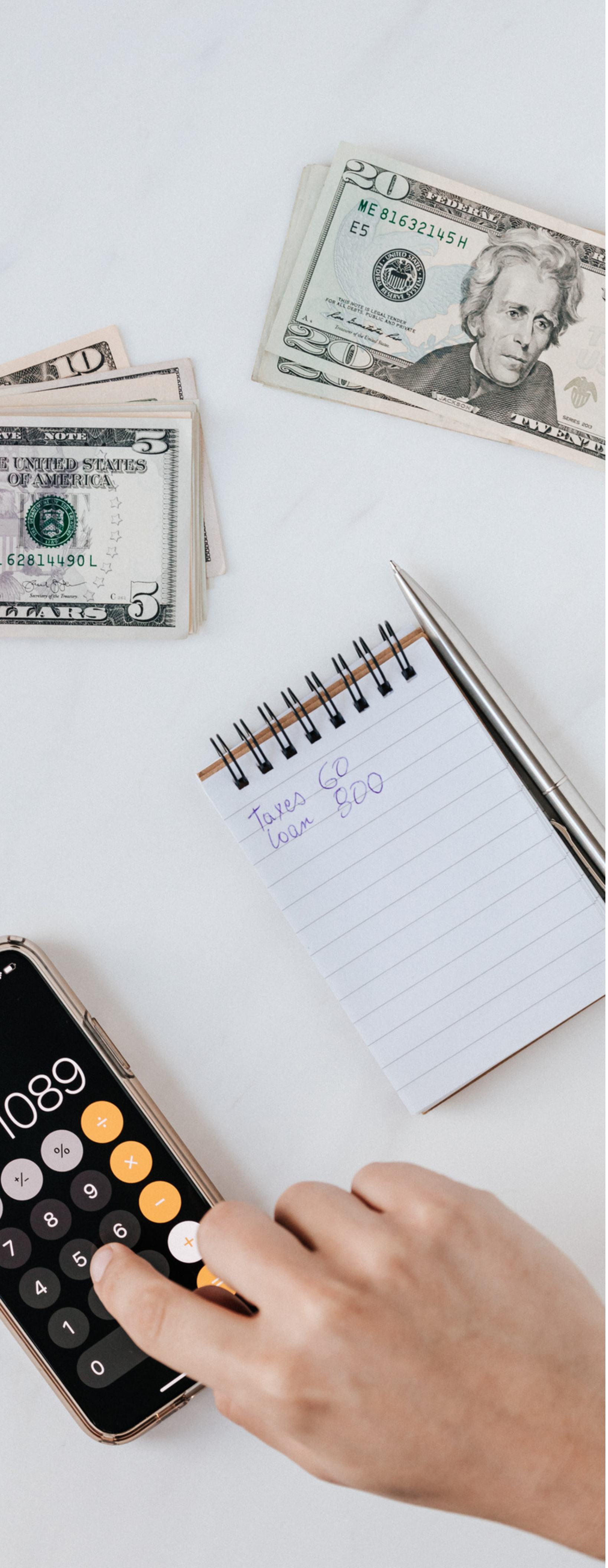
The Ultimate Guide to Understanding Taxes

for young professionals

BY

ALLSTREET
WEALTH



If there's one thing that confuses everyone, it's taxes.

Yet they're something we all need to know about and understand for our financial lives.

To help you out, we created a guide to understanding the basics of how you are taxed.

We'll look at:

- Income taxes
- Capital gains taxes
- How various investment accounts are taxed
- Tax credits
- Tax deductions
- And common tax credits & deductions that can be used

Read the guide

Income Tax

In the US, we have a **progressive** tax system, meaning that your tax rate goes up as your income goes up.

What confuses a lot of people is that taxes are also ***marginal***, which means that your entire income doesn't fall into one single tax bracket.

The marginal tax is the amount of tax you incur on each additional dollar of income.

Let's look at the chart below and go through a simple example for an individual tax filer to explain this further.

Single filers

Tax rate	Taxable income bracket	Tax owed
10%	$0 to $9,950	10% of taxable income
12%	$9,951 to $40,525	$995 plus 12% of the amount over $9,950
22%	$40,526 to $86,375	$4,664 plus 22% of the amount over $40,525
24%	$86,376 to $164,925	$14,751 plus 24% of the amount over $86,375
32%	$164,926 to $209,425	$33,603 plus 32% of the amount over $164,925
35%	$209,426 to $523,600	$47,843 plus 35% of the amount over $209,425
37%	$523,601 or more	$157,804.25 plus 37% of the amount over $523,600

For this example, let's assume we have an individual who has an adjusted gross income (AGI) of $100,000.

