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Green Trader Tax

Tips For Traders On Preparing 2023 Tax Returns

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TIPS FOR TRADERS ON PREPARING 2023 TAX RETURNS

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for 60 minutes
(Interactive Brokers)

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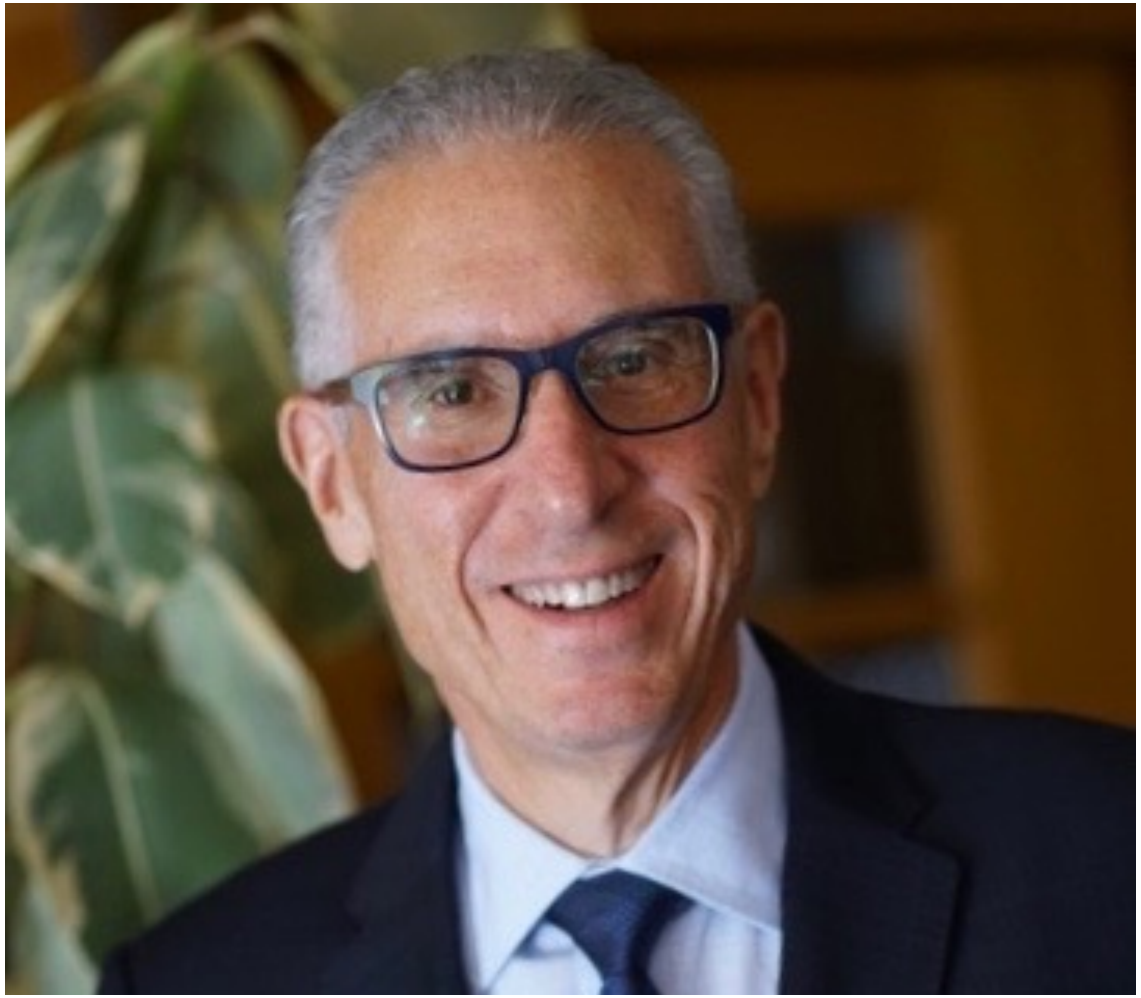

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Overview

- Join Robert A. Green, CPA, from GreenTraderTax.com, for insights and information to help traders file their 2023 federal tax returns in a timely and accurate manner in 2024.

