1%	-1%	-1%	-2%	-2%	-1%
Other income	0%	-5%	-1%	-1%	0%	0%
C. Percent Taking Standard/Itemized Deductions						
Itemized Deduction	54%	84%	79%	85%	96%	47%
Standard Deduction	46%	16%	21%	15%	4%	53%
D. Percent of Total Itemized Deductions, by Deduction Type						
Medical-related deductions	16%	13%	24%	18%	6%	16%
Federal income tax (capped amount)	27%	22%	24%	25%	21%	29%
Other taxes	11%	11%	11%	11%	10%	11%
Home mortgage interest	26%	27%	20%	25%	24%	28%
Investment interest	1%	4%	1%	2%	7%	0%
Contributions	12%	18%	14%	15%	28%	9%
Other deductions	6%	6%	5%	4%	3%	6%

One-fifth of all households are married couples who file a joint return. This percentage is higher for all Schedule E household groups, and again declines from 38% for households with negative Schedule E to 25% for households with the largest Schedule E incomes.

One-quarter of all households are married couples who file separate income tax returns. This percentage is substantially higher for all Schedule E households *increasing* from 31% for households with negative Schedule E income to 58% for households with the highest Schedule E incomes. Only 21% of all households with no Schedule E income use this filing status.

Heads of households comprise 9% of all households, but only 3% of households with Schedule E income were of this filing type.

Section B shows the percent of total income that is contributed from various sources of income for each of the groups. For all households, 60% of total income is from wages and salaries. This percentage is lower for households with Schedule E income, ranging from 53% for households with negative Schedule E income to just 17% for households with the highest Schedule E incomes. Wage and salary income comprises 76% of all income for all other households.

Interest and dividend income comprises just 6% of total income for all households, but comprises between 8% and 12% of income for Schedule E households. For households with no Schedule E income, interest and dividend income comprises just 4% of total income.

For all households, capital gains income makes up 10% of total income; but for those households who have negative Schedule E income capital gains makes up 40% of total income. Capital gains income accounts for 16-17% of total income for households with low and medium Schedule E income, but accounts for just 12% of total income for those households with the highest Schedule E incomes.

“Business income” includes net business income from Schedule C and other net gains from the sale of business property. Overall, and for all households with no Schedule E income, business income is 4% of total income. For Schedule E households business income ranges from 8% of total income for households with negative Schedule E income to just 2% of total income for households with the highest Schedule E income.

Retirement income averages around 11-12% for all households, and for households with no Schedule E income. For households with Schedule E income, the share of total income from retirement income sources jumps from 11% for households with negative Schedule E to 15% for households with low Schedule E income, then drops to just 2% for households with the highest Schedule E incomes.

Farm income and other income play relatively minor roles for all of the groups.

Section C of Table 5 shows the percentage of each group that takes either the standard deduction or itemizes their deductions. Overall, 54% of households itemize deductions while 46% take the standard deduction. These percentages are nearly reversed for all households that have no Schedule E income because most households with Schedule E income, regardless of the nature or size of that income, itemize deductions. Overall, 84% of all households with Schedule E income itemize their deductions.

Section D of Table 5 shows the distribution of itemized deductions, by deduction type, for each of the groups, for households within each group that itemize their deductions.

Medical-related deductions include deductions for medical expenses, and premiums for medical care and long-term care insurance. These deductions make up 16% of all itemized deductions for all households. Overall, these deductions also make up 16% of total deductions for all households with Schedule E income, but there is significant variation in this percentage across the Schedule E income groups. For example, medical deductions make up 24% of all deductions for households with low Schedule E income, but make up just 6% of deductions for households with the highest Schedule E incomes.

Taxpayers are allowed to itemize their federal income tax paid during the tax year, but only up to $5,000 ($10,000 if married and filing a joint return). This deduction averaged 27% of all itemized deductions for all households. Across Schedule E household groups this percentage is generally lower but fairly consistent; with the high Schedule E income group having the lowest percentage (21%). For households with no Schedule E income this deduction represents 29% of all itemized deductions.

The itemized deduction for other taxes averages around 11% for all groups.

Home mortgage interest represents 26% of total itemized deductions for all households. While there is some variation across the four Schedule E income groups, overall this percentage is just slightly lower (24%) for all households with Schedule E income.

The deduction for investment interest averages 1% for all households, but is slightly higher for households with negative Schedule E income (4%) and households with the highest Schedule E incomes (7%).

Charitable contributions make up 12% of total itemized deductions for all households that itemize deductions. This percentage is higher for all Schedule E income groups, but at 28% it is significantly higher for households with the highest Schedule E incomes. For households with no Schedule E income, just 9% of total deductions is from charitable contributions.

“Other” deductions, which include child and dependent care expenses, casualty and theft losses, unreimbursed employee business expenses, political contributions, gambling losses and other miscellaneous deductions average 6% for all households and households with no Schedule E income. This percentage declines from 6% to 3% for Schedule E income groups as Schedule E incomes grow.

Schedule D and Schedule E Income Study
Study Results and Findings

Schedule D

Introduction

Montana taxpayers with capital gains income enter the same amount that they reported on their federal returns on the first page of their state returns. This amount is captured in the normal data entry process. Taxpayers with capital gains income are required to provide copies of their federal Schedule D and any supporting schedules, such as Forms 2439, 4684, 4797, 6252, 6781, 8594, and 8824. These federal forms are retained with the returns, but their contents are not captured in the normal data entry process.

A stratified random sample of returns with capital gains income was drawn for the years 2002 through 2006, and information from the accompanying federal Schedule Ds and supporting schedules was recorded. Most of the information that follows is based on this sample. Details of sample selection, data entry, and estimation are in Appendix C.

This report provides information relating to three separate concepts of "capital gains income". It is important to understand the differences between these concepts, and to be aware of which concept is being addressed at different times in the discussion that follows. The three general concepts are:

- "Current year capital gains". This concept refers to the total net capital gains reported by taxpayers for the current tax year. Current year gains may be negative or positive, but do not include any carryover capital losses from prior years.
- "Capital gains before the cap on losses". Taxpayers with a net capital loss in any year are allowed to include the loss in adjusted gross income, with the amount of loss that can be claimed in any single year capped at $3,000 ($1,500 if married and filing a separate tax return). Losses in excess of the cap amount can be carried over to subsequent tax years until the loss is fully used. This concept refers to the sum of the taxpayer's current year gains (or losses) plus the total amount of any unused carryover losses from previous years.
- "Capital gains after the cap on losses". This concept refers to the amount of capital gains reported after the cap on total capital losses has been applied. If a single taxpayer has current year capital losses and prior year capital loss carryovers that exceed $3,000 then capital gains after the cap on losses equals negative $3,000; with this latter amount reported on the tax return.

A simple example will help demonstrate the differences in these three concepts. John sells securities during the current tax year for which he receives a long-term positive gain of $60,000. His current year capital gain is $60,000. John also has $75,000 of long-term carryover losses that can be used to offset the current year gains. John's capital gains before the cap on losses is negative $15,000. However, because of the cap on capital losses that can be claimed in any year John's reported capital gains after the cap on losses is negative $3,000. John is allowed to carry over $12,000 in capital losses to the following tax year.

Trends in Aggregate Capital Gains and Losses

Table D-1 shows *population totals* of capital gains income reported on full-year resident Montana income tax returns for 2002 through 2006. The left side of the table shows the total number of returns and the number and percent with capital gains income. The proportion of returns with capital gains income is higher in later years, but the difference is relatively small.

Table D-1
Capital Gains Income Reported on Montana Income Tax Returns, 2002 - 2006
($ million)

	Total Returns	Returns with Capital Gains	% of Total	Federal Total Income	Capital Gains Income	% of Total
2002	388,453	90,725	23.4%	$13,706.6	$637.4	4.7%
2003	390,406	89,657	23.0%	$14,276.9	$790.9	5.5%
2004	398,477	97,774	24.5%	$15,733.1	$1,193.2	7.6%
2005	402,271	101,581	25.3%	$17,556.8	$1,554.1	8.9%
2006	417,285	103,573	24.8%	$19,609.2	$2,006.0	10.2%

The right side of the table shows total income before any federal or state adjustments (the same as Line 22 on IRS Form 1040), total capital gains income, and the percent of total income from capital gains. Over this five year period, the proportion of total income from capital gains more than doubled, from 4.7% to 10.2%. Total income grew by 43.1%, but capital gains income grew by 315%.

Capital gains are reported on federal Schedule D. On Schedule D, subtotals are calculated for short-term (less than 12 months holding period) and long-term capital gains. The total is calculated and transferred to the return, but with a limit of $3,000 on losses ($1,500 for a married person filing a separate return). Losses of more than $3,000 must be carried forward to the next year. Net capital gains before the cap on losses includes any losses carried forward from previous years. Because of the cap on losses, total capital gains income reported on tax returns generally will be higher than total capital gains reported on the corresponding Schedule Ds.

Table D-2 shows *sample estimates* of gains and losses reported on Schedule Ds. The first two columns show estimates of the number of returns with short-term gains or losses and total net short-term gains. Standard errors of the estimates are in parentheses under each value. The third and fourth columns show estimates of the number of returns with long-term gains or losses and total net long-term gains. The fifth column shows estimates of the total number of returns with capital gains or losses, and the fifth column is the sum of the estimates of short-term and long-term net gains. The right hand column is the sample estimate of capital gains income, after the cap on losses, that would be carried forward to returns.

Table D-2
Sample Estimates of Capital Gains and Losses Reported on Schedule D Filed with Montana Returns, 2002 - 2006
($ million, standard errors in parentheses)

	Short Term Gains		Long Term Gains		Total Gains Before Cap on Losses		Capital Gains Income After Cap on Losses
	Returns	$ million	Returns	$ million	Returns	$ million	$ million
2002	38,654	-$682.9	85,119	-$495.1	90,735	-$1,178.0	$624.1
	(1,674)	($ 160.5)	(821)	($ 289.3)	n/a	($ 449.8)	($ 19.8)
2003	36,983	-$597.3	85,995	-$722.9	89,663	-$1,320.2	$829.8
	(1,806)	($ 121.7)	(719)	($ 335.1)	n/a	($ 456.8)	($ 47.7)
2004	38,857	-$452.0	93,160	$677.5	97,783	$225.6	$1,523.4
	(2,024)	($ 140.9)	(802)	($ 317.7)	n/a	($ 458.5)	($ 247.7)
2005	41,162	-$479.1	98,101	$800.5	101,583	$321.5	$1,640.2
	(2,337)	($ 153.5)	(794)	($ 171.7)	n/a	($ 325.2)	($ 57.9)
2006	42,116	-$472.5	97,844	$1,424.2	103,577	$951.6	$2,178.5
	(2,403)	($ 151.9)	(1,027)	($ 271.3)	n/a	($ 423.1)	($ 83.9)

The sample estimates of capital gains income reported on returns are within 10% of the actual amounts for 2002, 2003, 2005, and 2006, but almost 30% different for 2004. The estimate of capital gains income also is less precise for 2004 – the standard error is much larger for this year than for the other four. The difference between estimated and actual capital gains income is less than twice the standard error of the estimate for 2002 through 2005. It is slightly more than twice (2.06 times) the standard error of the estimate for 2006.

The estimates of the number of returns with short-term and long-term gains are relatively precise with standard errors that are 6% or less of the estimates. The estimates of short- and long-term capital gains are less precise, with standard errors ranging from 19% to 58% of the estimate.

The estimates of total gains are less precise than the estimates of the short-term and long-term components for 2004 through 2006. This is because the standard error is based on the combined variation of short-term and long-term gains, while the total is the difference between the positive sum of long-term gains and the negative sum of short-term gains. This is especially true for 2004 and 2005, where the long-term net gain and the short-term net loss are close in size, and their difference is smaller than its standard error.

While capital gains income after the cap on losses was positive all five years and more than tripled during the period, capital gains before the cap on losses was a large negative amount in the first two years and increased to a smaller positive amount in the last three years. The large difference between pre-cap gains (or losses) and post-cap gains shows that even in 2006, a year with extraordinary capital gains income, significant losses were being carried forward to future years.

Short-term gains were negative all five years. The estimated number of returns with short-term gains or losses dropped from 2002 to 2003 but then increased each of the remaining years. All of the year-to-year differences could be due to the fact that these are estimates from a random sample, but the five-year pattern of differences almost certainly is not. Statistics for the tests of statistical significance in this section are reported in Tables D-2A through D-11A in the appendix at the end of the section.

Estimated short-term losses decreased in 2003 and 2004 before stabilizing in 2005 and 2006. Because these estimates have relatively large standard errors, all of the year-to-year differences could be due to sampling error. However, the five-year pattern of differences almost certainly is not.

The estimated number of returns with long-term gains increased each year, except for 2006. The estimated year-to-year changes are unlikely to be due to random sampling error for 2004 and 2005 but may be for 2003 and 2006. Estimated long-term gains were negative in 2002 and became even more negative in 2003. Estimated long-term gains became positive in 2004 and increased in 2005 and 2006. The changes from the previous year are unlikely to be due to random sampling for 2004 and 2006 but may be for 2003 and 2005.

The net gains reported in any year include losses carried forward from previous years. Table D-3 shows sample estimates of total current short-term and long-term gains or losses and short-term gains and losses carried forward from previous years.

Table D-3
Sample Estimates of Current Gains and Losses and Carryover Losses
($ million, standard errors in parentheses)

	Short Term		Long Term		Total	
	Current	Carryover	Current	Carryover	Current	Carryover
2002	-$218.5	-$468.2	$210.5	-$696.2	-$7.9	-$1,164.4
	($202.6)	($69.9)	($503.3)	($195.3)	($705.9)	($265.2)
2003	$72.7	-$669.0	$435.5	-$1,144.3	$508.2	-$1,813.2
	($82.1)	($111.7)	($541.7)	($181.6)	($623.8)	($293.3)
2004	$27.4	-$496.6	$1,937.5	-$1,047.3	$1,964.9	-$1,543.8
	($46.8)	($124.6)	($698.9)	($247.4)	($745.7)	($371.9)
2005	$15.6	-$492.4	$1,781.5	-$984.9	$1,797.1	-$1,477.3
	($90.4)	($132.4)	($386.0)	($144.6)	($476.4)	($277.0)
2006	-$14.6	-$457.9	$2,240.7	-$820.1	$2,226.1	-$1,278.0
	($92.1)	($127.3)	($549.1)	($150.0)	($641.1)	($277.3)

Current year capital gains were close to zero in 2002 and increased each year to $2.2 billion in 2006. Total losses carried over from previous years were $1.2 billion and $1.3 billion in 2002 and 2006; they were higher, at $1.5 billion, in 2004 and 2005, and much higher, $1.8 billion, in 2003. The higher carryover losses in 2004 and 2005 were primarily long-term. In 2003, both short- and long-term carryover losses were higher than in other years. Current year losses appear to have been higher than normal in 2002, leading to higher-than-normal carryover losses in 2003.

Current short-term gains were negative in 2002 and 2006; and, except in 2002, were small relative to current long-term gains and both short-term and long-term carryover losses. Current long-term gains had more variation, in both absolute and relative terms, showing a ten-fold increase from 2002 to 2006.

The changes in capital gains before the cap on losses in Table D-2 can be seen to derive primarily from the large changes in current year long-term gains and the higher than normal carryover losses in 2003, with changes in current short-term gains having a smaller impact. All of the year-to-year changes in table D-3 could be due to sampling error, but for each column, it is almost certain that the five year pattern is not.

The pattern of carryover losses suggests that there may be normal levels of both short- and long-term carryover losses, and that, after an unusual year, short-term carryover losses return to normal quickly while long-term carryover losses take longer to return to normal. With only five years of data, it is impossible to be certain whether this apparent pattern holds over a longer time or is just coincidence. However, it is possible to get some hints.

If short-term carryover losses were at a normal level in 2002 and returned to normal in 2004 through 2006, then the data should show three things: The number of returns with new short-term losses to carry forward and the amount of new losses should be higher in 2002 and approximately the same in 2003 through 2006. The number of returns offsetting old losses against current gains and the amount of old losses offset should be higher in 2003 and approximately the same in 2002 and 2004 through 2006. And, the amount of new losses to carry forward and the amount of old losses being offset should be approximately equal in 2004 through 2006.

To see whether these conditions were met, loss carry-forwards were calculated for each Schedule D in the sample[11]. For each year, the number of Schedule Ds with new losses to carry forward and the number offsetting old losses against new gains were estimated. Also for each year, the amount of losses carried forward from earlier years and the amount to be carried over to later years was estimated.

[11] Loss carryforwards are calculated as follows: Short- and long-term gains and losses are totaled separately. Short-term losses that are carried forward from the past are netted against current short-term gains, and long-term carryforward losses are netted against current long-term gains. If a taxpayer has a short-term loss in the current year, that loss is applied first against the $3,000 cap. Short-term losses of more than $3,000 must be carried forward. If the taxpayer has a short-term gain or a short-term loss of less than $3,000, long-term losses are applied against the remaining cap amount. Long-term losses that exceed the difference between $3,000 and short-term losses must be carried forward.

Table D-4compares short-term losses carried forward from previous years to calculated short-term losses that must be carried forward to the next year. The left half shows estimates for Schedule Ds where new net losses must be carried forward to the next year. It shows estimates of the number of such Schedule Ds, the amount of losses they carried forward from the previous year, the amount of losses they must carry forward to the next year, and the change in the amount of carryover losses. The same information for Schedule Ds where losses carried over from previous years were at least partly offset by new net gains is shown on the right side of the table. The right-hand column shows the net change in carryover losses.

Table D-4
Sample Estimates of Changes in Short-Term Loss Carry-forwards

	Returns with Short-Term Losses To Carry Forward to Next Year Greater Than Short-Term Losses Carried Forward From Previous Year				Returns with Short-Term Losses To Carry Forward to Next Year Less Than Short-Term Losses Carried Forward From Previous Year				
	N	Losses Carried Forward From Previous Year	Losses to Carry Forward to Next Year	Change	N	Losses Carried Forward From Previous Year	Losses to Carry Forward to Next Year	Change	Net Change in Short-Term Carry-over Losses
2002	10,786	$312.1	$637.3	$325.2	7,784	$156.1	$125.4	-$30.7	$294.6
2003	3,539	$118.3	$197.4	$79.2	12,422	$550.7	$443.8	-$106.9	-$27.7
2004	3,318	$98.5	$152.9	$54.4	8,982	$398.0	$352.6	-$45.4	$8.9
2005	4,777	$114.5	$212.0	$97.5	7,106	$378.0	$339.8	-$38.2	$59.3
2006	4,121	$161.1	$279.8	$118.8	5,996	$296.9	$265.6	-$31.3	$87.5

The number of taxpayers with new short-term losses to carry forward and the amount of new carry-forwards are both in a relatively narrow range in 2003 through 2006. The number of taxpayers offsetting old losses against current gains and the amount of old losses offset cover a wider range in 2002 and 2004 through 2006 and appear to have a downward trend in 2004 through 2006.

Table D-5 shows the same information for long-term loss carry-forwards. If long-term carry-over losses were slowly returning to normal, both the number of returns with new carry-over losses and the amount of new carry-over losses should show a downward trend from 2002 through 2006, and both the number of returns offsetting old losses against new gains and the amount of old losses offset should show a downward trend from 2003 through 2006.

Table D-5
Sample Estimates of Changes in Long-Term Loss Carry-forwards

	Returns with Long-Term Losses To Carry Forward to Next Year Greater Than Long-Term Losses Carried Forward From Previous Year				Returns with long-Term Losses To Carry Forward to Next Year Less Than Long-Term Losses Carried Forward From Previous Year				
	N	Losses Carried Forward From Previous Year	Losses to Carry Forward to Next Year	Change	N	Losses Carried Forward From Previous Year	Losses to Carry Forward to Next Year	Change	Net Change in Long-Term Carry-over Losses
2002	23,408	$377.3	$1,675.5	$1,298.2	9,918	$318.9	$196.1	-$122.9	$1,175.3
2003	19,865	$497.1	$1,663.7	$1,166.6	17,019	$647.1	$490.4	-$156.7	$1,009.9
2004	12,015	$335.6	$822.3	$486.7	22,408	$711.7	$468.7	-$242.9	$243.8
2005	10,361	$362.2	$936.2	$573.9	22,899	$622.7	$373.0	-$249.6	$324.3
2006	8,485	$318.8	$911.7	$593.0	18,387	$501.3	$308.7	-$192.6	$400.3

The number of returns with new losses to carry forward and the amount of new carry-forwards roughly follow the expected pattern. The number of returns offsetting old losses and the amount of old losses offset both increased through 2005 before falling in 2006.

