

# TRADER TAX BENEFITS – PART I INTERACTIVE BROKERS WEBINAR

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# Presented by:

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# Robert A. Green Bio

- Robert A. Green is a CPA and founder and CEO of Green & Company Inc. (GreenTraderTax.com), a publishing company, and Managing Member and Founder of Green, Neuschwander & Manning, LLC, a tax and accounting firm catering to traders, investment management, and small business. He is a leading authority on trader tax.
- Mr. Green is a contributor to Forbes. He is also the author of The Tax Guide for Traders (McGraw-Hill, 2004), Green's 2016 Trader Tax Guide and wrote the "Business of Trading" column for Active Trader magazine for 14 years until the magazine closed in 2015.

# Robert A. Green Bio

- Mr. Green is frequently interviewed and has appeared in the New York Times, Wall Street Journal, Forbes, and Barron's. Mr. Green has also appeared on CNBC, Bloomberg Television, and Forbes.com Video Network.
- He is the chief tax speaker at the MoneyShow University and Traders Expo and taught "Trader Tax 101" for CCH to tax professionals.

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- **Robert A. Green and the Green companies are not affiliated with Interactive Brokers.**

# TRADER TAX BENEFITS

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Active traders may be able to reap more tax breaks vs. casual investors, including business expenses, Section 475 MTM “tax loss insurance” and employee benefits (health insurance and retirement plans)

# TRADER TAX STATUS

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Trader tax status (TTS) constitutes business treatment and it unlocks an assortment of meaningful tax benefits for active traders who qualify.



# TTS Defined

- GreenTraderTax coined the term “trader tax status” (TTS) in the late 1990’s, and we’ve focused on trader tax benefits ever since.
- By default, the IRS considers traders to have “investor tax status” with:
  - Restricted Section 212 investment expense treatment,
  - \$3,000 capital loss limitation,
  - Wash sale loss limitations, and
  - No opportunity for employee benefit plan deductions.

# TTS Benefits Include:

1. Section 162 business expense treatment.
2. The opportunity to make a timely Section 475 MTM election for exemption from capital loss limitations, and wash sale loss adjustments - using ordinary loss treatment (“tax loss insurance”).
3. Unlocking employee benefit plan deductions including health insurance and retirement plans with an S-Corp.

# Claiming TTS Is Different From Electing Section 475 MTM

- Individuals and entities can claim TTS business expense treatment for 2016, and even other open tax years (usually up to three years prior).
- Assess TTS based on facts and circumstances, it's not an election like Section 475.
- A TTS trader may elect Section 475 on a timely basis. Some never elect Section 475 as they are two separate but related issues. Example: If you have capital loss carryovers, you may want to hold off on electing Section 475.

# Existing Vs. New Taxpayer

## Section 475 Election

- After April 18, 2016, it's too late to elect Section 475 for 2016 for existing taxpayers.
- A new entity can take advantage of the “new taxpayer” exception for making a Section 475 election within 75-days of the inception of the company.
- Forming an entity in late Nov. 2016 is probably too late in the year for establishing TTS and electing Section 475. Consider a new entity starting Jan. 1, 2017.

# BUSINESS EXPENSE TREATMENT

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If you qualify for trader tax status, you can use the more favorable business expense treatment vs. investment expense treatment on Schedule A.

# All Reasonable Business Expenses

- TTS traders can deduct all reasonable business expenses, whether they have trading gains or losses, saving around \$5,000 per year on average.
- Business expense deductions hinge on qualifying for TTS, of course.
- Investors, on the other hand, are very limited with investment interest expense and investment expense treatment as itemized deductions on Schedule A.

# TTS Business Deductions Include:

1. Tangible personal property like a computer, up to \$2,500 per item, providing you file a Sec. 1.263(a)-1(f) safe harbor election with your tax return.
2. Section 179 (100%), bonus, and or regular depreciation on computers, equipment, furniture and fixtures.
3. Amortization on start-up costs (Section 195), organization costs (Section 248) and software.

