GREEN’S 2017 TRADER TAX GUIDE

THE SAVVY TRADER’S GUIDE TO 2016 TAX PREPARATION & 2017 TAX PLANNING

BY ROBERT A. GREEN, CPA
About Us
Green & Company, Inc. (GreenTraderTax.com) offers extensive educational resources for investors, active traders, investment managers and small businesses on its website, including a blog covering the latest tax and regulatory topics, trader tax guides, Webinars, videos, calculators and other resources. For more information or to participate in free Webinars, visit www.greentrader-tax.com or call (888) 558-5257 or (203) 456-1537.

Green, Neuschwander & Manning, LLC, our CPA firm, caters to investors, active traders, investment managers and small businesses, providing tax compliance services, accounting, consultations, entity services, and IRS/state tax exam representation services.

Bottom Line
Our motto is be smart, creative, forward thinking, cutting edge and even aggressive, but keep it legal. You deserve excellence in content, ideas, judgment and decision-making. Thanks for being our customer and reading our guide.

Thank you to all my fellow professionals at Green, Neuschwander & Manning, LLC for their help in crafting our strategies. Special thanks to my co-managing member Darren L. Neuschwander, CPA.

Sincerely,

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Use Green’s 2017 Trader Tax Guide to receive every trader tax break you’re entitled to this tax season. Whether you self-prepare your tax returns using consumer tax preparation software or app, engage a CPA firm or local tax storefront, this guide can help everyone through the process. Many of our tax compliance clients use it to take advantage of our offerings, as an educated consumer is the best customer.

Unfortunately, it may be too late for some tax breaks on your 2016 tax return if you wait until you’re actually filing your taxes. If this is the case, then use this guide to execute these tax strategies — including forming an entity with employee-benefit plan deductions — and elections on time for tax-year 2017.

Unsure what type of trader you are? Read Different Types of Traders in our Trader Tax Center.

TAX REFORM IS LIKELY IN 2017
President Trump and leaders of the Republican-controlled Congress say tax reform is a priority in 2017.

Use Green’s 2017 Trader Tax Guide for preparing 2016 tax returns based on current tax law, and for tax planning during 2017. Except for Chapter 17 on tax reform, the guide is based on current tax law. Stay informed about tax reform and its impact on traders on the GreenTraderTax.com blog.

To date, plans for tax reform do not change “trader tax status,” Section 475 MTM, wash sale loss rules on securities, Section 988 forex rules, entities and employee benefits for traders. That’s the bulk of content in this guide. Tax reform plans limit or repeal investment expenses, making trader tax status even more attractive.

The biggest positive news for traders may be Trump’s tax plan’s preferential tax rate of 15% on corporation net income, which he promised to extend to small business operating in pass-through entities. I hope a trading entity, which qualifies for trader tax status, can also qualify for this preferential business tax rate.

BUSINESS TRADERS ARE FAR BETTER OFF THAN INVESTORS IN THE TAX CODE
By default, the IRS lumps all traders into “investor tax status,” and investors get penalized in the tax code. Investors have restricted investment interest and investment expenses, capital-loss limitations ($3,000 per year), wash-sale loss deferrals, no Section 475 mark-to-market (MTM) election and no employee-benefit plans (retirement and health insurance deductions). Business traders who qualify for trader tax status (TTS), though, are entitled to these tax breaks.

Don’t confuse TTS with the related tax-treatment election of Section 475 MTM accounting, which converts new capital gains and losses into business ordinary gains and losses. Only qualified business traders may use Section 475 MTM; investors may not.

A business trader can assess and claim TTS after year-end and even going back three open tax years. But business traders may only use Section 475 MTM if they filed an election on time, either by April 15 of the current year (i.e., April 18, 2016 for 2016), or within 75 days of inception of a new taxpayer (i.e., a new entity). For more on TTS, see Chapter 1.

Investment expenses are limited to 2% of adjusted gross income (AGI) and they are not deductible for the Alternative Minimum Tax (AMT). Plus, investment expenses exclude home office, education and startup expenses, all important business deductions for qualifying business traders.