These results suggest that there may be a normal level of carryover losses and that short-run carry-forwards return to normal much faster than long-run carry-forwards. These results also suggest that either other factors are at work or that the process of returning to normal is not simple, especially for long-run carry-forwards. On the other hand, these results certainly do not rule out the possibility that the apparent patterns are just coincidence. Identifying any patterns with confidence would require data covering multiple business cycles.

Types of Capital Gains Transactions – Short-Term v. Long-Term

Schedule D is divided into three parts: Part I for reporting short-term gains on assets held for less than a year, Part II for reporting long-term gains, and Part III for calculating losses that must be carried forward to the next year. Parts I and II each contain several lines for reporting gains and losses from sales of different types of asset. Some taxpayers report only short-term gains, some report only long-term gains, and some report both.

Table D-6 shows the proportions of Schedule Ds with short-term and long-term gains or losses.

Table D-6
Proportion of Schedule Ds with Short Term and Long Term Gains

	Short Term Only		Long Term Only		Both		Total
	N	%	N	%	N	%	N
2002	5,616	6.2%	52,081	57.4%	33,039	36.4%	90,735
	(821)	(0.9%)	(1,674)	(1.8%)	(2,494)	(2.7%)	
2003	3,668	4.1%	52,680	58.8%	33,315	37.2%	89,663
	(719)	(0.8%)	(1,806)	(2.0%)	(2,525)	(2.8%)	
2004	4,623	4.7%	58,926	60.3%	34,234	35.0%	97,783
	(802)	(0.8%)	(2,024)	(2.1%)	(2,826)	(2.9%)	
2005	3,481	3.4%	60,421	59.5%	37,681	37.1%	101,583
	(794)	(0.8%)	(2,337)	(2.3%)	(3,131)	(3.1%)	
2006	5,733	5.5%	61,462	59.3%	36,383	35.1%	103,577
	(1,027)	(1.0%)	(2,403)	(2.3%)	(3,430)	(3.3%)	

The proportions changed little from year to year, with about 5% of Schedule Ds having short-term gains only, almost 60% having long-term gains only, and a little more than a third having both. None of the year-to-year changes in percents are statistically significant, though the changes in short-term percents for 2003 and 2006 are close. The five-year pattern is almost certain not to be due to sampling error. The percent of Schedule Ds with both is just 100% minus the percents with short- or long-term gains only, so there are no independent tests for significance of changes in it.

Capital Gains Transactions – By Type of Asset

Capital gains can arise from a variety of transactions. Schedule D has nine lines for reporting specific types of gains and losses.

Lines 1 and 8 are catch-all lines for reporting gains that do not go on another line, but are used primarily for reporting gains from the sale of securities, a taxpayer’s principal residence or land. Line 1 is for short-term gains, and Line 8 is for long-term gains. These lines actually consist of a series of lines, one for each asset sale, and may be extended indefinitely through continuation sheets (Schedule D-1). The total gains from any continuation sheets are reported on Lines 2 and 9, but since the same types of items are reported on these lines, they are not treated as separate lines in what follows.

Lines 4 and 5 (short-term), and 11 through 13 (long-term) are for reporting gains from specific types of transactions.

Undistributed long-term gains from a regulated investment company (mutual fund) or a real estate investment trust are reported to the taxpayer on Form 2439. The total of these undistributed gains is included in Line 11.

If a taxpayer receives reimbursement for a casualty or theft loss, such as from insurance, and the reimbursement is greater than the loss of fair market value of the property subject to the casualty or theft, the excess is a capital gain. If the property was held for less than a year, the gain is reported on Line 4. Otherwise, it is reported on Line 11.

Capital gains or losses on the sale or exchange of an individual's property used in a trade or business are reported on Line 11.

Capital gains or losses on installment sales are reported on Line 4 if the property was held for less than a year and on Line 11 otherwise.

Capital gains and losses from regulated futures contracts, foreign currency contracts, options other than for stock, and futures and option contracts bought and sold by a dealer in the regular course of business are reported on Lines 4 and 11. Short-term gains and losses on contracts bought and sold within the tax year are reported on Line 4. For contracts that are open at the end of a year, unrealized gains or losses must be calculated as of the last business day of the year. When such a contract is closed out, gain or loss is calculated from the basis at the beginning of the year. In both cases, gains or losses on contracts carried over from one year to the next are treated as 40% short-term, reported on Line 4, and 60% long-term, reported on Line11.

A straddle is a financial transaction where a taxpayer takes offsetting positions in a financial market, such as options to buy and sell the same commodity. For tax purposes, the two contracts that make up a straddle are treated as a single transaction, even if one is closed out before the other. Short-term gains and losses from straddles are reported on Line 4, and long-term gains and losses are reported on Line 11.

Gains and losses from like-kind exchanges are reported on Line 4, if short-term, and Line 11 if long-term.

Capital gains or losses passed through to a taxpayer from a partnership, S corporation, estate, or trust are reported on Line 5 if short-term and on Line 12 if long-term.

Distributions of long-term capital gains from a regulated investment company or real estate investment trust are reported on Line13. Distributions of short-term gains from a regulated investment company or real estate investment trust are treated as dividend income rather than capital gains.

Lines 6 and 14 are for reporting losses that have been carried forward from previous years when the taxpayer's net loss was greater than $3,000 ($1,500 for married filing a separate return). Line 6 is for short-term losses carried forward, and Line 14 is for long-term losses carried forward.

To summarize by line

- Line 1 is short-term gains or losses not reported on another line, including gains from the sale of securities, principal residences, and land.
- Line 4 is short-term gains or losses from
  - casualty and theft loss,
  - installment sales,
  - futures, currency, and options contracts, and straddles, and
  - like-kind exchanges.
- Line 5 is short-term gains or losses from a pass-through entity.
- Line 6 is short-term losses carried forward from an earlier year.
- Line 7 is total short-term gains or losses.
- Line 8 is long-term gains or losses not reported on another line, including gains from the sale of securities, principal residences, and land.
- Line 11 is long-term gains or losses from
  - casualty and theft loss,
  - sale of property used in a trade or business,
  - installment sales,
  - futures, currency, and options contracts, and straddles, and
  - like-kind exchanges.
- Line 12 is long-term gains or losses from a pass-through entity.
- Line 13 is distributions of long-term gains from a regulated investment company or real estate investment trust.
- Line 14 is long-term losses carried forward from an earlier year.
- Line 15 is total long-term gains or losses.

Table D-7 shows the percent of Schedule Ds with gains or losses on each line. The left side of the table shows the four lines for types of short-term gains or losses and Line 7, the short-term total. The right side shows the five lines for types of long-term gains or losses and Line 15, the long-term total.

Table D-7
Percent of Schedule Ds with Gains or Losses on Each Line

	Short Term Gans and Losses					Long Term Gains and Losses					
	Line 1	Line 4	Line 5	Line 6	Line 7 S.T Total	Line 8	Line 11	Line 12	Line 13	Line 14	Line 15 L.T. Total
2002	34.4%	1.5%	7.2%	12.9%	42.6%	58.0%	29.7%	16.7%	29.9%	20.1%	93.8%
	(1.8%)	(0.5%)	(1.0%)	(1.0%)	(1.8%)	(1.9%)	(1.7%)	(1.5%)	(1.8%)	(1.2%)	(0.9%)
2003	30.5%	1.4%	8.2%	15.6%	41.2%	56.8%	29.1%	20.5%	32.2%	30.3%	95.9%
	(1.9%)	(0.5%)	(1.2%)	(1.2%)	(2.0%)	(2.1%)	(1.8%)	(1.7%)	(2.0%)	(1.5%)	(0.8%)
2004	30.2%	1.5%	7.5%	10.0%	39.7%	60.8%	27.5%	15.8%	37.3%	29.3%	95.3%
	(2.0%)	(0.5%)	(1.1%)	(1.0%)	(2.1%)	(2.1%)	(1.8%)	(1.6%)	(2.1%)	(1.5%)	(0.8%)
2005	31.9%	1.8%	7.9%	8.3%	40.5%	55.0%	28.8%	19.8%	45.8%	27.5%	96.6%
	(2.2%)	(0.6%)	(1.3%)	(1.0%)	(2.3%)	(2.4%)	(2.1%)	(1.9%)	(2.4%)	(1.6%)	(0.8%)
2006	30.6%	2.2%	9.8%	7.2%	40.7%	53.0%	30.7%	18.5%	45.2%	21.0%	94.5%
	(2.2%)	(0.7%)	(1.4%)	(0.9%)	(2.3%)	(2.4%)	(2.1%)	(1.9%)	(2.4%)	(1.5%)	(1.0%)
average	31.5%	1.7%	8.1%	10.8%	41.0%	56.7%	29.2%	18.3%	38.1%	25.6%	95.2%

For each line, the five year pattern of estimated changes is almost certain not to be due to sampling error. In addition, some of the larger year-to-year changes, such as Line 14 from 2002 to 2003 and Line 6 from 2003 to 2004, are unlikely to be due to sampling error.

About 40% of Schedule Ds report short-term gains or losses each year. Of these, about three-fourths report gains or losses on Line 1. Two percent or less of Schedule Ds report short-term gains or losses on Line 4 from casualty and theft loss, installment sales, financial derivatives, and like-kind exchanges. This percentage appears to have a slight upward trend from 2003 to 2006.

Between seven and ten percent of Schedule Ds report short-term gains or losses from pass-through entities on line 5. The percentage is highest for 2006, but this could represent either a trend or year-to-year variation. The fraction of Schedule Ds with short-term losses carried forward on Line 6 peaked at 16% in 2003 and decreased each year through 2006.

About 95% of Schedule Ds report long-term gains or losses each year. The fraction reporting long-term gains or losses on Line 8 varied between 53% and 61%, but showed no trend. About 30% of Schedule Ds reported long-term gains or losses from casualty or theft loss, sale of business property, installment sales, financial derivatives, and like-kind exchanges on Line 11, with little variation between years. The fraction reporting long-term gains or losses from pass-through entities on Line 12 varied between 16% and 20%, but with no trend. The fraction reporting capital gains distributions from RICs and REITs on Line 13 increased each year, from 30% in 2002 to 45% in 2006. The fraction with long-term losses carried forward on Line 14 jumped from 20% in 2002 to 30% in 2003 and then decreased every year, to 21% in 2006.

Table D-8 shows sample estimates of total short-term gains and losses reported on each line in Part I of Schedule D. It also shows sample estimates of the total amount of short-term gains reported on Line 7, the sum of the estimates of individual line items and the discrepancy between the total on Line 7 and the sum of line items. This discrepancy in the estimates is due to discrepancies on individual Schedule Ds in the sample. A fraction of income tax returns and supporting schedules are inconsistent. Inconsistent tax returns are caught by the Department of Revenue's data processing system, and taxpayers are asked to correct them. Discrepancies in Schedule Ds and the supporting schedules are not caught by the department because they are not normally recorded in the department's data processing system. For most of the Schedule Ds in the sample with discrepancies, it was possible to eliminate the discrepancies using information in the supporting schedules. Those where the remaining discrepancies were judged to be too large were dropped from the sample, but some with discrepancies were retained.

Table D-8
Short Term Gains and Losses Reported on Each Line
$ million

	Line 1 Other Gains and Losses	Line 4 Casualty & Theft Installment Sales Financial Derivatives Like-Kind Exchanges	Line 5 Pass-Through Entities	Current Gains, Sum of Lines 1, 4, and 5	Line 6 Loss Carry-forward	Line 7 Short Term Total	Sum of Line Items	Discrepancy
2002	-$172.8	$5.7	-$51.3	-$218.5	-$468.2	-$682.9	-$686.7	-$3.8
	($52.8)	($4.5)	($33.8)		($69.9)	($160.5)		
2003	$76.9	-$19.3	$15.0	$72.7	-$669.0	-$597.3	-$596.3	$1.1
	($36.3)	($12.7)	($17.8)		($111.7)	($121.7)		
2004	$20.8	-$0.4	$7.0	$27.4	-$496.6	-$452.0	-$469.2	-$17.2
	($24.9)	($2.9)	($8.5)		($124.6)	($140.9)		
2005	$11.7	-$0.2	$4.0	$15.6	-$492.4	-$479.1	-$476.9	$2.2
	($34.5)	($4.1)	($14.4)		($132.4)	($153.5)		
2006	-$35.5	-$4.4	$25.3	-$14.6	-$457.9	-$472.5	-$472.5	$0.0
	($44.9)	($9.9)	($11.2)		($127.3)	($151.9)		

As was seen above, total short-term capital gains were negative each year. In this period, short-term gains and losses were dominated by losses carried forward from previous years. In 2002, current short-term losses reported on Lines 1, 4 and 5 were $219 million. This combined with $468 million of losses carried forward from 2001 to give total short-term losses of $687 million. In the later years, carryforwards were even more dominant. Total current short-term gains reported on Lines 1, 4, and 5 ranged from -$15 million to $73 million, while short-term loss carryforwards ranged from $458 million to $669 million.

The estimated changes from 2002 to 2003 for all of the lines are unlikely to be due to sampling error as are all the five-year patterns. All of the year-to-year changes for 2004 through 2006 could be due to sampling error.

Table D-9 shows sample estimates of total long-term gains and losses reported on each line of Part II of Schedule D for 2002 through 2006. It also shows the sample estimate of total long-term gains reported on line 15, the sum of the line-item estimates, and the discrepancy between the estimated total and the sum of line-item estimates.

Table D-9
Long Term Gains and Losses Reported on Each Line
$ million

	Line 8 Other Gains and Losses	Line 11 Casualty & Theft Installment Sales Business Property Derivatives & Exchanges	Line12 Pass-Through Entities	Line 13 Capital Gains Distributions	Current Gains, Sum of Lines 8, 11, 12, and 13	Line 14 Loss Carry-forward	Long Term Total	Sum of Line Items	Discrepancy
2002	-$607.5	$685.2	$112.1	$20.7	$210.5	-$696.2	-$495.1	-$485.7	$9.4
	($109.8)	($103.3)	($82.1)	($4.3)		($195.3)	($289.3)		
2003	-$245.2	$609.2	$51.6	$19.9	$435.5	-$1,144.3	-$722.9	-$708.7	$14.2
	($287.0)	($67.1)	($121.5)	($4.8)		($181.6)	($335.1)		
2004	$619.8	$974.6	$126.5	$59.7	$1,780.6	-$1,047.3	$677.5	$733.3	$55.8
	($162.6)	($251.1)	($91.0)	($10.2)		($247.4)	($317.7)		
2005	$538.8	$833.3	$281.9	$127.5	$1,781.5	-$984.9	$800.5	$796.6	-$3.9
	($112.0)	($91.2)	($80.2)	($17.7)		($144.6)	($171.7)		
2006	$682.4	$1,023.1	$347.4	$187.9	$2,240.7	-$820.1	$1,424.2	$1,420.6	-$3.6
	($118.0)	($140.3)	($69.5)	($25.4)		($150.0)	($271.3)		

Total long-term gains were negative in 2002, became even more negative in 2003, then increased each year from 2004 through 2006. Total long-term gains were $1,919 million higher in 2006 than in 2002. Most of this increase is from gains reported on Line 8. Gains reported on Line 8, which includes gains on securities and other gains not reported on another line, increased every year except 2005 and were $1,303 million higher in 2006 than in 2002.

Total gains reported on each of Lines 11, 12, and 13 were positive every year, and the total for each line was higher in 2006 than in 2002. Gains reported on Line 11 were larger than current gains or losses reported on the other lines every year.

The observed five-year patterns are extremely unlikely to be due to sampling error, as are some of the year-to-year changes, such as Line 13 from 2004 on and Line 8 for 2004.

Each individual capital gain transaction was assigned to one of ten categories, either by the data entry staff or based on the line where it appeared on one of the supporting forms. The categories were:

- Securities,
- Gains from partnerships, S-Corps and fiduciaries,
- Sale of the taxpayer's principal residence,
- Sale of land,
- Capital gains distributions,
- Sale of business property,
- Installment sales,
- Commodity or other futures contracts,
- Sale of other assets, and
- Unidentifiable.

Transactions generally were classified as unidentifiable because supporting information was missing or because the information on Schedule D was cryptic, usually because of excessive abbreviations or jargon, or simply unreadable. The percentage of unidentifiable transactions varied significantly between years.

Table D-10 shows estimates of the number of identifiable capital gains transactions in each category for 2002 through 2006. These estimates are weighted counts of numbers of line item entries on Schedule Ds and supporting schedules. As estimates of numbers of transactions, these are all low. For some categories, the estimates are low because of missing or incomplete supporting schedules or illegible or cryptic entries. For some, the estimates are low because a line item entry may represent either a single transaction or a total from multiple transactions and there is no way to know which.

Because it is impossible to know how many transactions are on missing forms or are represented by summary totals, no attempt was made to adjust for missing data. The estimates in Table D-10 should be good indicators of relative orders of magnitude, but should not be used to make inferences about trends or precise proportions of transactions in each category.

Table D-10
Estimated Number of Current Capital Gains Transactions by Type of Transaction

Asset Category	2,002	2003	2004	2005	2006
Securities	194,027	377,638	334,013	475,373	463,285
Corporate Stock	185,791	344,002	314,513	449,234	439,097
Other Securities	8,236	33,636	19,500	26,138	24,189
Gains & Losses from Partnerships, S-Corps, Fiduciaries	21,675	25,678	22,782	28,137	29,340
Sale of Principal Residence	367	890	893	1,377	1,551
Sale of Land	4,402	4,175	6,703	7,419	6,265
Capital Gains Distributions from RICs & REITs	27,159	28,830	36,514	46,483	46,862
Sale or Trade of Business	16,646	15,613	17,747	15,716	20,351
Installment Sales	3,659	4,407	3,773	3,628	3,715
Commodity and Other Futures contracts	89	1,423	506	979	1,682
Like-Kind Exchanges	74	67	90	290	104

The vast majority of transactions are sales of securities, primarily corporate stock, with transactions in the hundreds of thousands. Three categories, gains and losses from pass-through entities, capital gains distributions, and sale of business property, had transactions in the tens of thousands. Sales of land and installment sales were in the thousands. Sales of principal residences and like-kind exchanges had much lower numbers. The number of futures contract line items also was small, but most line items in this category probably represent multiple transactions.

Securities are reported on Lines 1 and 8 of Schedule D and on continuation lines on Schedule D-1. The IRS allows taxpayers to substitute their own list of transactions for Schedule D-1, and this is fairly common for taxpayers with large numbers of transactions. Part of the undercounting of securities transactions is from missing or incomplete Schedule D-1s, and part is from illegible, cryptic, or missing asset descriptions on Schedule D-1. Some taxpayers have hundreds or even thousands of line items on Lines 1 and 8, and a few of these taxpayers having missing or indecipherable D-1s could result in securities transactions being undercounted by tens or hundreds of thousands. It is almost certain that Table D-10 shows the correct relative importance of securities, and that they account for somewhere on the order of two-thirds to four-fifths of transactions.

Gains or losses from partnerships, S-corps, and fiduciaries are reported to the taxpayer on Form K-1. The pass-through entity files a copy of the K-1 with the IRS, and the taxpayer reports the total of these gains or losses on Lines 5 or 12 of Schedule D. It is impossible to tell whether the amounts reported on Lines 5 and 12 are from one K-1 or from multiple K-1s. The actual number of transactions in this category could be up to several times higher than shown in Table D-10, making up something on the order of 5% to 10% of the total.

Non-excludable gains on the sale of a principal residence and other land sales are reported on Line 1 or 8 of Schedule D or on Schedule D-1. The only reasons for missing data in this category are indecipherable line item entries and missing D-1s. The percentage of transactions that are missing is probably smaller in these categories than in most of the larger categories, and each of these categories is likely to account for no more than 1% of transactions.