# TTS Business Deductions Include:

4. Education expenses paid and courses taken after commencement of your trading business activity.
5. Otherwise, pre-business education may not be deductible, or it may be included in Section 195 start-up costs.
6. Books/publications, market data, online and professional services, chat rooms, mentors, coaches, supplies, phone, travel/entertainment, seminars, conferences, assistants, consultants and more.



# TTS Business Deductions Include:

7. Home-office expenses for the business portion of your home (share of rent, mortgage interest, real estate tax, depreciation on home, utilities, repairs, insurance and all other home costs).
8. Margin interest expenses (not limited to investment income).
9. Stock borrow fees for short sellers.

# INVESTORS FACE LIMITATIONS ON TAX DEDUCTIONS

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Investors are entitled to deduct Section 212 investment expenses including “investment interest expenses” and “investment expenses” reported on Schedule A (itemized deductions).

# Investment Interest Expense

- Calculate investment interest expense on Form 4952 where it's limited to net investment income, with the balance carried over.
- Net investment income is portfolio income minus investment expenses. (Read Form 4952 instructions for further details.)
- Taxpayers carry over unused investment interest expense to the subsequent tax year(s), whereas they may not carry over unused investment expenses, which means they may entirely lose some investment expenses.

# Investment Expense Limitations

- Investment expenses are “miscellaneous itemized deductions” in excess of 2% of adjusted gross income (AGI).
- Not deductible for the alternative minimum tax (AMT).
- Investment expenses are wasted when a taxpayer has negative taxable income.

# Investment Expenses Exclude:

- Unlike traders qualifying for TTS, investors can't deduct education including most seminars and travel costs, home-office expenses, and Section 195 start-up costs.
- Trading commissions are not separately stated expenses, they are part of trading gain or loss.

# Itemized Deduction Limitations

- Most itemized deductions are subject to a phase-out for the upper-income brackets (known as the Pease limitation, indexed for inflation).
- Some taxpayers are better off using the standard deduction than the itemized deduction.
- TTS business expense treatment is far better than investment expense treatment.

# TRADER TAX STATUS: HOW TO QUALIFY

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It's not easy to qualify for trader tax status. Learn our golden rules based on trader tax court cases.

# TTS Case Law Is Vague

- Currently, there's no statutory law with objective tests for how to qualify for TTS. Subjective case law applies.
- Leading tax publishers have interpreted case law to show a two-part test to qualify for TTS:
  - “Taxpayers’ trading activity must be substantial, regular, frequent and continuous.
  - The taxpayer must seek to catch the swings in the daily market movements and profit from these short-term changes rather than profiting from the long-term holding of investments.” (Not day trading per se).



## IRS Pub. 550: Investment Income and Expenses (Special Rules For Traders)

“The following facts and circumstances should be considered in determining if your activity is a securities trading business.

- Typical holding periods for securities bought and sold.
- The frequency and dollar amount of your trades during the year.
- The extent to which you pursue the activity to produce income for a livelihood.
- The amount of time you devote to the activity.”

# Qualification Golden Rules: Hours & Frequency

- *Hours*: Spends more than four hours per day, almost every market day working on his trading business. (Section 469 passive-activity material participation rules don't apply.)
- Has few *sporadic lapses* in the trading business during the year. Traders can take vacations, sick time, and personal time off just like everyone else. Keep good records.
- *Frequency*: Executes trades on close to four days per week, every week. Figure 75% of available trading days.

# Qualification Golden Rules: Volume & Proceeds

- *Volume*: Makes 60 total trades per month (Poppe court).
- The markets are open approximately 250 days per year, and with personal days and holidays, you might be able to trade on 240 days per year. With a 75% frequency, you would trade on 180 days per year, so 720 total trades divided by 180 trading days equals **four trades per trading day**. (The buy and sell count separately.)
- *Proceeds*: Has proceeds in the millions of dollars per year on equities. More traders are using options and futures, which have lower proceeds values.