- Green interviews Darren Neuschwander, CPA, head of tax compliance services for Green, Neuschwander & Manning, LLC.

Overview

- Learn how traders, eligible for trader tax status (TTS), maximize business expenses, make vital tax elections, and utilize pass-through entities for further tax benefits, including health insurance, retirement plans, QBI, EBL, NOL, and SALT deductions.

- Learn all the various tax treatments for multiple financial products, wash sales, and other accounting methods.

- Learn tips for filing tax extensions and paying taxes on time to avoid penalties.

- Learn common errors on TTS traders’ tax returns that lead to an IRS or state exam.

TRADER TAX STATUS

Trader tax status is the ticket to tax savings

- Trader tax status (TTS) constitutes business expense treatment and unlocks meaningful tax benefits for active traders who qualify.

- The first step is to determine eligibility.

- If you qualify for TTS, you can claim some tax breaks, such as business expense treatment, after the fact and elect and set up other tax breaks — like Section 475 MTM and employee-benefit plans (health and retirement) — on a timely basis.

TTS business expenses

- If you qualified for TTS in 2023, you could claim business expenses on Schedule C. No IRS election was required.

- Schedule C is part of an individual tax return (Form 1040).

- On an S-Corp or partnership tax return, deduct TTS business expenses on page 1 from ordinary business income. (Business expenses are not separately stated items on the Schedule K-1).

- See the Green Trader Tax Center for a list of TTS business expenses.

Section 475 MTM accounting

- Don’t confuse TTS business expenses with a Section 475 MTM accounting election that a TTS trader could have submitted by April 15, 2023, for the tax year 2023. (Or, if elected in a prior year.)

- The 475 election is like graduate school, and TTS is like undergraduate university; you need TTS to make and use a 475 election.

- Without a timely 475 election, it’s too late to avoid wash sale losses and the $3,000 capital loss limitation.

- And there’s no QBI deduction on capital gains; QBI is allowed on Section 475 income.

HOW TO QUALIFY FOR TRADER TAX STATUS

Volume of trades

- We recommend an average of four transactions per day, four days per week, 16 trades per week, 60 a month, and 720 annually.

- Count each open and closing transaction separately, not round trip. Scaling in and out counts, too.

- If the broker breaks down the trades into smaller lot sizes, don’t count those extra lot sizes.

- While a full year looks better, a partial year is okay. We prefer you to establish TTS for a minimum of Q4. For example, start TTS no later than October 1, 2023, and continue TTS well into 2024.

Frequency and holding period

- *Frequency*: Execute trades on nearly four weekly days, around a 75% frequency rate.
- *Holding period*: In the Endicott Court, the IRS said the average holding period must be 31 days or less. That's a bright-line test.
- *Segregate investments*: It's wise to segregate investments from trading. Otherwise, the IRS could consider the long investment holding periods, which can make the average holding period over 31 days, undermining qualification for TTS.

Other factors for TTS qualification

- *Trades full-time or part-time* for a good portion of the day. Part-time and money-losing traders face more IRS scrutiny. Part-year qualification for TTS is okay.

- *Hours*: Spends more than four hours daily, almost every market day, working on their trading business—all-time counts.

- *Avoid sporadic lapses*: A trader has few to no intermittent stoppages in the trading business during the year. Vacations are okay.

Other factors for TTS qualification

- *Intention*: Has the intention to run a business and make a living. It doesn't have to be your primary living.

- *Operations*: Has significant business equipment, education, business services, and a home office.

- *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 want to see over $15,000 for the minimum account size for trading futures.

- For more information, see Trader Tax Status: How To Qualify.

TAX REPORTING FOR A SOLE PROPRIETOR TRADING BUSINESS

Multiple tax forms for traders

- The IRS uses multiple tax forms for trading businesses eligible for trader tax status (TTS).

