How different types of investment income are taxed

Learn how interest income, capital gains, dividends and retirement income are treated at filing time.

The federal tax system is not exactly straightforward. There are myriad deductions and credits, various tax brackets, additional payroll and Medicare surtaxes, and a slew of different categories to help us define our income … for tax purposes.

You'd think there'd be only two: regular income and investment income. Regular income would be what you get in your paycheck, and investment income would be the money you earn from investments. But even something as seemingly simple as investment income has subcategories, each taxed differently from the next. Let's break it down.

Interest income

There are certificates of deposit and high-yield savings accounts (rare these days), and bonds. Interest income becomes part of your regular income and is generally taxed at your marginal rate during the year in which you receive it, even if it's reinvested. This is what gets reported on your 1099-INT forms.

Capital gains

When you sell a security, any positive difference between what you paid and what you earned is called a capital gain. If you bought 1,000 shares for example, at $14 each and sold them for $20,000, you'd have a $6,000 gain that would be subject to taxes. For most people, securities held over a year (long-term capital gains) will either incur a 0%, 15% or 20% tax. Short-term capital gains are taxed at your ordinary income tax rate.

Dividends

Dividend income is derived from equities that pay shareholders dividends on a regular basis. Qualified dividends are treated at the same preferred rates as long-term capital gains.

Retirement income

Withdrawals from traditional IRAs, 401(k)s or annuities and pension income are typically taxable, while withdrawals from Roth IRAs or employer-sponsored plans funded with after-tax contributions are not taxable. But some subcategories are trickier. If you make more than $25,000, or $32,000 if married filing jointly, up to 85% of your Social Security benefits will be taxed. Income from an immediate annuity is taxed if the annuity was purchased with money that has never been taxed, say in an IRA. Interest income from municipal bonds is generally exempt from federal taxes, but it could still be subject to state or local income taxes, alternative minimum tax, or partial taxation of the income in certain instances.

These examples are merely guidelines. It's important to remember that taxes aren't the only thing to consider. Your personal tax and financial advisors can help you select appropriate income-generating securities for your needs and determine your exact tax liability.

Next steps

As you plan for what taxes you'll pay on your investments, start by:

- Understanding the different types of income
- Considering your entire investment portfolio
- Asking your advisor about the tax liability for each of your investments

Raymond James does not provide tax services. Please discuss these matters with the appropriate professional.