(AGI is the income you earned minus deductions taken)

How much would he owe in tax?

From looking at the chart, you'll see that he is in the 24% tax bracket, but not all of his income falls in this bracket.

Tax rate	Taxable income bracket	Tax owed
10%	$0 to $9,950	10% of taxable income
12%	$9,951 to $40,525	$995 plus 12% of the amount over $9,950
22%	$40,526 to $86,375	$4,664 plus 22% of the amount over $40,525
24%	$86,376 to $164,925	$14,751 plus 24% of the amount over $86,375
32%	$164,926 to $209,425	$33,603 plus 32% of the amount over $164,925
35%	$209,426 to $523,600	$47,843 plus 35% of the amount over $209,425
37%	$523,601 or more	$157,804.25 plus 37% of the amount over $523,600

- His first $9,950 of income gets taxed at 10% for a total of $995
- Then from $9,951 to $40,525 he would be taxed at 12% for a total of $4,664
- Then from $40,526 to $86,375 he would be taxed at 22% for a total of $14,752
- Then from $86,376 to $100,000 he would be taxed at 24% for a total tax bill of $18,021

As you can see, he does not pay 24% tax on all the income he makes. He only pays 24% tax on the dollars that fall into that bracket.

This is what we mean by marginal taxes.

The other number to be mindful of is your **effective tax rate.**

The **effective tax rate** represents the percentage of a person's taxable income that they pay in taxes. To find this number you divide your income by your total tax.

For this example it would be **18.02%** ($100,000 / $18,021 = 18.02), not 24%.

This is important to understand because most people think they are taxed based on where their income lies within the tax brackets but they aren't. So if someone makes $100,000, they often think they are in the 24% tax bracket, but only the dollars they made above $85,525 are taxed at that 24% rate.

They are effectively taxed at ~18%.

The key takeaways here are that taxes are progressive, meaning that as your income goes up, so do your taxes. However, not every dollar you make is taxed in your top marginal tax bracket.

This creates a lot of opportunities for tax planning. You can fill up tax brackets for Roth conversions to maximize that tax bracket.

Or you can take advantage of accounts that reduce your taxable income so no dollars are in a certain tax bracket.

Marginal Tax Rate

The highest tax bracket you fall into

Effective Tax Rate

The average tax rate that you pay on all income

Capital Gains Taxes

Capital gains are the profits you receive from the sale of an asset.

This could be from selling a stock, mutual fund, house, crypto, etc. The gain you receive from the sale is considered a taxable event.

To know how much you will be taxed depends on how long you hold the investment, as well as your tax bracket.

Capital gains are either:

- Short term (investments held for less than 1 year)
- Or long term (investments held for more than 1 year)

Note: This is for taxable accounts, not tax-sheltered accounts like 401(k)'s, Roth IRA's, etc.

Short Term Gains

Taxed at ordinary income rate

- 10%
- 12%
- 22%
- 24%
- 32%
- 35%
- 37%

Long Term Gains

Taxed at more favorable rates

- 0%
- 15%
- 20%

Short Term Capital Gains

Investments that are held and sold within one year are taxed based on your ordinary income tax rate (10%, 12%, 22%, 24%. 32%, 35%, or 37%).

Let's keep using the example above and assume he still has an income of $100,000. Now, he bought an investment for $10,000 and then sold it for $30,000 just 10 months later, resulting in a gain of $20,000.

To determine his tax liability, you would add that gain to $100,000 (his income) and you would see that he now has a total income of $120,000 (income + gains) resulting in more money being taxed in the 24% tax bracket.

He would owe $4,800 ($20,000 x 24% = $4,800) in short-term capital gains tax on this investment.

If you are someone in a higher tax bracket, holding investments for a longer period of time can be beneficial since you will be taxed at a lower rate (explained more below). If you're in the 24% tax bracket and sell a short term investment, it could potentially propel you into the 32% tax bracket.

This is why financial & tax planning is so important!

Many people get themselves in tough situations by not knowing this information and then they're stuck trying to figure out how to afford a hefty tax bill.

Make sure that when you sell your investments that you're also saving money to pay for the tax you'll owe!

Long Terms Capital Gains

Long term capital gains come from investments that are held for longer than a year. They're subject to a lower tax rate than short term capital gains. In 2022, the long-term capital gains tax rates are either 0%, 15%, or 20% (depending on your income).

The chart below shows what tax rate you correspond to based on income and how you choose to file your taxes.