- It can be confusing to taxpayers, accountants, and the IRS. Traders enter gains and losses, portfolio income, and business expenses in various tax forms.

- Which tax form or schedule should a forex trader use? It depends on their circumstances. Which form is correct for securities traders using the Section 475 MTM method? Can trading gains be reported directly on Schedule C? The different reporting strategies for the various types of traders make tax time not so cut and dry.

Schedules C for expenses only

- Most sole-proprietorship businesses report revenue, cost of goods sold, and expenses on Schedule C. The IRS can easily see if they are profitable; they cannot do so with sole proprietor traders.
- TTS traders qualifying for TTS report only trading business expenses on Schedule C.
- Trading gains and losses are reported in other tax forms, depending on the situation.
- It's helpful to include a tax return footnote tying the trader schedules together to show profitability, if possible.

Schedule D and Form 8949

- Sales of securities for each trade are reported on Form 8949, which feeds into Schedule D.

- Net capital losses are limited to $3,000 per year against ordinary income. The rest is a capital loss carryover. Capital losses are unlimited against capital gains.

- If you have significant capital loss carryovers going into 2024 and have substantial trading gains by April 15, 2024, consider skipping a 2024 Section 475 election due April 15, 2024, as that would convert trading income to ordinary income, which would not use up the capital loss carryover.

Form 8949 required for traders with wash sales

See Form 8949 and the IRS instructions for Form 8949:

- “Exception 1. Form 8949 isn't required for certain transactions. You may be able to aggregate those transactions and report them directly on either line 1a (for short-term transactions) or line 8a (for long-term transactions) of Schedule D. This option applies only to transactions (other than sales of collectibles) for which: • You received a Form 1099-B (or substitute statement) that shows basis was reported to the IRS and doesn't show any adjustments in box 1f or 1g…”

- Most traders generate wash sale loss (WS) adjustments, which are reported on boxes 1f and 1g, so 1099-Bs with WS don’t meet the above exception; the trader must report each trade on Form 8949.

- See Securities, Accounting Solutions, and Form 8949 & 1099-B Issues.

Schedule 4797 for MTM accounting

- TTS traders who elected and have Section 475 MTM on securities report each securities trade on Form 4797 Part II.

- MTM accounting means open securities trades are marked-to-market at year-end prices.

- Form 4797 Part II receives ordinary gain or loss treatment, avoiding the capital loss limitation and wash-sale loss rules. (It's "tax loss insurance.")

- Profitable traders also can benefit from Section 475 using the 20% qualified business income (QBI) deduction. There are thresholds and caps with QBI.

Section 475 election

- Existing taxpayers file a Section 475 election statement by the due date of the prior year's tax return or extension with the IRS and perfect it later with a Form 3115 (change in accounting method) filing by the tax return deadline, including extension.

- Learn about making a Section 481(a) adjustment to convert from the realization to the MTM method of accounting.

- A Section 475 election for 2023 was due by April 18, 2023. The next opportunity to elect 475 is 2024 by April 15, 2024. Learn the nuances of making a 475 election here.

- "New taxpayers" (like a new entity) can elect Section 475 by internal resolution (not with the IRS) within 75 days of inception. New taxpayers don't file Form 3115 since they have adopted the 475 MTM accounting method.

Net operating losses (NOL)

- In 2018, the Tax Cuts and Jobs Act (TCJA) repealed the two-year NOL carryback, except for certain farming losses and casualty and disaster insurance companies.
- TCJA carries forward NOLs indefinitely (20 years before the TCJA changes).
- The NOL deduction is limited to 80% of the subsequent year's taxable income.

