Shavano LIVING

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The Earl FAMILY

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YOUR THREE TYPES OF TAXED INCOME

Taxes are fickle. One classification misunderstanding and the IRS could blindside you with a tax or tax rate you weren't expecting. Small business owners are especially vulnerable since their personal and business assets can be uncomfortably intertwined. The key to tax savings is in understanding three main types of taxed income and how the money you make (or lose) should be classified.

Earned Income

The income you actively make by working for yourself or someone else is called earned income. Wages, salaries, tips, and self-employment net earnings make up the bulk of this category.

Earned income is subject to two types of taxes: employment taxes and ordinary income taxes. Employment taxes include Social Security and Medicare taxes as well as any applicable workers' compensation fees. Ordinary income taxes include both federal and state income taxes, although some states like Texas don't levy an income tax.

It's the ordinary income that's subject to the much-debated marginal tax brackets. These tax brackets determine how much federal income tax you need to pay at certain levels of your income. For the 2019 tax year, the marginal tax brackets range from 10% up to 37%. Once you reach a certain income threshold with your ordinary income, you can face an additional Medicare tax, an Alternative Minimum Tax (AMT), and other tax expenses.

Other forms of income that originate or are tied to earned income are subject to marginal income tax rates as well, including union strike benefits, some long-term disability benefits, pensions, 401(k) and traditional IRA distributions, and even alimony.

Investment Income

Also called portfolio income, investment income is made by selling an investment for more than what was paid. Most stocks, bonds, mutual funds, and some real estate fall into this category.

If an investment asset is held for one year or longer before it's sold, it will be classified as a long-term capital gain for tax purposes. That's an important point because most long-term capital gains are taxed at a 15% rate or less. High-income taxpayers may pay 20% plus Net Investment Income Tax (NIIT), but that's still lower than what they'd pay if it were classified as ordinary income. Capital gains from selling unrecaptured section 1250 real property or collectibles like coins or art are also taxed at higher rates.

Passive Income

The IRS defines this area as any rental activity or any business in which the taxpayer does not materially participate. Examples can include equipment leasing, rental real estate, and limited partnerships. Dividend income received from Real Estate Investment Trusts (REITs) may also qualify, as might income from selling intellectual property like books authored by the taxpayer, but those areas are very murky.

Income generated in this way is usually taxed at ordinary income rates, which means it's subject to the marginal tax brackets and related tax rules.

Special Considerations for Business Owners

Business owners are often hit with each of these three taxes. How you classify your business—whether it's a corporation or pass-through entity, for instance—plays a significant role in how you'll be taxed on business income and investments. It also plays a role in how you take advantage of business deductions and losses.

Many business owners don't have difficulties until they face a year of extremes: big gains, huge losses, or the sale of their business. It's at those points—usually when it's too late—when clarity kicks in. Any tax changes or changes to your business can poke holes in a previously watertight plan as well, so plan ahead and reevaluate often.

Steven Bankler, a resident of Shavano Park, has more than 42 years of experience in the accounting industry. Steven's expertise lies in consulting, planning, tax, and asset protection as well as exit strategy services for closely-held businesses. He also provides litigation support (both as a testifying expert witness and a consulting expert), business negotiations and estate planning. Visit www.bankler.com for additional tax strategy tips and to learn more about Steven Bankler, CPA, Ltd.

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