## Qualification Golden Rules: Holding Period & Intention

- *Holding period*: Makes mostly day trades or swing trades. Few positions are held for more than a few weeks. The Endicott court concluded the average holding period must not exceed 31 days. (Segregate investments, so you don't pollute the average holding period on trading positions.)
- *Intention*: Has the intention to run a business and make a living. It doesn't have to be your primary living. (The hobby loss rules do not apply since trading is not personal or recreational in nature.)

## Qualification Golden Rules: Operations & Account Size

- *Operations*: Has significant business equipment, education, business services and a home office. Most business traders have multiple monitors and a workstation.
- *Account size*: Has a material account size. Securities traders need \$25,000 for “pattern day trader” (PDT) status, allowing day trading with up to 4:1 margin rather than 2:1. Without PDT status, equities traders can’t day trade, and they will have a very hard time qualifying for TTS. (Futures, options and forex traders can have smaller account sizes, but try to keep a minimum of \$15,000.)

# What Doesn't Qualify For TTS?

There are three factors that don't qualify for TTS:

- Automated trading without much involvement by the trader.
- Engaging a professional outside investment manager.
- Trading in retirement funds. (These trades should not be included in the golden rule calculations.)

# Green's 2016 Trader Tax Guide

- Our guide has more in-depth information on how to qualify for trader tax status, and it includes several examples of full-time and part-time traders that do and do not qualify.
- After you read the guide, consider a 30-minute paid consultation to see if you qualify for these incredible tax breaks.

# SECTION 475 MTM ELECTION

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Section 475 MTM exempts TTS traders from capital loss and wash sale loss limitations – tax loss insurance.



## Avoid Capital Loss Limitations With A Section 475 Election

- Investors have an annual \$3,000 capital loss limitation against other income, and wash sale loss deferrals on securities.
- Investors have no choice, but business traders qualifying for TTS can avoid it by filing a timely election for business ordinary tax-loss treatment: Section 475 mark-to-market (MTM) for securities, and/or on Section 1256 contracts if elected.
- Consider a Section 475 election for securities only, so futures trades retain lower 60/40 capital gains rates on Section 1256 contracts.

## Ordinary Loss Treatment Is Better

- Section 475 trades are ordinary gain or loss, not capital gain and loss, so the capital loss limitation does not apply.
- Section 475 ordinary losses are unlimited business losses, offsetting all types of income, and they contribute to net operating losses (NOLs), which often generate immediate tax relief. (Carry back an NOL two years and or carry it forward 20 years.)
- Section 475 trades are also exempt from wash sale loss treatment.

## Section 475 Election Statement

- Existing taxpayer individuals that qualify for TTS and want Section 475 for 2017 must file a 2017 Section 475 election statement with their 2016 tax return or extension by April 15, 2017.
- Existing S-Corps and partnerships file in the same manner for 2017 by March 15, 2017.
- The MTM election statement is one simple paragraph; unfortunately, the IRS hasn't created a tax form for it.

# Sample Election Statement For Section 475

- “Pursuant to IRC 475(f), the Taxpayer hereby elects to adopt the mark-to-market method of accounting for the tax year ended Dec. 31, 2017 and subsequent tax years.
- The election applies to the following trade or business: Trader in Securities as a sole proprietor (for securities only and not Section 1256 contracts).”

## Section 475 Step Two: Filing Form 3115

- Don't forget an important second step:
- Existing taxpayers complete the election process by filing a Form 3115 (change of accounting method) with the election-year tax return.
- A 2017 MTM election statement filed by April 15, 2017, is reported and perfected on a 2017 Form 3115 filed with your 2017 tax return in 2018 – by the due date of the tax return including extensions.
- Once you make a Section 475 election, you must use Section 475 tax treatment as long as you qualify for TTS. (It's not an annual election.)

