

HOW TO MAXIMIZE TAX DEDUCTIONS FOR TRADERS



March 14, 2019 @ 12:00 pm EST
(Interactive Brokers Webinar)

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- We focus on tax compliance (preparation/planning services), accounting, consultations, entity formations, and IRS/state tax controversy.
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Webinar description

- TCJA regulations, tax forms, and instructions have some surprises and unintended consequences. In this Webinar, Robert A. Green will discuss how to maximize tax deductions for traders.
- There are lingering questions about whether a trader is eligible for a “qualified business income” (QBI) deduction.
- Learn how to claim trader tax status (business expense treatment).
- Consider a 2019 Section 475 election for tax loss insurance.

UNCERTAINTY ABOUT USING QBI TAX TREATMENT FOR TRADERS

In 199A regs, there's a rationale for traders to use QBI tax treatment, but also a reference to Section 864(c) to deny QBI treatment to TTS traders.

QBI Tax Treatment For Traders

- Traders in securities and/or commodities, qualifying for trader tax status (TTS) as a sole proprietor, S-Corp, or partnership (including hedge funds), are wondering if they should use “qualified business income” (QBI) tax treatment on their 2018 tax returns.
- I see a rationale to include such treatment, but there are conflicts and unresolved questions, which renders it uncertain at this time.
- It’s wise for *all* TTS traders and hedge funds to file 2018 tax extensions to have additional time for a resolution.

QBI *might* apply to all TTS traders

- QBI treatment might be an issue for all TTS traders, not just the ones who elected Section 475 ordinary income or loss.
- For example, a TTS sole proprietor trader filing a Schedule C would report business expenses as a QBI loss, which might reduce aggregate QBI from other activities, thereby reducing an overall QBI deduction. There are QBI loss carryovers, too.
- Many TTS traders and hedge funds don't want QBI tax treatment since it includes business expenses but excludes most trading income (capital gains, Section 988 forex, and swap income, dividends and interest income.)

Conflicts and unresolved questions

- Section 199A QBI regs include “trading” as a “specified service trade or business” (SSTB), including trading for your own account, and QBI counts Section 475 ordinary income or loss, and trading business expenses.
- However, Sections 199A, 864(b) and (c) seem to deny QBI treatment for TTS traders, because trading is not “effectively connected income” (ECI).
- It seems that hedge fund accountants prefer the Section 864 rationale as they see QBI losses, not income because few hedge funds use Section 475.

Section 864 a “trade or business within the U.S.” does not include:

- “Section 864(b) — Trade or business within the U.S.
- Section 864(b)(2) — Trading in securities or commodities.
- (A): Stocks and securities.
- (ii) Trading for taxpayer’s own account. Trading in stocks or securities for the taxpayer’s own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions. This clause shall not apply in the case of a dealer in stocks or securities.

Section 864(c)

- Section 199A final regs imply that if a trade or business does not constitute “effectively connected income” (ECI) in the hands of a non-resident alien under Section 864(c), then it’s not QBI for a U.S. resident taxpayer operating a domestic trade or business.

QBI examples for TTS traders

- If a TTS/475 trader has taxable income under the threshold of \$415,000/\$157,500 (married/other taxpayers), they might get a 20% QBI deduction on the (lower of) net QBI, vs. taxable income minus long-term capital gains.
- Once a trader enters the phase-out range, the deduction drops fast. If they are 50% into the phase-out, they lose much more than half of the deduction due to the wage and property factor.

Practical aspects

- Only 475 traders would be eligible for a QBI deduction. If their taxable income is over the income cap, they won't get any QBI deduction on a specified service trade or business.
- Most TTS traders will have QBI losses from business expenses, and because they don't use 475, or because they have 475 losses.
- It might be better to adopt Section 864 as a convenient way to avoid QBI reporting complications.

HOW TO QUALIFY FOR TRADER TAX STATUS FOR HUGE SAVINGS

It's not too late to claim TTS and use business expense treatment on 2018 tax returns.

Trader tax status benefits

- Trader tax status (TTS) constitutes business expense treatment and unlocks an assortment of meaningful tax benefits for active traders who qualify.
- The first step is to determine eligibility.
- If you do qualify for TTS, you can claim some tax breaks such as business expense treatment after the fact and elect and set up other breaks — like Section 475 MTM and employee-benefit plans — on a timely basis.

There's no election for TTS

- TTS is an optional tax status based on facts and circumstances only. A trader may qualify for TTS one year but not the next.
- TTS qualification can be for part of a year, as well. Perhaps a taxpayer qualified for TTS in 2017 and quit or suspended active trading on June 30, 2018.
- Include the period of qualification on Schedule C or the pass-through entity tax return and deduct business expenses for the partial-year period. If elected, use Section 475 for trades made during the TTS period, too.