Capital gains distributions from RICs and REITS are reported to taxpayers on Form 1099-DIV. Taxpayers then enter the total of the amounts from all of their 1099-DIVs on Line 13 of Schedule D. There should be very few Schedule Ds in the sample where Line 13 was erroneously left blank, but there is no way to know whether each Line 13 represents one distribution or multiple distributions. The number of transactions in this category may be only slightly higher than shown in Table D-10 or it may be up to several times higher. Depending on the average number of distributions for each Line 13 entry, this category could be anywhere from about 5% to about 15% of transactions.

Gains from the sale or trade of business property are reported on Form 4797. Each transaction should be reported on a separate line, and taxpayers should file multiple Form 4797s if they have too many transactions to fit on the lines on one form. Transactions would be missing only if a Form 4797 is missing. The actual number of transactions probably is not much higher than is shown in Table D-10, and this category probably accounts for less than 5% of transactions.

Taxpayers report gains from installment sales on Form 6252, and each transaction should have a separate Form 6252. Missing transactions should come only from missing Form 6252s. The actual number of transactions probably is not much higher than the number shown in Table D-10, and installment sales probably account for less than 1% of transactions.

Taxpayers report gains from commodity and other futures contracts on Form 6781. Each entry on a Form 6781 may represent a single transaction, but is more likely to represent the sum of gains for the year reported to the taxpayer by their broker on Form

1099-B. The actual number of transactions is likely to be some multiple of the number shown in Table D-10, but still to be no more than a percent or two of total transactions.

Taxpayers report gains from like-kind exchanges on Form 8824. Taxpayers who had multiple exchanges have the choice of filing a Form 8824 for each or filing a summary Form 8824 with an attached schedule listing the exchanges. The actual number of transactions may be a multiple of the number shown in Table D-10, but is probably much less than 1% of the total.

Table D-11 shows estimates of the total of net gains in each category for 2002 through 2006. Two of the categories correspond to lines on Schedule D, and the estimates for those categories are the estimated totals for those lines. The other categories are each part of the total on one or more lines on Schedule D, and the amount for each of these categories was estimated from the supporting schedules. As in Table D-10, no attempt has been made to adjust the estimates for missing data, and the value of unidentified gains is shown at the bottom of the table.

The estimates for securities, sale of a principal residence, and sale of land are from the transactions reported on Lines 1 and 8, and their continuation on Schedule D-1. The amount of gains on these lines that could not be classified or was on missing D-1s is shown at the bottom of the table. In all the years except 2003 the total that was unclassifiable or missing is negative.

The estimate for gains from pass-through entities is the sum of gains reported on Lines 5 and 12. The estimate for capital gains distributions is the total reported on Line 13. These estimates are not affected by missing supporting schedules, but they may be affected by the discrepancies on Schedule D shown in Tables D-8 and D-9.

Gains from sale or trade of business property, installment sales, futures contracts, and like-kind exchanges are reported on Forms 2439, 4684, 4797, 6252, 6781, and 8824. The short-term and long-term totals from these forms are carried forward to Lines 4 and 11. The estimates for these categories were constructed by matching the amounts on Lines 4 and 11 to entries on the supporting schedules. These estimates are based on either the amounts shown on particular lines or on the supporting schedules. The amount of gains on these lines that could not be attributed to a supporting schedule, usually because the supporting schedule was missing, is shown at the bottom of the table.

Table D-11
Estimated Value of Current Capital Gains Transactions by Type of Transaction
$ million

Asset Category	2002	2003	2004	2005	2006
Securities	-$776.3	-$307.3	$545.9	$229.0	$297.4
Corporate Stock	-$770.3	-$307.3	$540.2	$228.6	$306.5
Other Securities	-$6.0	$0.0	$5.7	$0.4	-$9.1
Gains & Losses from Partnerships, S-Corps, Fiduciaries	$60.8	$66.6	$133.5	$285.9	$372.7
Sale of Principal Residence	$4.0	$27.3	$73.3	$77.5	$116.5
Sale of Land	$91.2	$99.4	$186.6	$289.0	$272.9
Capital Gains Distributions from RICs & REITs	$20.7	$19.9	$59.7	$127.5	$187.9
Sale or Trade of Business Property	$452.4	$443.8	$614.6	$549.9	$659.3
Installment Sales	$54.1	$69.9	$64.0	$57.9	$65.5
Commodity and Other Futures Contracts	$0.1	-$45.4	$2.1	-$0.1	-$19.5
Like-Kind Exchanges	$4.5	$11.4	$8.6	$18.0	$20.7
Unidentified or Missing					
Lines 1 and 8	-$99.2	$12.3	-$8.2	-$45.0	-$39.8
Lines 4 and 11	$179.8	$110.3	$284.9	$207.4	$292.7
Total Current Gains	-$7.9	$508.2	$1,964.9	$1,797.1	$2,226.1

Table D-12 shows average gains in each category, calculated by dividing the total in Table D-11 by the number of transactions in Table D-10.

Table D-12
Estimated Average Gain by Type of Transaction
$ Million

Asset Category	2002	2003	2004	2005	2006
Corporate Stock	-$4,146	-$893	$1,718	$509	$698
Other Securities	-$724	$0	$290	$17	-$376
Gains & Losses from Partnerships, S-Corps, Fiduciaries	$2,805	$2,594	$5,860	$10,161	$12,703
Sale of Principal Residence	$10,906	$30,699	$82,053	$56,292	$75,072
Sale of Land	$20,708	$23,808	$27,843	$38,959	$43,551
Capital Gains Distributions from RICs & REITs	$762	$690	$1,635	$2,743	$4,010
Sale or Trade of Business Property	$27,178	$28,428	$34,634	$34,990	$32,395
Installment Sales	$14,782	$15,852	$16,965	$15,953	$17,623
Commodity and Other Futures Contracts	$1,495	-$31,920	$4,239	-$86	-$11,617
Like-Kind Exchanges	$60,504	$168,621	$95,461	$62,345	$200,060

Two categories, securities and sale or trade of business property, have gains or losses in the hundreds of millions each year. However, these two categories follow very different patterns. Securities gains and losses are very volatile, ranging from a net loss of almost $800 million in 2002 to a net gain of over $400 million in 2004. Gains from the sale or trade of business property are much more stable, varying between about $450 million and about $660 million.

Four categories, gains from pass-through entities, sale of a principal residence, sale of land, and capital gains distributions, were in the hundreds of millions in 2006 but were generally smaller in the earlier years. For all of them, both the number of gains and the average gain generally increased.

Both gains from pass-through entities and capital gains distributions had about five-fold increases in average gains, and the average gain on the sale of land slightly more than doubled. All three had smaller increases in the number of transactions. For sales of a principal residence, the average gain increased almost seven-fold and the number of transactions increased about four-fold.

Only gains from the sale of a principal residence over $250,000 ($500,000 for a joint return) are taxable. The increase in the number of principle residence sales with gains over the exclusion amount and the increase in the average non-excludable gain reflect the rising home prices in at least some parts of the state. As home prices rose, more gains were over the limit, and the average amount by which these gains were over the limit increased. The relative increases in the number and average size of gains are smaller for the sale of land at least partly because the entire gain from a land sale is taxable.

Gains from installment sales were relatively stable, with small changes in both the number of gains and the average gain.

Gains and losses from commodity and other futures contracts were volatile, but relatively small. Both the estimated number of transactions and the average gain or loss vary greatly from year to year. However, since each reported line item could represent a summary of an unknown number of individual transactions, it is difficult to know how the number of transactions actually varied over time.

Gains from like-kind exchanges varied from year to year, with a general upward trend. The number of transactions was very small, which probably accounts for the year-to-year volatility.

Gains from the sale or trade of business property can be further classified based on where they are recorded on Form 4797. Table D-13 shows gains from sales of two types of property, gains from casualty or theft loss of business property, gains from installment sales of business property, and gains from like-kind exchanges of business property.

The first two lines show gains from cash sales under two circumstances. The first line shows gains from sales where all of any gain is taxed as a capital gain. The second line shows capital gains from sales where part of the gains is taxed as ordinary income and part is taxed as capital gains. In general, part of a gain may be taxed as ordinary income if the owner was allowed to take depreciation deductions under an accelerated depreciation schedule[12]. For depreciable real estate, a gain is taxed as ordinary income up to any excess of actual depreciation and amortization deductions over deductions that would have been allowed under straight-line depreciation. For other assets, a gain is taxed as ordinary income up to the total of depreciation and amortization deductions. The apparent rational for this treatment is as follows: Depreciation and amortization deductions are intended to allow taxpayers to reduce income by the loss of asset values due to aging and wear and tear. If a taxpayer sells an asset for more than the purchase price less depreciation, the depreciation taken must have overstated the loss of the

[12] Specifically, part of a gain may be taxed as ordinary income for property falling under sections 1245, 1250, 1252, 1254, and1255 of the IRS code.

asset's value due to time and use. Therefore, taxing part of the gain as ordinary income recaptures the excess depreciation deductions taken in earlier years.

A large number of Form 4797s had an amount in the total line, but no or incomplete entries in the individual lines. The last three lines of Table D-13 show the total of the line items, the part of the Form 4797 total for which there were no line items, and the total of capital gains on Form 4797s.

Table D-13
Capital Gains from Sale or Disposition of Business Property
$ million

	2002	2003	2004	2005	2006
Sales Where All of Gain is Capital Gain	72,518,067	59,805,640	113,017,327	112,179,521	82,121,476
Sales Where Part of Gain is Ordinary Income	128,459,245	139,031,503	253,767,078	172,919,120	158,061,894
Gains from Casualty or Theft Loss	-72,140	1,216,526	8,458	0	72,178
Gains from Installment Sales	46,176,497	42,486,832	58,290,488	43,890,903	53,707,827
Gains from Like-Kind Exchanges	4,256,201	6,567,115	9,591,874	17,415,525	28,079,952
Line Item Total	251,337,870	249,107,616	434,675,224	346,405,069	322,043,327
Missing	215,850,720	204,618,247	182,797,565	227,128,595	345,471,329
Total Form 4797 Capital Gains	467,188,590	453,725,863	617,472,790	573,533,663	667,514,655

The data entry staff were asked to classify transactions in the section of Form 4797 for cash sales where all of the gain is a capital gain. Table D-14 shows the results of this classification.

Table D-14
Gains from Sale of Business Property Where All of Gain is Capital Gain

	2002	2003	2004	2005	2006
Farmland	9,186,583	11,137,451	10,227,840	12,036,104	11,856,575
Depreciable farm real estate	2,046,215	3,157,822	1,561,471	3,875,144	4,577,530
Farm implements	-290,661	253,734	-4,234	462,155	-84,799
Depreciable non-farm real estate	10,641,356	5,930,260	37,772,023	35,899,793	15,010,418
Depreciable personal property	482,881	703,108	-42,703	3,751,156	1,448,938
Timber	2,837,986	1,952,331	2,285,838	1,794,094	843,566
Coal	104,438	0	17,213	1,211,013	161,027
Livestock	29,221,695	29,038,387	37,045,964	35,682,577	27,203,227
Other	14,242,536	6,389,901	23,000,939	17,467,484	19,756,238
Not Recorded	4,045,037	1,242,647	1,152,976	0	1,348,755
Total Line 2 Gains	72,518,067	59,805,640	113,017,327	112,179,521	82,121,476

The Size of Taxpayer's Net Gains

As was shown in Table D-1, 23% to 25% of returns reported capital gains income each year. Table D-15 shows how capital gains income on these returns was distributed by size. It shows sample estimates of the percent of tax returns with capital gains income in eight size groups[13]. It also shows the change in these percentages from 2002 to 2006 in absolute terms (change in percentage points, i.e. from 6% to 9% is a change of 3%) and in relative terms (9% is 50% more than 6%).

Table D - 15
Size Distribution of Capital Gains Income

	Percent of All Returns with Capital Gains in Size Class					Change 2002 - 2006	
Capital Gains	2002	2003	2004	2005	2006	Absolute	Relative
<$0	48.3%	48.7%	39.7%	33.3%	26.7%	-21.6%	-44.7%
$1 - $10,000	40.5%	38.7%	45.9%	49.9%	53.8%	13.4%	32.8%
$10,001 - $25,000	5.5%	5.9%	6.5%	7.3%	8.6%	3.1%	56.4%
$25,001 - $50,000	2.8%	3.2%	3.6%	4.0%	4.6%	1.9%	64.3%
$50,001 - $100,000	1.6%	1.8%	2.2%	2.7%	3.0%	1.3%	87.5%
$100,001 - $200,000	0.8%	1.0%	1.1%	1.5%	1.7%	0.9%	112.5%
>$200,000	0.5%	0.7%	0.9%	1.3%	1.6%	1.1%	220.0%

In 2002 and 2003, returns with losses made up the largest group, but this is the only group to consistently shrink during the period, making up a little more than half as large a share of the population in 2006 as in 2002.

The groups with positive gains all increased or stayed the same as a percent of the population every year, with only one exception – from 2002 to 2003 for taxpayers with gains of $10,000 or less. In absolute terms, the increases were larger for the groups with lower gains: taxpayers with gains of $10,000 or less increased by 13.4% of the population of returns with capital gains income, while taxpayers with gains of more than $200,000 increased by 1.1% of the population. In relative terms, the increases generally were larger for the groups with higher gains: the percentage of taxpayers with gains of $10,000 or less increased by over 40%, while the percentage of taxpayers with gains larger than $200,000 more than tripled.

[13] Since Table D-15 groups all returns with a net loss together, the distribution in Table D-15 is the same before and after the cap on losses.

Table D-16 shows total capital gains income before the cap on losses reported on returns with gains in the seven non-zero groups. It also shows the change from 2003, the year with lowest gains, to 2006, the year with highest gains.

Table D - 16
Total of Capital Gains Income by Size of Gain
$ million

	Sum of Capital Gains in Size Class					Change
Capital Gains	2002	2003	2004	2005	2006	2003 - 2006
<$0	-$1,906.7	-$2,254.2	-$1,184.7	-$1,400.2	-$1,290.6	$963.6
$1 - $10,000	$87.3	$90.7	$188.6	$144.6	$185.0	$94.3
$10,001 - $25,000	$83.6	$88.8	$187.2	$122.1	$146.7	$57.8
$25,001 - $50,000	$88.9	$104.4	$157.2	$142.9	$174.0	$69.6
$50,001 - $100,000	$106.0	$119.0	$154.6	$189.4	$220.4	$101.5
$100,001 - $200,000	$104.2	$123.3	$149.0	$212.2	$241.8	$118.5
>$200,000	$258.5	$407.8	$573.6	$910.4	$1,274.3	$866.5
Total	-$1,178.0	-$1,320.2	$225.6	$321.5	$951.6	$2,271.8

Increased losses accounted for the reductions in total gains from 2002 to 2003, and the reduction in losses from 2003 to 2006 accounted for 42% of the increase in net gains in that period. Total gains in each group with gains increased every year, except for the groups with gains of $50,000 or less in 2005. For taxpayers with gains of more than $10,000, the increases were larger for the groups with larger gains. This is consistent with the large absolute increase in the percentage of returns with gains of $10,000 or less and the larger relative increase in the percentage of returns in groups with larger gains.

Distribution of Capital Gains Among Taxpayers

In examining the distribution of capital gains by income, it is important to keep in mind that capital gains are part of total income, so that the two are not independent. Some taxpayers have high incomes in a year because they have high capital gains. Some taxpayers have negative incomes partly because they have capital losses. With other types of income held constant, the higher a taxpayer's capital gains, the higher their income.

Table D-17 shows the percentage of households in each of ten income groups with capital gains or losses for 2002 through 2006. For example, in 2004, 54.1% of all households with incomes between $100,001 and $150,000 reported capital gains (or losses).

Table D - 17
Percent of Returns with Capital Gains Income by Income Group

Household Income	2002	2003	2004	2005	2006
<$0	59.0%	58.9%	57.3%	53.2%	51.8%
$0 - $25,000	14.7%	14.4%	15.1%	15.1%	14.4%
$25,001 - $50,000	22.9%	22.1%	23.1%	22.8%	21.5%
$50,001 - $100,000	33.8%	32.4%	34.6%	35.0%	34.2%
$100,001 - $150,000	55.7%	53.0%	54.1%	54.5%	52.2%
$150,001 - $200,000	66.9%	68.1%	69.3%	69.1%	67.3%
$200,001 - $300,000	74.2%	75.6%	77.4%	77.3%	75.6%
$300,001 - $400,000	83.1%	80.3%	81.6%	81.5%	81.3%
$400,001 - $500,000	83.5%	83.1%	85.7%	85.0%	86.0%
>$500,000	88.1%	89.6%	90.4%	90.9%	91.1%
Total	23.4%	23.0%	24.5%	25.3%	24.8%

Overall, a little less than a quarter of households have capital gains income. Between 50% and 60% of households with negative income have capital gains or losses. This percentage decreased each year from 2002 through 2006.

In each year, the percentage of households with capital gains was higher with higher positive income. The percentage rises from about 15% for households with income of $25,000 or less to around 90% for households with income over $500,000.

Table D-18 shows sample estimates of capital gains before the cap on losses by income group for 2002 through 2006.

Table D - 18
Capital Gains Before Cap on Losses by Income Group
$ million

Household Income	2002	2003	2004	2005	2006
<$0	-$223.8	-$311.9	-$77.5	-$104.9	-$233.3
	($366.1)	($152.4)	($53.4)	($66.5)	($164.5)
$0 - $25,000	-$73.6	-$96.3	-$4.2	-$28.7	-$32.1
	($62.4)	($57.2)	($44.4)	($25.9)	($43.8)
$25,001 - $50,000	-$15.3	-$322.3	$97.6	$24.7	$18.7
	($28.9)	($262.7)	($108.5)	($15.4)	($27.2)
$50,001 - $100,000	-$47.9	-$20.4	$36.3	$47.5	$71.9
	($53.1)	($65.7)	($75.1)	($36.7)	($62.6)
$100,001 - $150,000	$3.6	$27.3	$83.4	$66.9	$61.1
	($29.1)	($18.3)	($55.7)	($39.8)	($47.8)
$150,001 - $200,000	-$18.2	-$28.4	$21.9	$71.9	$88.0
	($53.9)	($36.0)	($67.5)	($16.4)	($25.4)
$200,001 - $300,000	-$15.9	-$89.7	$26.7	$28.5	$121.7
	($29.3)	($64.9)	($191.0)	($73.1)	($58.2)
$300,001 - $400,000	-$102.7	-$195.0	$57.8	-$59.1	$95.2
	($80.8)	($90.7)	($68.4)	($84.3)	($41.7)
$400,001 - $500,000	-$21.1	-$119.9	-$66.1	-$2.9	$79.3
	($29.6)	($77.4)	($67.5)	($54.8)	($34.9)
>$500,000	-$663.1	-$163.7	$49.6	$277.6	$681.2
	($145.8)	($177.6)	($247.3)	($248.8)	($329.6)
Total	-$1,178.0	-$1,320.2	$225.6	$321.5	$951.6
	($879.2)	($1,002.8)	($979.0)	($661.7)	($835.6)

As would be expected, total gains before the cap on losses were negative for almost all income groups in 2002 and 2003 when total gains were negative. In the three years when total gains were positive, gains were almost always positive for groups with income over $25,000. Some households in these groups will have negative gains in any year, and the fact that in three of twenty-four cases net losses were greater than net gains is probably due to chance rather than some systematic factor affecting that income group.

Returns with negative income had net losses all five years. This is not surprising, since to have negative income, a household must have some combination of losses from business or asset sales that more than offset its income from other sources.

Returns with income of $25,000 or less also had net losses all five years. Most households in this income range do not have capital gains. Those who do are likely to be more similar to households with negative income than to other households with low incomes: They have a combination of business losses and negative capital gains and positive income of other types, such as wages and salaries, interest, or dividends. They differ from households with negative income in having losses that are less than their other income.

Table D-19 shows capital gains income after the cap on losses (population data).

