What Is Gross Income? Here’s Everything to Know.

I’m sure your accountant has asked you before for your gross and net income when preparing your tax return, right?

But what exactly is gross income, and how does it differ from net income?

Continue reading for everything you need to know about gross income and how it applies to you.

What is gross income?

For individuals, your gross income is the total amount of earned income that you can find on your paycheque before any taxes and deductions are taken off.

It considers all sources of income from your wage, rental income, interest income and even dividend profits.

Businesses calculate gross income slightly differently. Their gross income is also called gross profit, the income they make from selling their product or service minus the actual cost of those products sold.

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How is gross income calculated?

Now that you know what gross income is, how do you calculate it?

You may need to calculate your total gross income to acquire a loan from the bank to satisfy the lender.

Your potential landlord may require it to ensure you can afford the rent.

You may even be applying for a credit card, and they require your gross income amount before approving your application.

Continue reading for how both individuals and businesses can calculate their gross income.

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Gross income calculation for individuals

As gross pay for individuals includes numerous forms of income from employment, rental income, interest income and dividend payments, this must be considered when calculating your gross income.

Example:

If Alex earns an annual income of $100,000 a year at his office job and he also earns $70,000 in rental income from real estate he owns, $10,000 from dividend profits and $5,000 in interest income on his savings account his calculation would be as follows:

Gross Income = $100,000 + $70,000 + $10,000 + $5,000 = $185,000

Gross income calculation for businesses

A business's gross profit is on the income statement of the business.

It is the business's annual gross margin before taking off any indirect expenses, interest and taxes.

This calculation represents the business income earned from selling goods or services after deducting any tax deductions regarding the direct costs that the business incurred.

Examples of direct costs can include:

- Employee labor costs.
- Equipment used in the production phase.
- The cost of supplies.
- The cost of the raw materials.
- Any required shipping costs.

Example:

If the total revenue of Brian's Hardware Store totaled $1,300,000 and their expenses were as follows, what is their gross income?:

- Material cost: $150,000
- Supply cost: $60,000
- Equipment cost: $340,000
- Labor cost: $150,000
- Shipping cost: $100,000

To calculate the gross profit, revenue minus the cost of goods sold (COGS), of Brian's Hardware Store, the calculation is as follows:

Gross Income = $1,300,000 (COGS) -$150,000 – $60,000 – $340,000 – $150,000 – $100,000 = $500,000

What is net income?

Another question your accountant may ask you is what your net income is.

Your net income is your gross income minus any taxes and deductions taken off by your employer.

Essentially, you can see your take-home pay on your pay stub

on payday.

Net income represents your actual total earnings and is what you can use to give yourself an idea of the amount of money you can spend throughout the month.

It is also a good indicator of how much you might pay in taxes every year.

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How do I calculate my net income?

To calculate your net income, first, take your gross income and deduct the following expenses:

- Income taxes.
- Health insurance payments.
- Retirement account contributions.
- Social Security and Medicare taxes.
- Loan payments.
- Child support payments.
- Alimony payments.
- Wage garnishments.

Example:

If Susan's annual salary is $150,000 a year as a lawyer, and she has the following expenses, what is her net income?:

- Income taxes: $8,000.
- Health insurance payments: $2,000.
- Retirement account contributions: $5,000.
- Loan payments: $10,000.

To calculate Susan's net income, the calculation is as follows:

Net Income = $150,000 – $8,000 – $2,000 – $5,000 – $10,000 =

$125,000

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What is taxable income?

You will use your gross income when you fill out your state and federal income tax papers.

Next, you can deduct any applicable deductions to determine how much you may owe.

Remember that your gross income is not the same as your taxable income.

This is because some sources of income are not counted as part of your gross income for tax purposes.

Some sources of income that are not taxable include:

- Life insurance payouts.
- Specific Social Security benefits.
- State or municipal bond interest.
- Certain inheritances or gifts.
- 401(k) contributions.
- Health savings account contributions.
- Educator expenses.

Your taxable income is also what may be used to determine what tax bracket you are in.

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What isn't considered taxable

income?

While most sources of income are considered taxable, there are a few cases where income isn’t taxed.

Partnership income

Typically, a partnership is not considered to be a taxable entity.

The distributive share of partnership income, such as the gains, losses, deductions or credits, is usually based on the partnership agreement.

You must report these on your tax return regardless of whether they have been distributed.

Even though a partnership typically doesn’t pay tax, it is still required to file an information return.

S corporation income

Typically, an S corporation does not have to pay any tax on its income.

Instead, the income, losses, deductions and credits are passed through to the shareholders based on each of their pro rata shares.

Again, even though an S corporation normally doesn’t pay tax, it is still required to file a return.

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What is adjusted gross income?

The IRS defines your adjusted gross income (AGI) as your gross income minus any applicable adjustments.

Your adjusted gross income will never be higher than your total gross income and can be lower.

Your accountant will use your adjusted gross income as the starting point for calculating your taxes for the year and helping to determine your eligibility for any tax credits and deductions to help lower your overall tax bill.

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What are tax brackets?

There are several different tax brackets that you can fall under at income tax time.

Federal income tax rates are broken down into seven sections called tax brackets.

As your income increases, so does the tax rate that you will pay.

To figure out what your marginal tax rate is or what your highest federal tax bracket is, you may need to know the following:

- You will need to know your filing status. The options are single, married filing jointly, married filing separately, head of household or qualified widow.
- You will also need to know your taxable income as described above.

Once you know these two things, you can figure out what tax bracket you fall under.

Remember that not all your income will be taxed at that rate. The reason is that the U.S. income tax system works off a graduated system so that individuals pay an increasing rate as their income increases.

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What are capital gains?

You might have heard someone talk about capital gains before, but what exactly are they and how do they apply to you?

Capital gains include the profit from the sale of any capital asset.

These can include the sale of:

- Shares of stock.
- Selling of a business.
- Selling a parcel of land.
- Selling a piece of artwork.

For the most part, capital gains are included in your taxable income but normally are taxed at a lower rate.

For capital gains to apply, the asset has to be sold at a higher price than what it was purchased for.

On the other hand, a capital loss occurs when an asset is sold for less than it was previously purchased for.

Both capital gains and losses are taxed either as short-term or long-term gains. Short-term is classified as being owned for a year or less and long-term is if the asset was owned for over a year.

Typically, short-term capital gains are taxed at up to 37%, and long-term gains are taxed at up to 20%.

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What is modified adjusted gross income?

Your modified adjusted gross income (MAGI) is how the IRS determines if you are eligible for certain deductions or contributions to a Roth IRA.

The IRA will also use MAGI to help determine if a taxpayer is eligible for specific educational tax benefits and other income tax credits.

To calculate your MAGI, the following calculation is used:

MAGI = Adjusted gross income + Qualifying tax deductions

Your modified adjusted gross income is calculated by taking your adjusted gross income and adding back the following deductions:

- Passive income or losses.
- Rental property losses.
- Interest earned on EE savings bonds.
- Excluded foreign income.
- Half of the self-employment tax.
- Any deductions for IRA contributions.
- Deductions of student loan interest.

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Gross income takeaways

To sum up, your gross income as an individual is any income you receive, including your salary, earned interest, dividend income, rental income and money you receive for your pension.

If you are a business owner, it is your total revenue minus the cost of goods sold.

Individuals will provide their gross income at income tax time, which will become their adjusted gross income and taxable income after certain deductions and exceptions.

If you want to calculate your gross and net income to better understand your finances and create a proper budget, implement the above calculations.

Check out Entrepreneur's other articles for more information about gross income and other financial topics.

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