

IRS EXAMS: HOW TO DEFEND TRADER TAX BREAKS AND WIN

green **TraderTax**

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Presenter:

Robert A. Green,
CPA

Managing Member

GNM TraderTax
GREEN, NEUSCHWANDER & MANNING, LLC

green TraderTax



Robert A. Green CPA

Job:

- Managing Member of Green, Neuschwander & Manning, LLC, a tax and accounting firm catering to traders and investment managers. CEO of GreenTraderTax.com.

Focus on traders:

- Trading is a real profession, and other tax professionals and solution providers underserve them. Traders deserve tax advice from CPAs and tax attorneys who are acutely aware of different tax laws and regulations that apply to them.

Robert Green's Content

- Mr. Green is the leading authority on trader tax. He is the author of Green's 2017 Trader Tax Guide, which GreenTraderTax published as an annual tax guide every year since 1997.
- Mr. Green has been a contributor to Forbes.com since 2010. Mr. Green wrote the "Business of Trading" column for Active Trader magazine for 14 years until the magazine closed in 2015. Leading brokerage firms and other financial media feature Mr. Green's blog posts and Webinar content.

Robert Green's Media

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

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- Where specific advice is necessary or appropriate, you may wish to consult with a qualified tax advisor, CPA, attorney, financial planner, or investment manager.
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- This presentation is based on current tax law, and tax reform changes may occur in 2017 or 2018.

Overview

- IRS tax notices may question trader tax status (TTS) and the right to deduct trading business expenses on a Schedule C for individuals or pass-through entity tax returns.
- The IRS figures it can force limited investment expense treatment on Schedule A and a capital loss limitation instead of unlimited Section 475 MTM ordinary business losses which are conditional on qualifying for TTS.
- The IRS has recently been victorious against traders Assaderaghi, Nelson and Endicott in tax court.

ISSUES WITH TRADERS

The IRS has several initiatives underway that affect traders.

BROKERS FORM 1099-B MATCHING TO FORM 8949

We expect issues over IRS cost-basis reporting on securities, including cost-basis and wash sales.

1099-B Matching To Form 8949

- With 1099-B IRS computer matching to align broker 1099-Bs with taxpayer Form 8949s, traders should expect to receive tax notices with questions about the differences.
- The IRS indicated they would hold off on these reconciliations for a few years, and 2016 could be the year the IRS starts sending tax notices.
- We've begun to see clients receive these notices.

IRS Rules Cause These Differences

- If a taxpayer complies with Section 1091 rules requiring wash-sale loss calculations based on substantially identical positions (between stocks and options) across all their accounts including IRAs, they will likely have discrepancies with broker 1099-Bs based on identical positions (exact symbol) for wash sales calculated on a separate account basis only.
- In this case, you need to include a tax return footnote explaining the differences between the IRS wash sale loss rules for brokers vs. taxpayers.
- Try to reconcile gross proceeds on 1099-B with Form 8949.

Wash Sale Losses

- I rarely hear about IRS agents reviewing wash sale loss adjustments for active securities traders.
- Some agents may not understand that IRS wash sale rules vary between brokers and taxpayers.

Few agents would even ask to see IRA statements, where wash sales may occur with individual taxable accounts.

- Wash sales may become more of an issue in the future.

ATTACKS ON TRADER TAX STATUS (TTS)

TTS is the lynchpin to many tax benefits.

Sole Proprietor Traders

- Sole proprietor business traders may receive IRS questions on Schedule Cs, as only trading business expenses are reported there which causes it to look like a losing business. That's a red flag.
- Traders enter trading-related income and loss on other tax forms.
- Sole proprietor business traders with substantial ordinary losses from trading expenses and Section 475 MTM losses should expect to hear from the IRS since such losses will likely generate huge net operating loss (NOL) carryback refunds.

Don't Mess Up Trader Tax Return Filings

- Other attention grabbers are perennial money-losing traders and messed up tax return filings on TTS, Section 475, tax treatment and omitted footnotes.
- Although the IRS is underfunded and the number of agents is down, the slack is being taken up by computer matching and computer-generated tax notices.
- We hope more traders assess TTS properly.
- Don't play the audit lottery by trying to cheat the IRS and your state on tax treatment.

Arguments Against Qualification For TTS

- *Not a primary living:* The law requires the intention to make "a" living, including a supplemental living, in a business-like manner.
- *Trading period is too short.* In *Chen vs. Commissioner*, Chen traded only three months, and he lost his pro-see case. A significant percentage of side businesses last only a few months before failing.
- *Sporadic lapses.* Trading must be regular, frequent and continuous and if you take off several weeks or months, several times during the year, it's hard to win against this argument.

