Reconcile

The Ignorance Tax:

Why Retail Investors Are Likely to Overpay in Taxes

A close look at how little tax savviness retail investors have.

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Introduction

Introduction

Benjamin Franklin once said that there are only two certainties in life: death and taxes. Fortunately, there are many ways to make the latter more manageable. But while the rich play the tax code to preserve their riches, millions of working Americans are leaving money on the table.

Pandemic stimulus and low interests brought about a boom across asset classes as new investors poured into every market - stocks, crypto, real estate, and other alternatives. Many did handsomely—booking hefty gains as investors bought the dip and the market rose from its April 2020 lows. There’s just one problem: many people didn’t get their tax bill until after they spent their meaningful gains, or reinvested them. And in 2022, many investors are getting a taste for the ugliness that sometimes awaits them when things in the market go south.

At Reconcile, we're on a mission to help investors avoid the dreaded surprise of finding out you owe thousands of dollars in taxes. We want to ensure investors can smartly maximize their returns and pay the least amount of tax as legally possible.

We conducted a survey to get to the bottom of how people have been thinking about those seemingly infinite rows on their tax returns, especially as the coming tax season approaches. What we found is that very few people optimize or plan for tax season, especially when it comes to their investments. In this study, we'll delve into three big ideas from our research about taxes. We'll also include some honorable mentions at the end:

- Finding #1: Very few Americans have a tax plan
- Finding #2: Americans don't know if (or where) they're making money
- Finding #3: People rely on tax preparers to save them on their taxes
- Honorable Mentions: The multi-asset/multi-platform future, qualified stays king, and tax-loss harvesting

Key Findings

#1: Very few Americans have a tax plan

In 2020, Census.gov observed that the median U.S. household income was $67,521. Thanks to the COVID-19 pandemic, household income actually declined for the first time since 2011 in the first year of the pandemic, and while 2021 and 2022 ultimately reversed that trend, the average worker ended up making less in those years after adjusting for inflation.

Roughly half of our survey falls just around this median, which means that many of the people who took our survey could benefit massively from deductions or credits such as the child tax credit, education credits, electric vehicle credits, or other write-offs which help them recoup taxes they paid. There's just one problem: most of them have no idea these credits and deductions exist.

If our survey is any indicator, Americans don't understand how impactful tax credits and deductions can be for them come tax season. Best case, these missed credits or deductions would help working people claw back a few thousand bucks. Worst case, they could help a household recoup a high single-digit amount of their income.

That’s just one side of the coin. We’ll spend most of our study looking at the other side of the coin: investing. Unsurprisingly, the lack of literacy on tax planning also trickles down in harrowing ways when it comes to investing and optimizing for long-term growth.

Many Americans concede that they are underserved when it comes to tax planning. More than 41% of our survey said that they had never tried tax strategies such as tax-loss harvesting, investing in tax-deferred accounts, contributing to donor advised funds, or selling long-term capital gains.

In fact, 59% of our sample said they had no tax strategy at all when it comes to investing and another 10% said that they “didn’t know” about popular tax strategies.

Most retail investors aren't optimizing their taxes

70%

of retail investors don't make use of any tax strategy

73%

of retail investors don't use tax-loss harvesting

75%

of retail investors aren't confident to self-optimize taxes

To make this more personal, consider your own income. Now consider the impact that lowering your income—either indirectly through credits or directly through deductions like tax-loss harvesting—could have on you. If your adjusted gross income, the figure that the Internal Revenue Service uses to discern how much in taxes you should pay, was reduced by $3,000, $5,000, or even $10,000, you might receive a substantial refund.

And for the average American, these kinds of deductions and credits are pervasive—and missed. For that, Americans are missing out on potentially life-changing amounts of money.

Even in the simplest cases where Americans can move the needle—namely with qualified accounts like 401(K)s or Individual Retirement Accounts—there is still a lack of literacy on how these accounts could be used and what purpose they might serve over the long run.

Either way, one resounding understanding from our survey is that Americans are not educated about tax decisions that could save them money.

#2: Are Americans making money on their investments? Nobody knows.

It’s not exactly a secret—2020 and 2021 were a banner year for the financial markets. That’s ironic for a number of reasons, namely because the COVID-19 pandemic led to economic upheaval and a massive bout of unemployment, but just how banner was it? Well, most Americans have no clue.

69% of our survey said that they didn’t sell any investments at a loss in 2021, while an additional 10% indicated that they didn’t know. While that’s possible, it’s not particularly believable—-especially considering how many retail-popular growth stocks began sinking in late 2021.

It's hard to know when you're selling at a loss

79%

of retail investors either don't know or claim to not have sold any investments at a loss in 2021

There's no easy way to track what is winning or losing, especially when people are so multi-asset.

But it’s hard to blame Americans for not knowing how their year was: there is no easy way to track what investments are winning or losing in their brokerage and crypto accounts. Most just take the profit or loss off their year-end 1099 and call it a day. This is a surprising gap in the financial space, especially since the pandemic helped open up the floodgates for a new fintechs, the rise of crypto, and more robust personal finance options.

33% of our respondents indicated that they used Fidelity, one of the largest sponsors of 401(K) plans and an emergent player in the digital assets place.