## “New Taxpayer” Exception: Applies To A New Entity

- A new entity (new taxpayer) can deliver Section 475 MTM on trading losses generated in the entity account if the entity files an internal Section 475 MTM election (entity resolution) within 75 days of inception.
- A new entity does not have to file a Form 3115 since it's *adopting* Section 475 from beginning, rather than changing its accounting method.
- If you start trading in June, after the April 15<sup>th</sup> external election deadline, consider a new entity for an internal Section 475 election.

## Section 475 Election: Decision-Making & Revocation

- If you have substantial capital loss carryovers, hold off on making a Section 475 election if you have current year trading gains since you need capital gains vs. Section 475 ordinary income for utilizing capital loss carryovers.
- If you have significant current year trading losses before the election deadline, make the election, and you can revoke it in the subsequent tax year using similar procedures to making an election.
- Both the election and revocation is free with the IRS.

## Section 475: Segregate Investment Positions

- Traders can have it all: Section 475 business ordinary loss treatment on active securities trading, lower 60/40 capital gains rates on Section 1256 contracts, and long-term capital gains on segregated investment positions.
- On duly segregated investments, Section 475 traders don't give up tax deferral and lower long-term capital gains rates.
- Segregation must be done in form and substance and that can be confusing. A prior IRS proposed regulation called for designation of investment accounts, but that was not sufficient as traders could use substance to trump form.



## Further Reading On Sec. 475

- Green's 2016 Trader Tax Guide (Chapter 2)
- GreenTraderTax blog post archive:

<http://greentradertax.com/category/section475mtm/>

# EMPLOYEE BENEFIT PLANS

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It's important to unlock deductibility of health insurance premiums and retirement plan contributions. By default, traders are not entitled to these valuable deductions.

# Trading Income Is Not Self-Employment Income

- Employee benefit plan deductions require SEI, but trading income is not SEI. (Exception: If a trader uses a *full* membership to a futures or options exchange for trading Section 1256 contracts on that exchange, it is SEI (Section 1402i).
- A sole proprietor trader cannot pay him or herself compensation, so they cannot arrange health insurance and retirement plan deductions related to trading income.
- It's a misconception that traders owe SE tax when they use TTS or Section 475 MTM – they do not.

# Traders Need An S-Corp. For Employee Benefit Plans

- Traders qualifying for TTS may form an S-Corp trading company to pay officer compensation to unlock employee-benefit plan deductions including health insurance premiums and a high-deductible retirement plan contribution.
- Alternatively, an S-Corp or C-Corp management company in association with a trading LLC or partnership,
- Investment companies without TTS may not pay compensation to owners to unlock employee benefit plan deductions.

## Officer Health Insurance Premiums Deducted on S-Corps

- For the deduction, the S-Corp adds the officer's health insurance premiums to officer W-2 wages, and it's exempt from payroll taxes, including FICA and Medicare.
- The officer takes an AGI deduction for these health insurance premiums on his or her individual tax return, thereby offsetting the wage component.

# A Solo 401(k) Retirement Plan Is Attractive

- One of the best retirement plans for business traders is a defined-contribution Solo 401(k) plan.
- It combines a 100% deductible “elective deferral” contribution of \$18,000 for 2016 and 2017, with a 25% deductible profit-sharing plan contribution based on wages. There is also a “catch-up provision” of \$6,000 for 2016 and 2017, for taxpayers age 50 and over.
- Together, the maximum tax-deductible contribution is \$53,000 for 2016, and \$54,000 for 2017, plus the \$6,000 catch-up provision.

# AVOID IRS CONTROVERSY

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Don't botch your tax reporting of TTS, it can draw IRS attention.

# Tax Forms And Compliance

- The IRS hasn't created specialized tax forms for individual trading businesses.
- Traders enter gains and losses, portfolio income, business expenses and investment expenses on various forms. It's often confusing. Which form should you use if you're a forex trader? Which form is best for securities traders using the Section 475 MTM method? The different reporting strategies for the various types of traders make tax time not so cut-and-dried.



