Federal Taxation of Common Investments

When it comes to deciding where and how to invest[1] money, there are a number of issues that an individual should consider. A clearly defined investment goal, the need for liquidity, an investor's risk tolerance, and the general economic outlook are just a few of the points to think about.

An additional and significant concern is how an investment - and any income derived from it - will be taxed, particularly at the federal level,[2] both now and when the investment is sold or disposed of.

3.8% Tax on Net Investment Income

Certain individuals, estates, and trusts may be subject to the 3.8% surtax on "Net Investment Income" (NII). This surtax is in addition to any other federal tax, including the Alternative Minimum Tax (AMT) or the 0.9% Additional Hospital Insurance Tax.

For individuals, the tax applies to the *lesser* of (1) net investment income, or (2) the excess of modified adjusted gross income (MAGI)[3] over a specified "threshold" amount, which varies with taxpayer filing status:

Taxpayer Filing Status	Threshold Amount
Married Filing Jointly, Surviving Spouse	$250,000
Married Filing Separately	$125,000
Single, Head of Household	$200,000

For estates and trusts, the 3.8% tax applies to the *lesser* of (1) undistributed net income, or (2) the excess of adjusted gross income (AGI) over the dollar amount at which the highest income tax bracket begins. For 2025, the highest income tax bracket applicable to an estate or trust begins at $15,650; for 2024 it was $15,200.

"Net" investment income = investment income - allowable investment expenses

[1] Investing involves risk, including the possible loss of principal.
[2] The discussion here concerns federal income tax law. State or local law may vary widely.
[3] For these purposes, MAGI is a taxpayer's regular adjusted gross income (AGI) increased by certain exclusions for foreign earned income. For most taxpayers, MAGI and AGI will be the same. The threshold amounts are not subject to adjustment for inflation.

In general, *investment income* includes interest and dividends, non-qualified annuities, royalties, amounts received for the use of patents, rent (tangible property), passive activity income, net gain from the disposition of property, and a number of other, more esoteric types of income.

Investment income does *not* include items such as income from a business in which the taxpayer is an active participant, Social Security or Veteran's benefits, alimony, tax-exempt (municipal bond) interest, distributions from certain qualified retirement plans, and Alaska Permanent Fund dividends.

Investment expenses include investment interest expense, advisory and brokerage fees[1], expenses related to rental and royalty income, and state and local income taxes allocable to items included in investment income.

Capital Gains

Federal income tax law distinguishes between "earned income" (wages or self-employment income) and income from the profitable sale of "capital" assets. Earned income is termed "ordinary" income and is taxable at marginal rates up to 37.0%. Gain from the sale of capital assets is called "capital" gain and is treated for federal income tax purposes more favorably than ordinary income. A taxpayer is generally not required to include the gain or loss realized from the sale of an asset on his or her income tax return until the asset is actually sold or otherwise disposed of.

- **Capital asset:** The Internal Revenue Code (IRC) defines the term "capital asset" in a negative sense by first declaring that all assets are capital assets and then listing certain exceptions. Assets such as stocks, bonds, and other securities held by individuals are capital assets. In broad, general terms, all assets held for investment purposes are "capital" assets.

- **Holding period:** The length of time an asset is owned, beginning the day after it is acquired and ending the day it is disposed of. The amount of time an asset is held

[1] Under the provisions of the Tax Cuts and Jobs Act of 2017 (JCTA), for tax years 2018-2025, neither investment interest expense nor advisory and brokerage fees are deductible expenses. Thus, they are also not deductible for the purpose of the 3.8% tax on Net Investment Income.

affects the tax treatment of any gain or loss when the asset is sold. *Short-term* assets are those held 12 months or less. *Long-term* assets are generally those held more than 12 months.

- **Adjusted basis:** *Basis* is the dollar amount of your investment in property, usually what you paid for it.[1] Basis is used to measure gain or loss when you sell or dispose of an investment. For assets such as stock or bonds, basis is *increased* by costs such as commissions or transfer and recording fees. Basis may also be *decreased* by non-taxable stock dividends, stock splits, or non-dividend distributions. *Adjusted basis* is the term used to describe an asset's basis after any adjustments.

- **Amount realized:** When an asset is sold, the value in money or other property received, less any sales expenses such as commissions or other fees.

Capital gain/loss formula: Amount realized – adjusted basis = gain (or loss)

At the end of a tax year, an individual's short-term (ST) gains are combined with ST losses to determine a net ST gain or loss position for the year.[2] Separately, long-term (LT) gains are combined with LT losses to determine a net LT gain or loss for the year.[2] Finally, the net ST result is combined with the net LT result, to determine an individual's overall capital gain or loss for the year.

Example 1: Sally has the following gains and losses at the end of her tax year:
$4,100 ST capital loss and a $100 ST capital gain = $4,000 ST capital loss.
$1,500 LT capital loss and a $1,000 LT capital gain = $500 LT capital loss.