Excess business losses (EBL)

- In 2018, TCJA introduced an excess business loss (EBL) limitation.
- The 2020 CARES Act suspended TCJA's EBL and NOL changes for 2018, 2019, and 2020 and allowed five-year NOL carrybacks (i.e., a 2020 NOL carryback to 2015).
- TCJA's EBL and NOL carryforward rules apply for tax years 2021 through 2028.
- The inflation-adjusted 2023 EBL threshold is $578,000 (married)/$289,000 (other taxpayers), and the 2024 EBL threshold is $610,000 (married)/$305,000 (other taxpayers).
- Add the excess over the EBL threshold to an NOL carryforward.

Deduction on qualified business income (QBI)

- In 2018, TCJA introduced a new tax deduction for pass-through businesses, including sole proprietors, partnerships, and S-Corps. Subject to haircuts and limitations, a pass-through business could be eligible for a 20% deduction on qualified business income (QBI).

- TTS traders are considered a “specified service trade or business” (SSTB), so taxable income above the following thresholds is not deductible: $364,200/$182,100 (married/other taxpayers) for 2023 and $383,900/$191,950 (married/other taxpayers) for 2024.

- QBI for traders includes Section 475 ordinary income and loss and trading business expenses. QBI excludes capital gains and losses, Section 988 forex income or loss, dividends, and interest income.

Deduction on qualified business income (QBI)

- There is also a phase-out range above the threshold of $100,000/$50,000 (married/other taxpayers). The W-2 wage and property basis limitations apply within the phase-out range.

- TTS traders with an S-Corp usually have wages, whereas sole proprietor traders do not.

- See IRS Form 8995 and 8995-A.

Schedule 6781 for futures

- Section 1256 contract traders (i.e., futures) should use Form 6781 (unless they elected Section 475 for commodities/futures; those are reported on Form 4797).
- Section 1256 traders rely on a one-page Form 1099-B showing their net trading gain or loss (aggregate profit or loss on contracts). That amount is entered in summary format on Form 6781 Part I.
- Section 1256 contracts enjoy lower 60/40 capital gains tax rates: 60% (including day trades) is subject to lower long-term capital gains rates, and 40% is taxed as short-term capital gains using the ordinary rate.
- At the maximum tax bracket for 2023, the blended 60/40 rate is 26.8% — 10.2%, lower than the highest regular bracket of 37%.
- Most futures traders skip a Section 475 election to retain 60/40 capital gains rates.
- See Section 1256 Contracts.

Section 1256 loss carryback election

- If a trader or investor has a significant Section 1256 loss, they should consider carrying back the loss three tax years but only apply it against Section 1256 gains in those years.

- To make this election, check box D labeled “Net section 1256 contracts loss election” on the top of Form 6781 filed on a timely basis.

Digital assets including cryptocurrencies

- For sales of digital assets, including cryptocurrencies, use Form 8949.
- Digital assets are not subject to wash sale loss rules or Section 475 MTM because the IRS treats digital assets as "intangible assets," not securities or commodities.
- Be sure to answer the IRS question on tax returns about digital assets. See https://www.irs.gov/newsroom/taxpayers-should-continue-to-report-all-cryptocurrency-digital-asset-income.
- For more information, see Cryptocurrencies.

Tax treatment for financial products

- We cover U.S. and international equities, U.S. futures, and other Section 1256 contracts, options, ETFs, ETNs, forex, precious metals, foreign futures, cryptocurrencies, and swap contracts.

- It's important to distinguish between securities vs. Section 1256 contracts with lower 60/40 capital gains rates vs. other financial products such as forex or swaps with ordinary income or loss treatment. Various elections are available to change tax treatment.

- See Tax Treatment On Financial Products.

FORM 1099-B AND WASH SALE LOSS ADJUSTMENTS

Form 1099-B and wash sale loss adjustments

- Proceeds, minus cost basis, plus wash sale loss adjustments equal net trading gain or loss using the realization method.

- For example, the WS loss column could be $500,000, but most of that amount might be included in the cost basis column, so most wash sales are closed. What matters is how much of the WS loss is open and deferred to the subsequent tax year.

- Buying back a losing December 2023 trade within 30 days into January 2024 triggers a 2023 WS loss.

