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Capital Gains & Losses

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CAPITAL GAINS & LOSSES

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Income taxes are imposed on the largest number of taxpayers and produce the major part of the federal revenue. It is now well recognized that the personal income tax is the most rational and scientific of all our tax instruments. Exemption rates and the definition of income can be adjusted to raise revenue and to achieve a desired burden distribution in accordance with ability to pay. The personal income tax can achieve constructive social and economic objectives better than any other tax. Income taxes thus lend themselves to the fine arts of the lobbyists and are in a continual state of revision.

A principle of the federal income tax is that the taxpayer's income from all sources should be combined and taxed by one overall rate schedule.

Each income tax law from the time of the Civil War to the present time has contained some provision for the taxation of gains from the sale of capital assets, although that term was not used in the statutes before 1921.

After the Civil War the Treasury was low and an income tax was introduced. This first income tax law, that of 1861, was very simple and short. In fact, it did not specify whether the tax was on gross or net income, nor did it enumerate any allowable deductions other than taxes. Before it went into effect, Congress met again and drafted another measure. This law of 1862 is interesting not only because it provided for the first national income tax to be levied in this country, but also because it established the office of Commissioner of Internal Revenue. During the ten years this tax was collected, members of Congress were as puzzled as the present Congress over the taxation of profits from sale of capital assets.

In 1913, forty-two years after the death of the Civil War tax, the 16th Amendment was passed and the income tax law went into effect. From March 1, 1913, to 1916, gain realized by individuals from the sale of capital assets was taxable as ordinary income, that is, at the regular normal and surtax rates. No mention was made of losses except those incurred in trade; hence capital losses were not deductible.

In 1916, the law was relaxed somewhat to allow deductions of such losses, but it restricted those of individuals to the amount of the capital gains. In the Act of 1918, capital gains of individuals were taxable in full and capital losses were deductible in full against income of any kind.

In drafting the Revenue Act of 1921, Congress was impressed not only by complaints of taxpayers to the effect that the war taxes were too high and that they retarded normal business transactions, but also by the argument of the Treasury that the government was not getting so large a yield of revenue as it would if rates were lower. Many of the larger taxpayers held their property instead of selling it at a profit because of the tax, but on the other hand they sold property to take their deductible losses.

The administration adopted the policy of tax reductions after the First World War and Congress radically changed the method of computing the tax on capital gains of individuals.

For the first time the income tax law contained specific provisions for the taxation of gains from the sale of capital assets. If the individual chose, the gain could be segregated from ordinary income and taxed at a special rate of 12½%.

In 1934, Congress adopted a schedule of percentages of gain to be included in income which decreased as the length of time the asset was held increased. This, then, was the forerunner of our present-day taxation of capital gains and losses. There is probably no tax area in which Congress has shown more uncertainty and misgivings than capital gains and losses, and they still present perennial issues of major proportions.

What are the characteristics of capital gains and losses that cause so much trouble?

1. Realized capital gains and losses do not have any set periodicity. They accrue over many years. Therefore when capital gains are realized in a given year, they have a tendency to place the taxpayer in a higher bracket and his gains are taxed at much higher rates than if they had been realized regularly over the years.

2. Capital gains and losses are not regularly recurrent as other forms of income. Substantial capital gains may be realized on very few occasions in a taxpayer's lifetime; yet when they are realized, they are

taxed more heavily than would be the case if they were realized regularly over the years.

3. With most recipients of substantial capital gains, the capital-gain income represents something over and above the basic income and therefore seldom affects the standard of living of the recipient.

4. Capital gains and losses can be taken when most advantageous to the taxpayer.

5. Capital gains have a tendency to be concentrated in the upper income groups.

Now that we know the characteristics of capital gains and losses, let us discuss the source from which the gain or loss is derived. The gain or loss is derived from the sale of a capital asset.

In general, a capital asset is any asset or property held for the further production of wealth or as a source of income. The capital gain arises from the sale of the asset itself at a price higher than that for which it was obtained. However, as applied to capital gains and losses, the sale of assets is unusual and not regularly recurrent. In the case of a company which manufactures and sells shoes, any gain from the sale of shoes is ordinary income because shoes are its stock in trade and the income therefrom is recurring income.

