How Do My Investments Impact the Way I File My Taxes?

Investing is an excellent way to grow your own personal wealth. But when it comes to filing your taxes when you have investments, there are certain things you need to know—so you don't end up with penalties like this week's listener, Lorraine, did back in 2019. For advice, host Stefanie O'Connell Rodriguez turns to Kristin Myers, editor-in-chief of The Balance, and Caleb Silver, editor-in-chief of Investopedia.

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Lorraine: I absolutely freaked out. I honestly looked at it, started crying, and was like, "Oh my gosh, we're going to jail for tax evasion just because I had no idea that we were missing a form for our taxes."

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Stefanie O'Connell Rodriguez: This is Taxes in Ten, a limited series from the podcast Money Confidential at *Real Simple*. I'm your host, Stefanie O'Connell Rodriguez. And this week, we're talking to a 32-year-old Kentucky-based listener working in healthcare administration, who we're calling Lorraine, not her real name.

Back in 2018, Lorraine and her husband cashed out some of the mutual funds they had to purchase their first home.

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Lorraine: By the time we did taxes in March of 2019 I hadn't received any paperwork from the brokerage company that we cashed out the investments through.

Stefanie O'Connell Rodriguez: So, Lorraine and her husband filed their taxes that year like they always did.

Lorraine: In January of 2020, I got a bright red letter from the IRS saying we owed about $4,000 in back taxes for the capital gains taxes off of those investments. I'd never cashed out investments before; I had no idea that that was something that needed to go along with my taxes.

Stefanie O'Connell Rodriguez: Realizing the mistake, Lorraine immediately sought the help of a tax professional and mailed off a check to the IRS to resolve the outstanding tax balance.

Lorraine: Then, COVID hit. And I guess with the IRS being short-staffed just like everywhere else, we are now over two years into this investigation with the IRS and they still have not closed it out, even though we've sent the money in.

Stefanie O'Connell Rodriguez: In the two years since, Lorraine has followed up with the IRS repeatedly.

Lorraine: We're still on pins and needles, waiting for the IRS to tell us that we've paid the money that we needed to pay for that capital gains tax. I now know that just because I didn't get anything in the mail from my brokerage firm doesn't mean that I shouldn't have called and asked for the correct tax forms.

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Caleb Silver: Capital gains taxes are the taxes on the profit you make in an investment. So that could be a stock. You bought it for 10 bucks, you sold it for a hundred bucks. Your profit is $90. If you held it less than a year, you're going to pay short-term capital gains based on your income level. If you've had it more than a year, you're going to pay those long-term capital gains. Any tradable asset—that applies to even gold, even commodities—if you traded anything in the near or short term or the long-term and made a profit on it, you could be taxed on that asset as long as it's tradable and there's a record of it.

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Stefanie O'Connell Rodriguez: That's Caleb Silver, editor in chief of Investopedia. He and Kristin Meyers, editor in chief of The Balance, are back with us today to wrap up our Taxes in Ten series by breaking down the ways our investments can affect us come tax time, and what we need to know about those tax implications to make the most of our investments.

All right, I have a confession to make: Last year was the first year I bought cryptocurrency.

Caleb Silver: Well, you're not the only one, millions and millions of people did it. The question for you is, did you then sell that cryptocurrency at a higher price from where you bought it and make a profit? And did you do that within the 12 months within that calendar year? Because if you did that, then you could be subject, Stefanie, to short term capital gains taxes. If you didn't sell it and you're just holding onto it, you owe no taxes on that until you sell it at a profit, but only if you make a profit and it really depends on how long you've held it.

Stefanie O'Connell Rodriguez: And is this kind of a rule across all kinds of investments?

Caleb Silver: Yeah, you could apply the same rule to stocks. You could apply the same rule to non-fungible tokens. You could apply the same rule to fine wine. But for a lot of folks, if you are buying and selling cryptocurrency throughout the year or stocks trying to cash in on short term profits, you're going to owe a lot of short-term capital gains and you probably didn't realize it at the time. A lot of folks don't think they do until they get that tax bill from their broker at the end of the year with their statement, they realize they owe some taxes on all that trading activity.

Stefanie O'Connell Rodriguez: Well my other confession is that I'm a very boring investor so I am holding onto my investments. So let's say that my gains or losses aren't yet realized, does that have an implication for me tax wise?

Caleb Silver: Not until you actually realize those gains, or you start getting distributions from your retirement accounts—talking about your 401(k), potentially talking about an IRA you may have set up for yourself. When you start taking distributions, you'll be taxed on that, but you're not taxed on that money is just sitting there growing and compounding over time. And that is why we try to encourage so many people to take advantage—if they have an employee sponsored retirement account, or if they're working for themselves to set up a retirement account—so they can make some of those tax-free contributions and let them grow over time. It costs you nothing in taxes as they grow, when you sell that's when you'll pay.

Stefanie O'Connell Rodriguez: Let's talk a little bit about those retirement accounts, especially for folks who are for the first time contributing to an IRA or 401(k). Maybe they've heard the word tax advantaged, but they don't really understand what that means.

Caleb Silver: Well, first of all, let's talk about taxable accounts, those that are not advantaged. I think it's a little easier to see what the difference is once you understand what a taxable account is. Maybe you have a Robinhood account. Maybe you have an online brokerage account. That is a taxable account. You're going to be buying and selling and trading stock or investing and making moves within your portfolio. Every move you make within there is going to be taxed either for short-term capital gains or long-term capital gains.

