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Green Trader Tax

Trader Tax Law: 2021 Mid-Year Update

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TRADER TAX LAW: 2021 MID-YEAR UPDATE



July 14, 2021 @ 12:00 pm ET
for 60 minutes
(Interactive Brokers)

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Description

- Join Robert A. Green, CPA of GreenTraderTax, for tax developments impacting traders, including entities, a SALT cap workaround, and President Biden's tax hike proposals on investors.
- A new entity qualifying for trader tax status (TTS) can elect Section 475, providing an exemption from wash sale loss adjustments, the \$3,000 capital loss limitation, and eligibility for a 20% QBI deduction.
- In addition, an S-Corp can deduct health insurance premiums and a [high-deductible retirement plan](#) like a Solo 410(k).
- Mid-year is an excellent time to consider a new TTS entity,

Description

- An entity might offer a [SALT cap workaround](#) to circumvent the \$10,000 limit on state and local itemized deductions.
- Biden's tax proposals in Treasury's FY 2022 Green Book curtail long-term capital gains for taxpayers making over \$1M and closes the carried interest tax break for fund managers earning over \$400,000.
- However, Biden's Greenbook does not offer to remove the contentious SALT cap, and it retains the 20% QBI tax deduction.
- In addition, it does not propose a financial transaction tax.

MID-YEAR ENTITY FORMATION

Late-year 2021 Section 475 election

- A new entity eligible for [trader tax status](#) (TTS) can elect [Section 475](#) within 75-days of inception.
- Section 475 provides an exemption from wash sale loss adjustments on securities, the \$3,000 capital loss limitation, and eligibility for a 20% QBI deduction if taxable income is under the 2021 threshold (\$330,000/\$165,000 married/other taxpayers).
- The [deadline](#) for an individual to elect 475 for 2021 was May 17, 2021, and June 15, 2021, for TX, LA, and OK residents.
- If you missed the deadline, forming a new entity is the only way to obtain 475 later in the year. Some traders also use an entity for a “do-over” on 475 vs. capital gains.

Segregation of investments

- Suppose a trader holds investment positions in equities and trades substantially identical securities positions in equities or equity options using TTS and Section 475.
- The IRS could recharacterize trades as investments, or vice versa, whichever suits them best.
- For example, the IRS could reclassify an investment position in Apple equity currently deferred for long-term capital gains into Section 475 MTM ordinary income at year-end.
- Alternatively, the IRS could recharacterize Section 475 MTM ordinary losses on Apple options as capital losses triggering a \$3,000 capital loss limitation.

Ringfence TTS/475 using an entity

- Traders with overlap between investing and trading should consider ringfencing TTS/475 trading into an entity and conducting their investment activity on the individual level.
- That solution would fix the potential IRS problem above about using Section 475.
- Consider an LLC taxed as a partnership. Or an S-Corp if you also want health and retirement plan deductions.
- See <https://greentradertax.com/traders-should-consider-section-475-election-by-the-tax-deadline/>

AN S-CORP PROVIDES EMPLOYEE BENEFITS

S-Corp creates earned income

- A TTS S-Corp pays officer compensation, which engineers the earned income required for employee benefit tax deductions, including health insurance premiums and retirement plan contributions.
- Conversely, trading gains from capital gains or Section 475 ordinary income are considered unearned income, for which the IRS does not permit deductions for health insurance and retirement plan contributions.

Sole proprietor traders don't have earned income

- An individual TTS trader deducts business expenses on Schedule C.
- However, a sole proprietor TTS trader cannot arrange AGI deductions for health insurance premiums and retirement plan contributions because underlying trading gains are not self-employment income (SEI) or earned income. A sole proprietor of any kind cannot pay himself payroll (salaries).
- It's also tricky for a TTS partnership to create SEI since partnership compensation and other expenses reduce it.
- Whereas S-Corp payments *do not* reduce SEI, making the S-Corp the structure of choice for TTS traders for arranging employee benefits.