27% reported using brokerage newcomer Robinhood, which bested passive investing king Vanguard, which 18% of respondents reported using to invest.

TD Ameritrade and Charles Schwab were equally popular in the poll—used by about 10% of respondents each.

Most popular brokerages used by survey participants

Fidelity Investments
Robinhood
Vanguard
TD Ameritrade
charles SCHWAB
coinbase
GEMINI
E*TRADE
Webull
BINANCE
InteractiveBrokers
acorns

In crypto-land, our survey result showed that Robinhood had more users (27%) than crypto giant Coinbase (18%.) Both were arms and legs above Gemini, which was used by 4% of the sample.

Surprisingly, 33% of people reported using “Other” brokers or crypto exchanges that we had not listed—largely a mix of smaller competitors that you sometimes come across in the wild. E-Trade, Webull, Binance U.S., and other players were among the names.

The breakdown is a surprising indictment of the fragmentation that the financial sector is facing. It’s also a look into just how many different platforms that users are now trading across, complicating things like tax planning, asset overlap, or awareness on how much their investments are making. We’re not just talking about returns, but also dividends and income.

This level of complexity makes it hard to believe that a little-informed public is actively optimizing their finances. They’re likely not considering asset placement, the impact that tax lots have on their sales (such as first in first out (FIFO) or last in first out (LIFO), etc.), or gauging their tax impact across multiple exchanges and brokers.

The reason why is simple: it’s difficult and time-consuming for an engaged investor, let alone the average person.

#3: People rely on their tax preparer to save on taxes

Nearly 40% of our survey said they relied on a financial or tax advisor to learn about taxes and the ways they can lower them. But there's one huge problem with that strategy.

Many financial advisors and tax preparers aren't really in the business of tax advisory, which means they might not be proactively helping people lower their taxes—just tending to the low-hanging fruit and collecting their check when handing the IRS a finished tax return.

Tax prep is a high volume business. It's also a profitable one for tax incumbents like Intuit TurboTax and H&R Block. Though these companies do offer more specific tax services, most people can't really tell the difference.

In fact, just 28% of our survey said that they turn to a professional tax advisor for help. And even then, there could be considerable variability in the quality of services that each tax advisor provides. After all, every accountant is different—it's just like any job where people have different specialties and levels of expertise.

Most investors **don't have a tax advisor** for help

28%

of retail investors turn to a professional tax advisor for help

Respondents believed their accountants would help. They don't realize most accountants are just tax-preparers, not advisors.

Even though they could add more value, many tax advisors, accountants, and financial advisors aren't sure what their clients are doing. That's in part because people are trading their own money on more platforms than ever before. However, these experienced—and often extremely helpful parties—are largely "over it" when it comes to chasing down a client for access to their third-party broker account or crypto exchanges.

So besides the fact that more people are using more platforms, the important information needed to make proactive plans for tax season is simply not accessible to the people who need it to make those decisions. Especially in a year like 2022, where stocks and other investments have fallen aggressively from last year, people might not even know what options are at their disposal to get a beefier tax refund.

Honorable Mentions

Three Honorable Mentions

As we said, our survey findings include three big ideas - but there are some other observations we found in conducting our research that are recurring across these three findings. Before we dive deep, we want to talk about their impact on the survey.

01

Investors are more multi-asset and multi-platform than ever

02

American's' idea of "tax planning" generally boils down to their 401(K)

03

The most popular tax strategy outside of investing in a qualified account like a 401(K) or IRA is tax-loss harvesting

First, investors are more multi-asset and multi-platform than ever

This suggests that Americans of all ages and backgrounds are managing more financial “moving parts” than they have historically, which likely means they have more tax forms and more data to keep track of.

When it comes to assets, 65% of our sample said they invested in stocks in 2021, while 29% invested in crypto, 24% in bonds, 20% in real estate, and 23% in other alternatives. And when it comes to platforms, while names like Fidelity and Robinhood were popular, investors were spread across a slew of platforms—both established and new.

It’s reasonable to expect that Americans, especially ones deeply engaged with their finances, will continue to grow the mix of this multi-asset future. Particularly in this market, alternatives might have the greatest room to grow their share of the fintech pie.