Meet Golden Rules For TTS

- Traders need to meet the golden rules for TTS laid out in Green's 2017 Trader Tax Guide.
- Volume: Approximately four or more total trades per day, with over 15 trades per week per Poppe court.
- Frequency: Over 75% of available trading days, close to four days per week with at least one trade execution.
- Average holding period up to 31 days per Endicott Court. Four or more hours per day, including research and administration. Account size over \$15,000. Significant equipment, business expenses, and a home office or an outside office.

SECTION 475 ELECTION

Many traders don't adhere to Section 475 election rules, and the IRS may deny ordinary loss treatment.

Messed Up Section 475 Elections

- Many traders miss the Section 475 election statement deadline of March 15 (pass-through entities) or April 15 (individuals) of the current year. Or, the second step, filing a timely Form 3115 (Change of Accounting Method).
- There is a relief for a late Form 3115, but not the election statement.
- New taxpayers (new entities) may elect Section 475 within 75 days of inception, in their books and records.
- Many traders capitulate on qualification for TTS after the IRS denies Section 475 on technical grounds of filing the election late or never at all.

SECTION 475 IMPROPER IDENTIFICATION

Traders want the best of both worlds: Ordinary treatment on trading and capital gains on investments. Don't mess that up!

Segregate Investments

- The IRS and some states have been playing havoc with traders in exams, claiming traders did not adequately comply with Section 475 rules for segregation of investment positions from trading positions.
- Noncompliance gives the agent license to drag misidentified investment positions into Section 475 mark-to-market (MTM) or to boot misidentified trading losses out of Section 475 into capital loss treatment subject to the \$3,000 capital loss limitation.
- Both of these types of exam changes cause huge tax bills, penalties, and interest.

Misidentified Investments

- Traders don't want to lose capital gains deferral and lower long-term capital gains rates on investment positions in securities.
- With misidentified investments, the IRS has the power to drag positions into Section 475, subjecting them to MTM and ordinary income tax rates.
- Section 475 contains a clause to limit unrealized losses on investment positions incorrectly dragged into Section 475. (See Green's 2017 Trader Tax Guide.)

Tips For Segregation

- If you claim TTS and use Section 475 MTM, you can prevent this problem by carefully identifying each investment position on a contemporaneous basis.
- When you receive confirmation of the purchase of an investment position, email yourself to identify it as investment position as that constitutes a timestamp in your books and records.
- Don't hold onto winning Section 475 trading positions and morph them into investment positions, as that does not comply with the rules.

Designate Investment Accounts

- If identifying each separate investment is inconvenient, then ring-fence investments into identified investment accounts vs. active trading accounts.
- Use “do not trade” lists for investing vs. trading accounts, so you don’t trade the same symbol in both accounts.
- But this compliance is not enough. If you hyperactively trade around your investments, the IRS can say you failed to segregate the investment in substance.

An Entity Account Is Better For Segregation

- The simple fix is to conduct all business trading with Section 475 on securities in entity accounts.
- It's wise to avoid investment positions in the entity accounts. But some traders want to use portfolio margining, and brokers don't allow that between individual and entity accounts. That can become a problem for Section 475 segregation of investment rules, especially if you trade the same symbols.
- Keep investments in your individual investment accounts. The individual and entity accounts are not connected for purposes of Section 475 rules since they're separate taxpayer identification numbers. If you must do portfolio margining in an entity account, then skip Section 475.

SET UP YOUR TRADING BUSINESS CORRECTLY

Taking precautions helps avoid IRS scrutiny.

Tips To Avoid IRS Questions

- The most important tip is to get help before setting up your trading business and to get help preparing your trader tax returns.
- The process includes considering the best entity structure, dealing with startup costs correctly, adopting tax reporting strategies to reduce red flags and explaining your TTS and treatment in well-written footnotes accompanying the return.
- A proper business setup and trader tax return filed on time will rarely be questioned, except for those with large ordinary losses, including net operating loss (NOL) carrybacks, which tend to draw more IRS attention.
- Reduce the risk of IRS oversight in this situation, significant NOLs based on weak TTS should be carried forward instead.

Red Flags On Trader Tax Returns

- Don't use trader tax status (TTS) unless you qualify.
- Document qualification in tax return footnotes.
- Don't mess up the reporting like entering trading gains and losses directly on Schedule C as that triggers an IRS exam or notice.
- Don't be overly aggressive on Schedule C business expenses and maintain good support for your expenses.
- Follow the rules on Form 8949 cost-basis reporting and don't report "details available on request." List each securities trade line-by-line.