Health insurance premiums

- A TTS S-Corp reimburses and deducts officer/owner health insurance premiums (HI) through officer compensation without payroll taxes.
- If an S-Corp commences mid-year, then deduct HI from the entity start date, not before.
- Ex-employer HI like Cobra is not “self-employed” HI, so it’s not deductible through the TTS S-Corp.
- An HSA deduction does not require earned income.

HOW SOME TRADERS DOUBLE-UP ON RETIREMENT PLAN CONTRIBUTIONS

How Some Traders Double-Up On Retirement Plan Contributions

- In the examples below, full-time Trader A contributes the \$64,500 cap to a Solo 401(k) retirement plan for 2021.
- Part-time Trader B doubles up on retirement benefits, maximizing an unaffiliated employer 401(k) plan for \$19,500 and contributing up to the \$58,000 cap in her TTS S-Corp profit-sharing plan.
- Unfortunately, part-time Trader C is out of luck; his consulting company is affiliated with his TTS S-Corp, so he must include consulting company employees in his retirement plan.

Full-time Trader A

- This person owns a single-member LLC (SMLLC) taxed as an S-Corp, eligible for TTS business expense deductions.
- In December 2021, based on sufficient annual profits, a TTS S-Corp can pay maximum-required officer compensation of \$154,000 to make the Solo 401(k) retirement plan contribution cap of \$58,000 (\$64,500 for age 50 or older; 2021 limits).
- Trader A's Solo 401(k) plan comprises a \$19,500 [elective deferral](#), \$6,500 [catch-up](#) elective deferral for age 50 or older, and a \$38,500 [profit-sharing contribution](#) for an overall plan limit of \$64,500.

Part-time Trader B working for Big Tech

- This trader has a full-time job with a Big Tech company earning a W-2 salary of \$300,000 per year.
- Trader B seeks to maximize participation in her employer's 401(k) retirement plan, with an elective deferral of \$19,500 (under age 50), plus an employer matching contribution of 6%, which does not count towards the elective deferral limit.
- Trader B also operates a TTS S-Corp and makes \$400,000 in capital gains for 2021. In addition to her employer's 401(k), Trader B wants to utilize a Solo 401(k) retirement plan to maximize her savings.

Part-time Trader B working for Big Tech

- The critical issue is whether Trader B's TTS S-Corp is affiliated with her employer. Assuming it is unaffiliated, Trader B can maximize multiple employer retirement plans, with an essential restriction: An individual can only defer the limit (\$19,500 plus \$6,500 catch-up, if over 50) regardless of the number of plans.
- So, Trader B skips the elective deferral in her Solo 401(k) and makes a \$58,000 (2021 limit) profit-sharing contribution to her Solo 401(k) plan or contributes to a SEP IRA.
- Trader B would need \$232,000 in wages to maximize the profit-sharing contribution of \$58,000 (\$232,000 divided by a 25% rate for an S-Corp).

Part-time Trader C with an Affiliated Company

- This trader owns 100% of a consulting business S-Corp with 10 full-time employees.
- The consulting S-Corp does not offer a retirement plan to its employees.
- Trader C wonders if the TTS S-Corp can establish a Solo 401(k) plan and deny participation by consulting business employees.
- The answer is no because these two employers are affiliated.

Part-time Trader C with an Affiliated Company

- The controlled group non-discrimination rules prevent an owner from discriminating against his employees by excluding them from retirement benefits.
- It is wise to consult an employee benefits attorney about vesting and other means to work within the constraints of the non-discrimination, controlled group, and affiliated service group rules.
- See <https://greentradertax.com/how-some-traders-double-up-on-retirement-plan-contributions/>.

SALT CAP WORKAROUND

SALT cap workaround

- Since 2018, taxpayers living in high-tax states have been unable to take an itemized deduction of state and local taxes over a limitation (known as the [“SALT” cap](#)) of \$10,000 per year.
- This limitation came from the 2017 Tax Cuts and Jobs Act (TCJA) and is effective for tax years 2018 through 2025.
- But the good news is that some states have a workaround.