CAN YOU DEDUCT 2016 TRADING LOSSES?
Many traders bought this guide hoping to find a way to deduct their 2016 trading losses. Maybe they qualify for TTS, but that only gives them the right to deduct their trading business expenses.

Securities trading and Section 1256-contract trading receive capital gain/loss treatment by default, and there’s a $3,000 capital loss limitation against ordinary income. Yes, Section 475 MTM would have made those losses business ordinary losses, but you had to file the Section 475 MTM election by April 18, 2016 as an “existing taxpayer.” (New taxpayers may elect Section 475 internally within 75 days of inception.) If you did not do this, you’re stuck with capital loss treatment and your next problem is how to use up a capital loss carryover in the next year(s). If you elect Section 475 by April 18, 2017, your 2017 business trading gains will be ordinary rather than capital. Remember, you need capital gains to use up capital loss carryovers. That creates a pre-
document that we address in Chapter 2 on Section 475 MTM. Once a trader has a capital loss carryover hole, he needs a capital gains ladder to climb out of that hole and a Section 475 election to prevent digging a bigger hole. An entity is better for electing and revoking Section 475 as needed. In 2015, the IRS changed the law to allow revocation of Section 475 elections.

If you have losses from trading Section 1256 contracts (like futures), you may be in luck if you have Section 1256 gains in the prior three tax years. On the top of Form 6781, you can file a Section 1256 loss carryback election. Business traders may elect Section 475 MTM on Section 1256 contracts, but most elect it on securities only so they can retain the lower 60/40 tax rates on Section 1256 gains. Sixty percent is a long-term capital gain even on day trades. Long-term rates are lower.

If you have losses trading spot or forward forex contracts in the off-exchange Interbank market, you may be in luck. By default, Section 988 for forex transactions receives ordinary gain or loss treatment, which means the capital loss limitation doesn’t apply. But without TTS, the loss isn’t a business loss and if you have negative taxable income, the negative part is often wasted—it’s not a business net operating loss (NOL) or capital loss carryover. Forex traders can file a contemporaneous “capital gains and losses” election in their own books and records to opt out of Section 988, which is wise if you have capital loss carryovers. Contemporaneous means in advance, not after the fact using hindsight. In some cases, this election qualifies for Section 1256(g) lower 60/40 tax rates. See Chapter 3 for more details.

**OPTION TRADERS**

Option traders generally don’t day trade; rather they execute both simple and complex trades over weekly and monthly time horizons. While many option traders may execute trades only a few days per week, they have a position on almost every day of the week. But three recent trader tax court cases for option traders (Assaderaghi, Nelson and Endicott) indicate the IRS requires more frequency than just trading two days per week. See Chapter 11 for details on these three cases. While trading monthly options may be a challenge for claiming TTS, in the past year we’ve noticed more clients trading weekly options, which is better for TTS. Some option traders set aside capital for active trading in equities, which helps them qualify for TTS.

**FUTURES AND FOREX TRADERS**

Futures traders, other Section 1256 contract traders and forex traders have it much easier. Futures brokers report Section 1256 contracts in summary fashion, with mark-to-market accounting for realized and unrealized gains and losses, on a simple one-page 1099-B. Taxpayers can rely on a Section 1256 contract 1099-B to report “aggregate profit or (loss) on contracts” on Form 6781, Part I. See Chapter 4.

Spot forex is not a “covered security” and it’s not by default a Section 1256 contract. Therefore, spot forex brokers should not issue a 1099-B. Spot forex brokers do offer online tax reports and taxpayers should report the summary amount, with or without attachment of those reports on their tax returns.

**TAX TREATMENT ON FINANCIAL PRODUCTS**

There are complexities in sorting through different tax-treatment rules and tax rates. It’s often hard to tell what falls into each category, but in Chapter 3 we cover the many trading instruments and their tax treatment.

