How Does Income Tax Work?

By: Exchange Capital Management

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Taxes have been at the forefront of the American psyche since well before we ever thought to claim independence from the British. While we are all familiar with the idea of taxes, especially when they are pulled from our paychecks, we often overlook the intricacies of the tax code. Although the concept of income tax is generally easy to understand, the details of what is considered taxable income and the rate it is taxed can be complex and often misunderstood.

What Income Is Taxable?

Before we look at how income is taxed, it's vital to understand what income is taxable. In general, all forms of income are considered taxable, except for those that are specifically exempted by the tax code, such as alimony payments, child support, and inheritances. For income that is taxable, there are two main tax rates: ordinary income and capital gains.

> **Ordinary Income Tax:** This tax includes earned income (wages, salary, and bonuses), retirement account withdrawals, ordinary dividends, interest payments, and short-term capital gains (profits on the sale of investments held for a year or less).
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> **Capital Gains Tax:** This tax includes long-term capital gains (investments held for more than a year) and qualified dividends.

Note that all income, no matter the source, is factored into your Adjusted Gross Income (AGI) for that tax year.

What Are The 2023 Federal Ordinary Income Tax Brackets?

There are seven federal ordinary income tax brackets. Which bracket you will be subject to is contingent on your filing status and your combined ordinary income for that year. Keep in mind that your combined ordinary income does NOT include long-term capital gains and qualified dividends.

2023 FEDERAL ORDINARY INCOME TAX RATES

Tax Rate	Single	Married, Filing Jointly	Head of Household
10%	$0 to $11,000	$0 to $22,000	$0 to $15,700
12%	$11,000 to $44,725	$22,000 to $89,450	$15,700 to $59,850
22%	$44,725 to $95,375	$89,450 to $190,750	$59,850 to $95,350
24%	$95,375 to $182,100	$190,750 to $364,200	$95,350 to $182,100
32%	$182,100 to $231,250	$364,200 to $462,500	$182,100 to $231,250
35%	$231,250 to $578,125	$462,500 to $693,750	$231,250 to $578,100
37%	$578,125 or more	$693,750 or more	$578,100 or more

There is a common misconception that whichever tax bracket you fall under is how all your income will be taxed. However, America has a progressive tax system. This means that as you earn more money, your tax rate increases, but only for the portion of your income that falls within each bracket.

For example, imagine you are a single filer with a $60,000 salary and no other income who is taking the standard deduction of $13,850 in 2023. Considering the deduction, you will have $46,150 of taxable income for 2023. Under the progressive tax system, the first $11,000 you earn will be taxed at a rate of 10%; the next $33,725 will be taxed at 12%; then the final amount of $1,425 will be taxed at 22%.

Most people focus on their marginal tax rate, which is the highest rate that any of their income will be taxed. While your marginal rate provides a glimpse into your tax liability, it doesn't give you the full picture. Instead, consider your effective tax rate. This rate takes into account all your income and the applicable taxes. This is your average tax rate, expressed as a percentage of your total income. To calculate your effective tax rate, add up all the taxes you owe and divide that number by your total income.

In our example of a single filer with a $60,000 salary taking the standard deduction of $13,850, the federal ordinary income tax equates to $5,460.50. Here's the math that got us there:

Step One: $11,000 x .10 = $1,100

Step Two: $33,725 x .12 = $4,047

Step Three: $1,425 x .22 = $313.50

Step Four: Add up the total tax bill ($1,100 + $4,047 + $313.50 = $5,460.50)

By dividing the total tax bill by their annual income with the deduction accounted for ($46,150), you will find the effective rate of 11.8%. The effective rate will provide a clear picture of how your overall income will be taxed, rather than simply looking at the highest marginal rate at which you will be taxed.

What Are The 2023 Federal Long-term Capital Gains Tax Brackets?

We've looked at how ordinary income is taxed, but what about capital gains? While short-term capital gains are taxed as ordinary income, long-term capital gains will be taxed more favorably. Unlike your ordinary income tax bracket, your capital gains tax bracket is determined by your total taxable income in a given year.

2023 LONG-TERM CAPITAL GAINS TAX RATES

Tax Rate	Single	Married, Filing Jointly	Head of Household
0%	$0 to $44,625	$0 to $89,250	$0 to $59,750
15%	$44,626 to $492,300	$89,251 to $553,850	$59,751 to $523,050
20%	$492,301 or more	$553,851 or more	$523,051 or more

Your total taxable income includes both ordinary and capital gains income. Imagine your ordinary income as your base, and your long-term capital gains and qualified dividends will be stacked on top to find your applicable tax rate. Using the example above, a single filer with

$46,150 of ordinary taxable income (deduction already included) and $10,000 of capital gain income would sit squarely in the 15% capital gains tax bracket.

In another example, a married couple filing jointly with $85,000 of ordinary income and $40,000 of capital gains would teeter between the 0% and 15% tax bracket. Here's how the taxes will play out:

> **Find the amount of taxable income:** Assume the couple takes the standard deduction for their ordinary income, which is $27,700 in 2023 for a married couple filing jointly.
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> Once you subtract the total amount of ordinary income ($85,000) by the standard deduction ($27,700), you'll find they have $57,300 of taxable ordinary income. This puts their base for capital gains tax at 0%.
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> **Add capital gains income to ordinary income:** Next, you need to stack their $40,000 of capital gains on top of their ordinary income, which pushes some of their capital gains into the 15% bracket.
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> **Figure out how the capital gains will be progressively taxed:** Since their income combined teeters between two brackets, some capital gains will be taxed at 0%, and the rest at 15%.
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> Since you have $40,000 of capital gains, $31,951 will fall into the 0% bracket and the remaining $8,049 will be taxed at 15%.

Is There State Income Tax?

State income tax is also applied to the same sources of income as your federal taxes. The rules and rates for state income tax vary, with some simplifying their tax with a flat rate and some not imposing an income tax at all.

Many states, such as Ohio, New York, and Virginia, use a tax structure similar to that of the federal government. This means a progressive tax system that increases as an individual's income increases. However, these brackets and rates differ significantly from those at the federal level. Since the stipulations on state income tax vary greatly, you should research your state's tax brackets and rates to have a thorough understanding of how income tax works as a whole.

The Bottom Line

Most income will be taxed. While there is no magic solution to avoid taxes, you should take advantage of tax planning opportunities to ensure you aren't subjecting yourself to unnecessary taxes. By understanding how the tax system works, you can navigate your finances and minimize your tax burden.