See details and updates at <https://greentrader.com/unlock-state-local-tax-deductions-with-a-salt-cap-workaround/>.

IRS Notice 2020-75

- On Nov. 9, 2020, Treasury and the IRS issued [Notice 2020-75](#), which says they “intend to issue proposed regulations to clarify that State and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment.”
- This IRS notice allows states to pursue their SALT cap workarounds if done within general guidelines.

The workaround

- To date, state laws for SALT cap workarounds vary, but the general idea is that a pass-through entity (PTE) assesses a tax at the state's rate on individuals.
- The state then grants the respective owners of the PTE a tax credit on their state personal income tax return.
- The SALT cap only applies to individual taxes, not PTE entity-level taxes.
- Other states subject the PTE to an entity-level tax and then exclude that PTE income from the owner's state tax return.

The workaround

- Check the latest news in your state to see if your state has enacted a SALT cap workaround when the tax law is effective (i.e., 2020, 2021 or 2022) and how it works.
- For example, Connecticut made the PTE tax mandatory for the SALT cap workaround strategy.
- Most of the other states make it elective, giving the taxpayer more choices; however, don't miss the election deadline.
- Consult your tax advisor to see how this strategy might save you money and whether you should consider forming a pass-through entity soon in 2021.

Traders seem to qualify for the SALT cap workaround

- Many traders eligible for [trader tax status](#) (TTS) already use a PTE like a spousal-member LLC/partnership or single-member LLC/S-Corp.
- A TTS trader in securities, commodities, and other financial products, has business expense treatment.
- A TTS trader actively buys and sells capital assets with capital gains and losses, or Section 475 ordinary gains and losses, if elected on a timely basis.

Here's an example

- In 2021, Joe Trader pays \$35,000 of state income taxes on the S-Corp level using a SALT cap workaround. His S-Corp net income is \$500,000, subject to a state tax rate of 7%.
- Joe reaches his SALT cap of \$10,000 with real estate taxes of \$11,000, so he loses a \$1,000 deduction.
- Joe deducts \$35,000 of the S-Corp state taxes from his gross income saving \$12,950 in federal taxes (\$35,000 state tax deduction x 37% top marginal federal tax rate).
- Without a SALT cap workaround, Joe would have \$36,000 of non-deductible SALT.

PRESIDENT BIDEN'S FY 2022 GREEN BOOK

Strengthen Taxation Of High-Income Taxpayers

- See President Biden's Treasury's FY 2022 [Green Book](#), which includes tax proposals.
- A few tax hikes stand out: Increasing the top ordinary tax rate to 39.6%, subjecting long-term capital gains for taxpayers making over \$1M to the top ordinary rate, treating transfers of appreciated property by gift or on death as realization events (capital gains), and closing the carried interest tax break for fund managers earning over \$400,000.
- However, the Green Book does not offer to remove the contentious SALT cap, and it retains the 20% QBI tax deduction from TCJA. In addition, it does not propose a financial transaction tax, although some bills in Congress do.

Increase The Top Marginal Income Tax Rate For High Earners

- “The proposal would increase the top marginal individual income tax rate to 39.6 percent. This rate would be applied to taxable income in excess of the 2017 top bracket threshold, adjusted for inflation. In taxable year 2022, the top marginal tax rate would apply to taxable income over \$509,300 for married individuals filing a joint return, \$452,700 for unmarried individuals (other than surviving spouses), \$481,000 for head of household filers, and \$254,650 for married individuals filing a separate return. After 2022, the thresholds would be indexed for inflation using the C-CPI-U, which is used for all current tax rate thresholds for the individual income tax. The proposal would be effective for taxable years beginning after December 31, 2021.”

