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Capital Gains and Losses

By RUTH A. CLARK, C. P. A.

Since the enactment of the Income Tax law in 1913, the Treasury Department has endeavored to adopt provisions for a fair and equitable tax on Capital Gains and Losses. Special rules have been provided for computing the income from the sale or exchange of a capital asset.

Under the law applicable to the year 1941, capital gains and losses were classified as short-term and long-term. Capital assets held for less than eighteen months are classified as short-term, over eighteen months, as long-term.

Short-term capital gains are taxable in full both by individuals and corporations. Short-term capital losses are deductible only to the extent of short-term capital gains. However, the balance of the loss may be carried over to the succeeding year and may be applied against a net short-term capital gain. The carry-over is limited to one year.

Long-term capital gains are not taxable in full. If held less than twenty-four months, only 66⅔% of the gain is taken into account. If held over twenty-four months, only 50% of the gain is taken into account.

After computing the percentage limitation, the balance is taxable at the same rates as other income with the exception that the maximum tax rate would not be in excess of 30%. Under the 1941 law, this alternate method is not advantageous to the taxpayer unless his net income exceeds $12,000.

In reality, the maximum rate on long-term capital gains held over twenty-four months does not exceed 15% as the 30% top rate is applied against only 50% of the gain.

While short-term capital losses are allowed only to the extent of short-term capital gains, long-term capital losses can be offset against any income after applying the percentage limitations. However, the alternative method applies also to long-term capital losses and provides that such losses cannot reduce the net income by more than 30% of the loss after applying the percentage limitations.

Effective with the year 1940, the capital gains and losses of corporations are subject to the same provisions as individuals except that the percentage limitations on long-term capital gains and losses do not apply to corporations. Beginning with the year 1940, the $2000 limitation on capital losses no longer applies to corporations. An asset may be sold at any time and the entire loss offset against any income.

The necessity of keeping accurate records as to the length of time an asset has been held is important. First, the length of time held decides whether the gain or loss is short-term or long-term. This is important in the case of a corporation for the reason that a long-term capital loss is deductible in full while a short-term capital loss can only be applied against a short-term capital gain. In the case of an individual, in addition to determining whether short-term or long-term, the length of time held determines the percentage to be used in computing the amount subject to tax. The law and regulations provides methods of determining the period for which Capital Assets are held.

In the case of a husband and wife, it may be more advantageous to file joint returns if capital losses are sustained. When husband and wife file a joint return, they are considered as one taxpayer. Short-term capital losses of either can be applied against any short-term capital gains. Long-term capital losses can be offset against any income of either spouse.

In order to take advantage of the capital gains and losses provisions, it is necessary that there be a sale or exchange of a capital asset as set forth in the law. Also the property must be considered a capital asset in accordance with the provisions of the law.

The taxation of Capital Gains and Losses has always been a very controversial subject. Some changes in the method of taxing Capital Gains and Losses are proposed in the 1942 Tax Bill presented to the House by the Ways and Means Committee. However, except for the first few years after the enactment of the Amendment in 1913, the gain on the sale of Capital Assets has been given Preferential Treatment, including the proposed 1942 Act.