

Windfalls take breath away at tax time

Stocks, Bitcoin carry unwelcome surprise



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A clever little term is being bantered about on social media this tax season to describe how tax preparers might break the bad news to clients: Congratulations.

It's a word you might offer, according to the Urban Dictionary, to a co-worker who has accepted a job promotion that is a mixed blessing. Maybe something that moves her up the ranks but puts her in more direct contact with a cantankerous colleague.

"I think I'm going to use it with clients that have to pay a big tax bill because they made a lot of money," enrolled agent Matthew Cordes said in a light-hearted tweet.

Big tax headache from big gains

Investors and others who saw financial success in 2021 are seeing eye-popping numbers for taxable income, often triggering tax bills many never imagined.

Blame Bitcoin and other virtual currencies. Blame lots of trading in stocks. And yes, blame mutual funds that paid out some extraordinary capital gains distributions after a robust rally on Wall Street last year.

The S&P 500 rose nearly 26.9% in 2021. The Dow Jones Industrial Average climbed 18.73% in 2021. And your tax bill?

Big gains can mean big money at tax time.

James O'Riley told me of one investor who made well over a million dollars buying and selling virtual currency almost daily last year.

The man – a friend of a friend who wasn't aware of all the tax ramifications – ended up being shocked by the outcome, according to O'Riley, a CPA and tax director for Doeren Mayhew in Troy, Michigan.

He had taken early retirement – or so he thought, O'Riley said – but then owed more than \$400,000 in federal taxes for 2021 on his virtual currency gains.

The gain of more than \$1 million last year amounted to short-term profits that are taxed at regular income tax rates. In this case, the money was taxed at the top rate of 37% plus a "net investment income tax" of 3.8%.

"The problem is the value of the portfolio dropped substantially in 2022, to a level where he needs to sell the entire portfolio just to pay the taxes," O'Riley said.

One small plus side to this story: The investor lives in Florida, which does not have a state income tax. More money would have been owed on the state level if the man who bet on Bitcoin lived in a state with an income tax.

Mutual fund investors get clobbered by unusual capital gains

One didn't need to be a day trader, though, to face tax headaches. Even passive investors saw incredible tax troubles.

One reader told me that he has been investing money in mutual funds for about 30 years and doesn't remember anything like this happening.

For 2021, his capital gains distributions from his mutual funds outside of tax-deferred retirement accounts increased by a shocking \$82,000 in 2021 from 2020.

And as a result, the couple reported \$115,000 in capital gains distributions on their 2021 return.

The retired couple who live in the Traverse City area in northern Michigan saw their federal and state of Michigan tax burden go up by \$20,000 this tax season.

Fortunately, the couple – who asked not to be named because they didn't want others to read about their finances – was able to pay and did not have to



Investors and others who saw financial success in 2021 are seeing eye-popping numbers for taxable income, often triggering tax bills many never imagined. SETH WENIG/AP

borrow money to cover the taxes due.

Cordes, who prepares about 650 individual tax returns a year, told about one elderly client who normally would have to report about \$5,000 to \$8,000 in taxable capital gains distributions from mutual funds held outside of tax-deferred retirement accounts.

This year, the client had to report \$55,000 in taxable capital gains distributions.

"His tax due this April 18 is over \$11,000."

Cordes has heard of clients elsewhere facing even bigger tax bills due to massive capital gains distributions.

These "surprise" tax bills involve capital gains distributions from mutual funds held outside of a traditional 401(k) or tax-deferred IRA.

"Most taxpayers do not realize that mutual funds must distribute the capital gains that are realized within the fund," Cordes said.

"Those capital gains are then reinvested and the taxpayer does not 'receive' anything in the form of a cash payout," he said.

What you'd get is a 1099-DIV to report those capital gains distributions from mutual funds. Typically, those are sent out in late January.

Good rally shares some of the blame

The strong rebound in the stock market in the second half of 2020 after the meltdown at the start of the pandemic plus sizable gains last year resulted in larger distributions than normal, according to Fidelity Investments.

In such extended periods of broad growth, fund managers are less likely to have losses to offset gains.

About 53% of the mutual funds based in the United States, including exchange-traded funds, reported capital gains distributions for 2021. That was up from 43.1% in 2020, according to Chicago-based Morningstar Direct, a research firm.

Morningstar noted that 5,405 mutual funds reported capital gains in 2021, compared with 4,234 in 2020.

How many funds pay out such distributions vary year to year. Based on Morningstar Direct data going back to 1990, spikes where 60% or so of mutual funds had capital gains distributions, were relatively rare and took place in 1993, 1997, 1998, and 2007.

During that time, we saw four years – 2002 and 2003, as well as 2009 and 2010 – when only 25% or fewer funds had such distributions.

Five-figure income gains

The dollar amount of the distributions, though, can shock investors who

have been saving a great deal in mutual funds for decades.

Some funds distributed 10% to 20% or more of their net asset value – which can add four or five figures of income to an investor's 1040 this tax season.

Take this easy math example. If you had \$10,000 in a mutual fund outside of a retirement account, you'd have an extra \$1,000 in taxable capital gains income when a fund has a 10% capital gains distribution.

Many investors over the years have built up quite a bit of savings in taxable mutual funds held outside of retirement accounts. In those cases, you're looking at taxable income when a mutual fund has a capital gains distribution.