Securities have realized gain and loss treatment and they are subject to wash-sale rules and the $3,000 per year capital loss limitation on individual tax returns. Section 1256 contracts — including futures — are marked to market at year-end, so there are no wash-sale adjustments and they have lower 60/40 tax rates. Options have a wide range of tax treatment. An option is a derivative of an underlying financial instrument and the tax treatment is generally the same. Equity options are taxed the same as equities, which are securities. Index options are derivatives of indexes, and broad-based indexes are Section 1256 contracts. Simple and complex equity option trades have special tax rules on holding period, adjustments and more. Forex receives ordinary gain or loss treatment on realized trades (including rollovers) unless you file a contemporaneous capital gains election and in some cases navigate into lower 60/40 tax rates. Physical precious metals are collectibles and if these capital assets are held over one year, sales are subject to the taxpayer’s ordinary rate capped at 28% (the collectibles rate). Bitcoin is an intangible asset taxed like securities. Nadex binary options tax treatment is unclear and we make a case to tax them like swaps with ordinary income or loss. Foreign futures are taxed like securities unless the IRS issues a revenue ruling allowing Section 1256 tax benefits (but that is rare). New in this year’s guide: I cover tax treatment...
Summary

for volatility products, including futures, ETFs and ETNs (exchange traded notes). See Chapter 3 for various tax treatments.

**SHORT SELLING**
The essence of trading is buying and selling financial products for income. If you think the asset will rise in value, buy first and sell afterward — this is what's known as a "long position." If you want to speculate on the asset declining in value, borrow the security to sell it first, and buy it back later to close the short position — this is "selling short." (There are other ways to speculate on market drops like buying put options or inverse ETFs, both of which are long positions.) There are two types of short sales: (1) a short sale and (2) a short sale against the box. Both involve borrowing securities from another account holder, arranged by a broker. Learn about tax treatment for short selling in Chapter 16, a new chapter in this year's guide.

**BUSINESS TRADERS SHOULD USE ENTITY**
Many traders start off with individual accounts, joint accounts and IRAs. Why should they consider an entity trading account? Business traders solidify TTS, unlock employee-benefit deductions, gain flexibility with a Section 475 election or revocation and can prevent wash-sale losses with individual and IRA accounts. The IRS can apply Section 267 related party transaction rules if a trader purposely tries to avoid a wash sale loss between an entity and individual account. An entity return consolidates your trading activity on a pass-through tax return (partnership Form 1065 or S-Corp 1120-S), making life easier for you, your accountant and the IRS. Individually held investments are separate from business trading in the entity, which is a different taxpayer. The entity is simple and inexpensive to set up and operate. For more details on entities, see Chapter 7.

**RETIREMENT PLANS**
Retirement plans for traders can be used several ways. You can trade in the retirement plan, build it up with annual tax-deductible contributions, borrow money from a qualified plan (not an IRA) to start a trading business and convert it to a Roth IRA for permanent tax-free build-up. There are plenty of pitfalls to avoid like early withdrawals subject to ordinary income tax rates and 10% excise tax penalties, and penalties on prohibited transactions. Avoid IRA-owned LLCs and self-dealing as that blows up the IRA. Tax-free compounded returns in retirement plans are valuable and trading losses are deductible in the sense that future retirement plan distributions are lower.

Annual tax-deductible contributions to retirement plans generally save traders more in income taxes than they cost in self-employment (SE) or payroll taxes. Trading gains are not earned income, so traders use entities to create earned income by paying compensation to themselves through an S-Corp. trading company or S-Corp or C-Corp management company. A married couple working in the business can save well over $10,000 by establishing defined-contribution Solo 401(k) plans for each of them. Defined-benefit plans can save much more; we cover defined benefit plans in depth in Chapter 8. (One exception: Members of a futures exchange are subject to SE taxes on their trades made on those exchanges.) Chapter 8 delves into various retirement plan options and provides the math so you can see exactly how this tax savings strategy works.

**OBAMACARE TAXES**
The Obamacare 3.8% Medicare tax on unearned income started in 2013 for taxpayers with AGI over $250,000 (married) and $200,000 (single). In this guide, we focus on what affects traders and investment managers in particular. One key point is that the net investment income tax (NIT) applies on net investment income (NII). Traders can reduce it by deducting their trading and investment expenses, including salaries paid to them and their spouses. There are complex IRS regulations for the three buckets in NII: portfolio, rents and royalties (1), passive entities and investment companies (2), and capital gains and losses (3). Generally, taxpayers can’t use a loss from one bucket against income in another bucket.