Business expense treatment

- Business expense treatment allows for full ordinary deductions, including home-office, education, Section 195 start-up expenses, Section 248 organization expenses, margin interest, tangible property expense, Section 179 (100%) depreciation, amortization on software, seminars, market data, stock borrow fees, and much more.
- As an example of the potential savings, if TTS business expenses and home office deductions are \$20,000, and the taxpayer's federal and state tax bracket is 35%, then income tax savings is about \$7,000.

TCJA suspended investment expenses

- TCJA suspended “certain (all) miscellaneous itemized deductions subject to the 2% floor,” including investment fees and expenses, commencing in 2018.
- The only remaining itemized deductions for investors are investment-interest expenses, which are limited to investment income, and stock borrow fees deducted as “other itemized deductions.”
- TCJA gives more incentive for traders to try to qualify for TTS.

Golden rules for TTS

- **Trades full time or part time**, for a good portion of the day, almost every day the markets are open. Part-time and money-losing traders face more IRS scrutiny, and individuals face more scrutiny than entity traders.
- **Hours**: Spends more than four hours per day, almost every market day working on his trading business. All-time in the trading activity counts, including execution of trade orders, research, administration, accounting, education, travel, meetings, and more.

Golden rules for TTS

- **Few sporadic lapses:** Has infrequent lapses in the trading business during the year. Traders can take vacations, sick time, and personal time off just like everyone else.
- **Frequency:** Executes trades on close to four days per week, every week. Recent tax-court cases show that to help prevent IRS challenge of a TTS claim; it is wise to trade close to four days per week or 75% of available trading days — even if this requires the taxpayer to make smaller trades with reduced risk on otherwise non-trading days.

Golden rules for TTS

- **Volume:** Makes 720 total trades per year (Poppe court) on an annualized basis. The buy and sell count as two total trades. The court mentioned Poppe having 60 trades per month. During the year, it's crucial to consider the volume of trades daily. We recommend 720 trades per year — about four trades per day, four days per week, 16 trades per week, and 60 trades a month.
- The markets are open approximately 250 days, and with personal days and holidays, you might be able to trade on 240 days. A 75% frequency equals 180 days per year, so 720 total trades divided by 180 trading days equals four trades per day.

Golden rules for TTS

- **Holding period:** Makes mostly day trades or swing trades. The IRS stated that the holding period is the most critical factor, and in the Endicott court, the IRS said average holding period must be 31 days or less. That's a bright-line test.
- **Intention:** Has the intention to run a business and make a living. Traders must have the intention to run a separate trading business — trading his or her own money — but it doesn't have to be one's exclusive or primary means of making a living. The key word is “a” living, which means it can be a supplemental living.

Golden rules for TTS

- **Operations:** Has significant business equipment, education, business services, and a home office. Most business traders have multiple monitors, computers, mobile devices, cloud services, trading services, and subscriptions, education expenses, high-speed broadband, wireless, and a home office.
- **Account size:** Has a material account size. Securities traders need to have \$25,000 on deposit with a U.S.-based broker to achieve “pattern day trader” (PDT) status. We like to see more than \$15,000 for trading other financial instruments.

What doesn't qualify?

- Automated trading without much involvement by the trader (but a trader creating his or her program qualifies).
- Engaging a professional outside investment manager.
- Trading in retirement funds. Do not include these trades in the golden rule calculations.

Automated trading systems

- An entirely canned automated trading service with little to no involvement by the trader doesn't help TTS; in fact, it can undermine it. The IRS may view this type of automated trading service the same as a trader who uses a broker to make most buy and sell decisions and executions.
- On the other hand, if the trader can show he's very involved with the automated trading program or service — perhaps by writing the code or algorithms, setting the entry and exit signals, and turning over only execution to the program — the IRS may not count the automated trading activity against the trader.

Trade copying software

- Some traders use a “trade copying” software and copy close to 100% of the trades.
- Trade copying can be similar to using a canned automated service or outside adviser, where the copycat trader does not qualify for TTS on those trades.

TTS TRADERS ELECT SECTION 475 FOR MASSIVE TAX SAVINGS

Section 475 tax benefits

- If you are a securities trader eligible for trader tax status (TTS), consider making a timely Section 475 election for 2019. (**Act by March 15 for existing partnerships or S-Corps** and April 15 for individuals.)
- Section 475 means you'll avoid wash sales and the capital loss limitation.
- You might also become eligible for the 20% qualified business income deduction, although QBI treatment is currently uncertain for TTS traders. (See prior slides.)

Tax loss insurance

- Historically, the chief tax benefit of Section 475 was deducting trading losses without limits.
- Section 475 trades are exempt from onerous wash sale loss adjustments on securities, which can trigger a tax bill on phantom income at year-end.
- Section 475 ordinary losses are not capital losses, which means the puny \$3,000 capital loss limitation doesn't apply.
- Short-term capital gains are taxed with the ordinary rate just like Section 475 ordinary income.