For many retirement savers with 401(k)s and IRAs, it's a non-event if the mutual fund is in a tax-sheltered account. You're getting hit with taxes when you begin withdrawing money from traditional retirement accounts. Qualified withdrawals from Roth IRAs are not taxable.

Capital gains distributions can be characterized as short-term or long-term based on the investment strategies of the mutual fund.

For the taxpayer, a short-term distribution would be taxed at the individual's ordinary income tax rate. There are seven income tax rates in place currently 10%, 12%, 22%, 24%, 32%, 35% and the highest at 37%.

In general, the more active a fund manager is with trading, the more likely the fund would distribute short-term gains. As a result, investors may find it more advantageous to hold funds with a higher turnover rate in tax-shelters accounts, such as traditional IRAs and Roth IRAs, according to Fidelity.

Taxpayers receive a break on long-term distributions. The long-term capital gains tax rates are 0%, 15% and 20%, depending on your income.

Mutual fund companies began publishing estimates last November of the capital gains distributions that were likely to be made in mid-December. But funds may pay distributions throughout a year.

These "off-cycle" distributions may be the result of a fund merger or investment mandate change, according to Fidelity.

Growth funds again made significant distributions, but in 2021 value strategies gained popularity and made some make some big distributions, according to Morningstar experts Christopher Franz and Anthony Thorn.

Morningstar experts noted that it's not all pain, as reinvested capital gains distributions will increase your cost basis and ultimately could reduce the capital gains taxes you owe when you eventually sell the fund.

Obituaries

Jodi (Lamb) Miller-Pfaff

SILVERTON - Jodi Miller-Pfaff passed away on April 9, 2022, in her Silverton, Oregon home after a three-year battle with pancreatic cancer. Jodi was born in Salem, Oregon on September 25, 1947. She grew up in Independence, Oregon and graduated from Central High School. She married Neil Everett Miller in 1966 and was married for 27 years until he passed away. They raised their two children Beth and Scott in the Milwaukie/Gladstone area. Jodi was a wonderful wife and mother who was at every game, concert and play cheering her children on.

Jodi was a hard worker. She wanted to make a better life for her family and usually had at least two jobs. She worked as a telephone operator, ran the front of a busy florist in Portland, managed a Hallmark card store, and then worked in the dental and medical fields as an office manager. She also sold Tupperware and was a favorite Avon lady for several years in the 1980s. She loved to visit her customers to chat and catch up on the latest gossip. Everyone loved her at every job she had. She always had a smile on her face.

Jodi always kept a beautiful home. She had great taste and people always raved over her house and the way it was decorated. She loved antiques and was a collector of many things including Golden Books, stamps, flower frogs and vintage Santas. She was an avid reader, she read at least a novel a week and loved her home decorating magazines. She also volunteered at the local grade school to read with the children. She loved to tend to her yard and flower garden. Her yard has always been one of the best in the neighborhood. She had beautiful flowers and trees and had enjoyed growing vegetables in her Silverton backyard. She said she got her green thumb from her beloved Grandma Edie. She loved music, concerts, antiques, and the occasional bingo night with friends.

Jodi reunited with an old classmate, Norm Pfaff at a high school reunion planning committee in 1995. They married and built their dream log home in Bend, Oregon. They moved to Silverton in 2018 to downsize and enjoy retirement. They enjoyed trips to Cabo, their cabin in Detroit Lake and their place at Nye Beach near Newport. They also shared a Rick Steves dream trip to Europe in 2017 visiting Germany, Switzerland, Italy, and her favorite, Paris, France. She also went on a beautiful bucket list trip to Hawaii with her daughter Beth last September. Jodi had many friends, old ones from her life when her kids were young and many new friends that she made in Silverton. She cherished her friends and was loved by so many. She loved life and was her smart, sassy, vivacious self until the end. She will be missed so much and remembered forever.

She is survived by her husband, Norm Pfaff and four children, Beth Weber, Scott Miller, and his wife Zaira, Brian Pfaff and his wife Melissa and Cadi Brown and her husband Daron. She had 12 grandchildren: Brian, Austin, Lillian, Kendall, Francisco, Zaid, Alex, Chase, Charlotte, John, Zander, and Heath.

A memorial will be held at Detroit Lake to celebrate her life this summer. Donations to the Pancreatic Cancer Society can be made at pancan.org/donate.

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NOTICE OF BUDGET COMMITTEE MEETING

A public meeting of the Budget Committee of the Silver Falls School District, Marion and Clackamas Counties, State of Oregon, to discuss the budget for the fiscal year July 1, 2022 to June 30, 2023, will be held at Silverton High School's library; 1456 Pine Street, Silverton, Oregon. There will also be a virtual option to join via Zoom. The link can be found at <https://meetings.boardbook.org/Public/Organization/1569>. The meeting will take place on April 28, 2022, at 7:00 PM. The purpose of the meeting is to receive the budget message and to receive comments from the public on the budget. This is a public meeting where deliberation of the Budget Committee will take place. Any person may appear at the meeting and discuss the proposed programs with the Budget Committee. A copy of the budget document may be inspected or obtained on or after April 27, 2022, by calling the Silver Falls School District office at (503)873-5303 ext. 1137 to make arrangements. Please call 503-873-5303 if you require accommodations to fully participate in the meeting. A copy of this notice is posted on the Silver Falls School District website at <http://silverfallschools.org>
Silverton Appeal April 13, 20, 2022