Table D - 19
Capital Gains Income After Cap on Losses by Income Group
$ million

Household Income	2002	2003	2004	2005	2006
<$0	$16.9	$24.7	$13.5	$15.0	$14.1
$0 - $25,000	$21.3	$16.7	$28.5	$32.6	$38.8
$25,001 - $50,000	$45.1	$48.5	$63.9	$66.0	$79.7
$50,001 - $100,000	$96.7	$108.5	$149.9	$184.2	$210.6
$100,001 - $150,000	$74.8	$86.6	$108.9	$150.8	$177.5
$150,001 - $200,000	$48.0	$56.1	$77.4	$104.3	$127.2
$200,001 - $300,000	$62.7	$78.0	$105.7	$151.8	$182.8
$300,001 - $400,000	$41.5	$48.3	$74.5	$94.6	$121.3
$400,001 - $500,000	$27.3	$33.6	$42.9	$69.2	$99.8
>$500,000	$203.2	$289.9	$527.9	$685.5	$954.3
Total	$637.4	$790.9	$1,193.2	$1,554.1	$2,006.0

After the cap on losses, capital gains income is positive for all income groups in all years, even for the group with negative income. The highest income group accounts for between one-third and one-half of capital gains income, with its share increasing as total capital gains income increased throughout the period.

Table D-20 shows capital loss carryforwards by income group, estimated by subtracting the pre-cap capital gains in Table D-18 from the post-cap capital gains income in Table D-19.

Table D - 20
Capital Loss Carry-forward by Income Group
$ million

Household Income	2002	2003	2004	2005	2006
<$0	$338.5	$371.6	$130.7	$153.8	$287.9
	($216.4)	($148.2)	($49.5)	($55.6)	($162.4)
$0 - $25,000	$95.5	$98.2	$78.8	$86.9	$64.6
	($47.3)	($32.1)	($26.0)	($20.0)	($19.2)
$25,001 - $50,000	$43.7	$135.1	$84.9	$28.8	$45.3
	($19.4)	($42.2)	($24.7)	($8.5)	($22.1)
$50,001 - $100,000	$118.8	$96.4	$120.1	$96.4	$117.4
	($42.8)	($50.0)	($53.8)	($25.2)	($54.8)
$100,001 - $150,000	$41.5	$39.0	$36.5	$78.0	$79.3
	($21.5)	($13.3)	($10.2)	($42.8)	($28.7)
$150,001 - $200,000	$54.2	$76.6	$117.0	$19.1	$23.1
	($32.6)	($36.8)	($49.2)	($9.4)	($11.6)
$200,001 - $300,000	$58.4	$154.0	$225.8	$101.5	$72.8
	($22.1)	($58.9)	($102.4)	($40.5)	($44.3)
$300,001 - $400,000	$134.8	$229.7	$73.7	$185.3	$80.8
	($48.3)	($84.9)	($19.2)	($69.6)	($32.8)
$400,001 - $500,000	$42.0	$145.3	$114.4	$115.6	$62.8
	($16.1)	($74.8)	($54.9)	($48.4)	($28.2)
>$500,000	$235.9	$467.3	$561.4	$612.0	$443.9
	($59.0)	($74.8)	($54.9)	($48.4)	($28.2)
Total	$1,163.2	$1,813.2	$1,543.2	$1,477.3	$1,277.9
	($525.6)	($137.4)	($313.9)	($227.2)	($177.5)

As would be expected, taxpayers with negative incomes have significant capital loss carryforwards most years. Somewhat surprisingly, the highest income group also has the highest amount of losses to carry forward in each year.

Table D-21 shows estimated average capital gains before the cap on losses, calculated by dividing the estimated total net gains for each income group in Table D-18 by the estimated number of Schedule Ds in each income group.

Table D - 21
Average Capital Gains Before Cap on Losses by Income Group

Household Income	2002	2003	2004	2005	2006
<$0	-$41,539	-$35,244	-$10,862	-$13,576	-$32,313
	($88,838.4)	($38,702.1)	($14,609.0)	($22,080.9)	($65,064.2)
$0 - $25,000	-$7,349	-$5,965	-$214	-$1,807	-$2,098
	($2,150.8)	($2,049.0)	($1,521.2)	($920.2)	($1,636.7)
$25,001 - $50,000	-$2,161	-$23,044	$7,160	$2,125	$1,735
	($1,343.1)	($12,566.5)	($4,914.4)	($702.6)	($1,265.8)
$50,001 - $100,000	-$4,528	-$1,336	$1,692	$2,504	$3,920
	($2,184.7)	($2,716.1)	($2,735.1)	($1,237.1)	($2,008.5)
$100,001 - $150,000	$1,149	$5,173	$12,308	$9,009	$6,036
	($4,744.3)	($2,803.9)	($7,169.5)	($4,228.0)	($4,474.5)
$150,001 - $200,000	-$8,245	-$7,085	$3,559	$17,040	$14,755
	($25,056.9)	($15,186.1)	($23,408.5)	($4,806.1)	($6,499.8)
$200,001 - $300,000	-$5,311	-$12,587	$2,736	$3,200	$14,957
	($16,719.1)	($33,884.6)	($81,921.8)	($25,742.7)	($17,937.4)
$300,001 - $400,000	-$33,242	-$31,653	$11,553	-$7,080	$13,219
	($111,956.0)	($121,228.8)	($77,684.7)	($75,554.3)	($32,396.3)
$400,001 - $500,000	-$13,542	-$29,616	-$17,488	-$605	$14,744
	($81,443.0)	($204,137.0)	($153,751.9)	($88,925.9)	($47,930.6)
>$500,000	-$138,374	-$18,576	$6,046	$20,410	$43,429
	($226,809.8)	($231,584.6)	($230,305.0)	($172,643.4)	($182,884.5)
All	-$23,169	-$14,717	$2,218	$3,165	$9,139

Table D-22 shows sample estimates of the percent of Schedule Ds with net gains and net losses by income group.

Table D - 22
Percent of Schedule Ds with Gains and Losses by Income Group

	2002		2003		2004		2005		2006	
Household Income	% with Net Gain	% with Net Loss	% with Net Gain	% with Net Loss	% with Net Gain	% with Net Loss	% with Net Gain	% with Net Loss	% with Net Gain	% with Net Loss
<$0	34.1%	65.9%	35.0%	65.0%	37.2%	62.8%	35.7%	64.3%	44.0%	56.0%
	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.2%)	(0.1%)	(0.1%)	(0.2%)	(0.2%)
$0 - $25,000	51.4%	48.6%	49.1%	50.9%	60.7%	39.3%	62.6%	37.4%	68.2%	31.8%
	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)
$25,001 - $50,000	53.8%	46.2%	54.9%	45.1%	64.2%	35.8%	69.6%	30.4%	74.6%	25.4%
	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)
$50,001 - $100,000	53.2%	46.8%	53.3%	46.7%	65.2%	34.8%	69.8%	30.2%	75.8%	24.2%
	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.0%)	(0.0%)	(0.1%)	(0.1%)	(0.1%)	(0.0%)
$100,001 - $150,000	54.1%	45.9%	55.7%	44.3%	64.7%	35.3%	71.9%	28.1%	78.9%	21.1%
	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)	(0.1%)
$150,001 - $200,000	55.8%	44.2%	58.2%	41.8%	67.8%	32.2%	71.9%	28.1%	80.9%	19.1%
	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)
$200,001 - $300,000	53.0%	47.0%	57.9%	42.1%	67.0%	33.0%	74.0%	26.0%	81.1%	18.9%
	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)
$300,001 - $400,000	52.2%	47.8%	56.8%	43.2%	68.4%	31.6%	74.9%	25.1%	81.2%	18.8%
	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)
$400,001 - $500,000	52.9%	47.1%	54.6%	45.4%	68.9%	31.1%	74.4%	25.6%	82.9%	17.1%
	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)
>$500,000	55.1%	44.9%	66.0%	34.0%	70.7%	29.3%	77.8%	22.2%	83.4%	16.6%
	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)	(0.0%)
Total	52.0%	48.0%	52.1%	47.9%	62.8%	37.2%	67.3%	32.7%	73.8%	26.2%

As total capital gains before the cap on losses shifted from negative in 2002 and 2003 to positive in 2004 through 2006, average capital gains before the cap on losses made the same shift, and the proportion of Schedule Ds with gains increased from about half to about three-quarters. Taxpayers with incomes over $500,000 had the highest average gains in 2005 and 2006 and the highest average losses in 2002 but not in 2003. Taxpayers with incomes over $500,000 had the highest proportion of gains each year. Taxpayers with higher income generally had a higher proportion of gains, but there are cases in every year except 2006 where an income group had a higher proportion of gains than one or more groups with higher incomes.

Conclusions

Capital gains income after the cap on losses was known from tax returns. The sample of Schedule Ds examined provides previously unknown information on pre-cap gains and losses and details of gains and losses by type of asset. Notable findings include the following:

- While capital gains income after the cap on losses varied widely in the five years examined, capital gains before the cap on losses varied much more widely and were negative two of the five years.
- Short-term gains were negative all five years and varied within a smaller range than long-term gains.
- Losses carried forward from previous years were significant every year. Both short- and long-term losses carried forward from previous years were highest in 2003, which followed the year with lowest current gains. Both short- and long-term carryover losses varied within a relatively narrow range in the other years.
- Short-term losses carried forward from previous years were much larger than current short-term gains or losses every year. Long-term losses carried forward from previous years were larger than current long-term gains in the two years with lowest current long-term gains and smaller in the other three years.
- There may be normal or baseline levels of both short-term and long-term carryover losses. After a year with larger-than-normal losses, short-term carryover losses appear to return to normal quickly while long-term carryover losses appear to return to normal over a much longer period. However, many more years of data would be needed to confirm these patterns..
- About 35% of Schedule Ds have both long-term and short-term gains, about 60% have only long-term gains, and about 5% have only short-term gains.
- Sales of securities, primarily corporate stock, account for the vast majority of capital gains transactions.
- Gains from sales of business equipment accounts for the largest proportion of total gains, and is also one of the most stable types of capital gains.
- Gains from pass-through entities, sales of principal residence and land, and capital gains distributions from RICs and REITS accounted for significant shares of capital gains in years when total gains were high but were more volatile than gains from sales of business equipment.
- Gains and losses from sales of securities were large and volatile, ranging from losses that offset gains in all other categories in 2002 to gains that were almost one-fourth of the total in 2004.
- The proportion of tax returns with capital gains or losses was stable at a little less than one-fourth. The proportion of returns with losses decreased every year in the period. The proportion of returns with gains increased every year. The increase in returns with gains was largest in absolute terms for returns with gains of $10,000 or less, but was largest in relative terms for returns with gains of $200,000 or more.

Appendix: Test Statistics

The following tables present statistics to test for differences between years for most of the sample estimates presented in this section. The table numbers are the same as the corresponding tables in the main text with an "A" added. For example, Table D-2A presents test statistics for Table D-2. For tables in the main text that present population data, there are no corresponding tables of test statistics. No test statistics are presented for estimates by income group. The sample was not stratified by income. The standard errors of the income group estimates probably are significantly larger than they would be if the sample had been stratified by income. Failure to reject the hypothesis that two or more values are equal would reflect the inefficiency of the income group estimators as much as actual population differences.

These test statistics should be interpreted with some caution. Standard statistical tests assume that the only source of error is sampling error, that the sample is representative of the population, and that the population and the sample have well-behaved distributions. This is clearly not always the case with this data. As was pointed out above, some of the sample means, proportions, and totals presented above are statistically fragile, in the sense that a few observations have a disproportionate influence on the calculated values. In addition, the data contains non-sampling errors that may be systematic. Many of the Schedule Ds in the sample obviously had errors – the line items did not add up to the totals or the totals did not match the taxpayer's return. Fortunately, Schedule D has enough redundancy that most of the problem returns could be made consistent. One area where such data correction was not possible is the categories of capital gains. Most of the categorization was done by data entry staff. There do not appear to be large differences in how the data entry staff categorized transactions, except in the fraction that were classified as unidentifiable.

Each of the following tables presents t-statistics for differences between one year's value and the previous year's. This is just the standard statistic for testing whether the means from two samples are different:

$$t = (m_1 - m_2)/\mathrm{sqrt}(s^2{}_1 + s^2{}_2)$$

where m_1 and m_2 are the two sample means and $s_1 + s_2$ are their standard errors.

Some of the tables also present F statistics for the hypothesis that all five years' values are the same. This is calculated as

$$F_{4,N-4} = ((SSE_1 - SSE_0)/4)/(SSE_0/(N-4))$$

Where SSE_1 is the sum of squared errors around the mean for the combined five-year sample, SSE_0 is the sum of squared errors around the five individual annual means, 4 is the number of restrictions placed on parameters by the hypothesis, and N is the combined five-year sample size, 13,510. As was pointed out in the text, in all cases the hypothesis that all five years were the same was very strongly rejected. This is primarily due to the very large combined sample size.

In each table, each t- and F statistic is accompanied by a P value. For the t-statistics this is the probability that a random variable drawn from the t distribution with the corresponding degrees of freedom will be farther than the t-statistic from zero, i.e. the confidence level for a two sided test. For the F statistics, the P value is the probability that a random variable drawn from the F distribution with the corresponding degrees of freedom will be larger than the F statistic, i.e. the confidence level for a one-sided test. In both cases, the P value can be interpreted as the probability that the difference between sample estimates would be at least as large as the observed difference if the two (or five) underlying population values really were the same.

Table D-2A
Sample Estimates of Capital Gains and Losses Reported on Schedule D Filed with Montana Returns, 2002 - 2006
Tests for Significance of Differences Between Years

		Short Term Gains		Long Term Gains		Total Gains	Capital Gains Income After Cap on Losses
		Returns	$ million	Returns	$ million	Before Cap on Losses	$ million
t test for difference from previous year							
2003	*t*	-0.679	0.425	0.802	-0.514	-0.222	3.983
	P	49.7%	67.1%	42.2%	60.7%	82.4%	0.0%
2004	*t*	0.690	0.781	6.655	3.033	2.388	2.750
	P	49.0%	43.5%	0.0%	0.2%	1.7%	0.6%
2005	*t*	0.746	-0.130	4.379	0.341	0.171	0.459
	P	45.6%	89.6%	0.0%	73.3%	86.5%	64.6%
2006	*t*	0.285	0.030	-0.198	1.942	1.181	5.282
	P	77.6%	97.6%	84.3%	5.2%	23.8%	0.0%
F test for identity of all years							
	F	61,175.9	5,370.3	2,630.5	31,627.9		57,577.7
	P	0.0%	0.0%	0.0%	0.0%		0.0%

Table D-3A
Sample Estimates of Current Gains and Losses and Carryover Losses
Tests for Significance of Differences Between Years

		Short Term		Long Term		Total	
		Current	Carryover	Current	Carryover	Current	Carryover
t test for difference from previous year							
2003	*t*	1.327	-1.553	0.310	-1.715	0.552	-1.674
	P	18.4%	12.0%	75.6%	8.6%	58.1%	9.4%
2004	*t*	-0.492	1.147	1.165	1.206	1.012	1.186
	P	62.3%	25.2%	24.4%	22.8%	31.2%	23.5%
2005	*t*	-0.106	-0.090	0.395	-0.673	0.345	-0.451
	P	91.6%	92.8%	69.3%	25.1%	73.0%	65.2%
2006	*t*	-0.234	0.200	0.679	0.804	0.533	0.521
	P	81.5%	84.1%	49.7%	42.1%	59.4%	60.2%
F test for identity of all years							
	F	87,950.7	2,140.3	98,643.1	2,665.9		
	P	0.0%	0.0%	0.0%	0.0%		

Table 6A
Proportion of Schedule Ds with Short Term and Long Term Gains
Tests for Significance of Differences Between Years

		Short Term Only		Long Term Only		Both	
		N	%	N	%	N	%
t test for difference from previous year							
2003	t	-1.785	-1.73584	0.243	0.496	0.078	0.189
	P	7.4%	8.3%	80.8%	62.0%	93.8%	85.0%
2004	t	0.887	0.555056	2.302	0.523	0.242	-0.532
	P	37.5%	57.9%	2.1%	60.1%	80.8%	59.5%
2005	t	-1.012	-1.14801	0.483	-0.253	0.817	0.493
	P	31.2%	25.1%	62.9%	80.0%	41.4%	62.2%
2006	t	1.734	1.669016	0.311	-0.043	-0.279	-0.435
	P	8.3%	9.5%	75.6%	96.6%	78.0%	66.4%
F test for identity of all years							
	F	61,175.9		2,630.5			
	P	0.0%		0.0%			

Table 7A
Percent of Schedule Ds with Gains or Losses on Each Line
Tests for Significance of Differences Between Years

		Short Term Gans and Losses					Long Term Gains and Losses					
		Line 1	Line 4	Line 5	Line 6	Line 7 S.T Total	Line 8	Line 11	Line 12	Line 13	Line 14	Line 15 L.T. Total
t test for difference from previous year												
2003	t	-1.509	-0.185	0.654	1.666	-0.496	-0.424	-0.244	1.642	0.827	5.223	1.736
	P	13.1%	85.3%	51.3%	9.6%	62.0%	67.1%	80.7%	10.1%	40.8%	0.0%	8.3%
2004	t	-0.121	0.171	-0.447	-3.507	-0.523	1.346	-0.632	-1.967	1.806	-0.443	-0.555
	P	90.4%	86.4%	65.5%	0.0%	60.1%	17.8%	52.7%	4.9%	7.1%	65.8%	57.9%
2005	t	0.596	0.436	0.265	-1.216	0.253	-1.815	0.471	1.599	2.677	-0.826	1.148
	P	55.1%	66.3%	79.1%	22.4%	80.0%	7.0%	63.7%	11.0%	0.7%	40.9%	25.1%
2006	t	-0.423	0.364	1.014	-0.855	0.043	-0.606	0.654	-0.490	-0.154	-2.948	-1.669
	P	67.2%	71.6%	31.0%	39.3%	96.6%	54.5%	51.3%	62.4%	87.8%	0.3%	9.5%
F test for identity of all years												
	F	68,604.4	47,962.3	53,376.6	87,950.7	61,175.9	46,367.8	53,891.3	53,986.2	74,806.0	98,643.1	2,630.5
	P	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

Table D-8A
Short Term Gains and Losses Reported on Each Line
Tests for Significance of Differences Between Years

		Line 1 Other Gains and Losses	Line 4 Casualty & Theft Installment Sales Financial Derivatives Like-Kind Exchanges	Line 5 Pass-Through Entities	Line 6 Loss Carry-forward	Short Term Total
t test for difference from previous year						
2003	t	3.885	-1.854	1.727	-1.553	0.425
	P	0.0%	6.4%	8.4%	12.0%	67.1%
2004	t	-1.296	1.459	-0.423	1.147	0.781
	P	19.5%	14.5%	67.3%	25.2%	43.5%
2005	t	-0.193	0.035	-0.161	-0.090	-0.130
	P	84.7%	97.2%	87.2%	92.8%	89.6%
2006	t	-0.835	-0.394	1.166	0.200	0.030
	P	40.4%	69.3%	24.4%	84.1%	97.6%
F test for identity of all years						
	F	31,081.3	18,716.1	53,511.8	2,140.3	5,370.3
	P	0.0%	0.0%	0.0%	0.0%	0.0%

Table D-9A
Long Term Gains and Losses Reported on Each Line
Tests for Significance of Differences Between Years

		Line 8 Other Gains and Losses	Line 11 Casualty & Theft Installment Sales Business Property Derivatives & Exchanges	Line12 Pass-Through Entities	Line 13 Capital Gains Distributions	Line 14 Loss Carry-forward	Long Term Total
t test for difference from previous year							
2003	t	1.202	-0.626	-0.420	-0.128	-1.715	-0.514
	P	23.0%	53.1%	67.4%	89.8%	8.6%	60.7%
2004	t	2.111	0.463	0.287	2.218	1.206	3.033
	P	3.5%	64.3%	77.4%	2.7%	22.8%	0.2%
2005	t	-0.167	0.358	1.542	4.048	-0.673	0.341
	P	86.8%	72.0%	12.3%	0.0%	50.1%	73.3%
2006	t	0.877	1.125	0.612	1.947	0.804	1.942
	P	38.1%	26.1%	54.1%	5.1%	42.1%	5.2%
F test for identity of all years							
	F	112,142.5	21,063.9	114,153.9	48,104.0	2,665.9	31,627.9
	P	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

Appendix: Comparison of 2006 Paper and Electronic Returns

For 2006, most electronically filed returns were available in an electronic data file. The electronic return data includes Schedule D and some of the supporting schedules. It does not include Schedule D-1, the continuation form for Lines 1 and 8 of Schedule D. This makes it possible to estimate total gains and gains by line for electronic returns, but it is not possible to estimate gains by asset type. The electronic returns also provide a way to check whether the sample of paper returns is representative of the entire population of returns, including paper and electronic returns.