Sally's net result for the year is a $4,500 capital loss. She can use this loss to offset up to $3,000 of ordinary income from other sources.[3] The remaining $1,500 ST loss is carried forward to future tax years. If a taxpayer dies with un-used capital losses, these losses expire with the taxpayer.

[1] Special rules apply to the basis of property acquired as a gift, inheritance, or in other types of transactions.
[2] These calculations also include any ST or LT losses carried over from earlier years.
[3] The offset is limited to $1,500 if Sally is using the Married Filing Separately filing status.

Example 2: Assume Roger has the following gains and losses at the end of his tax year:
$200 ST capital loss and a $10,000 ST capital gain = $9,800 ST capital gain.
$1,000 LT capital loss and a $2,200 LT capital gain = $1,200 LT capital gain.

Roger's net capital gain for the year is $11,000. This amount is included in his income on his form 1040.

The following table summarizes the capital gains rates under current federal income tax law:

Item	2024 Breakpoints	2025 Breakpoints	Capital Gains Rate
Tier I	Taxable income less than: Single: $47,025; HoH: $63,000; MFJ: $94,050; MFS: $47,025.	Taxable income less than: Single: $48,350; HoH: $64,750; MFJ: $96,700; MFS: $48,350.	0%
Tier II	Taxable income less than: Single: $518,900; HoH: $551,350; MFJ: $583,750; MFS: $291,850.	Taxable income less than: Single: $533,400; HoH: $566,700; MFJ: $600,050; MFS: $300,000.	15%
Tier III	Taxable income equal to or more than: Single: $518,900; HoH: $551,350; MFJ: $583,750; MFS: $291,850.	Taxable income equal to or more than: Single: $533,400; HoH: $566,700; MFJ: $600,050; MFS: $300,000.	20%
Real estate depreciation treated as capital gain[1]	N/A	N/A	25%
Sale of Collectibles	N/A	N/A	28%

Wash Sales

If an individual sells an investment at a loss, and within the 61-day period beginning 30 days before and ending 30 days after the sale date, acquires "substantially identical" stock or securities, a "wash sale" is created. In this situation the federal income tax code denies a deduction for the loss. The law is intended to discourage "tax-loss harvesting," (to artificially offset gains or other income) without a substantial change in the individual's economic position.

[1] Gain in excess of recaptured depreciation is taxed at the taxpayers's regular capital gains rate.

If the wash sale rules are violated, any loss is *disallowed*. Instead, the law requires the investor to add the amount of the loss to the basis of the substantially identical securities. Further, the holding period of the investment sold at a loss is added to the holding period of the replacement stock or securities.

Interest Income

- **Savings accounts:** Savings and other interest-bearing accounts generate interest income. The income is typically fully taxable at the federal and state or local level as ordinary income.
- **Money market mutual funds:** Although the income from a money market mutual fund is termed a "dividend," the income is treated as "interest" income and is taxed at all levels as ordinary income.
- **Municipal bonds:** These are debt instruments issued by states, counties, cities, and local government authorities such as a school or water district. With a few exceptions, interest income from municipal bonds is exempt from federal income tax.[1] Generally, municipal bond interest is also exempt from state and local income tax *if* the bond holder resides in the same jurisdiction where the bond was issued.[2]
- **"Private activity" municipal bonds:** Private activity municipal bonds are bonds which serve mixed public and private purposes. Unless such bonds meet certain requirements, the interest income from them is *not* exempt from federal income tax. State and local taxability can vary. In some instances, interest income from private activity bonds is a preference item for the individual alternative minimum tax.[3]
- **Corporate bonds:** Interest from corporate bonds is generally taxable as ordinary income at all levels.

[1] Tax-exempt municipal bond income may increase the *taxable* portion of an individual's Social Security benefits.

[2] For example, assume a resident of California owns a municipal bond issued in New York. Interest income from this bond would be exempt from federal income tax, but taxable to the state of California. If the California resident owned a municipal bond issued in California, the interest income would generally be exempt from both federal and California state income tax.

[3] Prior to purchase, an investor should verify the taxability of interest income from these securities.

- **U.S. government bonds:** The U.S. government issues a wide range of debt securities, backed by the "full faith and credit" of the federal government. Interest income from these U.S. government bonds is taxable to the federal government, but not taxable for state or local income taxes.

- **Other "government" securities:** There are a number of debt securities which are commonly regarded as being "federal government" bonds, but which are not backed by the "full faith and credit" of the U.S. government. Examples would include securities issued by the Government National Mortgage Association (GNMA) or the Federal National Mortgage Association (FNMA). Interest income from these securities is taxable at the federal level and may, or may not, be exempt from state or local income tax.[1]

- **Original Issue Discount (OID):** OID exists when a bond is first issued at a price that is *less* than its stated redemption price at maturity. The amount of OID is the difference between the issue price and the stated redemption price at maturity. OID is a form of interest which is generally included in income as it accrues over the life of the debt instrument, whether or not any payments are received from the issuer.

