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FINANCIAL GROUP, L.L.C.
Registered Investment Advisor

INVESTMENT TAXATION 101

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In 1789 founding father Benjamin Franklin famously wrote, “in this world nothing can be said to be certain, except death and taxes”. Taxation today is one of the most, if not the most, pertinent topic in politics, business, and personal finance. However, most people lack the slightest understanding of how taxes work, how to minimize one’s tax liability, and how to plan their personal finances to promote the most equitable future. Nevertheless, a basic understanding of simple tax policy can save an individual thousands of dollars and could improve an individual's standard of living.

ORDINARY INCOME

Whether you are an NBA all-star or a construction worker you are likely earning some sort of income. What many people fail to recognize how, ever is that there is a plethora of different income streams. Of course, there are basic earnings, which includes wages. This income stream is considered ordinary income and is taxed based on tax brackets.

For example, the first $9,700 is taxed at 10%. The next $29,775 is taxed at 12% and so on*. Your income and tax bracket have a direct relationship, as your income goes up so does your tax bracket.

There are many types of income that are taxed as ordinary income. Some of these include ordinary interest, short term capital gains, and social security benefits (if taxable). Additionally, distributions from IRAs and other retirement accounts are typically taxed as ordinary income.

**2019 IRS 1040 Instructions Page 6*

INTEREST INCOME

Interest is the charge for the privilege of lending money. In general, interest income is taxed as ordinary income, meaning it is taxed according to the same tax bracket rates as income earned via salary and wages. This includes interest earned on your bank account or bonds and CDs.

There are a few types of interest income that actually are excludable or exempt from federal taxation. This means that you do not have to pay taxes on these sources of income. The most common example is municipal bond interest income. If you purchase a municipal bond from the state or local municipality that you reside in, the interest you earn is triple tax free. This means that the interest is exempt from federal, state, and local taxes.

DIVIDEND INCOME

A dividend is a distribution of property that a corporation gives to its stockholders (owners). Most dividends are cash dividends, but a corporation could also distribute stock or other types of property. It is important to note that not all distributions of property are considered dividends. Some distributions are considered a "return of capital", which is when a corporation returns to a shareholder part or all of that shareholder's investment in the corporation.

For tax purposes, there are two types of dividends: qualified and non-qualified dividends. Non-qualified dividends are taxed as ordinary income just like interest and salaries. Qualified dividends are taxed based on capital gain tax rates, which are MUCH more optimal for taxpayers. Taxpayers either pay 0%, 15%, or 20% depending on their taxable income*.

To be considered a qualified dividend, three criteria must be met. First, the dividend must have been paid by a US company or a qualified foreign company. Second, the dividend cannot be listed as non-qualifying by Internal Revenue Service (IRS). Third, the stockholder receiving the dividend must have held the stock for the required dividend holding period**.

**2019 IRS Topic 409 Capital Gains and Losses*
***2019 IRS Publication 550 Page 19*

CAPITAL GAINS

Capital gains are recognized only on the sale and exchange of capital assets, which is most property owned and used for investment purposes. The most classic example of a capital asset is corporate stock. When your asset gains value, the gain is not immediately taxed because you have not realized the gain. However, once you sell the asset, the gain becomes taxable and depending on how long you have held the gain determines what rate is used to tax the asset.

Short-Term Capital Gains: are any realized gain that you have made on an asset you owned for less than a year and are taxed as ordinary income.

Long-Term Capital Gains: result from gains on assets held for over one year and are taxed at preferential rates (like qualified dividends).

On the Schedule D tax payers may net their short-term and long- term capital gains and losses. First, short term losses are netted against short- term gains, producing a net short- term gain or loss. The same is then done for long term gains and losses. Finally, the net short- term and net long- term gain or loss is netted creating a net capital gain or loss. If there is a net capital loss, you can deduct up to $3,000 of that loss against ordinary income during that current year. Any remaining loss is carried forward for future years.

Tax harvesting is the practice of offsetting capital gains with capital losses incurred though out the year, effectively minimizing the tax owed.

WARNING! WASH SALE RULE

When one incurs a capital loss, he or she can net this loss with his or her capital gains to decrease taxable income. A wash sale happens when a security is sold for a loss and that security or a substantially similar security is purchased within 30 days of the sale (both before and after the sale). Therefore, if someone sold a security for a loss and bought the security within 30 days of the sale, the day of the sale, or 30 days after the sale, the loss is disallowed and cannot be deducted. The purpose of the wash sale rule is to prevent the creation of artificial losses. As long as you wait 30 days to purchase back the security, the loss can be taken.

COVERED SECURITIES

Covered securities were defined recently to standardize security regulations and filings within the United States. Covered securities include stock bought after January 1st, 2011 and subsequently sold, mutual funds bought after January 1st, 2012 and subsequently sold, less complex bonds bought after January 1st, 2014 and a few other types of securities with various dates associated.

The notable element of covered securities is that the broker dealer must report the adjusted cost basis when the securities are sold. This is in addition to the taxpayer reporting the adjusted cost basis when filing his or her tax return.

This rule is beneficial when transferring a covered security from one broker dealer to another because the new broker deal is able to clearly determine the cost basis the security was purchased for originally.

NON-COVERED SECURITIES

For non-covered shares, which are the any of the above-mentioned securities purchased before the associated date, the broker does not have to report the adjusted cost basis to the IRS, and it is the responsibility of the taxpayer to supply it.

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