Form 1099-B and wash sale loss adjustments

- Using Section 475 MTM accounting, a TTS trader avoids WS loss adjustments and the $3,000 capital loss limitation. It’s okay to depart from the 1099-B.

- See Wash Sale Losses.

Trade accounting using TradeLog

- We had recommended TradeLog (TL) every year since 2001 when we helped bring Section 475 MTM accounting to the program.

- Use TL to download your trade history from your broker's Website (not the 1099-B) and calculate WS according to IRS rules for taxpayers. TradeLog can also calculate WS according to IRS rules for brokers and should match broker 1099-Bs.

- TL generates Form 8949 or Form 4797 (for Section 475 MTM).

- You can license the TL software to do the trade accounting. Alternatively, TL can do this trade accounting for you as a service.

- Green, Neuschwander & Manning, LLC (GNM) offers trade accounting services using TradeLog to GNM's tax compliance service clients.

PASS-THROUGH ENTITY BENEFITS

S-Corp tax breaks

- S-Corps eligible for TTS provide opportunities for deducting retirement plan contributions and health insurance premiums, two breaks sole-proprietor and partnership traders can’t use unless they have earned income.

- See Entity Solutions, Retirement Plan Solutions, and Tax Planning For S-Corps.

SALT cap workaround

- TCJA capped state and local income, sales, and property taxes (SALT) at $10,000 per year ($5,000 for married filing separately) and did not index it for inflation.

- About 29 states enacted SALT cap workaround laws.

- Generally, it would be best if you elected to make a “pass-through entity” (PTE) payment on a partnership or S-Corp tax return filed by your business.

- It doesn’t work with a sole proprietorship filing a Schedule C.

SALT cap workaround

- PTE is a business expense deduction shown on the state K-1, like a withholding credit.
- Most states credit the individual's state income tax liability with the PTE amount.
- Essentially, you convert a non-deductible SALT itemized deduction (over the cap) into a business expense deduction from gross income.

COMMON ERRORS

Reporting trading gains/losses on Schedule C

- Some accountants intuitively think TTS traders should enter trading income, loss, and expenses on Schedule C like other sole proprietors. That's wrong and often causes an IRS notice or exam.

- Some traders try to deduct significant capital losses on Schedule C after missing the Section 475 MTM election deadline for ordinary gain or loss treatment. They attempt to evade wash sale (WS) loss adjustments and capital loss limitations.

- Section 475 trades are detailed on Form 4797 Part II ordinary gains and losses, not Schedule C.

- Some traders use TTS and 475 when they should not.

SE tax errors

- Some traders and preparers treat TTS trading gains as self-employment income (SEI) subject to self-employment (SE) tax.
- That’s incorrect unless the trader is a full-scale member of an options or futures exchange and trading Section 1256 contracts on that exchange (Section 1402i).

Adjusted gross income (AGI) errors

- Some sole proprietor TTS traders incorrectly contribute to a retirement plan based on trading income and end up with an “excessive contribution” subject to tax penalties.

- Some mistakenly take an AGI deduction for self-employed health insurance premiums, which also requires SEI and trading income is not SEI.

- A TTS trader needs an S-Corp to arrange retirement and health insurance deductions before the year-end.

Net investment tax errors

- Include trading gains and losses in net investment income (NII) for calculating ACA 3.8% net investment tax (NIT).
- Some traders omit to deduct TTS trading expenses from NII.
- You cannot deduct investment fees and expenses from NII.
- See IRS Form 8960.
- See Tax Center: ACA Net Investment Income Tax

TAX EXTENSIONS

Tax extensions

- The 2023 income tax returns for individuals are due by April 15, 2024 — however, most active traders aren't ready to file a complete tax return by then.
- Some brokers issue corrected 1099-Bs right up to the deadline and often after the filing deadline.
- Many partnerships and S-Corps file extensions by March 15, 2024, and don't issue final Schedule K-1s to investors until after April 15.
- Traders don't have to rush to complete their tax returns by April 15. They can use a simple one-page automatic extension and pay taxes owed to the IRS and state.