# Sole Proprietor Trading Business

- Other sole-proprietorship businesses report revenue, the cost of goods sold and expenses on Schedule C. But, traders qualifying for trader tax status (TTS) report only expenses on Schedule C.
- Enter trading gains and losses for securities with the realization method on Form 8949; securities with the Section 475 MTM method on Form 4797; and Section 1256 contracts on Form 6781. Enter ordinary gain or loss for forex Section 988 as Other Income or Loss on line 21 of Form 1040, or if TTS, on Form 4797 Part II.

# Use A Footnote & Avoid Red Flags

- Traders should include a well-written statement with their tax return explaining TTS, how they qualify, tax treatments, and elections made.
- They should ask the IRS to view their trading business as a collection of tax forms. Otherwise, the IRS may see Schedule C as a losing business without any revenue. Most preparers do not include footnotes, and if they do, they may not tell the right story.
- Traders need to avoid red flags and errors on Schedule C and the other tax forms listed above.

## Schedule C: Transfer Of Income Strategy

- In Green's 2016 Trader Tax Guide, I explain how to transfer a portion of TTS trading gains to Schedule C to zero it out, after unlocking the home office and Section 179 depreciation deductions, which require income.
- Don't show net income on Schedule C that will awaken IRS computers to look for SE tax.
- This transfer of income strategy is our industry practice; tax form instructions do not address it. Read our tax guide if you are interested in learning more.

## An Entity Is Better Than a Schedule C

- Partnership and S-Corp trading business tax returns show trading gains, losses and business expenses on one set of forms, plus the IRS won't see the taxpayer's other activities on their individual return. That looks much better.
- The individual tax return is less confusing, with much of the Schedule K-1 income and expense reported on Schedule E in summary form. It looks like you invested in a hedge fund.
- A pass-through entity trading account is easy to set up and operate. Note: An entity account pays professional market data fees.

# Use TTS Safely

- Using TTS correctly should not draw IRS attention unless you have trading business expenses outside the norm (e.g., over \$100,000, not including stock borrow fees).
- The IRS may also be interested in your individual tax return if you have a large Section 475 ordinary loss, ask for a refund, and the IRS can easily see you may not qualify for TTS with insufficient securities trades listed on Form 1099-B.
- Many traders who could safely use TTS, skip it due to lack of understanding and experience, while others do not qualify for TTS and recklessly use it.

# Success With TTS

- Our CPA firm has filed several hundred sole proprietor trader tax returns each year since 1997 with great success. (I founded Green & Company CPAs in 1983.)
- We attribute our excellent record to sound reporting and well-crafted footnotes, as explained in this presentation.
- Don't shy away from using TTS, Section 475, and employee benefit plans - they are incredible tax benefits, and if entitled, you should use them.

# TAX TREATMENT ON FINANCIAL PRODUCTS – PART II

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If you like this Webinar for IB clients, you would likely enjoy our upcoming Webinar Part II scheduled on Dec. 13, 2016 @ 1:00 pm EST. Check the IB site for details.

# Tax Treatment On Financial Products

## - Part II

- Dec. 13, 2016 @ 1:00 pm EST
- Join trader tax expert Robert A. Green, CPA as he explains tax treatment of various financial products including securities subject to wash sale loss rules and cost basis reporting, Section 1256 contracts, options, ETFs, forex, foreign futures, precious metals and more.



# NEED HELP?

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Consider working with Green, Neuschwander & Manning, LLC. We have excellent CPAs and tax attorneys with significant trader tax experience.

# We Help Traders On Tax Matters



# GNM Professional Services

- Tax Compliance (Preparation/Planning)
- Consulting
- Entity Formation
- Accounting
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- Investment Management Services

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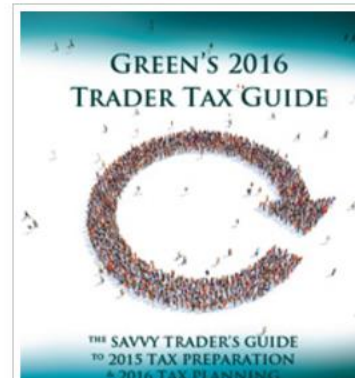
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