Do I Have to Pay Taxes on Investment Income?

By: Exchange Capital Management

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Investing is a powerful tool that can enable you to build wealth and reach your goals. However, there are tax implications that come with this pursuit. If you find yourself questioning whether your investments will be taxed, the simple answer is yes. Although how you will be taxed depends on the type of investments held in your portfolio.

What Are the Different Types of Investment Income?

It's important to note that we are speaking about the tax implications for taxable accounts, such as brokerage or savings accounts, and not tax-advantaged accounts, like a Roth or Traditional IRA. These account types follow different tax rules.

To understand the tax implications that come with taxable accounts, we must first define the different types of investment income:

> **Capital Gains (or Losses):** When you sell an investment, you will have either a capital gain or a capital loss. A capital gain occurs when you sell an investment for more than you paid. Conversely, a capital loss happens when you sell an investment for less than you paid. For example, if you buy a stock for $100 and sell it for $150, you have a capital gain of $50.
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> There are two types of capital gains (and losses): short-term and long-term. Short-term capital gains occur when an investment is held for a year or less before it is sold. Long-term capital gains occur when investments held for over a year are sold.

Interest: Interest is investment income paid by debt that you lend to a borrower, such as bonds and money you deposit into a savings account.

Dividends: Dividends are a portion of a company's profits that are distributed to its shareholders. Companies issue dividends as a way to share their financial success with their investors. If you own stock in a company, you may be paid dividend income. There are two types of dividends an investment may pay:

> **Qualified Dividends:** Qualified dividends are a type of dividend subject to capital gains tax rate. For a dividend to be considered qualified, it must meet certain requirements by the IRS. Specifically, the dividend must be paid by a U.S. corporation or a qualified foreign corporation, and the investor must hold the stock for a specified length of time. Common stock must be held for at least 60 days while preferred stock must be held for 90 days to qualify.
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> **Ordinary Dividends:** If a dividend does not meet the requirements to be a qualified dividend, it is considered an ordinary dividend. While qualified dividends are granted the more favorable capital gains tax rate, ordinary dividends will be subject to ordinary income tax.

How Will My Investment Income Be Taxed?

Investment income can be taxed in one of two ways:

Ordinary Income Tax: Ordinary income includes investment income, such as interest, ordinary dividends, and short-term capital gains. The rates range from 10% to 37% depending on your annual income that tax year.

Long-term Capital Gains Tax: Long-term capital gains (assets held for over a year) and qualified dividends are subject to this tax. Long-term capital gains tax is currently considered more favorable than ordinary income since there are only three brackets: 0%, 15%, and 20%.

More Taxes to Consider

Depending on where you live, you may have an extra layer of tax implications to consider. Some states may enact a state-level income tax rate which can range from 0% to a whopping 13%. Before making investment decisions, understand how your location can impact your overall tax bill.

When you think about how much money you make a year, it’s common to focus on your salary and overlook portfolio income. But it’s important to remember that all investment income counts towards your Adjusted Gross Income (AGI) for that tax year.

An increase in income regardless of where it comes from has the potential to raise, or trigger, other tax rates. For instance, Net Investment Income Tax (NIIT) is a 3.8% tax that applies to single filers earning over $200,000 and married couples filing jointly earning over $250,000. You could also be subject to Alternative Minimum Tax (AMT) depending on your annual income and individual circumstances. Note that increased income may impact financial planning strategies, such as eligibility for Roth contributions and the value of a Roth conversion.

Remember to take a holistic view when dealing with investments. Keep an eye on how your portfolio and investment income will affect the entirety of your taxes and financial planning strategies.

The Bottom Line

Seeing your money grow can be exciting, but it's equally important to understand how your investment income will impact your overall tax liability. By having a complete and thorough understanding of the tax implications that come with investing, you can ensure that you're making the most out of your investments.