Rate	Single	Married Filing Jointly	Married Filing Separately	Head of Household
0%	$0 – $41,675	$0 – $83,350	$0 – $41,675	$0 – $55,800
15%	$41,675 – $459,750	$83,350 – $517,200	$41,675 – $258,600	$55,800 – $488,500
20%	$459,750+	$517,200+	$258,600+	$488,500+

Let's say we have the same person as above who makes $100,000 and is a single filer. Let's also say he bought an investment for $10,000, three years ago, and just sold it for $30,000 resulting in a gain of $20,000. To figure out what he owes in tax you first have to find his tax rate.

To reference the chart, since he makes $100,000 he has a capital gains tax rate of 15%. Then you multiply this number by the gain received from the sale ($20,000) **resulting in $3,000 of tax**. Once you know how it works, it's fairly straightforward. But as you can see, holding this investment long term resulted in $1,800 less tax than the example above when the investment was held for less than a year and incurred short-term capital gains.

It's important to note that you should never hold or sell based solely on taxes.

Taxes On Cryptocurrencies/Assets

Cryptocurrencies are considered property for federal income tax purposes.

This means crypto is considered a capital asset and you will pay the same tax when you 'realize' a gain or loss just like any other capital asset. Selling a capital asset means you will pay tax at your income rate when you sell within 12 months and will receive favorable long term capital gains rates when you hold longer than 1 year. No different than what we chatted about above.

One main difference is that wash sale rules do not apply to cryptocurrencies right now. This means you could sell your investment at a loss and then buy the same investment right back so you can have that loss to offset other gains. This is a powerful tool that can be used for tax-loss harvesting (offsetting gains with losses). With stocks, you would have to wait 30 days to buy the stock back after the sale due to the wash sale rule, but you don't have to wait with crypto. This is a more complex strategy, so talk with your CPA or advisor on how to use it wisely.

Where people get confused with crypto is knowing what is considered taxable and what is not. So here's a quick list of common transactions to help you get a better understanding:

- Buying BTC, ETH, etc. is not a taxable event
- Selling BTC, ETH, etc. for USD or any other currency is a taxable event
- Selling BTC, ETH, etc. for any other crypto is a taxable event
- Swapping cryptocurrencies are generally a taxable event
- Buying an NFT is a taxable event (unless purchasing with USD)
- Selling an NFT for USD or any other cryptocurrency is a taxable event

Tax Treatment For Each Type Of Investment Account

There are 3 different types of tax accounts you want to know.

1. **Tax-free accounts**
2. **Tax-deferred accounts**
3. **Taxable accounts**

In the chart below, you'll see the main types of accounts (Roth, Traditional, Brokerage) and their tax treatment at the bottom:

	ROTH	TRADITIONAL	BROKERAGE
EXAMPLES	ROTH 401(k), ROTH IRA, some life insurance	Traditional 401(k), IRA, 403(b), etc.	Brokerage/ Taxable Investment Account
MONEY GOES IN	Post-tax so taxable income remains the same	Pre-tax and reduces your taxable income this year	Post-tax so taxable income remains the same
TAXES ON EARNINGS	Earnings grow tax free	Earnings grow deferred	Dividends, interest, and realized capital gains are taxable in the year earned

Tax-Free Accounts

These are accounts where you put post-tax dollars in, and then you will never be taxed again on those dollars. Examples of these accounts are Roth IRA's, Roth 401(k)'s, some life insurance, etc.

These are great for people who are in lower tax brackets today then they think they will be in the future (most likely retirement). You typically cannot use these accounts until retirement without incurring a penalty (except that you can pull your own contributions out of a Roth IRA penalty-free).

Tax-Deferred Accounts

These are accounts where you put in pre-tax dollars (so your taxable income this year is reduced by your contribution amounts), the money then grows tax-deferred, and you end up paying tax at your income rate when you pull the money out.

Examples are 401(k)'s, 403(b)'s, IRA's, HSA's, etc. These accounts are great for those who are high income earners and think they will be at a lower tax rate in retirement. You typically cannot use these accounts until retirement without a penalty.

Taxable Accounts

These are accounts where you put in post tax dollars and then you pay tax when you sell either based on your income rate (if it's a short term investment which is less than one year) or based on capital gains rates (if you hold for more than one year). You also will be taxed at your income rate for any dividends you receive.

These accounts are great for giving you options and flexibility. This money is available for you to use whenever you want, without penalties. But remember, you will have to pay the taxes though when you sell.

It is typically wise to have a mix of these different types of accounts which can be used at various times of your life. Tax diversification is never a bad idea - nobody knows what future tax rates will look like.

