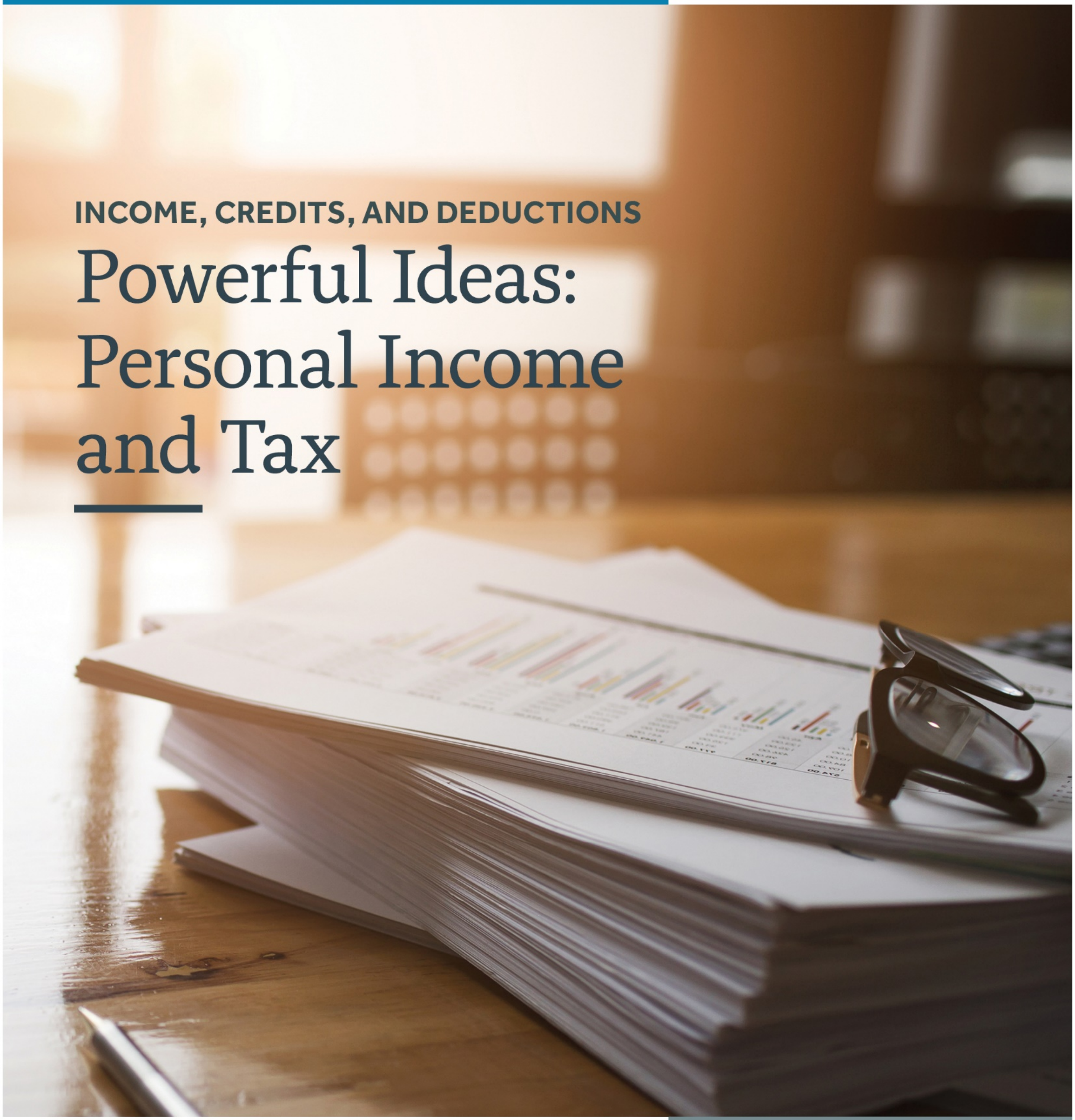
Navigating
Income Tax

INCOME, CREDITS, AND DEDUCTIONS

Powerful Ideas: Personal Income and Tax



Personal Income and Tax

Income taxation – in general

Income tax is imposed on net taxable income (gross income minus deductions, adjustments, and credits) and is imposed on individuals, corporations, estates, and trusts by the federal, most state, and some local governments. Federal tax rates for ordinary income in 2024 range from 10% to 37%. The rate of tax at the federal level is graduated; that is, the tax rates on higher amounts of income are higher than on lower amounts. In addition, federal tax rates on long-term capital gains and qualified dividends are 0% up to 23.8%, depending on taxable income.

What is income?

Section 61 of the Internal Revenue Code (IRC) defines gross income as all income from whatever source derived. Because IRC §61 essentially defines income as income, the Supreme Court in *Commissioner v. Glenshaw Glass Co.* was asked to clarify what income is for tax purposes. In doing so, the court defined income as "instances of [1] undeniable accessions to wealth, [2] clearly realized, and [3] over which the taxpayers have complete dominion."

Once the amount of income has been determined, how income is taxed is dependent on the basis of the "accession to wealth." Is the income from wages? Is it from the sale of property? Is it income from a business? Is it a dividend? The answers to these questions can help determine whether the income is taxed at ordinary or capital gains rates.

