Investment tax—it's complicated

Oftentimes when folks seek retirement planning guidance from me, their initial questions center around investment advice. I try to help them understand that in order to have a secure retirement plan, there are three critical areas that must be addressed: tax planning, income planning and investment planning. In order to appropriately strategize in all three areas, a general understanding of each is imperative.

Today, I want to discuss the taxation of investments. I consider this to be such an important part of retirement planning that when I teach courses and educated people, I dedicate an entire section to tax planning.

It is important to understand that investments are either tax-exempt or possibly subject to two types of tax, ordinary income tax and capital gains tax. Furthermore, there are two types of capital gains: long-term and short-term. It is important to understand the difference between the two because they are taxed differently.

Let me explain how investments can be subject to ordinary income tax. Many sources of income, in addition to wages and salary, are taxed as ordinary income. A good example is interest income. Investment vehicles such as savings accounts, CDs, money markets, bonds, annuities and, in some cases, preferred stock, provide interest income that is taxed as ordinary income.

Ordinary income is taxed as ordinary income tax rates and can range from 0 percent for lower income folks all the way up to 39.6 percent for higher income individuals. (High income and high net worth folks may also be subject to a 3.8 percent net investment income tax, and a 0.9 percent additional Medicare tax, both often referred to as Obamacare taxes, which first took effect in 2013.)

Capital gains, on the other hand, are generally recognized and therefore taxed when an investment is sold. If an investment that is sold has appreciated in value since its purchase, that increase, the capital gain, will be taxed as either a short-term capital gain or a long-term capital gain.

A short-term capital gains tax is incurred when any investment is sold within a year of its purchase, while a long-term capital gains tax is incurred when an investment is sold after holding it for more than a year. The time during which an investment is owned is called the "holding" period.

It is important to differentiate between short-term capital gains and long-term capital gains because short-term capital gains will generally be taxed as ordinary income tax rates, while long-term capital gains will either be tax-free, or taxed at more favorable rates of 15 percent to 20 percent, depending upon an individual's ordinary income tax rate.

We have talked a lot about capital gains, but what if we have a capital loss? Capital losses can offset capital gains. Capital losses from one investment can reduce the capital gains from other investments. A capital loss can also offset up to $3,000 of ordinary income this year ($1,500 for married persons filing separately).

Furthermore, capital losses not used this year can offset future capital gains. Schedule D of your federal income tax return is also used to identify capital losses that can be offset with capital gains.

In addition to understanding that investment income can be taxed as ordinary income or capital gains, it is important to understand that an investment account can be tax-deferred, tax-exempt or taxable. A tax-exempt investment account can include a Roth IRA or a 529 College Savings Plan. Both vehicles allow tax-free growth, meaning that both the income earned and the capital gains recognized are free from tax.

Some examples of tax-deferred investment vehicles include 401(k) plans and IRAs. In essence, any tax consequences from either ordinary income (remember, interest income is treated as ordinary income) or capital gains are "deferred" until some point in the future, in most cases, when it is withdrawn from either the 401(k) or IRA.

One last note: It is important to understand that capital losses cannot be used to offset capital gains in a tax-deferred vehicle, such as an IRA. So when evaluating an investment plan, ask why any type of asset that could lose value would be included in a tax-deferred vehicle since you cannot offset losses against gains.

Folks, make sure you seek advice that encompasses all aspects of retirement planning because it is not always what you make, but what you keep.

***About the author:** Scott Moore is the founder of Moore's Wealth Management and has decades of experience in finance and investment banking.*