Novice Tax Module

Taxable Investment Income

As you increase your tax knowledge, it's important to understand that not all investment income is treated the same way by the IRS. Different types of income have different tax rules.

Interest income is considered ordinary income and is taxed at your regular income tax rate. Sources can include savings accounts, bonds, and certificates of deposits (CDs). For example, if you're in the 22% tax bracket and you earn $100 in interest, you'll owe $22 in taxes on that amount.

Capital gains, which occur when you sell an investment for more than you paid, can be either short-term or long-term. If you hold the asset for one year or less before selling, your profit is a short-term gain and taxed as ordinary income. If you hold it for more than one year, it becomes a long-term gain and is taxed at a lower, preferential rate. These rates can either be 0%, 15%, or 20% depending on your taxable income.

Example) You bought a stock for $1,000 and sold it for $1,400. If you held it for 10 months, the $400 profit is short-term and would be taxed at your regular rate. If you held it for 14 months, it would qualify as a long-term gain and likely be taxed at 15% or even 0%, depending on your taxable income.

For further information on interest, the following link to the IRS Topic no. 403 goes into more detail. [https://www.irs.gov/taxtopics/tc403]

Selling Strategies

When you buy the same investment multiple times, each purchase is considered a different tax lot. A tax lot is created each time you buy shares of a security. When you later sell part of your investment, the price you originally paid for the shares (the cost basis) determines how much gain or loss you have.

The IRS generally assumes you sell your oldest shares first. This situation is referred to as FIFO: first-in, first-out. As in, the first security you bought will be the first one you sell. However, you can choose another method to potentially reduce your tax bill. This strategy becomes more useful as your portfolio grows and your investing decisions become more complex.

Example) Suppose you buy 10 shares of a stock at $50 and another 10 shares later at $70. If you then sell 10 shares when the price is $90, you can choose whether to sell the lower-cost $50 shares or the higher-cost $70 shares. Selling the $70 shares would result in a smaller taxable gain ($200 vs. $400), lowering your taxes.

Qualified Dividends vs. Ordinary Dividends

Some companies reward shareholders by paying dividends, either in cash or additional shares. However, not all dividends are taxed the same way. Qualified dividends are taxed at the lower capital gains rates (0%, 15%, or 20%), while ordinary dividends are taxed at your regular income rate. You will receive this dividend information each year on a Form 1099-DIV, which will tell you exactly how much of your dividends were considered qualified.

The holding criteria that must be met for dividends to be considered qualified are:

1. The company must be a U.S. corporation or a qualifying foreign company

2. You must hold the stock for more than 60 days during the 121-day period surrounding the ex-dividend date (the date by which you must own the stock to get the dividend)

Example) If you bought a dividend-paying stock and sold it just two weeks later, the dividend you received would likely be ordinary and taxed at a higher rate. However, if you held that stock for a few months or longer, the dividend would likely be qualified, meaning you'd pay less tax on it.

Tax-Advantaged Accounts

Tax-advantaged accounts are designed to help you save and invest more efficiently by reducing the taxes you pay. The most common of these are Traditional IRAs, Roth IRAs, and 401(k)s.

With a Traditional IRA or 401(k), you can often deduct your contributions from your taxable income, reducing your tax liability today. However, when you withdraw money in retirement, it's taxed as ordinary income. With a Roth IRA, you contribute after-tax dollars, but your money grows tax-free and withdrawals in retirement are also tax-free. However, you must follow certain rules or you may have to pay a penalty. These accounts also have contribution limits and rules about when you can withdraw funds, but they are useful tools for long-term wealth building.

Additionally, a 529 Plan is a tax-advantaged investment account that helps to pay for educational expenses. Any growth of the money invested is generally income tax-free as long as the money is used for qualified expenses, such as tuition and supplies.

Example) You invested $5,000 into a Roth IRA that will grow to $25,000 by retirement age. You do not get a tax break today, but you won't owe any tax on those gains once you reach retirement. In contrast, if you used a regular brokerage account, you'd likely owe capital gains taxes on that growth.

Capital Losses

Not all investments result in a gain. Sometimes, you may sell an asset for less than you paid, resulting in a capital loss. These losses can be used to offset capital gains, reducing your overall tax liability. For example, if you made $3,000 in profits on one stock but lost $1,000 on another, you'd only owe taxes on the net $2,000 gain. If your capital losses exceed your capital gains, you can deduct up to $3,000 of those losses from your regular income. Any leftover losses can be carried forward indefinitely, reducing your tax liability in future years.

However, if you sell an investment at a loss and repurchase the same (or substantially identical) security within 30 days, the IRS will disallow this loss. This means you can't use the intial loss to lower your tax bill that year. This rule is called the Wash Sale Rule.

Example) You sell shares of a stock at a $2,000 loss on October 1 and buy it back on October 15. This would be considered a wash sale because it was repurchased within the 30-day time period. Therefore, the $2,000 loss can't be claimed on your taxes to offset any capital gains.

Tax Filing

The following table describes some useful tax forms beyond those that are most commonly used.

Additional Tax Forms	
Form 5498	Info about transactions in IRAs
Form 5498 - ESA	Info about contributions to ESAs
Form 1099 - OID	Reports taxable interest income from certain debt instruments
Schedule K - 1	Details income share for partnerships or S corporations
Schedule B	File if taxable interest exceeds $1,500
Form 1099 - Q	Reports distributions from 529 plan or ESA

Tax Guidance

As your investing knowledge and profits grow, your taxes may become more complex. While many people file taxes on their own, there are situations where working with a tax professional may save you money and frustration.

Some situations where you might want to consult an expert are when:

- You have multiple investment accounts across different platforms
- You invest in options, real estate, or cryptocurrencies
- You receive dividends from international stocks
- You're unsure how to report tax-loss harvesting or complex trades

Sources of tax help can come from online preparation services, free volunteer programs, the IRS itself, CPAs, and tax attorneys.

Videos
Watch a video recap

Articles
The following articles elaborate above topics further and may be of interest to you:
Wash Sale Rule, Charles Schwab
Roth IRA vs. Traditional IRA, Charles Schwab