Investors are putting their money everywhere

1.7

average number of asset classes invested in

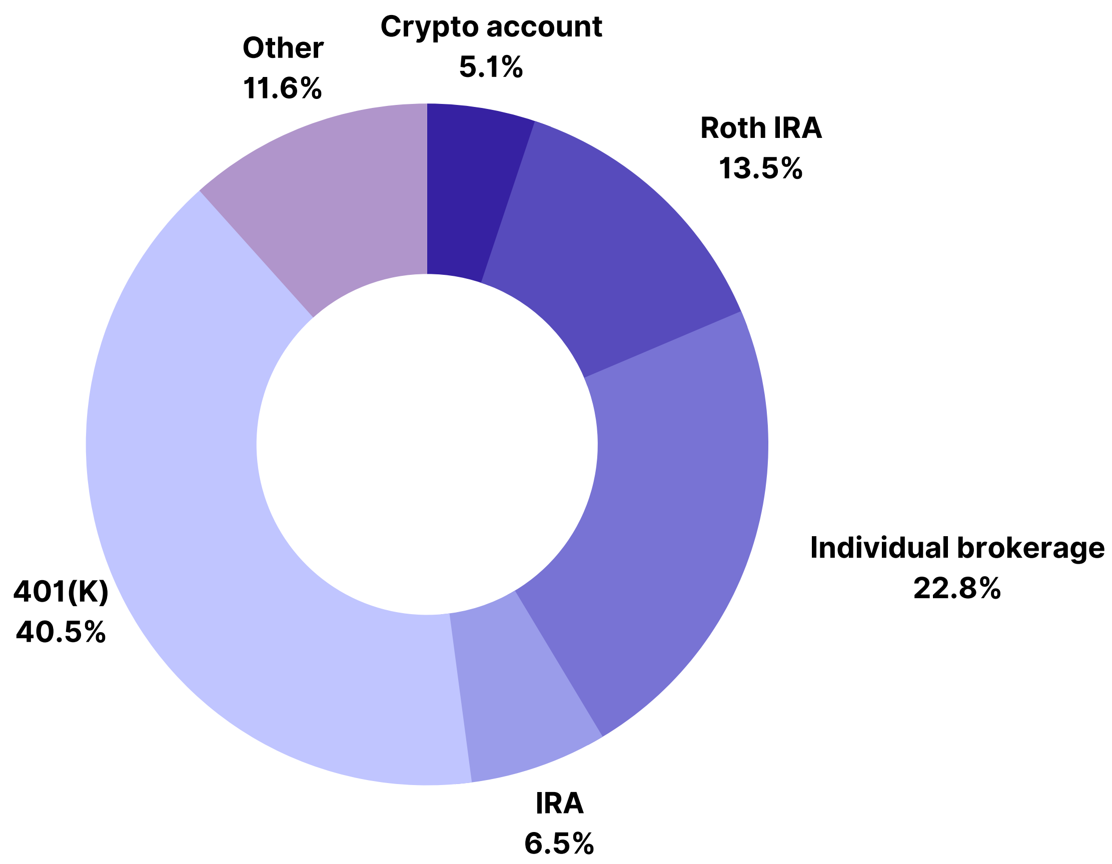
Investors flocked beyond stocks to other asset classes as they've become more accessible to the masses.

Second, we discovered that American's' idea of "tax planning" boils down to their 401(K).

The majority of our sample—41% of our survey—said they do most of their investing in their 401(K), which is a great start. 401(K)s generally confer tax benefits and often include employer contributions.

However, while some Americans recognize those benefits and identify them as a tax strategy, many in our survey failed to discern that 401(K)s or Individual Retirement Accounts confer money-saving benefits. In short, they couldn't identify where they fit into a tax plan.

Maybe even more importantly, there seems to be a weak suggestion that Americans don't understand the benefits of asset placement—that is, to put individual stocks that come with risks into individual accounts so they could be tax-loss harvested, while putting more diversified funds and long-term investments into a 401(K) or IRA.



Third, the most popular tax strategy outside of investing in a qualified account like a 401(K) or IRA is tax-loss harvesting.

Our third and final ‘honorable mention’ is that many Americans are leaving this huge tax saver on the table—just 27% of our survey decisively knew what that was and only 14% of our survey was actively making use of it. Our takeaway is that many Americans don’t proactively consider the tax implications when it comes to buying or selling an investment, which can be burdensome.

Investors unknowingly avoid simple tax saving strategies

14%

of retail investors make use of long-term tax rates

9%

of retail investors aim for low-tax, qualified dividends

4%

of retail investors take advantage of charitable donations

Conclusions

Conclusions

While it’s convenient to point to lackluster financial education, the reality is that a robust marketplace of fintechs has done little to educate the end user in a compelling and long-lasting way.

Millions of Americans are leaving thousands on the table because of a lack of literacy on investing, qualified accounts, how taxes work, and how they can plan for their long-term futures. That could be a symptom of an innate human desire to avoid planning over long time horizons, but it’s more likely a reality in that finances and money are a social taboo among a healthy portion of Americans—and we don’t do a great job of educating people to live whole financial lives.

Many technical products have also left their users’ success or failures up to the imagination. It’s hard for clients to visualize whether they are making money or losing money, making better decisions, or considering their whole financial picture. Well, at least until a 1099 appears in their mailbox or email at the end of the year—or in crypto’s case, in which you have to pay to generate one yourself.

In that sense, it feels like many of the financial applications of today are great tools. They give experienced and knowledgeable people free reign of the financial world. However, there are millions of people who are not so experienced and knowledgeable. That leaves something to be desired: more appropriate planning tools, the opportunity to connect with a financial advisor, and embedded finance features should all be top of mind for companies building apps for the modern investor.

Methodology

Methodology

The Reconcile survey was conducted online over a four day period from November 15 to November 19, 2022. We tallied 224 completed responses using a 95% confidence level and a 7% margin of error, based on an adult US population of 220,000,000. The results reported and summarized from the survey are presented ‘as is,’ without weighting on any demographic characteristics.