TAX NOTICES AND EXAMS

When a tax notice arrives, don't panic and gush out everything to an IRS agent.

Assess The Focus Of The Tax Notice

- Understand where the IRS or state is coming from; it may just be a computer-generated notice asking for a few simple open items.
- If the IRS is getting ready to challenge TTS and Section 475 MTM, it's important to step back and make sure you have a strong case for qualification, and that you elected Section 475 properly and on time.
- Don't expect the IRS to get it right the first time around. The IRS notice may have a questionnaire for a hobby-loss business or passive-loss activity and a trading business is exempt from those rules.

Do The Math On Qualification For TTS

- Agents often calculate volume, frequency and other metrics on your trading activity to determine TTS qualification in ways that are favorable to them and wrong in our view, so do the calculations right.
- Count each trade confirmation for volume. TTS court cases exclude option expirations or assignments. You may be able to include each leg of a complex options trade.
- You may only count days with at least one trade execution for frequency, which is actual trading days divided by available trading days. Exclude personal days from available trading days.
- Lumping investments in TTS metrics can make the average holding period too long.

You May Need Professional Help

- If you made a simple error on your tax return, but you clearly qualify for TTS and elected Section 475 MTM on time, you may be able to fix things quickly with a little expert advice.
- On the other hand, if you're a close call on TTS, engage your trader tax expert to be your formal tax representative.
- In some cases, a CPA may decline to be your formal representative if he or she thinks you aren't entitled to relief — perhaps because you apparently messed up the Section 475 MTM election or don't qualify for TTS.
- Even if a CPA doesn't agree to be your formal representative with a power of attorney, they can provide paramount advice and help behind the scenes on a consulting basis.

Large Ordinary Losses Attract Attention

- Most TTS traders have a reasonable amount of expenses which they can quickly document in an exam. There is not much IRS interest here.
- Trading is not a cash business; Form 1099-Bs and brokerage statements verify trading income and loss.
- The IRS focuses exams on individuals filing a TTS Schedule C, not an entity, and if they report substantial Section 475 ordinary business losses generating a large tax refund.
- Challenging and denying TTS does away with business expense treatment and ordinary loss treatment.

How To Reply To Tax Notices

- Answer the questions directly.
- Don't lie or obstruct the truth.
- Be very matter of fact.
- Don't incriminate yourself.
- Consult with an expert if you are unsure.

- If the agent questions Schedule C trading business expenses, provide a detailed and substantiated analysis of your trader tax status and explain the law and why you qualify for TTS.

EXAM RECONSIDERATION & LIMIT SCOPE

Don't let the agent go off on a wild goose chase.

Exam Reconsideration

- Traders can reply to the IRS with a “reconsideration” request, asking the IRS to close its exam before it gets underway.
- If the exam was prompted because a trader filed a Schedule C with a loss, even though the trader had trading gains more than expenses, the trader should be able to get the exam closed (assuming he or she easily qualifies for TTS). Other types of notices or exams can be closed with little work, too.
- The solution can be as simple as filing a corrected tax return with the proper tax treatment, i.e., filing Form 4797 rather than MTM losses incorrectly reported on Schedule C, and including a detailed footnote. (Providing you elected Section 475 MTM on time.)

Limit The Scope

- It's important to keep the agent on the subject of the notice and limit their scope, so it doesn't grow to more areas of your tax return or more years.
- Often, once the IRS finds a problem, it seeks to expand the exam to the prior and subsequent tax years.
- Don't let an agent pursue a line of questioning about hobby losses (not-for-profit activities) or passive loss activities. Neither applies to trading, so it's a waste of time and a distraction.

Trading Is Not A Hobby Loss Activity

- IRS notices may include questions about business status. But these agents often use standard questions geared to assess “hobby-loss” treatment.
- TTS requires the intention to run a business, thereby trumping the hobby-loss rules.
- Trading is not a recreational or personal activity, two key requirements for a hobby loss business.
- A trading business does not have to make a profit in three out of five years.

Trading Is Not A Passive Loss Activity

- An agent may start a line of questioning to assess "material participation" for determining whether the trading activity is "passive" versus an "active" business activity.
- Section 469 passive activity rules suspend a loss unless there is sufficient passive activity income to absorb it, or a sale of the investment.
- The “trading rule” in Section 469 exempts a trading business from passive activity rules.
- If an agent brings up this line of questioning, advise them of the trading rule.