How is ordinary income taxed?

Ordinary income is generally defined as income other than capital gains (defined below) and can consist of wages, salaries, tips, commissions, bonuses and other types of compensation from employment as well as interest, some dividend distributions, and net business income from a sole proprietorship, partnership, or S corporation. Ordinary income can be offset by ordinary losses and up to $3,000 of capital losses per year with any remaining capital losses being carried forward to subsequent years.

What are capital gains?

Capital gains income is taxed at rates that differ from ordinary income tax rates. Capital gains income is income from the sale of a capital asset. Capital assets are defined in IRC §1221 as property held by a taxpayer, not including the following:

- Inventory,
- Copyrights or literary, musical, or artistic compositions created by the taxpayer,
- Accounts or notes receivable,
- Derivatives held by a derivatives trader,
- Hedging transactions, or
- Supplies used in the taxpayer's business.

How are capital gains taxed?

The taxation of income from the sale of a capital asset depends on whether the asset has been held for more or less than one year. Long-term capital gains rates apply to income from the sale of a capital asset held for more than one year. Long-term capital gains rates are taxed at either 0%, 15%, or 20%, depending on the taxpayer's total taxable income. Short-term capital gains rates apply to income from the sale of a capital asset held for less than one year. Short-term capital gains are taxed at ordinary income tax rates.

When there are long-term and short-term capital gains and losses in any one tax year, the long-term and short-term capital gains or losses are netted against each other to determine if there is a net long-term or short-term capital gain or loss in that year. In other words, long-term capital gains and long-term capital losses are added together, and short-term capital gains and short-term capital losses are added together. Once short and long-term capital gains have been added together, they are then netted against each other to determine how much gain and how it will be taxed.

If the result is a long-term capital gain, the income will be taxed at rates of 0%, 15%, or 20%, depending on the taxpayer's total taxable income for the year. If the result is a short-term capital gain, the income will be taxed at ordinary income tax rates. Lastly, if the result is a net capital loss (regardless of whether it is short or long-term), $3,000 of losses can be used to offset ordinary income while any remaining losses are carried forward to the following tax year. The losses carried forward can offset long or short-term capital gains or up to $3,000 of ordinary income in future years.

How do I determine which capital gains rate applies?

As noted above, the long-term capital gains rate is determined by the taxpayer's total taxable income amount. If a married couple filing jointly has total taxable income of less than $94,050 ($47,025 for single filers) in 2024, long-term capital gains will be taxed at a 0% rate. If a married couple filing jointly has income in excess of $583,750 ($518,900 for single filers) in 2024, long-term capital gains will be taxed at 20%.

Note that only the long-term capital gains in excess of $583,750 (or $518,900 for single filers) will be taxed at 20%, while any capital gains under these amounts will be taxed at 15%. For example, if a married couple, filing jointly, has $600,000 of taxable income, $100,000 of which is long-term capital gains, the first $83,750 of long-term capital gains will be taxed at 15%, with the remaining $16,250 being taxed at 20%.

In addition, the net investment income tax may apply to certain capital gains transactions.

What is the net investment income tax?

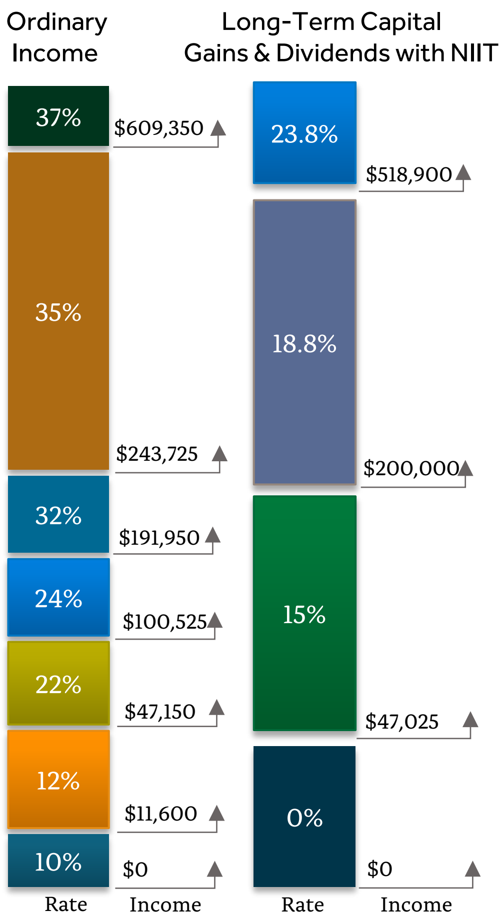
The net investment income tax (NIIT) is a tax imposed on investment income, which includes, but is not limited to:

- Interest,
- Dividends,
- Capital gains,
- Rental and royalty income,
- Non-qualified annuities,
- Income from businesses involved in trading of financial instruments or commodities, and
- Businesses that are passive activities to the taxpayer (within the meaning of IRC §469).

A 3.8% NIIT applies to the above types of income for individuals with adjusted gross income over $250,000 if married filing jointly, $200,000 for single or head of household filers, and $125,000 for married filing separately.

Below are the tax rates for 2024, including ordinary income, capital gains, and NIIT.

Single Taxpayer Rates



Married Filing Jointly Rates