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Investing

Robinhood Traders Face the Taxman After Falling In Love With Stocks

What should you know if you made money on your investments last year?

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Almost everyone who makes money must get acquainted with the taxman.

That's the reality dawning on U.S. investors who began buying and selling stocks on apps such as Robinhood last year, when they were cut off from other pastimes during pandemic lockdowns. At least 8 million people opened new brokerage accounts in the first nine months of 2020 — many of them young traders who were dipping their toes into the investing pool for the first time.

Now that these investors realize they could be on the hook for taxes, they aren't outraged (as George Harrison of the Beatles was when he wrote "Taxman") as much as confused about the rules.

Chase Alford recently received a notification from Robinhood alerting him that it's almost tax season. The 19-year-old investor, who ended 2020 with less than $5,000 in net gains, is unsure whether he has to pay up.

QuicktakeRobinhood and the Gamification of Investing

"I read up on it and everything that I saw didn't lead me to believe that I had to pay, however I was at the grocery store or something so I didn't dive into it as much as I needed to," said Alford, who got into trading in March when he was stuck at home in Fulshear, Texas.

So what should you know if you made money on your investments last year?

The U.S. tax code penalizes speculative trading by taxing short-term gains at a higher rate than long-term gains. The dividing line is one year: To get the lower, long-term capital gains rate, investors must hold onto a stock for a year and a day. Married couples who earn up to $80,000 pay nothing on long-term capital gains and qualified dividends. Most other middle-class income groups pay 15%, and the top rate for high earners is 23.8%. Short-term gains, meanwhile, are taxed like ordinary income, at a top rate of 37%.

Those who made big short-term gains in the market last year may owe a hefty check to the Internal Revenue Service and, depending on where they live, to their state tax collection agency.

When Americans get paid at work, taxes are usually withheld from their paychecks. Brokerages rarely do the same for gains on stocks and other investments. That can create a headache when taxes are due in April, especially if investors haven't put enough money aside.

"The biggest misconception most investors have is that they won't be taxed as long as they don't withdraw the money," said Ryan Marshall, a financial planner and partner at ELA Financial Group in Wyckoff, New Jersey. That's true for individual retirement accounts, or 401(k)-style plans. But any other investment income — from selling stocks and bonds, from dividends, and gains created by mutual funds — is taxable.

The boom in brokerage sign-ups last year means individual investors — known as retail traders — now account for a fifth of stock volume in the U.S., according to data from Bloomberg Intelligence. It wasn't just a U.S. phenomenon. Trading accounts across the globe tripled from 2019, according to a survey by BrokerChooser. In Japan, online firm Rakuten Securities saw a 25% jump in accounts in nine months, while small investors make up almost two-thirds of trading in South Korea. About one in three people in Saudi Arabia has a brokerage account.

Newbie investors are turning to search engines, tax websites, online communities, family members or CPA professionals for help as the start of the U.S. filing season approaches — on Feb. 12, two weeks later than usual.

"That's a whole other process that I need to learn," said Mac Coughlin, referring to his potential tax obligations. "Quite honestly I have no idea about any of it," the 20-year-old business major at Fordham University said. "I took a small loss over the whole course of the year so in terms of filing and tax returns I do not really understand the process."

For investors with negative returns in 2020 like Coughlin, trading losses can be turned into larger refunds from the IRS. For other investors, however, filing season may be costly. And traders with gains who ignore their tax obligations could wind up with even larger bills down the road.

Matthew Savello, a certified public accountant, spends his days answering questions about filing taxes in about 15 investing and stock groups on Discord, a popular chat service for young investors. He works full time at an accounting firm but has now also launched his own advisory, Prestige Tax & Accounting LLC.

"Now that it's actually coming time to file, people are starting to scramble a little bit," said Savello, 27. "One of the key things is you have to budget it. Probably most of the people I talked with actually have losses, there's not many who can actually pull this off successfully. And for the ones who do, budgeting has become quite an issue."

Robinhood — the company that's become synonymous with the retail investing phenomenon over the past year — says it recommends that its customers speak with a tax professional for specific questions about tax documents, including how to file. It's reaching out to users to update them on the information they can expect to receive from the company in preparation of tax season, including an overview of key dates and tax forms, according to a spokesperson.

Filing as an investor can mean collecting a lot more paperwork. There's the 1099-B form from brokers, the 1099-INT reporting interest income, and the 1099-DIV for dividends. Some firms consolidate all activity on one form. It might take until mid-February for your 1099-B to arrive, and other specialized forms, like the K-1s generated by partnership investments, take even longer. Those who trade cryptocurrencies or who jumped from platform to platform in 2020 might need to do extra work to compile all the taxable transactions they need to report.

The IRS gets a copy of every 1099. If you don't report every cent of income, the agency will notice and send a letter demanding money. In many cases, the IRS's computer could end up charging much more than you actually owe — for example, by taxing the entire proceeds of a sale, rather than just your gain.

"It's to your benefit to pay it off as quickly as you can," said Jordan Kendall, a partner at Marcum LLP. Ignoring your filing obligation altogether could be even more of a hassle.

"Many taxpayers don't realize that if you're delinquent in tax filings and you owe the government money, they could withhold your passport and stop you from traveling internationally," he said. "They could make your life difficult."

If you enter the right forms, tax software can generally figure out how much you owe. But if you're trading without knowing the tax rules, you can end up with a much bigger tax bill than expected.

In addition to lowering taxes by holding onto investments for more than a year, savvy investors can avoid them entirely by generating losses. By selling stocks that have dropped in value, they can offset any gains in their portfolio. It's something amateur investors are often reluctant to do.

"Selling at a loss, particularly, is the hardest move for new investors to make," said Linda P. Erickson, a financial planner at Erickson Advisors in North Carolina. "They seem to always want to wait until it 'comes back.'"

Losses can not only erase taxes on gains, they can also offset up $3,000 per year in ordinary income. Losses can also be carried over to future years. However, there's a catch to this strategy, often called "tax-loss harvesting": If you sell a stock at a loss, and then buy the stock again within 30 days, you can't claim the loss on your taxes.

The so-called “wash-sale rule,” designed to prevent taxpayers from gaming the system, could pose a problem for novices who spent 2020 trading in and out of the same few stocks. Their investments may have lost value, but they won’t be able to claim a loss on their 1040 form.

For many, the extra tax costs of trading might just mean a smaller refund. Those who made substantial money in 2020, however, may find themselves with unexpectedly large tax bills. The good news is that the IRS allows people to pay taxes by installment with only a little bit of extra paperwork. The bad news is that penalties and interest can apply.