Tax payments are due with the extension

- Traders can request an automatic six-month extension to file individual federal and state income tax returns until Oct. 15, 2024.

- The 2023 Form 4868 instructions indicate how easy it is to get this automatic extension — no reason is required.

- It's an extension to file a complete tax return, not an extension to pay taxes owed.

- The taxpayer should estimate and report what they think they owe for 2023 based on the tax information received.

Avoid late-filing and late-payment penalties

- We suggest taxpayers learn how the IRS and states assess late-filing and late-payment penalties so they can avoid or reduce them.

- If taxpayers cannot pay the taxes owed, they should estimate the balance due by April 15 and report it on the extension.

- Be sure to at least file the automatic extension on time to avoid the late-filing penalties, which are much higher than the late-payment penalty.

- See the 2023 Form 4868, page two, for an explanation of how to calculate these penalties.

- See Tax Extensions: 12 Tips To Save You Money.

Contact us

- Thank you for attending this Webinar or watching the recording. Visit www.GreenTraderTax.com for additional information.
- Email us your questions at info@gnmtradertax.com.
- For consultations, tax compliance (preparation) services, and trade accounting, consider Green, Neuschwander & Manning, LLC.

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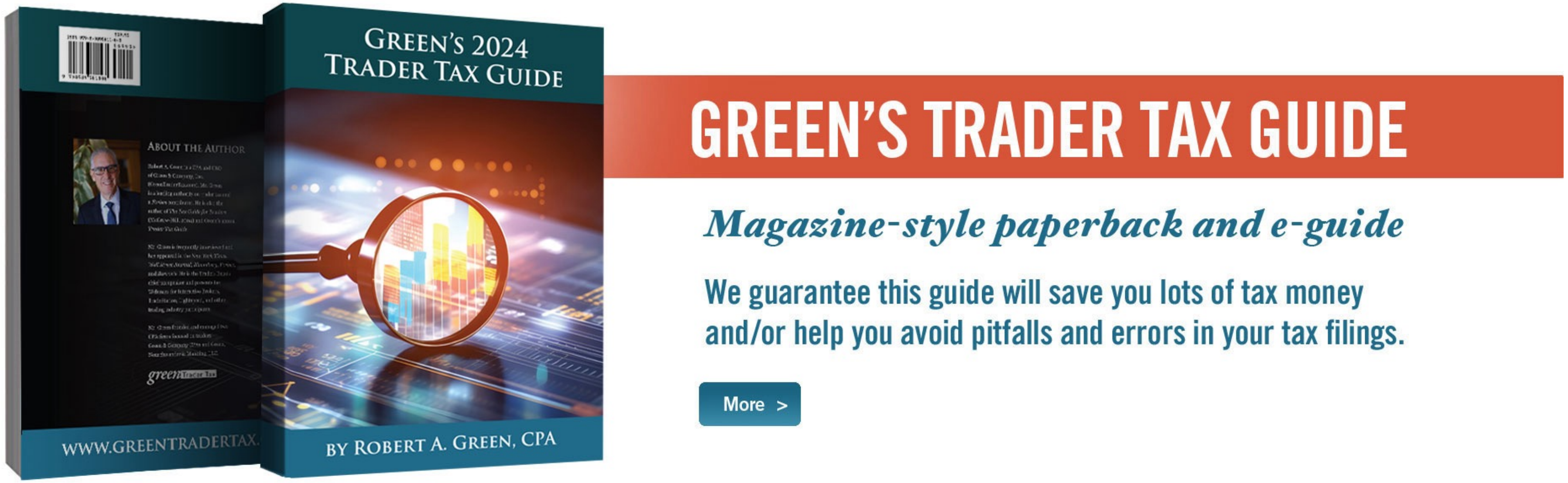

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