The distributions of electronic and paper returns differ in a number of systematic ways. In particular, paper returns tend to be more complicated, paper returns with losses have larger average losses, and paper returns with large gains have larger average gains. Because of this, better estimates of population totals can be obtained by combining information from the population of electronic returns and a sample of paper returns.

Differences Between Paper and Electronic Returns

The population of paper returns with income from Schedule D was divided into seven strata based on the size of capital gains income. The population of electronic returns with Schedule D has a slightly different distribution of the size of capital gains. This is shown in Table D-1B, which shows the percentages of paper and electronic returns in each of the strata.

Table D-1B
Paper and Electronic Returns
Percent in Each Stratum

Stratum	Capital Gains	Paper Returns	Electronic Returns
1	<$0	25.8%	27.4%
2	$1 - $10,000	52.7%	54.8%
3	$10,001 - $25,000	9.1%	8.1%
4	$25,001 - $50,000	5.1%	4.2%
5	$50,001 - $100,000	3.4%	2.6%
6	$100,001 - $200,000	1.9%	1.5%
7	>$200,000	2.0%	1.4%

A smaller percentage of paper returns are found in the first two strata, with losses and with gains of $10,000 or less. A larger percentage of paper returns are found in the other five strata, with capital gains of more than $10,000.

The fact that the distributions are different is not necessarily a problem for estimating population totals from a sample of paper returns if the paper returns are representative of the population within each stratum. Unfortunately, this is not the case. There are systematic differences between paper and electronic returns within each stratum.

Paper returns with a Schedule D are much more likely to have high total income than electronic returns with a Schedule D. Table D-2B shows the percent of paper and electronic returns with Schedule Ds in each stratum that are in the top decile of total income.

Table D-2B
Paper and Electronic Returns
Percent in Top Income Decile

Stratum	Capital Gains	Paper Returns	Electronic Returns
1	<$0	20.1%	1.0%
2	$1 - $10,000	14.1%	0.4%
3	$10,001 - $25,000	18.3%	1.3%
4	$25,001 - $50,000	22.2%	2.0%
5	$50,001 - $100,000	21.7%	3.3%
6	$100,001 - $200,000	21.9%	8.9%
7	>$200,000	63.7%	14.0%

The difference is large in all the strata. It is largest in absolute terms in the top stratum, but is largest in relative terms in the lowest.

Paper returns with a Schedule D are more likely to have large losses or large gains. Table D-3B shows average net gains in each of the seven strata. Strata 2 through 6 are defined by ranges of capital gains income after the cap on losses. In Strata 2 through 6, the average gain for electronic returns is close to the average gain for paper returns.

Table D-3B
Paper and Electronic Returns
Average Gain in Each Stratum

Stratum	Capital Gains	Paper Returns	Electronic Returns
1	<$0	-$46,701	-$12,822
2	$1 - $10,000	$3,318	$2,507
3	$10,001 - $25,000	$16,500	$15,593
4	$25,001 - $50,000	$36,232	$34,837
5	$50,001 - $100,000	$72,013	$69,295
6	$100,001 - $200,000	$139,301	$136,535
7	>$200,000	$751,743	$528,791

In Stratum 1, the difference between the average pre-cap loss for paper and electronic returns is about $34,000, and the average loss is over three times as large for paper returns as for electronic returns. In Stratum 7, the difference between the average gain for paper and electronic returns is about $223,000 and the average gain is 40% larger for paper returns. In the other strata, the absolute size of the differences is smaller, though, in Stratum 2 the average gain for paper returns is about one-third larger.

Paper returns are more likely to have short-term gains than electronic returns. Table D-4B shows the percent of paper and electronic returns in each stratum with short-term and long-term gains.

Table D-4B
Paper and Electronic Returns
Percent with Short-Term and Long-Term Gains

		Paper Returns		Electronic Returns	
Stratum	Capital Gains	Short-Term	Long-Term	Short-Term	Long-Term
1	<$0	49.7%	90.7%	24.7%	80.4%
2	$1 - $10,000	34.8%	94.9%	21.4%	92.9%
3	$10,001 - $25,000	41.1%	98.0%	23.3%	97.3%
4	$25,001 - $50,000	50.5%	97.9%	23.4%	97.8%
5	$50,001 - $100,000	42.8%	100.0%	22.9%	98.7%
6	$100,001 - $200,000	45.0%	98.6%	28.0%	99.8%
7	>$200,000	48.9%	99.8%	32.0%	100.0%

Most schedule Ds report long-term gains, and the differences between paper and electronic returns generally are relatively small. In all but the second stratum, between 41% and 51% of paper returns have short-term gains. Between 21% and 32% of electronic returns have short-term gains. The difference between paper and electronic returns ranges from 13 to 27 percentage points.

Taxpayers who filed paper returns are much less likely to be single. Table D-5B shows the percent of paper and electronic returns in each stratum filed by single taxpayers.

Table D-5B
Paper and Electronic Returns
Percent of Single Filers

Stratum	Capital Gains	Paper Returns	Electronic Returns
1	<$0	22.8%	38.2%
2	$1 - $10,000	24.7%	36.5%
3	$10,001 - $25,000	22.3%	28.8%
4	$25,001 - $50,000	15.3%	23.1%
5	$50,001 - $100,000	16.0%	23.8%
6	$100,001 - $200,000	13.6%	21.6%
7	>$200,000	17.3%	30.7%

The proportions of married couples who filed joint and separate returns differs between paper and electronic returns. Table D-6B shows the percent of married taxpayers who filed paper and electronic returns with Schedule Ds who filed a joint return.

Table D-6B
Paper and Electronic Returns
Percent of Married Couples Filing Joint Return

Stratum	Capital Gains	Paper Returns	Electronic Returns
1	<$0	55.2%	50.6%
2	$1 - $10,000	44.3%	43.8%
3	$10,001 - $25,000	41.2%	38.0%
4	$25,001 - $50,000	35.9%	36.1%
5	$50,001 - $100,000	33.5%	37.9%
6	$100,001 - $200,000	41.4%	33.4%
7	>$200,000	48.5%	44.5%

The percentage is higher for paper returns in the first three strata and the two highest. The percentage is higher for electronic returns in the fourth and fifth strata.

On average, paper returns with a Schedule D have slightly more exemptions than electronic returns with a Schedule D. This difference may be largely due to the smaller percentage of single taxpayers among paper returns. Taxpayers may also have more exemptions because they have more dependents or because they are over 65 or blind. Table D-7B shows the average number of exemptions claimed on paper and electronic returns with a Schedule D in each stratum.

Table D-7B
Paper and Electronic Returns
Average Number of Exemptions

Stratum	Capital Gains	Paper Returns	Electronic Returns
1	<$0	2.42	2.11
2	$1 - $10,000	2.31	2.07
3	$10,001 - $25,000	2.23	2.10
4	$25,001 - $50,000	2.26	2.18
5	$50,001 - $100,000	2.13	2.13
6	$100,001 - $200,000	2.20	2.06
7	>$200,000	2.42	2.13

Taxpayers who file paper returns tend to have more complicated returns in terms of the number and types of income they report. Table D-8B shows the average number of lines on which taxpayers reported income and the percent of taxpayers reporting income on each line.

In all strata, taxpayers who filed paper returns reported more different types of income on their returns. The difference is larger for the higher and lower strata and smaller for the middle strata.

Table D-8B
Paper and Electronic Returns
Types of Income

Stratum	1	2	3	4	5	6	7
Capital Gains	<$0	$1 - $10,000	$10,001 - $25,000	$25,001 - $50,000	$50,001 - $100,000	$100,001 - $200,000	>$200,000
Average Number of Types of Income on Return							
Paper Returns	5.83	5.79	5.97	5.97	6.09	6.29	6.54
Electronic Returns	4.80	4.98	5.51	5.62	5.79	5.82	4.86
Percent with Wage and Salary Income							
Paper Returns	67.2%	67.4%	61.9%	63.5%	63.7%	53.7%	60.0%
Electronic Returns	67.1%	70.8%	62.8%	63.2%	61.5%	59.7%	68.4%
Percent with Interest Income							
Paper Returns	94.0%	91.5%	97.0%	96.1%	94.3%	98.3%	98.6%
Electronic Returns	83.8%	83.7%	90.6%	92.4%	93.8%	94.0%	83.8%
Percent with Dividend Income							
Paper Returns	81.2%	78.2%	79.2%	75.4%	75.0%	79.3%	85.2%
Electronic Returns	71.7%	75.1%	71.3%	65.8%	66.5%	65.9%	59.1%
Percent with Net Business Income							
Paper Returns	30.6%	25.2%	26.2%	27.6%	35.8%	38.0%	32.5%
Electronic Returns	22.7%	22.5%	26.1%	28.7%	32.3%	32.0%	24.4%
Percent with Income from Rents, Royalties, Pass-Throughs							
Paper Returns	74.2%	76.3%	79.7%	87.2%	86.3%	83.9%	85.5%
Electronic Returns	34.6%	36.4%	53.7%	61.9%	67.8%	70.9%	38.2%
Percent with Income from Gains on Sale of Business Assets							
Paper Returns	19.634%	22.929%	21.287%	23.645%	27.358%	33.058%	34.545%
Electronic Returns	4.690%	10.241%	16.260%	19.000%	22.167%	24.574%	10.228%
Percent with Taxable IRA Distributions							
Paper Returns	15.973%	15.222%	15.842%	14.778%	12.264%	13.223%	11.157%
Electronic Returns	16.621%	14.919%	17.751%	15.190%	15.333%	14.489%	14.525%
Percent with Taxable Retirement							
Paper Returns	25.291%	23.699%	29.208%	17.241%	23.585%	23.140%	20.744%
Electronic Returns	34.837%	30.296%	30.786%	29.837%	28.500%	26.563%	32.101%
Percent with Farm Income							
Paper Returns	9.318%	14.066%	16.337%	18.227%	11.321%	19.008%	17.603%
Electronic Returns	5.011%	12.010%	16.938%	15.388%	15.833%	16.051%	7.434%
Percent with Taxable Social Security							
Paper Returns	20.632%	20.424%	31.188%	30.049%	29.245%	30.579%	32.893%
Electronic Returns	20.610%	21.057%	34.065%	34.884%	35.417%	32.813%	23.378%
Percent with Other Income							
Paper Returns	25.624%	21.002%	17.327%	19.704%	23.113%	23.554%	40.413%
Electronic Returns	13.705%	10.827%	14.309%	16.724%	17.917%	20.739%	14.095%

Taxpayers who filed paper returns were more likely to report interest income; dividend income; income from rents, royalties, and pass-throughs; gains on the sale of business assets; and other income in all seven strata. Paper filers were more likely to report net business income and farm income in most strata.

Taxpayers who filed electronic returns were more likely to report retirement income in all strata and taxable IRA distributions and social security in most strata. Electronic filers were more likely to report wage and salary income in four strata while paper filers were more likely to report wage and salary income in three.

All but one of the 77 differences in reporting percentages in Table D-8B is statistically significant at the 95% confidence level.

The conclusion to be drawn from all of these differences is that paper filers and electronic filers are two different sub-populations and that a sample of returns drawn from either sub-population will not be representative of the population as a whole. Combining separate parameter estimates from the two sub-populations will give better estimates of overall population parameters.

Capital Gains Estimates Based on Paper Returns, Electronic Returns, and Both

Tables D-9B through D-11B show the development of an estimate of 2006 capital gains from combined information from paper and electronic returns.

Table D-9B shows estimates of capital gains reported on paper returns based on the sample of paper returns. These are the sample totals for each stratum weighted by the ratio of paper returns in that stratum to the sample size for that stratum.

Table D-10B shows estimates of capital gains on electronic returns based on available electronic returns. These are the totals for valid records in the file of electronic returns for each stratum weighted by the ratio of electronic returns in that stratum to the number of valid records from that stratum in the electronic return data file.

Table D-11B shows estimates of population totals that are the sum of the estimates for paper returns only and the estimates for electronic returns only.

Table D-9B
Sample Estimates of Capital Gains Reported on 2006 Paper Returns

		Short Term		Long Term		Total		
Stratum	Capital Gains	N	$	N	$	N	$	Capital Gains Income on Return
1	<$0	6,173	-$230,926,755	11,281	-$349,702,651	12,433	-$580,629,406	-$28,670,403
2	$1 - $10,000	8,820	-$2,987,908	24,055	$87,117,124	25,358	$84,129,216	$84,129,216
3	$10,001 - $25,000	1,803	$3,043,278	4,297	$69,324,762	4,386	$72,368,040	$72,368,040
4	$25,001 - $50,000	1,243	$4,565,781	2,409	$84,564,726	2,460	$89,130,507	$89,130,507
5	$50,001 - $100,000	694	$3,950,709	1,622	$112,855,329	1,622	$116,806,038	$116,806,038
6	$100,001 - $200,000	416	$3,627,938	912	$125,224,450	925	$128,852,388	$128,852,388
7	>$200,000	461	$9,999,407	941	$698,876,434	943	$708,875,841	$708,875,841
Total		19,611	-$208,727,550	45,517	$828,260,174	48,127	$619,532,624	$1,171,491,627

Table D-10B
Capital Gains Reported on 2006 Electronic Returns

		Short Term		Long Term		Total		
Stratum	Capital Gains	N	$	N	$	N	$	Capital Gains Income on Return
1	<$0	3,758	-$33,593,413	12,219	-$161,333,365	15,202	-$194,926,779	-$24,594,412
2	$1 - $10,000	6,517	$2,713,187	28,239	$73,503,546	30,401	$76,216,733	$76,532,020
3	$10,001 - $25,000	1,048	$2,727,779	4,382	$67,486,546	4,503	$70,214,325	$70,214,325
4	$25,001 - $50,000	548	$2,716,694	2,291	$78,871,544	2,342	$81,588,238	$81,594,252
5	$50,001 - $100,000	329	-$421,217	1,421	$100,136,209	1,439	$99,714,992	$99,825,755
6	$100,001 - $200,000	227	$1,750,823	809	$108,978,958	811	$110,729,781	$110,729,781
7	>$200,000	240	$1,170,301	752	$396,481,680	752	$397,651,981	$397,651,981
Total		12,667	-$22,935,845	50,114	$664,125,117	55,450	$641,189,271	$811,953,702

Table D-11B
2006 Capital Gains Estimates from Combined Paper and Electronic Returns

		Short Term		Long Term		Total		Capital Gains
Stratum	Capital Gains	N	$	N	$	N	$	Income on Return
1	<$0	9,931	-$264,520,168	23,500	-$511,036,017	27,635	-$775,556,185	-$53,264,816
2	$1 - $10,000	15,337	-$274,720	52,294	$160,620,669	55,759	$160,345,949	$160,661,236
3	$10,001 - $25,000	2,852	$5,771,057	8,679	$136,811,309	8,889	$142,582,366	$142,582,366
4	$25,001 - $50,000	1,791	$7,282,475	4,701	$163,436,270	4,802	$170,718,745	$170,724,759
5	$50,001 - $100,000	1,023	$3,529,492	3,043	$212,991,538	3,061	$216,521,030	$216,631,793
6	$100,001 - $200,000	643	$5,378,761	1,722	$234,203,408	1,736	$239,582,169	$239,582,169
7	>$200,000	702	$11,169,708	1,693	$1,095,358,113	1,695	$1,106,527,822	$1,106,527,822
Total		32,278	-$231,663,395	95,631	$1,492,385,291	103,577	$1,260,721,896	$1,983,445,329

Neither paper returns or electronic returns are representative of the population as a whole, so that estimates based on one or the other are likely to be biased. This is illustrated in Tables D-12B through D-14B. Table D-12B shows estimates of population totals based on the sample of paper returns. Table D-13B shows estimates of population totals based on electronic returns. Table D-14B compares these two estimates of population totals with the combined estimate from Table D-11B and actual population totals.

Table D-12B
Estimates of 2006 Capital Gains from Paper Returns

		Short Term		Long Term		Total		Capital Gains
Stratum	$	N	$	N	$	N	$	Income on Return
1	<$0	13,721	-$513,285,071	25,074	-$777,290,402	27,635	-$1,290,575,474	-$63,726,224
2	$1 - $10,000	19,394	-$6,570,051	52,894	$191,560,116	55,759	$184,990,065	$184,990,065
3	$10,001 - $25,000	3,655	$6,167,750	8,709	$140,499,099	8,889	$146,666,848	$146,666,848
4	$25,001 - $50,000	2,426	$8,912,714	4,703	$165,076,076	4,802	$173,988,789	$173,988,789
5	$50,001 - $100,000	1,310	$7,455,711	3,061	$212,978,649	3,061	$220,434,360	$220,434,360
6	$100,001 - $200,000	780	$6,808,530	1,712	$235,007,965	1,736	$241,816,494	$241,816,494
7	>$200,000	830	$17,975,552	1,691	$1,256,343,517	1,695	$1,274,319,070	$1,274,319,070
Total		42,116	-$472,534,866	97,844	$1,424,175,019	103,577	$951,640,153	$2,178,489,402

Table D-13B
Estimates of 2006 Capital Gains from Electronic Returns

		Short Term		Long Term		Total		Capital Gains
Stratum	Capital Gains	N	$	N	$	N	$	Income on Return
1	<$0	6,831	-$61,067,915	22,212	-$293,280,476	27,635	-$354,348,391	-$44,709,046
2	$1 - $10,000	11,953	$4,976,307	51,794	$134,814,230	55,759	$139,790,538	$140,368,812
3	$10,001 - $25,000	2,069	$5,384,683	8,651	$133,219,608	8,889	$138,604,291	$138,604,291
4	$25,001 - $50,000	1,124	$5,570,271	4,698	$161,717,074	4,802	$167,287,345	$167,299,676
5	$50,001 - $100,000	700	-$896,002	3,022	$213,007,288	3,061	$212,111,286	$212,346,899
6	$100,001 - $200,000	486	$3,747,757	1,733	$233,277,040	1,736	$237,024,798	$237,024,798
7	>$200,000	542	$2,637,844	1,695	$893,664,496	1,695	$896,302,340	$896,302,340
Total		23,704	-$39,647,054	93,805	$1,476,419,261	103,577	$1,436,772,207	$1,747,237,770

Table D-14B
Comparison of Estimates of Capital Gains Income

Stratum	Capital Gains	Estimate Based on Paper Returns	Estimate Based on Electronic Returns	Combined Estimate	Actual Population Totals
1	<$0	-$63,726,224	-$44,709,046	-$53,264,816	-$57,771,450
2	$1 - $10,000	$184,990,065	$140,368,812	$160,661,236	$122,220,266
3	$10,001 - $25,000	$146,666,848	$138,604,291	$142,582,366	$141,900,322
4	$25,001 - $50,000	$173,988,789	$167,299,676	$170,724,759	$169,952,395
5	$50,001 - $100,000	$220,434,360	$212,346,899	$216,631,793	$213,970,651
6	$100,001 - $200,000	$241,816,494	$237,024,798	$239,582,169	$240,620,818
7	>$200,000	$1,274,319,070	$896,302,340	$1,106,527,822	$1,175,127,577
Total		$2,178,489,402	$1,747,237,770	$1,983,445,329	$2,006,020,579

The combined estimate is closer to the actual in five of the seven strata and the combined total is much closer than either of the other estimated totals. The combined estimate is 1.1% lower than the actual total, while the estimate based on paper returns is 8.6% higher than the actual and the estimate based on electronic returns is 12.0% lower than the actual.

The largest differences between the estimates are in the second stratum and the top stratum. As was shown in Table D-3B, the average gain for paper returns in both of these strata is much larger than the average gain for electronic returns. In the top stratum, this results in the estimate based on paper returns being high, the estimate based on electronic returns being quite low, and the combined estimate being relatively close. In the second stratum, all three estimates are high.

Given the differences between paper and electronic returns, the increasing use of electronic filing, and the fact that the combined estimates for 2006 are generally closer to known population totals than the estimates based on either paper returns only or electronic returns only, future studies of capital gains should use combined estimates from electronic returns and a sample of paper returns. Stratifying the sample of paper returns to concentrate on groups of taxpayers where paper filers and electronic filers differ may allow reliable results to be obtained with a smaller sample.