Business traders fare well with the final regulations for NII (after we fought for changes to the proposed regulations). With the final regulations, business traders are not disenfranchised from using their business trading losses and expenses for calculating NII. Just be sure to prepare Form 8960 (NIT) correctly.

The Obamacare individual health insurance mandate and related tax penalties for non-compliance, exchange subsidies and premium tax credits applied for the first time on 2014 individual income tax returns. Learn about the Obamacare tax forms and strategies for traders in applying for insurance on Obamacare exchanges to max-
imize their chance of receiving subsidies and premium tax credits.

Obamacare taxes apply for 2016. President Trump and Republican leaders in Congress plan to repeal Obamacare taxes in 2017, perhaps with a transition period, and I doubt they will make changes retroactive to 2016.

For more information, see Chapter 9 and Chapter 15.

**PROPRIETARY TRADING**

Proprietary trading vs. retail trading is covered in Chapter 12. The challenge for proprietary traders is deducting their business expenses, including home-office expenses. They’re allowed to deduct these expenses even if they trade from the firm’s office whether they are independent contractors or LLC members. We also address how to handle education/prop trading firm hybrids and writing off education or lost deposits. One problem for prop traders who are members of an LLC is the Schedule K-1 does not pass through self-employment income so they can’t make retirement plan contributions or deduct health insurance premiums.

New in this year’s guide: I cover “constructive receipt of income” for independent contractor prop traders who reinvest earnings rather than take cash distributions offered by the firm.

**INVESTMENT MANAGEMENT**

More traders are rising to the ranks of investment managers. Investment managers seek better tax treatment by using carried-interest (profit allocation) tax breaks passed through in their investment funds. There are tax advantages to receiving a share of capital gains (profit allocation) from fund investors rather than incentive fees from the fund, which otherwise are subject to ordinary tax rates and payroll taxes. Investment managers reduce payroll tax on management fees by using S-Corps. In recent years, both of these breaks have survived repeal talk, but that may not last with tax reform discussions in 2017. TTS, Section 475 MTM and other tax treatment elections are important considerations for hedge fund managers. Learn more about investment management taxation in Chapter 13.

**INTERNATIONAL TAX MATTERS**

U.S. traders move abroad, others make international investments and non-resident aliens invest in the U.S. How are their taxes handled? When it comes to international tax matters, we focus on the following types of traders: U.S. residents living abroad; U.S. residents with international investments; U.S. residents moving to tax possessions like Puerto Rico (with huge tax breaks); U.S. residents surrendering citizenship or green cards; and non-resident aliens investing in the U.S. with individual accounts or through an entity.

Many traders living in the U.S. have offshore trading and bank accounts to trade on foreign markets. Some offshore brokers encourage traders to form foreign entities as a requirement to get access or to set up a foreign brokerage account, in some cases to avoid CFTC rules limiting forex leverage or Reg T margin rules on securities. Look before you leap: Tax compliance for a foreign entity is significant and there are few to no tax advantages for traders.

Traders with foreign accounts need to learn about Foreign Bank Account Reporting (FBAR), Form 8938 (Statement of Specified Foreign Financial Assets), controlled foreign corporations (CFC), foreign disregarded entities, Passive Foreign Investment Companies (PFIC), tax treaties and more.

Chapter 14 touches upon these topics, along with the IRS’s “come clean” OVDP program, the Foreign Account Tax Compliance Act and CFTC regulations.

**DESK REFERENCE**

Some readers use our guides as a desk reference, to quickly find answers to specific questions in a given area. Others read this guide in its entirety. To accommodate desk-reference readers, we edit each chapter to stand alone, which inevitably means some chapters will contain information covered in other chapters.

**LINKS**

For your convenience, the orange areas are links to either a website or another section in the guide.