# Know the difference between ordinary income and capital gains for taxes

People often hear certain terms such as “capital gain” or “ordinary income,” especially in relation to the U.S. tax code.

Just what do these terms refer to? Here is some basic information on what these mean.

Income is taxed as either ordinary income or as capital gains. Each category has a different tax rate associated with it. The first step to determining the tax is to classify the income. A review of the expenses associated with the income is also helpful.

Ordinary income, which often includes salary, bonuses, commissions or pensions, is what is typically thought of as income when the term is discussed. In the world of stocks and bonds, ordinary income generally refers to interest and certain dividends.

Capital gains are also generated by the sale of investment assets. There are two types of capital gains: short and long term. Which type an asset produces depends on how long the asset has been held. Short-term gains are associated with assets that have been held for one year or less. Long-term capital gains are associated with assets held for more than one year. Longterm gains receive more favorable tax treatment.

Short-term capital gains, on the other hand, are included in the ordinary income category and are generally taxed a less favorable tax rate.

The capital gain is the amount of profit you earn from the disposition of a capital asset. In its basic sense, it is the difference between the selling price and the purchase price.

Often, tax law will specify the way the purchase price is arrived at, and there could be adjustments to the original purchase price. Different rules may apply to assets that were gifted or inherited.

Be aware that certain dividends will be classified as long-term capital gain income. These are called qualified dividends.

They qualify for long-term capital gain treatment.

Qualified dividends are paid from domestic corporations and some foreign corporations. The Form 1099, which provides the dividend amounts for tax purposes, will let you know how much of the dividends you have received are qualified.

Once you decide which type of income and the amount generated, you will need to review the tax rates that apply. The rate depends on your tax filing status and earnings for the year.

Every investment has certain expenses attached to it. Common stock may have commissions, fees, or other charges. These costs are added to the cost basis of the shares. They will be reflected in the amounts you purchase or sell an asset for.

Some people purchase assets on margin by borrowing money against the assets they have in a portfolio at a brokerage house. The interest paid on the margin loan has the potential to yield a tax deduction. This is true only to the extent it is paid and limited by the amount of net investment income shown on the return.

We keep referring to capital gains. Unfortunately, there could be capital losses as well if an asset is sold below its cost basis or purchase price. The capital losses can be used to offset capital gains. If you have excess capital losses, up to $3,000 of capital losses can be used to offset ordinary income. What capital losses are not used in a tax year may be carried forward to the future.

Knowing these basics can give you some control over your tax result. For example, the length of time you hold an asset can affect the type of gain it will generate at sale. As determining types of income can be complicated, we suggest you discuss your specific situation with a tax adviser.

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Email questions to Marc at mhebert@harborgroup.com. Your question and his response might appear in a future column.

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