Schedule D and Schedule E Income Study
Study Results and Findings

Schedule "E"

With respect to the individual income tax, the normal process for capturing and storing data from state tax returns includes capturing data only from the major forms – Form 2, Form 2A (or 2M), and Form S (or 2EZ). Hence, the only information captured pertaining to Schedule E income has been the *total* amount of Schedule E income as reported on the taxpayer's federal tax return.

In order to provide more detailed information regarding Schedule E incomes, temporary staff were hired to data capture information from a sample of tax returns for tax years 2002 through 2006. This detailed data capture process provided the foundation for the information which follows. Details regarding the data capture process and other issues surrounding the sample data are provided in Appendix A.

Schedule E – Summary Financial Findings

As discussed earlier, total income reported on Schedule E includes income from rental real estate; mineral and other royalties; income from partnerships and S corporations; income from estates and trusts; residual interests in Real Estate Mortgage Investment Conduits (REMICs); and income from rental of farm property. Each of these types of income was discussed earlier in this report.

This study provides for the first time a detailed look at the extent to which total Schedule E income is comprised of each of these components. It should be noted that the information presented throughout this report reflects *estimates* of the population of all Schedule E filers derived from samplings of Schedule E returns. As such, these estimates will not tie precisely to actual population information, such as the actual population value for total Schedule E income reported earlier in this document. The sample sizes are sufficiently large, however, that the information presented here should reflect the population data with a fairly high degree of precision.

With this in mind, Table E-1 shows the distribution of total Schedule E income across the various types of Schedule E incomes, for tax years 2002 through 2006.[14]

Over the 5-year period 2002-2006, total Schedule E income more than doubled, growing by 106%, from $1.08 billion in 2002 to $2.23 billion in 2006. Income from partnerships and S corporations was the fastest growing component of Schedule E

[14] Over the 5-year period 2002 – 2006 information from the samples showed that there was virtually no income reported from REMICs in some years, and extremely miniscule amounts in other years. Hence, income from REMICs is excluded from the rest of this discussion.

income, growing by 127%, from $797 million in 2002 to $1.81 billion in 2006. Most of this growth occurred in tax years 2005 and 2006; partnership and S corporation income grew by 74% alone in tax year 2005, and by an additional 22% in tax year 2006.

Income from estates and trusts nearly doubled over this time period, growing from $29 million in 2002 to $56 million in 2006. Farm rental income and rents and royalties income grew at much slower rates, growing by 26% and 44%, respectively, from 2002 to 2006.

Table E-1

Component Amount and Share of Total Schedule E Income
Tax Years 2002 - 2006

Type of Income	TY2002	TY2003	TY2004	TY2005	TY2006	% Change 2002 - 2006
Rents and Royalties	223,170,776	226,117,746	286,900,438	340,344,987	322,099,149	44.3%
Partnerships and S Corporations	797,155,048	747,878,419	850,667,364	1,496,624,371	1,809,145,585	127.0%
Estates and Trusts	29,373,432	28,933,026	30,720,732	48,215,228	55,968,349	90.5%
Farm Rental Income	32,453,941	45,199,877	37,881,278	32,508,684	40,832,352	25.8%
Total Schedule E Income	**1,082,153,197**	**1,048,129,068**	**1,206,169,812**	**1,917,693,270**	**2,228,045,435**	**105.9%**
Share of Total Schedule E Income						
Rents and Royalties	20.6%	21.6%	23.8%	17.7%	14.5%	
Partnerships and S Corporations	73.7%	71.4%	70.5%	78.0%	81.2%	
Estates and Trusts	2.7%	2.8%	2.5%	2.5%	2.5%	
Farm Rental Income	3.0%	4.3%	3.1%	1.7%	1.8%	
Total Schedule E Income	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	

Income from partnerships and S corporations is by far the largest component of total Schedule E income, with this component increasing its share significantly between 2002 and 2006. In 2002, partnership and S corporation income comprised 74% of total Schedule E income; this share dropped to about 71% in 2004 before increasing to 81.2% by 2006. It is this sudden and steep increase in partnership and S corporation income in tax years 2005 and 2006 that explains the rapid increase in total Schedule E income discussed previously in the history and background section of this report.

Even though rent and royalty income grew in absolute terms over the 2002-2006 period, the *share* of total Schedule E income comprised of rent and royalty income grew only over the 2002-2004 period from 20.6% to 23.8%, but has since dropped to just 14.5% of total Schedule E income in 2006.

Income from estates and trusts has grown sufficiently over time to maintain its share of total Schedule E income between 2.5% and 2.8% in all years. This income component also grew significantly in tax years 2005 and 2006.

Farm rental income has shown no consistent growth trend over the study period. In tax year 2003, this component totaled over $45 million and represented 4.4% of total Schedule E income. By 2006, this component totaled $40.8 million and represented just under 2% of total Schedule E income.

Comparing Montana data with federal tax data provides insight into whether Montana is mirroring, or behaving independently of, national trends. The IRS periodically publishes national data related to Schedule E income. Partnerships and S corporations are required to file information returns from which national trends can be drawn, and the IRS also publishes data from individual income tax returns showing amounts reported for the various types of income reported on Schedule E.

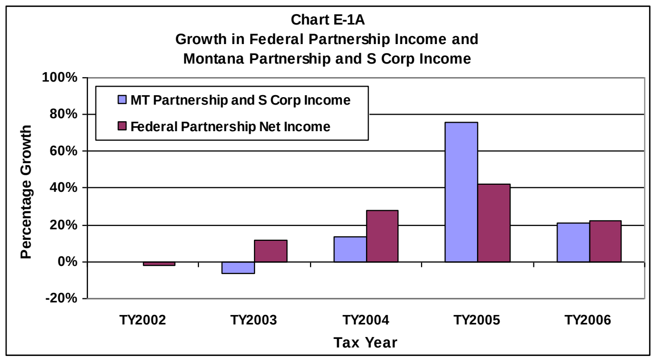

Chart E-1A shows the percentage growth in Montana partnership and S corporation income, and net income reported on all federal partnership information returns.[15] The chart shows that the nation experienced very rapid growth in partnership income during the same time frame that partnership and S corporation income was growing rapidly in Montana. The 41.9% growth in partnership income reported at the federal level in 2005 was the fastest growth in partnership net income since 1993.

The IRS also publishes data from partnership information returns by year and by state.[16] Returns are assigned to each state based on the zip code provided by the partnership on the first page of Form 1065, U.S. Return of Partnership Income. That data shows that:

- the number of partnership returns with a Montana address grew from 6,605 in 2002 to 8,145 in 2005, for total growth of 23.3% over this period;

- gross receipts from ordinary business activities of Montana partnerships grew by 85.2% over this same period, the 2nd fastest rate of growth among all states;

- ordinary business income of Montana partnerships grew 235.7% over this period, with most of this growth occurring in tax year 2005, where income grew 105% alone.

[15] Information from S corporation information returns at the federal level was available only through tax year 2003 at the time of this writing, and is therefore not shown in the chart.
[16] *Partnership and Sole Proprietorship Data, by Region and State, for Tax Years 2002-2005;* Internal Revenue Service, Statistics of Income Bulletin, Summer, 2008, Washington, D.C.

The IRS also publishes data from individual income tax returns showing growth in the separate components of Schedule E income similar to that shown in Table E-1 for Montana. Table E-1A compares the growth rates of Schedule E income components reported on federal income tax returns with the growth rates for those components as reported on Montana income tax returns for tax years 2003 through 2006.

As Table E-1A shows, rent and royalty income grew rapidly in Montana in tax years 2004 and 2005, before declining slightly in tax year 2006. On the other hand, growth in rent and royalty income at the national level was negative in all years, except for tax year 2003 where growth was positive but nominal.

Table E-1A

Growth Rates of Schedule E Income Components
As Reported on Montana and US Income Tax Returns
Tax Years 2003 - 2006

	TY2003	TY2004	TY2005	TY2006
Rent and Royalty - **MT**	1.3%	26.9%	18.6%	-5.4%
Rent and Royalty - **US**	0.8%	-6.3%	-4.8%	-14.8%
Partnership and S Corp - **MT**	-6.2%	13.7%	75.9%	20.9%
Partnership and S Corp - **US**	6.8%	24.4%	14.9%	10.8%
Estates and Trusts - **MT**	-1.5%	6.2%	56.9%	16.1%
Estates and Trusts - **US**	10.5%	12.8%	2.9%	15.7%
Total Schedule E Income[1] - **MT**	-4.5%	16.5%	61.4%	16.0%
Total Schedule E Income[1] - **US**	6.3%	20.9%	13.0%	9.3%

[1] *Does not include net farm rental income as data was not provided at the federal level.*

Pass-through income from partnerships and S corporations grew substantially both in Montana and across the nation during this time period. At the national level, growth was positive and fairly large in most years, with growth reaching 24.4% in tax year 2004 before tapering off but remaining positive in subsequent years. Following a slight decline in growth in tax year 2003, this income source grew dramatically in Montana, posting a growth rate of nearly 76% in tax year 2005 and followed by substantial growth of nearly 21% the next year. Although growth in this source of income was strong both in Montana and across the nation, it's clear that Montana experienced extraordinary growth in partnership and S corporation income reported on individual income tax returns over this time frame relative to the nation as a whole.

In Montana, growth in income from estates and trusts was fairly anemic in 2003 and 2004, but then grew by nearly 57% in tax year 2005, followed by growth of over 16% in the next year. Conversely, growth in estate and trust income at the national level grew slowest in 2005, growing just 2.9%; but growth was robust and steady in all other years.

Overall, growth in total Schedule E income was positive and fairly steady over this time frame at the national level, with growth peaking at almost 21% in 2004 before waning in subsequent years. Growth was more erratic in Montana, being negative in 2003, before rebounding in 2004 and then growing dramatically in 2005 by over 61%, followed by growth of 16% in 2006.

In short, while income reported on Schedule E grew substantially at both the national level and in Montana over this time period, the pattern of growth was significantly different in Montana compared to the pattern of growth nationally; particularly in tax year 2005 where growth in partnership and S corporation incomes, and growth in income from estates and trusts, was extraordinarily high in Montana.

Following sections provide additional detail regarding rent and royalty income, partnership and S corporation income, and income from estates and trusts.

Rent and Royalty Income

Table E-2 provides a variety of information pertaining to rental and royalty incomes. The top portion of the table shows the amount of *gross* rental and royalty income; that is, income before any expenses or deductions. Over the period 2002-2006, gross rental income grew relatively slowly, growing just 32.2% over the entire time frame. Gross royalty income grew at a much faster pace (219.5% over the period), with this growth occurring primarily in tax years 2004 and 2005, before declining slightly in 2006. This very rapid growth in royalty income likely is a direct result of the rapid growth in oil prices and oil production in Montana during this time frame.

Gross rental income comprises the vast majority of total rental and royalty income. In 2002, gross rental income comprised almost 94% of total rental and royalty income. However, due to the rapid growth in royalty income during this time period, gross rental income’s share of rental and royalty income had dropped to 86.4% of the total by 2006, while the share attributable to royalty income more than doubled from 6.1% to 13.6% over the time period.

When calculating *net* rental or *net* royalty income to report on Schedule E, taxpayers are allowed to deduct a variety of expenses (e.g., advertising, insurance, repairs, taxes, etc.), as well as depreciation and depletion allowances. The middle section of table E-2 shows the total expenses reported, and the total amount of depreciation or depletion deducted, in arriving at net rental and royalty income.

Table E-2

Schedule E Rent and Royalty Income and Expense Data
Tax Years 2002 - 2006

Type of Income and Expense	TY2002	TY2003	TY2004	TY2005	TY2006	% Change 2002 - 2006
Gross Rental Income	782,956,940	798,209,184	901,234,412	1,028,649,226	1,034,917,717	32.2%
Gross Royalty Income	50,813,974	60,095,894	102,229,490	180,034,181	162,354,217	219.5%
Total Gross Rent and Royalty Income	**833,770,914**	**858,305,078**	**1,003,463,902**	**1,208,683,407**	**1,197,271,934**	**43.6%**
Rental Share	*93.9%*	*93.0%*	*89.8%*	*85.1%*	*86.4%*	
Royalty Share	*6.1%*	*7.0%*	*10.2%*	*14.9%*	*13.6%*	
Total Expenses	463,045,831	473,314,659	525,741,112	659,954,813	677,766,268	46.4%
Total Depreciation and Depletion	159,374,369	169,418,771	195,988,219	223,488,325	230,305,451	44.5%
Total Expenses and Depreciation	**622,420,200**	**642,733,430**	**721,729,331**	**883,443,138**	**908,071,719**	**45.9%**
Expenses - As Share of Gross Income	*56%*	*55%*	*52%*	*55%*	*57%*	
Depreciation - As Share of Gross Income	*19%*	*20%*	*20%*	*18%*	*19%*	
Expenses and Depreciation - Share of Gross	*75%*	*75%*	*72%*	*73%*	*76%*	
Net Rent/Royalty Inc. (before loss limitations)	**211,350,714**	**215,571,648**	**281,734,571**	**325,240,269**	**289,200,215**	**36.8%**
Net Rent/Royalty Inc. (after loss limitations)	**223,170,776**	**226,117,746**	**286,900,438**	**340,344,987**	**322,099,149**	**44.3%**
Difference	11,820,062	10,546,098	5,165,867	15,104,718	32,898,934	
% Difference	6%	5%	2%	5%	11%	

Whereas total gross rent and royalty income grew by 43.6% over this time period, total expenses and depreciation/depletion grew just slightly faster (45.9%), with expenses and depreciation/depletion each growing at very similar overall rates.

The middle section of Table E-2 also shows that over the entire time period 2002-2006 total expenses offset 55% of gross income, and total depreciation and depletion offset 19% of gross income, with very little variation in these averages from year to year. In other words, three-quarters of total gross rental and royalty income is offset each year by expenses and depreciation/depletion. Alternatively, each year *net* rental and royalty income is about one-quarter of *gross* rental and royalty income, with this ratio remaining very stable over the time period under examination.

For certain taxpayers, the amount of net loss that may be claimed from rental real estate activity or from royalty losses may be limited by applicable “at-risk” and/or “passive activity” rules. The bottom section of Table E-2 shows net rental and royalty income before the application of any loss limitations (calculated as gross rental and royalty income less total expenses and depreciation/depletion), and net rental and royalty income after loss limitations have been applied. Loss limitations acted to increase net rental and royalty income by as little as $5.2 million in tax year 2004, and by as much as $32.9 million in tax year 2006. In these two years, loss limitations acted to increase net rental and royalty income by 2% and 11%, respectively.

Partnership and S Corporation Income

Taxpayers who are members of a partnership, or who are shareholders of an S corporation, must report their share of the income (gain or loss) from these entities, even if that income is not actually received during the tax year. Income accruing to these taxpayers is generally characterized as being “passive” or “nonpassive” in nature (if the income is not passive in nature, it is nonpassive in nature). Passive income stems from passive activities, which in general include any business activity in which the taxpayer did not “materially participate”, and, with exceptions, any rental activity.

Members of partnerships and shareholders of S corporations are also subject to “at-risk” and “passive activity” loss rules, which may act to limit the amount of net partnership or S corporation loss that can be reported for tax purposes.[17] These loss limitations are computed on forms that provide supporting documentation for Schedule E; hence, any amounts of passive and nonpassive loss reported on Schedule E itself have already had the loss limitation rules applied.

Table E-3 provides summary information pertaining to passive and nonpassive income and loss from partnerships and S corporations over the period 2002 to 2006.

Table E-3

Schedule E Partnership and S Corporation Income and Expense Data
Tax Years 2002 - 2006

Type of Income/Expense	TY2002	TY2003	TY2004	TY2005	TY2006	% Change 2002 - 2006
Passive income	302,058,022	282,344,589	292,804,303	762,605,503	1,122,890,903	271.7%
Passive loss allowed	70,438,220	79,880,938	85,887,537	111,564,118	187,371,758	166.0%
Net Passive Income	**231,619,802**	**202,463,651**	**206,916,766**	**651,041,385**	**935,519,145**	**303.9%**
Nonpassive income	886,676,148	1,019,497,770	1,046,831,742	1,390,162,001	1,630,401,793	83.9%
Nonpassive loss	262,586,865	359,055,768	267,683,480	388,432,991	561,003,221	113.6%
Section 179 expense	58,554,037	115,027,234	135,397,664	175,076,387	195,772,132	234.3%
Net Nonpassive Income	**565,535,246**	**545,414,768**	**643,750,598**	**826,652,623**	**873,626,440**	**54.5%**
Total Net Income	**797,155,048**	**747,878,419**	**850,667,364**	**1,477,694,008**	**1,809,145,585**	**127.0%**
Total Income	*1,188,734,170*	*1,301,842,359*	*1,339,636,045*	*2,152,767,504*	*2,753,292,696*	*131.6%*
Total Loss/Expense	*391,579,122*	*553,963,940*	*488,968,681*	*675,073,496*	*944,147,111*	*141.1%*
Loss/Expense as a % of Income	*32.9%*	*42.6%*	*36.5%*	*31.4%*	*34.3%*	

The top section of the table breaks out total net income into its passive and nonpassive components. Passive income reported by taxpayers remained fairly stable at around $300 million over the 2002 – 2004 period, but grew substantially in 2005 to $763 million (160% increase), and in 2006 to $1.12 billion (47% increase), resulting in net growth over the 5-year period of 272%.

[17] A full discussion of “material participation”, and “at-risk” and “passive activity” loss limitation rules is beyond the scope of this paper.

Passive losses also grew significantly in 2005 and 2006, but much less rapidly than passive income. Over the 5-year period shown, passive losses grew by 166%, from $70 million in 2002 to $187 million in 2006.

Because passive losses grew substantially slower than passive income, net passive income grew by 304% over this time frame, from $232 million in 2002 to $936 million in 2006 with most of this growth occurring in tax year 2005, where growth reached 215% alone.

Although a substantially larger source of income, nonpassive income grew much slower than passive income over the 5-year period, growing just 84% from $887 million in 2002 to $1.63 billion in 2006. Like passive income, most of the growth in nonpassive income occurred in the 2005 (33% growth) and 2006 (17% growth) tax years.

Nonpassive losses grew substantially faster than nonpassive income, growing from $263 million in 2002 to $561 million in 2006, which represents growth of 114% over the 5-year period. Nonpassive losses grew 37% in 2003, and then *dropped* by 25% in 2004, before growing 45% in both 2005 and 2006.

Section 179 Expense Deduction

Under section 179 of the Internal Revenue Code, taxpayers may elect to treat the cost of certain qualifying personal property (section 179 property) as an expense, rather than as a capital expenditure subject to depreciation. The total amount that can be expensed under this section is capped, with this capped amount reduced dollar for dollar by the amount of investment in qualifying property that exceeds the investment threshold set in statute.

For example, in tax year 2002 a taxpayer could elect to expense up to $24,000 of qualifying personal property placed into service, with this maximum deduction amount reduced dollar for dollar for every dollar of qualifying investment in excess of $200,000; hence, no expense deduction would be allowed if the taxpayer had put into service qualifying property that exceeded $224,000 in cost during the tax year.

Partnerships and S corporations may elect to take the section 179 expense deduction for qualifying personal property placed into service during the tax year. The amount of the deduction that is passed through to each individual share holder is provided to each member or shareholder on Schedule K-1 and/or Form 4562 (Depreciation and Amortization), and subsequently reported by the individual taxpayer on Schedule E.

As Table E-3 shows, reported section 179 expenses grew by 234% over the 5-year period 2002 - 2006. Section 179 expenses grew 94% in tax year 2003 alone, following passage of the federal *Jobs and Growth Tax Relief and Reconciliation Act of 2003*. That act increased the tax year 2003 maximum expense deduction from $25,000 to $100,000; and increased the qualifying investment threshold from $200,000 to $400,000. The act further provided that the increased expense limitation, and the investment threshold applied only to tax years 2003 through 2005, and would be indexed for inflation in 2004 and 2005. The *American Jobs Creation Act of 2004* extended the increased limits and indexing provisions to tax years 2006 and 2007.[18]

Nonpassive income net of nonpassive losses and section 179 expenses (net nonpassive income) grew comparatively slowly, growing by 55% over the 5-year period, because the 84% growth in nonpassive income was outpaced by the offsetting 114% growth in nonpassive losses and the 234% growth in section 179 expenses.