And then there are more tax-advantage accounts, like IRAs and 401(k)s. The money's not taxable on the way in and it's taxable on the way out. So, once you start taking out income from a traditional IRA, you owe tax on the earnings portion of those withdrawals at your regular income tax rates. So, however much money you make, wherever tax bracket you fit in, that's where you're going to pay those taxes.

But on the other hand, there are other things like a Roth IRA. You'll pay no tax at all on those earnings as they accumulate, or when you withdraw following the rules of the Roth IRA, a lot of people like the Roth IRA, especially as they get older, because they know those distributions won't be taxed. And if you max out your other retirement accounts, you can always start up a Roth IRA on the side.

Caleb Silver: If you're on your own, if you're running a small business, you can set up what we call a SEP account, SEP—that's your own retirement account for small businesses and make those contributions. It's a nice way to offset some of the profits or some of the income in the small business itself and put something away for the people that are running the business. You can do that for yourself, for your employees.

If you're trying to start up one of these accounts or your employer is offering you one of these accounts, you have to see if you're eligible. You can literally go to any one of these websites for any of these accounts, we can go to Rothira.com and find out your eligibility. There's a calculator in there for how much you make, how much you're able to contribute and what that might mean over time if it grows at a certain amount. So, there's a lot of easy tools to help you. One, figure out if you're eligible for these accounts, two, how much you can contribute, and three, how that contribution might grow over time given a set of variables. It's never been easier to start this type of DIY investing yourself, or, if you're working with a financial advisor, or you're already working with a broker or a planner who's helping you handle your money, they can answer these questions as well.

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Stefanie O'Connell Rodriguez: After the break, we'll be back with Caleb and Kristin, to talk through what all of those future tax implications mean for how we should approach our investing decisions today.

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Stefanie O'Connell Rodriguez: What are some of the ways that we can think about investing and think about the tax implications proactively?

Caleb Silver: It really depends on the type of investor you want to be. Those folks who are younger, or even have 10 to 15 good working years ahead of them, you're going to be long-term investors. You're trying to invest and put away money so that it can make you money while you're working, and then generate you income when you've stopped working or you're in retirement. So, you don't want to do a lot of trading activity in those accounts. If you want to trade stocks or cryptocurrencies or non-fungible tokens, set aside 5% of your portfolio and do it there—the gains and losses won't be that great and the tax burden won't be that great either.

But for your retirement accounts, for that long-term money, for that golden pot at the end of the rainbow there, you want to make sure those are long-term investments. Typically, in dividend-producing index funds or index funds in general that are very cheap, low expense ratios, and that generate money over time. And you don't pay taxes on those gains every year until you sell it. So, it's never been easier to do that type of investing, but if you're just trying to pick stocks, trading left and right, you're going to wind up with a bigger tax bill than probably your gains are going to produce.

Stefanie O'Connell Rodriguez: Kristin, I also want to talk about gifts. Maybe somebody just gave us money. What's the tax burden on that?

Kristin Myers: So, usually the person who gives, the donor, is the one who actually pays taxes on the gift. And if it is under a certain amount, then you actually don't have to pay tax on it. So, if you want to give your friend a thousand dollars, that is going to be tax-free. But if it's over $15,000, if you are a single person, then you're going to have to pay taxes. If you are married, you can give up to $30,000 and you won't have to pay any taxes on that.

And in your lifetime, you're going to have an exemption of up to 11.7 million dollars. So, you've got a lot of room, so you can give out 15,000, 15,000, 15,000, all across the board to your friends, your nieces, your nephews, up to that 11.7 million and then after that, the government also wants its cut.

And that gift also includes stocks. So, you can also give a stocked gift. So, let's say your niece was born and you wanna start giving her some investments to celebrate her first birthday or the arrival of your niece. You can also give a stock gift of up to $15,000 or $30,000 if you are a couple.

Stefanie O'Connell Rodriguez: I noticed that when we talk about investing, particularly when we talk about tax advantaged accounts, there tends to be a lot of agonizing over what is the best possible strategy and account for me. And I think those are great questions to ask, but I also worry that sometimes we get so caught up in asking ourselves those questions that we don't actually do the job of just starting and investing.

Caleb Silver: The best day to start investing was yesterday. The next best day is today. Start the account now. Make an automatic contribution in your online account so you're not worrying about it. You're not trying to buy the market low or buy the market high, just constantly doing it over time in a diversified index fund. You'll love yourself in 10 to 20 years, if you've set it and forget it.

Kristin Myers: The great thing is when it comes to investments, you can make changes. You can make changes within your 401(k). If you buy a stock and you don't like it, you can make reallocations in your portfolio. So, there is leeway to kind of make changes and even play with some of these investments that you are making. I would say that the first thing you want to ask yourself is what kind of investor are you? You want to ask if you're investing for the short term or if you're investing for the long-term, are you investing to retire or are you investing to help your kid go through college or to buy a house in 10 years?

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All of these questions will give you answers that I think will serve as really good guideposts for what direction you should go into.

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Stefanie O'Connell Rodriguez: This has been Taxes in Ten, a limited series from the podcast Money Confidential at *Real Simple*, featuring editor-in-chief of Investopedia, Caleb Silver, and editor in chief of The Balance, Kristin Meyers. For more tax tips and resources, visit RealSimple.com. I'm Stefanie O'Connell Rodriguez, we'll return in May for Season 2, featuring more of your money stories, struggles and secrets. To follow along or catch up on past episodes, find and follow Money Confidential on Apple Podcasts, Spotify or wherever you listen. And we'd love your feedback. If you're enjoying the show, leave us a rating and review, we'd really appreciate it.

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