Tax Deductions vs Tax Credits (and Common Ones to Use)

We often hear people mix up tax credits and tax deductions so we thought it could be helpful to break down what each of them are and how they work. Both are great for reducing your total tax liability and definitely something you want to be aware of.

Tax Deductions

Tax deductions reduce how much of your income is subject to taxes. So they reduce your tax bill by the percentage of whatever your highest federal income bracket is for you.

If you are in the 24% tax bracket, a $5,000 tax deduction would reduce your tax bill by $1,200 ($5,000 x . 24% = $1,200).

	Ex: A $15,00 tax deduction
Your AGI	$200,0000
Minus your tax deduction	$15,000
Taxable Income Left	$185,000
Multiple By Your Tax Rate (simplify to 1 number for example purposes)	32%
Total Tax Paid	$59,200
How much the tax deduction saved on taxes	$5,800

As you can see, having a $15,000 tax deduction in this example helped them save $5,800 on taxes. Not bad, right?

A tax deduction just reduces your income by that same amount and then you multiply your tax rate by your lower income after the deduction.

Here are some examples of different tax deductions you have at your disposal:

- Property Taxes
- Mortgage Interest
- State Taxes Paid
- Real Estate Expenses
- Charitable Contributions
- Medical Expenses
- Pre-Tax Retirement Contributions (401(k), traditional IRA, etc.)
- HSA Contributions

With tax deductions, some people choose to just take the standard deduction, a one size fits all reduction. It is $12,950 for singles in 2022 and $25,900 for married filing jointly. The standard deduction is just choosing to take that total amount for your deductions instead of itemizing them one by one.

This is a little bit more into the weeds, but you can take the standard deduction and also still deduct some things that are 'above-the-line-deduction'. Above-the-line deductions are expenses that are deducted to calculate an individual's adjusted gross income (AGI). These differ from itemized deductions, which are the dollar amounts deducted from the determined AGI.

Some examples are:

- Retirement Plan Contributions
- HSA, MSA Contributions
- Health Insurance premiums
- Self-Employed Business Expenses, SE Tax
- Alimony
- Educator Expenses
- Early Withdrawal Penalties
- Student Loan Interest
- Tuition and Fees

Tax Credits

Tax credits give you a dollar for dollar reduction of your tax liability.

They're even better than tax deductions because they directly reduce the amount of tax you owe.

So if you have a $1,000 tax credit, it actually reduces your tax bill by $1,000 (unlike tax deductions which lower it by $1,000 x your tax rate).

An example here of how tax credits work:

	Ex: A $15,00 tax credit
Your AGI	$200,0000
Minus your tax deduction	$0 since it's a tax credit
Taxable Income Left	$200,000
Multiple By Your Tax Rate (simplify to 1 number for example purposes)	32%
Total Tax Paid	$64,000
Less: Tax Credit	$15,000
	$49,000

With tax credits, you subtract the total credit from the amount of tax you owe which reduces your tax bill dollar for dollar by the amount of the credit.

Tax credits are very impactful!

There are a few things you need to know about tax credits though:

- Some tax credits are nonrefundable: This means that if you don't owe much in taxes in the first place, you won't end up being able to fully use the tax credit. Let's say you owe $2,000 in tax and have a $5,000 tax refund. If it is nonrefundable, then it will lower your tax bill to $0, but you won't get that extra $3,000 back. So you are unable to fully use it.

- Some tax credits are refundable: Some tax credits are refundable though, meaning you can get money back from them, they won't just lower your tax bill to $0. So in the example above, you owe $2,000 in tax and have a $5,000 tax credit, so if it is refundable, you would get $3,000 back on your taxes.
    - Some tax credits that work like this are the earned income tax credit and the child tax credit

These are a few of the tax credits to be aware of:

- Child Tax Credit
- Credit for other dependents
- Child and Dependent Care Credit
- Earned Income Tax Credit (EITC)
- The Retirement Contribution Savings Credit (Saver's Credit)
- American Opportunity Tax Credit (AOTC)
- Lifetime Learning Credit (LLC)

The TL;DR

Marginal Tax Rate

The highest tax bracket you fall into

Effective Tax Rate

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Income tax rates

10%, 12%, 22%, 24%, 32%, 35%, 37%

Capital gains tax rates

Short Term Gains Taxed at ordinary income rate

10%, 12%, 22%, 24%, 32%, 35%, 37%

Long Term Gains Taxed at more favorable rates

0%, 15%, 20%

Credits & deductions

Tax deductions
reduce how much of your income is subject to taxes

Tax credits
give you a dollar for dollar reduction of your tax liability

Tax-advantaged investment accounts

Tax-free accounts

Tax-deferred accts

Taxable accounts