Total net income from partnerships and S corporations (net passive income plus net nonpassive income) grew by 127% over the study period, with most of this growth occurring in tax year 2005 (74% growth rate), spurred by the 215% growth in net passive income in that year. Indeed, one of the more interesting findings from this study is the major shift in the importance of net partnership and S corporation *passive* income relative to net *nonpassive* income over this time period. As Table E-3 shows, over the period 2002 through 2004, net passive income from partnerships and S corporations was about one-third that of net nonpassive income. But by 2006 net passive income had grown to where it actually exceeded net nonpassive income.

The bottom portion of Table E-3 shows total income, and total losses and section 179 expenses, and the portion of total income offset by losses and expenses. Over the combined 5-year period losses and expenses offset 35% of total income. The portion of total income offset by losses and expenses does not vary substantially from this figure, with the exception of tax year 2003 where losses and expenses offset 43% of total income. In that year, losses and expenses, particularly the growth in section 179 expenses as a result of federal law changes, greatly outpaced the growth in both passive and nonpassive income.

Again, the importance of partnership and S corporation income with respect to growth in total Schedule E income over the time period examined is highlighted by the fact that in 2005 and 2006, the two years that experienced exceptional growth in total Schedule E income, growth in partnership and S corporation income accounted for 91% and 100% of growth in total net Schedule E income in those two years, respectively.

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The explosive growth in Schedule E partnership and S corporation *passive* income in 2005 and 2006 warrants further discussion. In particular, it would be helpful to policymakers, revenue estimators and others to understand precisely the reasons underlying this growth. Unfortunately, the information derived from Schedule E alone –

[18] The *Small Business and Work Opportunity Tax Act of 2007* set the maximum deduction at $125,000 for tax year 2007 and $128,000 for tax year 2008, with the latter amount to be adjusted for inflation for tax years 2009 and 2010. That Act also set the investment limitation at $500,000 for tax year 2007 and $510,000 for tax year 2008, with the latter amount to be adjusted for inflation for tax years 2009 and 2010. Under current law, the maximum deduction drops to $25,000 and the investment limitation drops to $200,000 beginning with tax year 2011, with neither of these amounts adjusted for inflation in subsequent years.

the information used in this study – provides no indication of the type of income received, or from which industries the income derives. Hence, the following discussion is based in part on fact, but in large part on speculation.

First, there was a fair amount of growth in the number of partnerships and S corporations filing tax returns over the 2002 - 2006 period. At the national level, filings of S corporation tax returns grew by 23% and the number of partnership returns grew by 29%, resulting in growth of both partnership and S corporation filings of just over 25%.

Growth in partnership and S corporation filings in Montana over this period was larger, with the number of S corporation tax returns growing by 31% and the number of partnership returns growing by 38%, resulting in growth of both partnership and S corporation filings of just over 34%.

The extent to which this growth in the number of partnerships and S corporations filing tax returns actually affected the growth in net passive income depends on a variety of factors including how many of these new entities reflect start-up companies, and how many include a change from one form of ownership (C corporations, e.g.) to partnership and S corporation status. If, for example, all of the growth were attributable to start-up companies it is unlikely that growth in the number of entities would contribute significantly to the overall growth in passive income.[19]

In addition, even though there was growth in the number of partnerships and S corporations, it is highly unlikely that all of the income from these new entities was distributed in the form of *passive* income; some likely was also distributed as nonpassive income. Given that net passive income grew by over 300% from 2002 to 2006, it is highly unlikely that growth in the number of new entities accounts for more than a small share of this growth; hence, there must be other reasons that account for the vast majority of the growth in passive income.

At the business entity level, passive income is comprised of income from passive activities in which the partnership or S corporation had no "material participation" in the production of the income. Examples of passive income include dividend income from holdings in other corporations, income from passive rental activities, capital gains income from the sale of investment assets, and royalty income from royalty holdings. At the individual level, passive income also includes a flow through of earnings directly attributable to the primary business activity of the partnership or S corporation to partners and shareholders who do not materially participate in the management or operation of the business. These examples of passive income suggest some other

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[19] Published IRS data shows that for tax year 2003, some 342.9 thousand corporations elected subchapter S status for the first time. Of those, 252.8 thousand (74%) were newly incorporated businesses; the remaining 90.1 thousand (26%) elected to make the conversion from a taxable corporation to an S corporation.

possible reasons that may explain the rapid growth in passive income in 2005 and 2006.

A portion of this exceptional growth in passive income may be attributable simply to a robust national, and Montana, economy during these years. Table E-3A provides information on basic economic indicators of output, income, and employment for the United States and Montana over the period 2002 - 2006.

Table E-3A

Select Economic Indicators
United States and Montana, 2002 - 2006

United States					
Economic Indicator	2002	2003	2004	2005	2006
GDP, % Change	3.4%	4.7%	6.6%	6.4%	6.3%
Personal Income, % Change	1.8%	3.1%	6.1%	5.6%	7.3%
Employment, % Change	-1.1%	-0.3%	1.1%	1.7%	1.8%
Employment Rate	5.8%	6.00%	5.50%	5.10%	4.60%

Montana					
Economic Indicator	2002	2003	2004	2005	2006
GDP, % Change	4.8%	8.3%	7.5%	9.2%	6.8%
Personal Income, % Change	2.1%	6.0%	6.8%	6.6%	6.7%
Employment, % Change	1.1%	1.2%	2.6%	2.3%	2.8%
Employment Rate	4.50%	4.30%	4.10%	3.80%	3.30%

Source: US Department of Commerce, Bureau of Economic Analysis; US Department of Labor, Bureau of Labor Statistics; Montana Department of Labor and Industry; Montana Department of Commerce, Census and Economic Information Center

Table E-3A shows that over the period 2002 – 2006 both the national economy and Montana's economy were performing well, with the national economy performing better in 2004, 2005, and 2006 than in the previous two years.
At the national level, growth in gross domestic product (GDP) was very robust with growth rates exceeding 6% in 2004 through 2006; personal income also grew quickly over these years, averaging 6.3%. Growth in total employment, on the other hand, was not as strong, turning negative in 2002 and 2003 before growing slowly in the remaining years. The unemployment rate reached a fairly high level of 6% in 2003 before declining to just 4.6% three years later. In general, the data at the national level reflect relatively slow growth in 2002 and 2003 as the nation recovered from the 2001-2002 downturn, and a resurgence in growth in the following years.

On the other hand, the Montana economy appears strong over this entire time frame; stronger than the national economy across all indicators. Growth in GDP at the state level averaged a very robust 7.3% over the entire time period with growth as high as 9.2% in tax year 2005, the year in which growth in partnership and S corporation income peaked. Excluding 2002, growth in personal income averaged 6.5%, reaching a high of 6.8% in tax year 2004. Employment growth was strong over the entire period, significantly outpacing growth in population (which averaged less than 1% over the period 2002 - 2006), and Montana's unemployment rate declined continuously over the entire period falling from 4.5% in 2002 to just 3.3% in 2006, well below the national average in all years.

It is difficult to determine the extent to which the general economy contributed to the extraordinary growth in partnership and S corporation passive income during the period under study, but the exceptional growth exhibited by state economic indicators over this period suggests that it likely was a contributing factor.

One economic sector that certainly contributed to Montana's overall economic growth during this time period is the oil and natural gas production sector. The gross value[20] of oil and gas production increased from $466.5 million in 2002 to $2.659 billion in 2006, which represents a 470% increase. The value of taxable royalties associated with oil and gas production grew even faster, growing by $280 million, from $51.6 million in 2002 to $331.8 million in 2006, reflecting a growth rate of 500% over this period.

As Table E-2 showed, gross royalty income reported directly on Schedule E increased from $50.8 million in 2002 to $162.4 million in 2006, reflecting growth of 220% over this period. Assuming that $100 million of this growth is in oil and gas royalties would leave $180 million of the total growth in taxable royalty income unaccounted for. To the extent that some or all of this amount was paid to partnerships or S corporations holding Montana oil and gas royalty interests, and that a sizeable amount of this income was flowed through to Montana members and shareholders of those entities, the increase in oil and gas royalty payments over this period would account for some portion of the total increase in partnership and S corporation portfolio (passive) income over this period as well.

Changes in federal tax law can significantly impact income subject to tax and state tax revenues. Among other things, the federal *Jobs and Growth Tax Relief Reconciliation Act of 2003* significantly reduced the tax rate applied to certain qualifying dividends. Generally, beginning with tax year 2003, dividends received during the tax year from a domestic corporation or a "qualified foreign corporation" were no longer subject to tax rates applied to ordinary income, but became subject to the same preferential tax rates applied to net capital gains income (generally, a maximum tax rate of 15%). The *Act* further provided that qualifying dividends received by partnerships and S corporations retain their qualifying nature when passed through to partners and shareholders.

Reducing the tax rate applied to dividend income likely induced at least some corporations to distribute a higher amount of retained and current year earnings than what otherwise would have occurred. To the extent that these distributions were made to partnerships and S corporations operating in Montana, and to the extent that these distributions were subsequently passed through to partners and shareholders who are Montana residents, this provision of the *2003 Act* may have resulted in a sizeable increase in passive income reported on Schedule E.

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[20] Gross value is determined by multiplying the total number of barrels of oil or cubic feet of natural gas produced and sold each month by the average well mouth value during the month.

IRS data suggest that this may have occurred at the national level. Chart E-3A shows the share of total net income of all US partnerships comprised of portfolio dividend income, and the rate of growth of dividend income over the period 2001 to 2006. Dividend income as a share of total net income has generally trended upwards over this time period, but jumped most noticeably in 2004, the year following the passage of the 2003 Act, to 12.8% of total net income, up from 10.4% the previous year. The amount of dividend income received by all partnerships grew by 57.6% in tax year 2004 and by an additional 31.9% in tax year 2005, and 29% in tax year 2006.

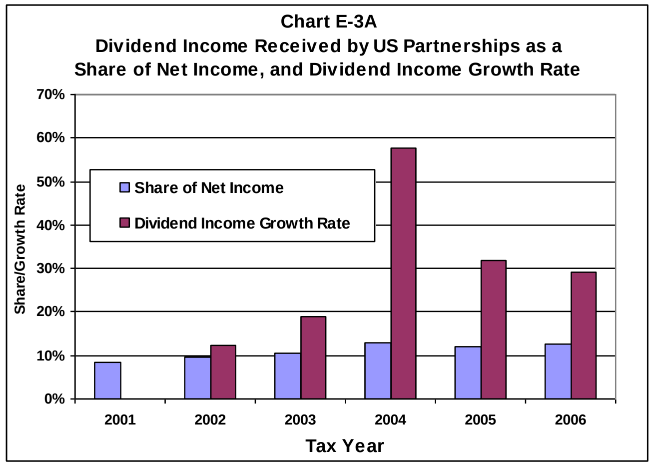

Chart E-3A
Dividend Income Received by US Partnerships as a Share of Net Income, and Dividend Income Growth Rate

The above sections discussed four possible factors that may have contributed to the extraordinary growth in passive income attributable to partnerships and S corporations over the study period: 1) growth in the number of partnerships and S corporations; 2) a robust economy; 3) rapid growth in oil and natural gas royalty payments; and 4) federal tax law changes that may have acted to induce an increase in dividend payments by corporations, some of which flowed to partnerships and S corporations operating in Montana, and were subsequently passed through to their partners and shareholders. The precise extent to which these, and perhaps other factors, contributed to this growth remains a subject for further research.

Estate and Trust Income

Table E-4 provides summary information pertaining to passive and nonpassive income and loss from estates and trusts over the period 2002 to 2006.

The top section of the table breaks out total net income into its passive and nonpassive components. Passive income reported by taxpayers from estates and trusts remained fairly stable over the entire time frame at around $20 million, with the exception of tax year 2005 where passive income totaled $30.2 million. Passive deductions and losses grew by 125% over the time period, resulting in a reduction in overall growth of net passive income of -1.5% over the period 2002 – 2006. Annual growth in net passive income was negative in three out of the fours years (2003 – 2006) for which growth could be measured.

Table E-4

Schedule E Estates and Trusts Income and Loss Data Tax Years 2002 - 2006						
Type of Income/Expense	**TY2002**	**TY2003**	**TY2004**	**TY2005**	**TY2006**	**% Change 2002 - 2006**
Passive income	21,015,880	20,112,689	17,221,937	30,175,348	22,950,694	9.2%
Passive deduction or loss allowed	1,789,599	3,089,361	831,032	1,464,496	4,019,316	124.6%
Net Passive Income	**19,226,281**	**17,023,328**	**16,390,905**	**28,710,852**	**18,931,378**	**-1.5%**
Nonpassive income	11,279,149	14,063,613	15,094,738	22,820,820	38,546,532	241.8%
Nonpassive deduction or loss	1,131,998	2,153,915	764,911	3,316,444	1,509,561	33.4%
Net Nonpassive Income	**10,147,151**	**11,909,698**	**14,329,827**	**19,504,376**	**37,036,971**	**265.0%**
Total Net Income	**29,373,432**	**28,933,026**	**30,720,732**	**48,215,228**	**55,968,349**	**90.5%**
Income	*32,295,029*	*34,176,302*	*32,316,675*	*52,996,168*	*61,497,226*	*90.4%*
Loss/Expense	*2,921,597*	*5,243,276*	*1,595,943*	*4,780,940*	*5,528,877*	*89.2%*
Loss/Exp as a % of Income	*9.0%*	*15.3%*	*4.9%*	*9.0%*	*9.0%*	

Nonpassive income from estates and trusts grew much more rapidly, growing from $11.3 million in 2002 to $38.5 million in 2006, registering growth of 242% over this time period. Following growth patterns similar to those for rental and royalty income, and partnerships and S corporations, most of this growth occurred in tax years 2005 and 2006, where growth in nonpassive income was 51% and 69%, respectively.

Nonpassive deductions and losses grew very slowly over the entire time frame increasing from $1.1 million in 2002 to $1.5 million in 2006, a growth rate of 33% over the 5-year period. Growth in nonpassive deductions was very erratic over the 5-year period, with growth being positive in two years, and negative in two other years. The growth patterns for nonpassive income and nonpassive deductions and losses results in growth in *net nonpassive income* of 265% over the period 2002-2006.

Total net income (net passive income plus net nonpassive income) from estates and trusts grew from $29 million in 2002 to $56 million in 2006, which represents growth of 91% over the entire time period. Again, most of this growth was registered in tax years 2005 and 2006.

The bottom portion of Table E-4 shows total income, total losses and expenses, and the portion of total income offset by losses and expenses. Over the 5-year period losses and expenses offset 9.4% of total income from estates and trusts. The portion of total income offset by losses and expenses is 9% in three out of the five years. Losses and expenses offset just over 15% of income in 2003, but only 5% of income in the following year, 2004.

Schedule E - Summary Demographic Findings

Following sections focus on selected demographic findings from the study, including how the distribution of Schedule E income by broad income brackets has changed over time, how the distribution of Schedule E income across filertypes has changed over time, and how the distribution of Schedule E income differs between the “elderly” population and all other households.

Schedule E Income – By Income Bracket

Table E-5 and Table E-6 show the distribution of Schedule E income *across broad income brackets*, by type of income, for tax years 2002 and 2006. Whereas Table E-5 shows the dollar amounts of income, Table E-6 shows the percentage of total Schedule E income by bracket, by income type.

Table E-5

Distribution of Total Schedule E Income
By Income Bracket and Type of Income

Tax Year 2002

Total Household Income Bracket	Rents and Royalty Income	Partnership and S Corp Income	Estates and Trusts Income	Net Farm Rental Income	Total Schedule E Income
$<0	3,116,833	(73,477,408)	22,927	(113,582)	(70,451,230)
$0 - $25,000	25,434,253	(14,336,450)	245,110	7,777,883	19,120,796
$25,000 - $50,000	37,348,048	13,896,984	1,718,711	6,323,667	59,287,410
$50,000 - $100,000	45,064,780	119,189,966	3,339,088	8,860,031	176,453,864
$100,000 - $150,000	36,762,532	92,069,851	3,600,565	3,844,690	136,277,637
$150,000 - $200,000	17,686,353	77,475,367	1,486,663	2,631,822	99,280,205
$200,000 - $300,000	16,130,045	97,391,676	11,368,398	2,132,207	127,022,326
$300,000 - $400,000	8,812,804	63,487,894	3,028,456	1,126,241	76,455,394
$400,000 - $500,000	8,037,803	47,104,387	(127,629)	(398,934)	54,615,628
$500,000+	24,777,325	374,352,781	4,691,144	269,917	404,091,168
Total	**223,170,776**	**797,155,048**	**29,373,432**	**32,453,941**	**1,082,153,198**

Tax Year 2006

Total Household Income Bracket	Rents and Royalty Income	Partnership and S Corp Income	Estates and Trusts Income	Net Farm Rental Income	Total Schedule E Income
$<0	(690,122)	(74,694,470)	609,066	(991,369)	(75,766,895)
$0 - $25,000	13,128,710	(290,568)	1,080,235	6,813,636	20,732,013
$25,000 - $50,000	34,097,754	28,724,716	3,603,729	3,725,064	70,151,263
$50,000 - $100,000	48,806,000	174,952,800	11,176,817	9,095,042	244,030,659
$100,000 - $150,000	47,061,441	156,030,592	8,578,894	6,221,171	217,892,097
$150,000 - $200,000	41,179,245	127,435,696	5,099,735	5,353,270	179,067,947
$200,000 - $300,000	36,939,052	209,424,119	5,463,122	3,918,850	255,745,143
$300,000 - $400,000	28,631,107	110,466,012	2,701,834	2,381,564	144,180,518
$400,000 - $500,000	13,587,999	86,734,307	1,712,149	1,775,182	103,809,636
$500,000+	59,357,963	990,362,383	15,942,768	2,539,941	1,068,203,054
Total	**322,099,149**	**1,809,145,586**	**55,968,348**	**40,832,352**	**2,228,045,435**

In tax year 2002, rents and royalty income was concentrated in households having less than $150,000 in total income, as these households accounted for fully two-thirds of total rents and royalty income. By 2006 the distribution shifted somewhat to higher income households as households with less than $150,000 of income accounted for just 44% of total rents and royalty income.

Partnership and S corporation income is concentrated in higher income households. In 2002 households with income of $500,000 or more accounted for 47% of the total, and in 2006 this percentage increase to almost 55% of the total.

The distribution of income from estates and trusts shows no consistent pattern, with income from this source centered around households with incomes between $200,000 and $300,000 in tax year 2002, and concentrated in households with incomes between $50,000 to $150,000 and households with incomes in excess of $500,000 in tax year 2006.

Table E-6

Share of Total Schedule E Income Distributed Across Income Brackets By Type of Income

Tax Year 2002

Total Household Income Bracket	Rents and Royalty Income	Partnership and S Corp Income	Estates and Trusts Income	Net Farm Rental Income	Total Schedule E Income
$<0	1.4%	-9.2%	0.1%	-0.3%	-6.5%
$0 - $25,000	11.4%	-1.8%	0.8%	24.0%	1.8%
$25,000 - $50,000	16.7%	1.7%	5.9%	19.5%	5.5%
$50,000 - $100,000	20.2%	15.0%	11.4%	27.3%	16.3%
$100,000 - $150,000	16.5%	11.5%	12.3%	11.8%	12.6%
$150,000 - $200,000	7.9%	9.7%	5.1%	8.1%	9.2%
$200,000 - $300,000	7.2%	12.2%	38.7%	6.6%	11.7%
$300,000 - $400,000	3.9%	8.0%	10.3%	3.5%	7.1%
$400,000 - $500,000	3.6%	5.9%	-0.4%	-1.2%	5.0%
$500,000+	11.1%	47.0%	16.0%	0.8%	37.3%
Total	100.0%	100.0%	100.0%	100.0%	100.0%

Tax Year 2006

Total Household Income Bracket	Rents and Royalty Income	Partnership and S Corp Income	Estates and Trusts Income	Net Farm Rental Income	Total Schedule E Income
$<0	-0.2%	-4.1%	1.1%	-2.4%	-3.4%
$0 - $25,000	4.1%	0.0%	1.9%	16.7%	0.9%
$25,000 - $50,000	10.6%	1.6%	6.4%	9.1%	3.1%
$50,000 - $100,000	15.2%	9.7%	20.0%	22.3%	11.0%
$100,000 - $150,000	14.6%	8.6%	15.3%	15.2%	9.8%
$150,000 - $200,000	12.8%	7.0%	9.1%	13.1%	8.0%
$200,000 - $300,000	11.5%	11.6%	9.8%	9.6%	11.5%
$300,000 - $400,000	8.9%	6.1%	4.8%	5.8%	6.5%
$400,000 - $500,000	4.2%	4.8%	3.1%	4.3%	4.7%
$500,000+	18.4%	54.7%	28.5%	6.2%	47.9%
Total	100.0%	100.0%	100.0%	100.0%	100.0%

Net farm rental income appears to be concentrated largely in lower income households. In 2002, households with less than $150,000 of total income accounted for 82% of this income, although by 2006 this percentage decreased to 60%.