Example 1: Avoiding the capital loss limitation

- A sole proprietor TTS trader incurred a trading loss of \$30,000 in 2018. He elected Section 475 for 2018 by April 17, 2018, and reported it as an ordinary loss on Form 4797 Part II. He also deducted \$10,000 of trading business expenses on a Schedule C. He offsets the entire trading business loss of \$40,000 against wage income of \$100,000 for a gross income of \$60,000. That generates a significant tax refund. Without a 475 election, this trader would have a \$3,000 capital loss limitation on Schedule D, a \$10,000 ordinary loss on Schedule C, and a gross income of \$87,000. He would also have a capital loss carryover of \$27,000.

Example 2: Avoiding wash sale losses

- The markets dropped in December 2018, and many traders incurred significant capital losses. Markets rallied back in January 2019, and many of traders repurchased positions they sold for losses in December. They didn't wait 31 days, so they triggered wash sale loss adjustments at year-end 2018. It caused many to owe significant capital gains taxes on phantom income. The deferred WS cost basis might cause some traders to have substantial capital losses in 2019, well above the capital loss limitation. A double whammy!
- A 475 election for 2019 can convert 2019 capital losses into ordinary losses. It doesn't fix 2018 but helps a lot in 2019.

New entity

- A new entity set up after April 15 can deliver Section 475 MTM for the rest of 2019 on trading losses generated in the entity account if it files an internal Section 475 MTM election within 75 days of inception.
- This election does not change the character of capital loss treatment on the individual accounts before or after its creation.
- The entity is meant to be a fix for going forward; it's not a means to clean up the past problems of capital loss treatment.

Ordinary losses

- Ordinary trading losses can offset all types of income (wages, portfolio income, and capital gains) on a joint or single filing, whereas capital losses only offset capital gains.
- Plus, business expenses and business ordinary trading losses comprise an NOL, which is carried forward.
- It doesn't matter if you are a trader or not in a carryforward year.
- Business ordinary trading loss treatment is the most significant contributor to federal and state tax refunds for traders.

NOLs & EBL

- Starting in 2018, TCJA repealed the two-year NOL carryback, except for certain farming losses and casualty and disaster insurance companies.
- This means NOLs are carried forward indefinitely, and the deduction of 2018 and subsequent-year NOLs are limited to 80% of taxable income.
- TCJA also introduced a new excess business loss (EBL) limitation of \$500,000 married and \$250,000 for other taxpayers. Add EBL to an NOL carryforward.

Best of all worlds

- There are many nuances and misconceptions about Section 475 MTM, and it's essential to learn the rules.
- For example, taxpayers are entitled to segregate investment positions that aren't subject to Section 475 MTM treatment, meaning at year-end, they can defer unrealized gains on properly segregated investments.
- Taxpayers can have the best of both worlds — ordinary tax losses on business trading and deferral with lower long-term capital gains tax rates on segregated investment positions.

Best of all worlds

- We generally recommend electing Section 475 on securities only to retain lower 60/40 capital gains rates on Section 1256 contracts. There is also a Section 1256 loss carryback election which is attractive to traders.
- Far too many accountants and traders confuse TTS and Section 475; they are two different things, yet very connected.

Section 475 election procedures

- Section 475 MTM is optional with TTS.
- Existing taxpayer individuals that qualify for TTS and want Section 475 must file a 2019 Section 475 election statement with their 2018 tax return or extension by April 15, 2019.
- Existing partnerships and S-Corps file in the same manner by March 15, 2019.

Election statement

- “Under Section 475(f), the Taxpayer elects to adopt the mark-to-market method of accounting for the tax year ending Dec. 31, 2019, 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 commodities/Section 1256 contracts).”
- Modify this according to your facts and circumstances.

Form 3115 filing

- Don't forget an essential second step: Existing taxpayers complete the election process by filing a Form 3115 (change of accounting method) with the election-year tax return.
- (I cover the Section 481(a) adjustment in Green's 2019 Trader Tax Guide, Chapter 2 on Section 475.)

New taxpayer exception

- The Section 475 election procedure is different for new taxpayers like a new entity.
- Within 75 days of inception, a new taxpayer may file the Section 475 election statement internally in its records.
- The new entity does not have to submit a Form 3115 because it's adopting Section 475 from inception, rather than changing its accounting method.

Capital loss carryover

- If you have a significant capital loss carryover going into 2019, you might want to wait on making a 475 election since you will need capital gains to use it up.
- (I cover this decision-making and related 475 strategies in my tax guide.)

QUESTIONS & ANSWERS

Closing Remarks

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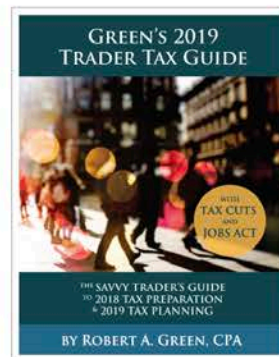
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