IRS NOTICE OF PROPOSED CHANGES (THE BILL)

Unless you agree with the IRS bill, don't accept the changes without further fight.

Agents May Jump To A Wrong Conclusion

- I've seen many agents issue IRS proposed change reports denying TTS, and Section 475 ordinary losses, without doing a proper analysis of TTS, and referring to trader tax court cases incorrectly.
- With reclassification to investment expense treatment, the trader did not receive many benefits from expenses.
- In this case, there isn't any need to scrutinize and deny expenses, which is usually the case in a small business exam. First deal with TTS, then expense specifics.

Utilize Trader Tax Court Cases

- Ask the agent to do a full analysis of qualification for trader tax status and refer to metrics in recent trader tax court cases. Poppe is a good case for TTS metrics.
- I've seen agents mention a few court cases, but not provide an analysis of the trader's case, or how it relates to those court cases. That's not acceptable, and it's grounds for an appeals case.
- Most agents should request the assistance of an IRS financial products expert.

IRS APPEALS

Expect the IRS agent to deny TTS unless you have a clear-cut case. Agree to disagree with the agent and go to the appeals level.

Appeals Letter

- Show the appeals officer how you are prepared to go to tax court to win based on the application of trader tax court cases.
- It's best to have a trader tax expert CPA or tax attorney in your corner to present your TTS qualification, explain trader tax law and prepare the formal appeals letter.
- Like most tax preparers, most IRS agents and appeals officers are not well versed in trader tax law, and they misapply trader tax court cases.
- Be prepared to negotiate in appeals, but hang tough to win a favorable outcome.
- The appeals letter should be in a professional style that serves as a precursor to a petition to file for tax court. That will earn respect from the appeals officer, and he or she will take you more seriously.

Transfer The Exam Or Appeals

- If you work with a CPA firm with expertise and experience on trader tax clients and IRS exams, it's probably a good idea to transfer the exam to your CPA's office and local IRS office.
- If your CPA has worked on many previous exams with local IRS agents, they probably have educated the agents on trader tax status, trader tax treatment, and Section 475 elections. The firm may have earned credibility with the IRS.
- This helps avoid problems with less informed agents on trader tax.

TAX COURT

It's a last resort for resolving controversy.

Small Case In Tax Court

- If appeals deny TTS and Section 475 MTM, and your trader tax expert thinks you have a good case, then file a petition in tax court.
- We suggest a “small case” filing. It's not a public ruling, so it's not precedent for others to utilize.
- Engage the trader tax expert to write the tax court petition — preferably a tax attorney well versed in trader tax law.

Example Of Small Claims Case

- A client engaged our CPA firm only after they ruined their tax return filing, begged for an IRS beat down, mishandled the agent and got overrun by the appeals officer.
- After a consultation, we felt they qualified for TTS and elected Section 475 MTM on time.
- Our tax attorney had less than a week to write the petition for tax court.
- The IRS considered our petition, conceded and closed the case abating a tax bill for well over \$100,000.

Trader Tax Court Cases

- Most trader tax court cases to date were cases where we feel the trader did not qualify for TTS.
- The best strategy is only to claim TTS when you clearly qualify for it.
- And make sure you elect Section 475 MTM correctly, too.
- (Read trader tax court cases in Green's 2017 Trader Tax Guide, Chapter 11.)

STATE TAX EXAMS

We've noticed more states challenging TTS and related tax breaks on their own, without the IRS taking the lead.

States Attack TTS

- Arizona tried to apply hobby-loss rules to a bona fide trading business; we said that was wrong and the state eventually agreed with us.
- Most states are based on or coupled to federal tax law, and they should not depart from federal tax law when they feel it's convenient.
- Recently, California and a few other state tax authorities initiated a state tax exam to challenge TTS for a few of our clients. In these situations we had two choices: try to get the exam reconsidered (closed) claiming TTS is an IRS matter (and that probably won't work) or present a case to win as we would with the IRS. We chose the latter and prevailed.

CLOSING REMARKS, QUESTIONS & ANSWERS

Closing Remarks

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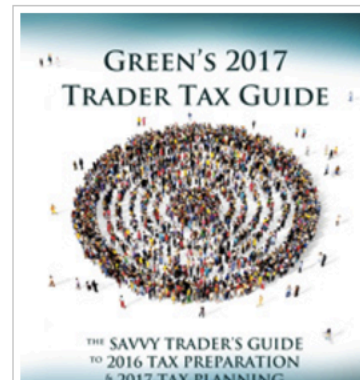
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