How to Pay Taxes on Investment Income

Calculating taxes on investments involves downloading tax forms from your broker and grasping various investment tax rates.

By Coryanne Hicks
Edited by Stephanie Steinberg

Feb. 9, 2024, at 4:09 p.m.

GETTY IMAGES

Did you sell investments for a profit last year? You may be facing a tax bill.

Key Takeaways

- To determine if you have a capital gain, take your sales price and subtract the original purchase price. The resulting gain is counted as income for tax purposes. If you held the asset for more than one year, you pay a preferential long-term capital gains tax rate of 0% to 20%, as opposed to the short-term capital gains tax rate of 0% to 37%.
- Investors can download investment income forms from their brokerage firm: IRS form 1099-B for capital gains, 1099-DIV for dividend income, and 1099-INT for interest income.
- Investors who need time to pay the full amount of their tax liability can apply for a monthly installment plan using IRS Form 9465.

If you sold investments for a profit in 2023, you could be facing a tax bill unless you sold other investments at a loss to offset that profit. In either case, just how much of your investment income is taxable and how it will be taxed can be a challenge to figure out.

Understanding Investment Income and Capital Gains Taxes

To determine if you have a capital gain, take your sales price and subtract the original purchase price. The resulting gain is counted as income for tax purposes, says David Blain, CEO of New Bern, North Carolina-based BlueSky Wealth Advisors.

Capital gains are classified as either long term or short term. Short-term capital gains are taxed at your ordinary income tax rate. You incur a long-term capital gain when you sell an investment that you have owned for more than one year at a profit. This is an advantage since long-term capital gains are taxed at more favorable rates than short-term capital gains.

In 2023, long-term capital gains rates range from 0% to 20%, based on your taxable income. Most people can expect to pay 15%. However, these rates may change when some provisions of the Tax Cuts and Jobs Act sunset on Dec. 31, 2025.

You can offset your long-term capital gains by selling other investments at a loss through tax-loss harvesting. An individual taxpayer can deduct up to $3,000 of capital losses in excess of capital gains against ordinary income each year. The remainder is carried forward to offset next year's gains.

The interest generated from certificates of deposit, money market funds and bonds is also taxed as ordinary income. The ordinary marginal income tax rate can run as high as 37%.

"Don't forget state taxes, since each state has its own tax laws," Blain says. "Some have capital gains tax, and some tax it as ordinary income."

Some stocks make distributions through dividends, and investors who sold those equities will pay tax on the dividend income received while they had ownership. "Interest income is taxed at your ordinary income tax bracket, ranging from 12% up to 37% federal tax," Blain says.

And once again, don't forget state taxes, he adds: "Some states tax interest income up to 13.3%."

Investors can download investment income forms from their brokerage firm. IRS form 1099-B is used by firms to report capital gains or losses. IRS Form 1099-DIV is used to report dividend income and capital gains distributions. IRS Form 1099-INT is for reporting interest income. Some brokers issue a Composite 1099 form that includes all three of these.

While brokers are required to supply these forms to investors so they can report different types of investment income, investors report this income using Schedule D, also known as Form 1040.

Withdrawals From Tax-Deferred Accounts Can Be Taxed

Tax-deferred accounts, such as 401(k)s; individual retirement accounts, known as IRAs; and health savings accounts, or HSAs, are known for their tax benefits since earnings don't incur taxes each year, but these accounts aren't tax-free forever.

"When you take money out, you pay ordinary income tax on the amount of money you withdraw from the account," Blain says. You don't have to take any money out of retirement accounts until you are 72 years of age (or 73 if you turned 72 after Dec. 31, 2022). And thanks to the Secure Act 2.0, the required minimum distribution, or RMD, age will increase to age 75 in 2033.

An exception to these RMDs is the Roth IRA. "Roth IRA distributions are tax-free, and there is no required date to take any money out," he says. This is because Roth IRAs are funded with after-tax dollars.

In other words, the IRS has already taken its cut, so it lets you keep everything else in your own pocket if you follow its rules. These rules are as follows:

- Roth IRA contributions can be withdrawn tax- and penalty-free at any age.
- Roth IRA earnings can be withdrawn without tax or penalty after age 59 ½, as long as the account is at least five years old.

Roth IRAs aren't the only way to generate tax-free income. Other examples of tax-exempt income are municipal bond interest, which is usually exempt from federal taxes and may also be exempt from state and local taxes if you live in the state that issues the bond. Interest earned on U.S. Treasury securities is the reverse of this: It's generally exempt from state taxes, but not federal taxes.

Prepare for Mutual Fund Distributions

Capital gains taxes can become particularly onerous when dealing with mutual funds. When mutual fund managers sell assets within the fund at a gain, that gain is passed onto investors in the fund and considered income by the IRS. These distributions are reported to you on Form 1099-DIV at the end of each calendar year.

"The mutual fund manager has discretion on when to buy and sell securities within the fund, and you as the investor are responsible for any associated capital gains," says Michael Berkhahn, a certified financial planner and vice president with Graham Capital Wealth Management. This lack of control on the investor's part and fact that these distributions may not come until December, make planning for mutual fund taxes challenging.

"The fluctuating capital gains each year adds an element of unpredictability to an investor's annual tax planning, which can be particularly frustrating," Berkhahn says. "This is why for higher income earners, it becomes imperative for investors to weigh these tax ramifications carefully before deciding on if mutual funds should be a part of their investment strategy."

Understand Federal Tax Consequences

It's good practice to set aside some money each month if you frequently buy and sell stocks, so you can avoid some of the sticker shock from the federal tax consequences.

"Most people are not great savers," says Steve Wittenberg, director of legacy planning at SEI. "It takes discipline to set aside money on a consistent basis for any purpose, especially taxes. The tax bill can become daunting when it comes to investing and making significant nonwage income."

He says many wealth advisors will work with clients to earmark assets in a low-risk or liquid account in anticipation of larger tax bills. "This way, cash will be on hand when the IRS comes knocking," he says.

Investors can adopt a few techniques to prepare and estimate how much to attempt to save. Some use the prior year's tax return as a guide, especially if the investment income is expected to be consistent, Wittenberg says.

"If your tax situation is more complex and particularly inconsistent, it is highly recommended that a tax preparer provide one or more tax projections to calculate the amount of tax that may be due," Wittenberg says.

Many investors need to file quarterly payments to pay their taxes on time and avoid underpayment penalties, he says.

Experts say if the amount due is less than $50,000, a taxpayer should file IRS Form 9465 or apply online for an installment agreement.

Ultimately, the driving force on investment decisions should be the stock, and not the tax, Blain says. "I've seen people refuse to sell something because they didn't want to pay the tax, or alternatively, trade too often and lose a good percentage of their gains to taxation."