How Are My Investments Taxed?

What Type of Account Is It?

The type of account your investments are held in is an important consideration when determining how that investment will be taxed. Certain accounts, such as individual retirement accounts (IRAs), Health Savings Accounts (HSAs), and employer-sponsored retirement accounts (such as 401(k)s), are tax-deferred, meaning no tax is due on the investments within them until funds are withdrawn.

In other accounts, such as a brokerage account, taxes may be owed based on the investment activity that occurs within the account. If the investment activity is potentially taxable, you may consider reviewing the account's activity to determine whether it is taxable for the year.

Ordinary Income: What You Need to Know

Many investments yield *ordinary income*, such as interest or rental income from real estate. Other sources of ordinary income include savings accounts, certificates of deposit (CDs), money market funds, annuities, bonds, and certain types of preferred stock. This type of income is taxed at standard income tax rates, rather than the typically lower capital gains rates.

Within a taxable account, when you receive this kind of income, it generally would be either taxable or tax exempt.

Tax-exempt income refers to income that is not subject to federal, and sometimes state, taxes. Municipal bonds and certain U.S. government securities are common sources of tax-exempt income.

Taxable income comes from investments which do not qualify as tax exempt, such as capital gains, dividends, and interest income. If your investments generate taxable ordinary income, you're required to report it on your federal tax return.

And a quick note on losses: Some investments can result in *ordinary losses* rather than income. These losses can offset ordinary income, helping to reduce your taxable income for the year.

Knowing Your Basis

In general terms, your *basis* is the amount you've invested in a particular asset. To determine your capital gain or loss when you sell or trade that asset, you need to know both your *original basis* and your *adjusted basis*.

Most of the time, your original basis is simply what you paid for the asset. For instance, if you bought 100 shares of stock at $1,000 each, your original basis in that stock would be $100,000. However, if you acquired the asset through a gift, inheritance, or certain types of nontaxable transactions, your basis may be calculated differently.

Over time, your basis can change due to various factors. This is known as your *adjusted basis*. For example, if you purchase a home for $150,000, that amount becomes your original basis. If you later spend $25,000 remodeling the kitchen, the adjusted basis may rise to $175,000.

Adjustments to basis can be increases or decreases, depending on the situation. For more guidance on what affects basis, refer to IRS Publication 551.

Calculating Capital Gains and Losses

When you sell stocks, bonds, or other capital assets, you will realize either a *capital gai*n or a *capital loss*. Your capital gain or loss would be calculated by subtracting your adjusted basis in the asset from the amount you received from the sale.

If you sell an asset for more than your adjusted basis, you'll have a capital gain. For example, if your original basis in a stock was $15,000 and you sell it for $20,000, then your capital gain is $5,000. Instead, if you sell it for less than your adjusted basis, you have a capital loss. Selling the same stock for $10,000 when the adjusted basis is $15,000 would result in a $5,000 capital loss.

Capital gains and losses can be either short term or long term, depending on the *holding period* and how the investment is reported on schedule D of your tax return. The holding period refers to the length of time you've owned the asset. A gain is considered short term if you held the asset for a year or less, and long term if you held it for more than one year.

How are Capital Gains and Losses Taxed?

After reviewing sales that occurred during the year, consider the holding periods and group the transactions based on whether they resulted in gains or losses. You may end up with categories such as long-term capital gains, long-term capital losses, short-term capital gains, and short-term capital losses.

Losses are netted against gains to reduce your taxable amount, after which you determine your overall gain or loss, and whether it is long term or short term. Schedule D of your federal tax return will guide you through this process.

Long-term capital gains and qualified dividends are usually taxed at preferential rates of 0 percent, 15 percent, or 20 percent, depending on your taxable income. However, certain types of gains may be subject to higher tax rates—up to 25 percent or 28 percent.

Calculating the tax on long-term gains and qualified dividends can be complex, as it depends on your net gains and taxable income.

The type of asset sold also affects the tax rate and, possibly, the method used to calculate gains or losses. For example, gains from the sale of antiques are taxed at a maximum rate of 28 percent, regardless of how long they were held.

Key Tax Considerations

- Interest income is generally taxed as ordinary income.
- Selling an asset often results in a capital gain or loss, depending on its purchase and sale prices.
    - Long-term capital gains typically qualify for lower tax rates, while short-term gains are taxed at your ordinary income rate.
- Dividends from money market funds are usually treated as ordinary income, even though they may resemble typical dividends.
- Dividends may be classified as:
    - *Qualified dividends*, which are taxed at long-term capital gains rates.
    - *Non-qualified dividends*, which are taxed at ordinary income rates.

Net-Investment Income Tax

Individuals with higher incomes may be subject to an additional 3.8 percent *net investment income tax*. This tax applies to those with investment income whose modified adjusted gross income (MAGI) exceeds certain thresholds.

The tax is 3.8 percent of the lesser of

- your net investment income, which includes income from interest, dividends, annuities, royalties, rents, capital gains, and passive business income; or

- the amount of your MAGI that exceeds the applicable threshold for the tax year.

Important exceptions to net investment income for this tax include:

- Interest from tax-exempt bonds
- Gains from the sale of personal residence
- Distributions from qualified retirement plans and IRAs

Resource by the CAPTRUST wealth planning team

This material is not individual investment advice. If you have questions or concerns regarding your own individual needs, please contact a CAPTRUST representative for further assistance. This material does not constitute legal, accounting, or tax advice. This material has been prepared solely for informational purposes. Investment advisory services offered by CapFinancial Partners, LLC ("CAPTRUST" or "CAPTRUST Financial Advisors"), an investment advisor registered under The Investment Advisors Act of 1940.

Legal Notice