The common types of capital assets are stocks and bonds. The sale of these assets accounts for well over 80% of the capital gains reported in an average year. An investment broker cannot claim capital gains or losses from such sales because stocks and bonds are his business and the source of his recurring income. Other taxpayers who sell stocks or bonds can claim a capital gain or loss because this income is not recurring.

A dealer in realty cannot claim capital gains and losses on the sale of realty because this is his stock in trade or property held primarily for sale to customers in the ordinary course of business. The realty held by the dealer is comparable to the inventory of the shoe manufacturer. A personal residence can be sold and the taxpayer can claim capital gain. Unfortunately, loss from the sale of a personal residence is not an allowable deduction. The tax on capital gains from the sale of a personal residence will be deferred if the taxpayer sells his old house within one year before or after the purchase and use of a newly purchased one. In a case where the taxpayer constructs a new residence, the new house must be occupied within eighteen months after the sale. To the extent that the selling price of the old house exceeds the cost of the newly-purchased one, the taxable gain is taxable immediately.

Property subject to depreciation allowances, used in the taxpayer's trade or business, is excluded from the definition of capital assets but is subject to a special provision in the law which allows such property to be treated as capital assets under certain conditions. This is really a relief provision inasmuch as it allows taxpayers to deduct a net loss from the sale of machinery or other depreciable equipment as an ordinary loss. Net gains from sale of depreciable property are taxable as long-term capital gains if the property is held over six months.

Property eligible for copywrite protection held by a taxpayer whose personal efforts created the asset, such as a radio program, theatrical production, or comic strip, is excluded from the definition of capital assets and the sale of such property is not subject to the capital gain and loss tax treatment.

Accounts receivable are excluded as well as certain Federal, state and municipal obligations issued on or after March 1, 1941.

Profit or loss from the sale of capital assets held for not more than six months is assumed to be speculative and is designated as short-term capital gain or loss. Short-term gains and losses are reported on the capital gain schedule at their full amount—100% of gain or loss. However, short-term losses must be offset against short-term gains.

Profit or loss from the sale of capital assets held for more than six months is assumed to be from investments and is designated as long-term capital gain or loss. Long-term gains and losses are reported on the capital gain schedule at 50% of the gain or loss. Again, the long-term losses may be offset against the gains. The net short-term gains or losses are then combined with the net long-term gains or losses to produce the final net gain or loss.

If there are net long-term capital gains, they cannot be taxed at more than 50% of one-half of the net long-term gain—or in effect, not more than 25% of the full long-term gain. This procedure minimizes the injustice of applying high-bracket rates to gains which have accrued over long periods of time. This tax treatment is also calculated to reduce the tendency of wealthy taxpayers to retain investments which have increased in value.

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18th Annual Joint Meeting of AWSCPA and ASWA
October 8-11, 1958

Place: Statler-Hilton Hotel; Detroit, Michigan

Theme: THE ACCOUNTANT AND HER PROFESSION

Schedule:

Wednesday, October 8.
  Pre-convention tours

Thursday, October 9.
  Morning: Registration; Joint Annual Business Meeting; Workshops.
  Luncheon: Chapter Presidents.
  Afternoon: AWSCPA Annual Business Meeting; Workshops.
  Evening: Anniversary Dinner honoring the Founders of both Societies.

Friday, October 10.
  Morning: ASWA Annual Business Meeting.
  Luncheon: Technical Program.
  Afternoon: ASWA Annual Business Meeting.
  Evening: AWSCPA Annual Dinner; Workshops.

Saturday, October 11.
  Morning: Technical Session.
  Luncheon: AWSCPA Board Meeting; ASWA Board Meeting; Editorial Board The Woman C.P.A.
  Evening: Reception; Banquet.

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The practical result of this treatment of long and short-term capital gains is to increase the tax on gains from property held not more than six months and to reduce the tax on assets held longer than six months.

If there are final net capital losses, they are deductible up to $1,000 per year against "other income". Any balance of capital loss over $1,000 may be carried forward for five years to be deducted from future net capital gains and up to $1,000 per year from future "other income".