- **Bonds purchased at a discount:** If a bond is purchased at a *discount* (generally, less than face value at maturity), this market discount is considered interest income. A taxpayer can choose to recognize the market discount over the period owned, and include it in current income, or, at maturity or when the bond is disposed of, any gain is considered interest income up to the amount of the market discount.

- **Bonds purchased at a premium:** If a bond is purchased at a *premium*, (generally, for more than face value at maturity), the premium paid is part of the basis in the bond. If a bond yields <u>taxable</u> income, the owner can *choose* to amortize the premium[2] over the remaining life of the bond or recover the premium paid when the bond is sold or redeemed. If a bond yields <u>tax-exempt</u> income, the owner *must* reduce the basis in the bond by amortizing the premium over the remaining bond life. Generally, any amortized bond premium reduces the amount of interest (taxable or tax-exempt) reportable on Form 1040.

[1] Prior to purchase, an investor should verify the taxability of interest income from these securities.

[2] Each year the basis of the bond is reduced, with taxable interest income being reduced by an equal amount.

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Dividends

The term "dividend" generally refers to distributions of money, stock, or other property paid by a corporation. Typically, dividends are paid to shareholders out of the earnings and profits of a corporation.

- **Ordinary dividends:** Ordinary dividends are taxable as ordinary income, at marginal tax rates up to 37.0%.[1] Mutual fund distributions of short-term capital gains are treated as ordinary dividends.

- **"Qualified" dividends:** Qualified dividends are dividends that meet certain requirements of the IRC. Generally, qualified dividends are dividends received from either a domestic corporation or a "qualified" foreign corporation. Additionally, the owner of the stock paying the dividend must meet certain length of ownership requirements. Unlike ordinary dividends, qualified dividends are taxed at the same preferential tax rates applicable to net capital gains.[2]

- **Dividend reinvestment plans:** Some corporations and mutual funds allow an investor to choose to buy more shares of the same stock or mutual fund, rather than taking the dividend in cash. You must generally report the dividends as ordinary income, fully taxable at the federal and state or local level.

- **Capital gain distributions:** Mutual funds, other regulated investment companies, and real estate investment trusts (REITs) may pay (or credit to your account) capital gain distributions. Capital gain distributions are taxed as long-term gains, regardless of how long you have owned the shares of the mutual fund, regulated investment company, or REIT.

- **Undistributed capital gains:** Some mutual funds and REITS keep their long-term capital gains and pay tax on them. Shareholders must include these gains on their personal income tax returns, even though they did not actually receive a distribution. A taxpayer can claim a credit (or a refund) of any tax paid.

[1] Ordinary dividends are subject to the 3.8% Net Investment Income Tax.

[2] Qualified dividends are <u>not</u> subject to the 3.8% Net Investment Income Tax.

- **Non-dividend distributions:** A "non-dividend" distribution is a distribution that is *not* paid out of the earnings or profits of a corporation. A non-dividend distribution (also known as a "return of capital") is not taxed, but rather reduces your basis in the stock you own. When the basis of your stock has been reduced to zero, any additional non-dividend distributions are reported as capital gain, either long-term or short-term, depending on how long the stock has been owned.

- **Stock dividends and stock rights:** Distributions by a corporation of its own stock are known as stock "dividends." Stock "rights" are distributions by a corporation of the right to acquire the corporation's stock. In most cases, stock dividends and stock rights are not taxable and are not reported on an investor's income tax return. The per-share basis of all shares owned is reduced by dividing the prior basis by the new number of shares owned. If a distribution of stock or stock rights is currently taxable, the basis in the stock or stock rights received is their fair market value when received.

Passive Activities

A number of different types of investments are classified under federal income tax law as "passive" activities. Generally speaking, passive activities are those in which the investor does not materially participate on a regular, continuous, and substantial basis. For example, a limited partner in a partnership would be considered to be a "passive" investor.

Federal income tax law mandates that losses from passive activities cannot be used to offset or reduce "earned" income, such as wages or self-employment income, nor can they be used to offset or reduce "portfolio" income such as dividends or interest. Losses from passive activities can *only* be used to offset income from other passive activities.

Passive losses in excess of passive income are not "lost." Rather, any unused passive losses are "suspended" and are carried to future tax years until they are either used to offset passive income, or until the year the investor completely disposes of his or her interest in the passive activity.

Foreign Tax Credit

If an investor paid or accrued taxes to a foreign country on foreign source income (such as interest or dividends) and is also subject to U.S. tax on the same income, he or she may be able to take a credit for the foreign tax paid. The foreign tax credit is intended to relieve an investor of what is effectively a double tax burden when the foreign source income is taxed by both the U.S. and the foreign country.

As an alternative, a taxpayer can choose to deduct the foreign taxes paid or accrued on foreign source income as an itemized deduction on Schedule A, subject to certain dollar limitations.

Seek Professional Guidance

The foregoing is a brief, high-level overview of some of the federal income tax laws applicable to commonly encountered investments. The advice and guidance of trained, experienced investment and tax professionals is strongly recommended.