Consistent with earlier findings, Tables E-5 and E-6 show that between 2002 and 2006 the distribution of Schedule E income shifted from lower income to higher income households as total Schedule E income more than doubled from $1.082 billion to $2.228 billion over this time period.

Table E-7 shows the distribution of total Schedule E income *across income types*, by income bracket, for tax years 2002 and 2006. Partnership and S corporation income comprised by far the largest share of total Schedule E income in most income brackets in both years. This income source accounted for 74% of total Schedule E income in tax year 2002 and 81% in tax year 2006. Furthermore, in both years, the share of total Schedule E income from this source tends to increase as household incomes increase.

However, in lower income brackets rents and royalties, and net farm income, account for a significant portion of total Schedule E income. For example, in 2002 these two sources of income accounted for 74% of total Schedule E income for households with total income between $25,000 and $50,000; in 2006 these two sources accounted for over 96% of total Schedule E income for households with total positive total income of less than $25,000.

Table E-7

Share of Total Schedule E Income Distributed Across Type of Income By Income Bracket

Tax Year 2002

Total Household Income Bracket	Rents and Royalty Income	Partnership and S Corp Income	Estates and Trusts Income	Net Farm Rental Income	Total Schedule E Income
$<0	-4.4%	104.3%	0.0%	0.2%	100.0%
$0 - $25,000	133.0%	-75.0%	1.3%	40.7%	100.0%
$25,000 - $50,000	63.0%	23.4%	2.9%	10.7%	100.0%
$50,000 - $100,000	25.5%	67.5%	1.9%	5.0%	100.0%
$100,000 - $150,000	27.0%	67.6%	2.6%	2.8%	100.0%
$150,000 - $200,000	17.8%	78.0%	1.5%	2.7%	100.0%
$200,000 - $300,000	12.7%	76.7%	8.9%	1.7%	100.0%
$300,000 - $400,000	11.5%	83.0%	4.0%	1.5%	100.0%
$400,000 - $500,000	14.7%	86.2%	-0.2%	-0.7%	100.0%
$500,000+	6.1%	92.6%	1.2%	0.1%	100.0%
Total	20.6%	73.7%	2.7%	3.0%	100.0%

Tax Year 2006

Total Household Income Bracket	Rents and Royalty Income	Partnership and S Corp Income	Estates and Trusts Income	Net Farm Rental Income	Total Schedule E Income
$<0	0.9%	98.6%	-0.8%	1.3%	100.0%
$0 - $25,000	63.3%	-1.4%	5.2%	32.9%	100.0%
$25,000 - $50,000	48.6%	40.9%	5.1%	5.3%	100.0%
$50,000 - $100,000	20.0%	71.7%	4.6%	3.7%	100.0%
$100,000 - $150,000	21.6%	71.6%	3.9%	2.9%	100.0%
$150,000 - $200,000	23.0%	71.2%	2.8%	3.0%	100.0%
$200,000 - $300,000	14.4%	81.9%	2.1%	1.5%	100.0%
$300,000 - $400,000	19.9%	76.6%	1.9%	1.7%	100.0%
$400,000 - $500,000	13.1%	83.6%	1.6%	1.7%	100.0%
$500,000+	5.6%	92.7%	1.5%	0.2%	100.0%
Total	14.5%	81.2%	2.5%	1.8%	100.0%

Schedule E Income – By Filertype

Tables E-8 and E-9 show the distribution of total Schedule E income *across filertypes,* by income type, for tax years 2002 and 2006. Table E-8 shows dollar distributions whereas Table E-9 shows percentage distributions. Filertypes include single filers, heads of households, married couples who file joint tax returns and married couples who file separate tax returns.

Table E-8

Dollar Distribution of Total Schedule E Income Across Filertypes, by Type of Income

Tax Year 2002

Filertype	Rents and Royalty Income	Partnership and S Corp Income	Estates and Trusts Income	Net Farm Rental Income	Total Schedule E Income
Single	39,382,283	82,859,203	13,145,004	4,375,712	139,762,202
Head of Household	3,649,355	19,390,120	1,018,566	85,692	24,143,734
Married - Joint	32,897,377	253,706,021	1,964,351	6,329,541	294,897,290
Married - Separate	147,241,760	441,199,705	13,245,512	21,662,997	623,349,974
All Households	223,170,776	797,155,049	29,373,433	32,453,941	1,082,153,199

Tax Year 2006

Filertype	Rents and Royalty Income	Partnership and S Corp Income	Estates and Trusts Income	Net Farm Rental Income	Total Schedule E Income
Single	59,194,382	225,723,083	16,249,793	9,128,933	310,296,191
Head of Household	6,892,274	30,655,252	4,321,477	1,672,448	43,541,452
Married - Joint	30,309,068	663,851,011	8,553,634	3,262,046	705,975,759
Married - Separate	225,703,425	888,916,240	26,843,443	26,768,924	1,168,232,033
All Households	322,099,149	1,809,145,587	55,968,348	40,832,351	2,228,045,435

Rent and royalty income is distributed largely to married couples who file separately. This group accounted for 66% of rent and royalty income in 2002, and just over 70% in 2006. But single filers also account for a sizeable amount of this income type.

Nearly all partnership and S corporation income accrues to married couples, with 87% going to married couples in 2002, and 86% in 2006. *Within married couple households*, 63% of partnership and S corporation income went to married couples who file separately in 2002; by 2006 this share had dropped to 57%.

In 2002, single filers and married couples who file separately each accounted for 45% of income reported from estates and trusts. By 2006, single filers accounted for a much smaller share of the total (29%), as the share going to married couples who file jointly increased from 6.7% to 15.3%, and the share going to married couples who file separately increased to 48%.

In both 2002 and 2006, married couples who file separately account for two-thirds of total net farm rental income. However, the share going to single filers increased from 13.5% in 2002 to over 22% in 2006 as the share going to married couples who file jointly decreased from about 20% to just 8% over this time period.

Overall, the distribution of total Schedule E income across filertypes did not shift a lot between 2002 and 2006, with married couples who file separately accounting for over half of this amount in both years.

Table E-9

Percentage Distribution of Total Schedule E Income
Across Filertypes, by Type of Income

Tax Year 2002

Filertype	Rents and Royalty Income	Partnership and S Corp Income	Estates and Trusts Income	Net Farm Rental Income	Total Schedule E Income
Single	17.6%	10.4%	44.8%	13.5%	12.9%
Head of Household	1.6%	2.4%	3.5%	0.3%	2.2%
Married - Joint	14.7%	31.8%	6.7%	19.5%	27.3%
Married - Separate	66.0%	55.3%	45.1%	66.7%	57.6%
All Households	100.0%	100.0%	100.0%	100.0%	100.0%

Tax Year 2006

Filertype	Rents and Royalty Income	Partnership and S Corp Income	Estates and Trusts Income	Net Farm Rental Income	Total Schedule E Income
Single	18.4%	12.5%	29.0%	22.4%	13.9%
Head of Household	2.1%	1.7%	7.7%	4.1%	2.0%
Married - Joint	9.4%	36.7%	15.3%	8.0%	31.7%
Married - Separate	70.1%	49.1%	48.0%	65.6%	52.4%
All Households	100.0%	100.0%	100.0%	100.0%	100.0%

Table E-10 shows the distribution of total Schedule E income *across income types*, by filertype, for tax years 2002 and 2006. Not surprisingly, partnership and S corporation income again comprised by far the largest share of total Schedule E income for all filertypes in both years.

In tax year 2002, single filers received a larger share of Schedule E income in the form of rent/royalty income and estate/trust income (38%) than any other filertype. However, by 2006 the share from these two sources for single filers declined to 24% as the share from partnerships and S corporations increased from 59% in 2002 to 73% in 2006.

Bucking the general trend for all other filertypes, head of household filertypes received a larger share of total Schedule E income in the form of partnership and S corporation income in 2002 (80%) than they did in 2006 (70%).

Married couples who file jointly received nearly all of their Schedule E income in the form of partnership and S corporation income with the share for this income type reaching 94% in tax year 2006.

Married couples who file separately also receive most of their Schedule E income in the form of partnership and S corporation income, but also received between a fifth and a quarter of total Schedule E income in 2002 and 2006, respectively, in the form of rent and royalty income.

Table E-10

Percentage Distribution of Total Schedule E Income
Across Income Type, By Filertype

Tax Year 2002

Filertype	Rents and Royalty Income	Partnership and S Corp Income	Estates and Trusts Income	Net Farm Rental Income	Total Schedule E Income
Single	28.2%	59.3%	9.4%	3.1%	100.0%
Head of Household	15.1%	80.3%	4.2%	0.4%	100.0%
Married - Joint	11.2%	86.0%	0.7%	2.1%	100.0%
Married - Separate	23.6%	70.8%	2.1%	3.5%	100.0%
All Households	20.6%	73.7%	2.7%	3.0%	100.0%

Tax Year 2006

Filertype	Rents and Royalty Income	Partnership and S Corp Income	Estates and Trusts Income	Net Farm Rental Income	Total Schedule E Income
Single	19.1%	72.7%	5.2%	2.9%	100.0%
Head of Household	15.8%	70.4%	9.9%	3.8%	100.0%
Married - Joint	4.3%	94.0%	1.2%	0.5%	100.0%
Married - Separate	19.3%	76.1%	2.3%	2.3%	100.0%
All Households	14.5%	81.2%	2.5%	1.8%	100.0%

Schedule E Income - Elderly Population v. All Other Households

Elderly households, which naturally include a large number of retired persons who no longer rely on wage and salary income, may rely more heavily on other forms of income, including Schedule E income. This section examines some of the differences between “elderly” households and all other households with respect to selected household characteristics.

The Montana individual income tax form includes many indicators of whether a household may have a certain characteristic that could define it as being in the broad category of “elderly” household. For the purposes of this study, an elderly household was one which exhibited one or more of the following characteristics:

- Taxpayers age 65 and older are allowed an *additional personal exemption*. Households where the taxpayer, or either spouse, claimed an additional exemption were included in the elderly group.

- Certain types of income reported on individual income tax returns may indicate an elderly member in the household. Hence, households where either spouse had *IRA income, taxable retirement income, or social security income* were included in the elderly group.

- Certain exclusions from income also indicate and elderly person in the household. Taxpayers age 65 and older are allowed to exclude up to $800 of interest income from taxation ($1,600 if married and filing jointly). In addition, certain taxpayers are allowed to exclude up to $3,600 of retirement income. Households where either spouse took either the elderly interest exclusion, or the retirement income exclusion, where included in the elderly group.

- Finally, if either the taxpayer or the taxpayer's spouse is age 62 or older, and either rent or own their own residence, the household may be entitled to the elderly homeowner renter credit. Households claiming this credit were also included in the elderly group.

Table 11 compares certain characteristics of all "elderly" households with all other households for tax years 2002 and 2006. In both years, elderly households comprised 27-28% of all households.

Table E-11

Total Household Income and Total Schedule E Income
All "Elderly" Households v. All Other Households; Tax Years 2002 and 2006

	Tax Year 2002		Tax Year 2006	
Item of Information	**All "Elderly" Households**	**All Other Households**	**All "Elderly" Households**	**All Other Households**
# of Households	104,567	283,886	116,251	301,034
Share of All Hshlds.	27%	73%	28%	72%
Total Household Income	4,316,731,390	9,831,006,887	6,877,989,261	13,277,540,733
Average Household Income	41,282	34,630	59,165	44,106
Share of Total Household Inc.	31%	69%	34%	66%
Total Schedule E Income	320,803,839	693,789,231	770,063,170	1,174,935,737
Average Schedule E Income	3,068	2,444	6,624	3,903
Share of Total Schedule E Inc.	32%	68%	40%	60%
Schedule E Share of Total Hsld. Inc.	7.4%	7.1%	11.2%	8.8%

In tax year 2002, elderly households accounted for 31% of total household income reported on all full-year resident income tax forms. The average household income of elderly households ($41,282) was 19% higher than the average household income of all other households ($34,630). Elderly households accounted for 32% of all Schedule E income, and had higher average Schedule E income ($3,068) than the average for all other households ($2,444). Schedule E income accounted for a slightly higher share of total household income for elderly households (7.4%) than for all other households (7.1%).

By 2006, these figures had shifted significantly. Elderly households now accounted for 34% of total household income, and the average total household income of elderly households ($59,165) was 34% higher than the average for all other households. Between 2002 and 2006, average household income for elderly households increased 43%, whereas the increase for all other households over this time period was just 27%. Fully 40% of all Schedule E income flowed to elderly households with the average Schedule E income of elderly households ($6,624) being 70% higher than the average for all other households ($3,903). By tax year 2006, Schedule E income comprised 11.2% of total household income in elderly households, but comprised just 8.8% of total household income for all other households.

Clearly, the large increase in reported Schedule E income over the 2002-2006 time period acted to benefit elderly households significantly more than it did all other households.

Table E-12 compares elderly households that have Schedule E income with all other households that have Schedule E income, for tax years 2002 and 2006. Elderly households comprised 42% of all households with Schedule E income in both 2002 and 2006.

Table E-12

Total Household Income and Total Schedule E Income
"Elderly" Households *With Sch. E Inc*. v. Other Households *With Sch. E Inc.*; Tax Years 2002 and 2006

	Tax Year 2002		Tax Year 2006	
Item of Information	**"Elderly" Households**	**All Other Households**	**"Elderly" Households**	**All Other Households**
# of Households	29,125	40,652	31,332	43,588
Share of All Hshlds.	42%	58%	42%	58%
Total Household Income	1,720,177,460	2,965,274,409	3,132,594,151	4,735,978,692
Average Household Income	59,062	72,943	99,981	108,653
Share of Total Household Inc.	37%	63%	40%	60%
Total Schedule E Income	320,803,839	693,789,231	770,063,170	1,174,935,737
Average Schedule E Income	11,015	17,067	24,578	26,955
Share of Total Schedule E Inc.	32%	68%	40%	60%
Schedule E Share of Total Hsld. Inc.	18.6%	23.4%	24.6%	24.8%

In 2002, elderly households accounted for 37% of total household income flowing to all households with Schedule E income, but average household income of elderly households with Schedule E income ($59,062) was 19% *lower* than the average household income of all other households with Schedule E income ($72,943). Elderly households accounted for 32% of all Schedule E income flowing to all households with Schedule E income, but the average Schedule E income of elderly households with Schedule E income ($11,015) was 35% lower than the average Schedule E income of all other households with Schedule E income ($17,067). Schedule E income comprised 18.6% of total household income for elderly households with Schedule E income and 23.4% of total household income for all other households with Schedule E income.

By 2006, 40% of all household income accruing to all households with Schedule E income flowed to elderly households with Schedule E income. Average total household income of elderly households ($99,981) was just 8% lower than that for all other households with Schedule E income ($108,653). By 2006, 40% of all Schedule E income also accrued to elderly households with Schedule E income and the average Schedule E income of elderly households ($24,578) was just 9% lower than that of all other households with Schedule E income ($26,955). Schedule E income comprised almost 25% of total household income for both elderly households with Schedule E income and all other households with Schedule E income.

Again, it appears that of all households with Schedule E income the large increase in total Schedule E income between 2002 and 2006 acted to benefit elderly households with Schedule E incomes significantly more than it did all other households with Schedule E incomes.

Table E-13 shows the distribution of Total Schedule E income, by type of income, for elderly and all other households, for tax years 2002 and 2006.[21] The table shows the total dollar amount and the percentage that the amount represents for both the row total and the column total. For example, for tax year 2002, elderly households received $115,397,446 in rents and royalty income. This represents 30% of the total Schedule E income received by these households (the row share), and 51.7% of the amount received by all households (the column share).

In tax year 2002, partnership and S corporation income comprised the largest share of total Schedule E income for both elderly households (59.4%) and all other households (81.5%), but elderly households relied much more heavily on the other types of Schedule E income. The total dollar amount of income accruing to elderly households from rent and royalty income, estate and trust income, and net farm rental income were all higher than the amounts accruing to all other households. Whereas rent and royalty income comprised 30% of total Schedule E income for elderly households, this income source comprised just 15.4% of total Schedule E income for all other households. The amount of net farm income accruing to elderly households was more than double the amount accruing to all other households.

[21] Whereas the data presented in Tables E-11 and E-12 were derived from actual population data, the information provided in Table E-13 is derived from the sample of Schedule E returns in each year. Hence, the total amounts of Schedule E income in Table E-13 will be different from the total amounts shown in the previous two tables.

Table E-13

Distribution of Schedule E Income, By Type of Income
Elderly Households v. All Other Households; Tax Years 2002 and 2006

Household Type	Rents and Royalty Income	Partnership and S Corp Income	Estates and Trusts Income	Net Farm Rental Income	Total Schedule E Income
Tax Year 2002					
Elderly Households	**115,397,446**	**227,992,755**	**17,782,195**	**22,884,800**	**384,057,196**
- Share of Row Total	30.0%	59.4%	4.6%	6.0%	100.0%
- Share of Column Total	51.7%	28.6%	60.5%	70.5%	35.5%
All Other Households	**107,773,330**	**569,162,294**	**11,591,238**	**9,569,140**	**698,096,002**
- Share of Row Total	15.4%	81.5%	1.7%	1.4%	100.0%
- Share of Column Total	48.3%	71.4%	39.5%	29.5%	64.5%
All Households	**223,170,776**	**797,155,049**	**29,373,433**	**32,453,940**	**1,082,153,198**
- Share of Row Total	20.6%	73.7%	2.7%	3.0%	100.0%
- Share of Column Total	100.0%	100.0%	100.0%	100.0%	100.0%

Household Type	Rents and Royalty Income	Partnership and S Corp Income	Estates and Trusts Income	Net Farm Rental Income	Total Schedule E Income
Tax Year 2006					
Elderly Households	**198,247,693**	**854,510,043**	**38,423,949**	**30,632,210**	**1,121,813,895**
- Share of Row Total	17.7%	76.2%	3.4%	2.7%	100.0%
- Share of Column Total	61.5%	47.2%	68.7%	75.0%	50.3%
All Other Households	**123,851,456**	**954,635,543**	**17,544,399**	**10,200,142**	**1,106,231,540**
- Share of Row Total	11.2%	86.3%	1.6%	0.9%	100.0%
- Share of Column Total	38.5%	52.8%	31.3%	25.0%	49.7%
All Households	**322,099,149**	**1,809,145,586**	**55,968,348**	**40,832,352**	**2,228,045,435**
- Share of Row Total	14.5%	81.2%	2.5%	1.8%	100.0%
- Share of Column Total	100.0%	100.0%	100.0%	100.0%	100.0%

By tax year 2006, partnership and S corporation income had grown significantly more important to elderly households, as this income source now comprised 76.2% of total Schedule E income, compared to 86.3% for all other households. Based on sample estimates, between 2002 and 2006 total Schedule E income accruing to elderly households increased by 192%, fueled by growth in partnership and S corporation income of 275%. For all other households, total Schedule E income grew by 58% as partnership and S corporation income grew by 68%. Elderly households continued to receive a larger dollar amount of income from rent and royalty income, estate and trust income, and net farm rental income than all other households in tax year 2006.[22]

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[22] Clearly, sampling error biases the growth in total Schedule E income between 2002 and 2006 towards elderly households. While the sample estimate for 2006 shows total Schedule E income almost evenly split between elderly and all other households, actual population data from Tables E-11 and E-12 show the split to be 40% to elderly households and 60% to all other households in tax year 2006.