CAPTRUST

How Are My Investments Taxed?

It's nice to own stocks, bonds, and other investments. Nice, that is, until it's time to fill out your federal income tax return. At that point, you may be left scratching your head. Just how do you report your investments, and how are they taxed?

Do I Define It as Ordinary Income or a Capital Gain?

To determine how an investment will be taxed in any given year, first ask yourself what went on with the investment that year. Did it generate interest income? If so, the income is probably considered ordinary. Did you sell the investment? If so, a capital gain or loss is probably involved. (It's worth noting that an investment can generate both ordinary income and, when later disposed of, capital gain income as well.)

If you receive dividend income, it may be taxed at either ordinary income tax rates or the rates that apply to long-term capital gain income. Dividends paid to an individual shareholder from a domestic corporation or qualified foreign corporation are generally taxed at the same rates that apply to long-term capital gains. But special rules and exclusions apply, and some dividends (such as those from money market mutual funds) continue to be treated as ordinary income.

The distinction between ordinary income and capital gain income is important because different tax rates may apply, and different reporting procedures may be involved. Here are some of the things you need to know.

It's Ordinary Income, But Is It Taxable?

Investments often produce ordinary income, like interest and rent produced from owning a rental property. Savings accounts, certificates of deposit, money market accounts, annuities, bonds, and some preferred stocks can also generate ordinary income. Ordinary income is taxed at ordinary (as opposed to capital gains) tax rates.

But not all ordinary income is taxable—and even if it is taxable, it may not be taxed immediately. If you receive ordinary income, the income can be categorized as taxable, tax-exempt, or tax-deferred.

- **Taxable income.** This is income that's not tax-exempt or tax-deferred. If you receive ordinary taxable income from your investments, you'll report it on your federal income tax return. In some cases, you may have to detail your investments and income on Schedule B.
- **Tax-exempt income.** This is income that's free from federal and state income tax, depending on the type of investment and the state of issue. Municipal bonds and U.S. government-issued securities are typical examples.
- **Tax-deferred income.** This is income for which taxation is postponed until some point in the future. For example, with a traditional 401(k) retirement plan or individual retirement account (IRA), earnings are reinvested and taxed only when you take money out. Therefore, the income earned in the 401(k) plan or IRA is considered tax-deferred.

A quick word about ordinary losses: It's possible for an investment to generate an ordinary loss, rather than ordinary income. These losses reduce ordinary income.

What Is Basis?

To understand what happens when you sell an investment vehicle, you also need to understand one key term: basis.

Generally speaking, *basis* refers to the amount of your investment in an asset. To calculate the capital gain or loss when you sell or exchange an asset, you must know how to determine both your initial basis and your adjusted basis in the asset.

Usually, your initial basis equals your cost—what you paid for the asset. For example, if you purchased 10 shares of stock for $1,000 each, your initial basis in the stock is $10,000. However, your initial basis can differ from the cost if you did not purchase an asset but received it as a gift, as an inheritance, or in a tax-free exchange.

Your initial basis in an asset can increase or decrease over time. This is your adjusted basis. For example, if you buy a house for $100,000, your initial basis in the house will be $100,000. If you later improve your home by installing a $5,000 deck, your adjusted basis in the house may be $105,000. To learn more about which items increase or decrease the basis of an asset, see IRS Publication 551 for details.

How Do I Calculate Capital Gain or Loss?

If you sell stocks, bonds, or other capital assets, you'll end up with a capital gain or loss. Special capital gains tax rates may apply and may be lower than ordinary income tax rates. Basically, capital gain or loss equals the amount that you realize on the sale of your asset (i.e., the amount of cash or the value of any property you receive) minus your adjusted basis in the asset.

If you sell an asset for more than its adjusted basis, you'll have a capital gain. Returning to the earlier example, assume you had an initial basis in stock of $10,000. If you sell those stocks for $15,000, your capital gain will be $5,000. The opposite is true as well. If you sell an asset for less than your adjusted basis in the asset, you'll have a capital loss. That means if you sell those same stocks for $8,000—with its adjusted basis of $10,000—your capital loss will be $2,000.

Schedule D of your income tax return is where you'll calculate your short-term and long-term capital gains and losses and figure out the tax due, if any. In order to compute your tax on capital gains for the year, the gain will be compared to your overall tax, if there were no special rates. See IRS Publication 544 for details.

In plain language, here are the three key terms you'll need to know to fill out Schedule D correctly:

- **Holding period.** Generally, the holding period refers to how long you owned an asset. A capital gain is classified as short term if the asset was held for a year or less, and long term if the asset was held for more than one year. The tax rates applied to long-term capital gains are generally lower than those applied to short-term capital gains. Short-term capital gains are taxed at the same rate as your ordinary income.
- **Taxable income.** Long-term capital gains and qualified dividends are generally taxed at special capital gains tax rates of 0 percent, 15 percent, or 20 percent, depending on your taxable income. (Some types of capital gains may be taxed as high as 25 or 28 percent.) The actual process of calculating tax on long-term capital gains and qualified dividends is complicated and depends on the amount of your net capital gains and qualified dividends and your taxable income.
- **Type of asset.** The type of asset that you sell will dictate the capital gain rate that applies and, possibly, the steps that you should take to calculate the capital gain or loss. For instance, the sale of an antique is taxed at the maximum tax rate of 28 percent even if you owned the item for more than 12 months.

Can I Use Capital Losses to Reduce My Tax Liability?

The short answer is yes. You can use capital losses from one investment to reduce your tax liability on capital gains from other investments. You can also use a capital loss against up to $3,000 of ordinary income this year ($1,500 for married people filing separately). Any losses not used this year can be used later to offset future capital gains. Schedule D of your federal income tax return can lead you through this process.

The Medicare Contribution Tax on Unearned Income May Apply

One last thing to note: High-income individuals may be subject to a 3.8 percent Medicare contribution tax on unearned income. This tax, which first took effect in 2013, also applies to estates and trusts, although slightly different rules apply.

The tax is equal to 3.8 percent of the lesser of your net investment income, including net income from interest, dividends, annuities, royalties and rents, and capital gains, as well as income from a business that is considered a passive activity, or the amount of your modified adjusted gross income that exceeds $200,000 for individuals, $250,000 if married filing a joint federal income tax return, or $125,000 if married filing a separate return.

The best way to think of it is this: If your adjusted gross income exceeds the dollar thresholds listed above, you are subject to the additional 3.8 percent tax. It's also worth mentioning that interest on tax-exempt bonds is not considered net investment income for purposes of this additional tax. Qualified retirement plan and IRA distributions are also not considered investment income.

Ask for Help When Things Get Complicated

Remember that every person's tax situation is unique, and the sales of some assets are more difficult to calculate and report than others. IRS publications may help you correctly calculate your capital gains or losses, but when you need it, don't hesitate to ask for help from an accountant or tax professional.

Source: Broadridge Investor Communication Solutions, Inc.