Reform The Taxation Of Capital Income

- “Tax capital income for high-income earners at ordinary rates. Long-term capital gains and qualified dividends of taxpayers with adjusted gross income of more than \$1 million would be taxed at ordinary income tax rates, with 37 percent generally being the highest rate (40.8 percent including the net investment income tax), but only to the extent that the taxpayer’s income exceeds \$1 million (\$500,000 for married filing separately), indexed for inflation after 2022. This proposal would be effective for gains required to be recognized after the date of announcement.” (In April 2021).
- “Treat transfers of appreciated property by gift or on death as realization events.” Realization triggers capital gains taxes, which repeals a “step-up basis” in estates.
- This likely applies to the 60% portion of Section 1256 futures contracts lower 60/40 capital gains rates.
- (See Green Book pages 61 – 64).

Rationalize Net Investment Income And Self-Employment Contributions Act Taxes

- “The proposal would (i) ensure that all pass-through business income of high-income taxpayers is subject to either the NIIT or SECA tax.” (Green Book pages 65 – 67).
- Consultants use S-Corps to reduce SE taxes, including social security and Medicare tax, by paying “reasonable compensation” of 25% to 50% of net income. They seek to reduce payroll tax, the equivalent of SE tax. This tax proposal will impact them.
- Trader’s underlying income in an S-Corp is already subject to NIIT, so this won’t be a tax hike for them.
- The Green Book does not raise the social security tax base, which Biden suggested on the campaign trail.

Close Loopholes: Tax Carried (Profits) Interests As Ordinary Income

- “The proposal would generally tax as ordinary income a partner’s share of income on an “investment services partnership interest” (ISPI) in an investment partnership, regardless of the character of the income at the partnership level, if the partner’s taxable income (from all sources) exceeds \$400,000. Accordingly, such income would not be eligible for the reduced rates that apply to long-term capital gains.
- In addition, the proposal would require partners in such investment partnerships to pay self-employment taxes on such income.” (See Green Book pages 82 – 83).

Close Loopholes: Repeal Deferral Of Gain From Like-Kind Exchanges

- “The proposal would allow the deferral of gain up to an aggregate amount of \$500,000 for each taxpayer (\$1 million in the case of married individuals filing a joint return) each year for real property exchanges that are like kind. Any gains from like-kind exchanges in excess of \$500,000 (or \$1 million in the case of married individuals filing a joint return) during a taxable year would be recognized by the taxpayer in the year the taxpayer transfers the real property subject to the exchange. The proposal would be effective for exchanges completed in taxable years beginning after December 31, 2021.” (Green Book page 84).
- TCJA limited LKE to real property starting in 2018. Many cryptocurrency traders inappropriately used LKE to defer capital gains on coin-to-coin trades before 2018. The IRS just stated that was wrong in an IRS memorandum <https://www.irs.gov/pub/irs-wd/202124008.pdf>.

TAX BILLS PENDING IN CONGRESS

Senate Finance Committee: Phase-out QBI deduction for wealthy

- Senate Finance Committee Chairman Ron Wyden plans to propose several tax hikes focused on upper-income taxpayers.
- “Wyden’s legislation, which is still being drafted, will take aim at a temporary deduction of up to 20% that is available under [Section 199A](#) (QBI deduction) for partnerships, LLCs, and other entities taxed only at the individual owner level. Wyden (D-Ore.), a vocal critic of the Trump-era tax code overhaul (TCJA), will likely aim to start phasing out the deduction for individuals making above \$400,000 in annual business income, with the perk unavailable for people making over \$500,000.” (Bloomberg Tax).
- Trading is a service business so TTS/475 ordinary income is already phased out below the above QBI thresholds under TCJA.

Senate Finance Committee: MTM accounting for wealthy

- [Top Senate Democrat Pushing Forward With Capital Gains Overhaul:](#)
- “Senate Finance Chairman Ron Wyden (D-Ore.) will soon release legislation to implement mark-to-market (MTM) taxation on unrealized capital gains held by the wealthy. Wyden has been touting the benefits of implementing an annual tax on unrealized gains from stocks, bonds, real estate, and other assets since the fall of 2019. The bill is still being written, but Wyden’s staff told Bloomberg Tax that the proposal is being tweaked to align with the Biden administration’s capital gains proposals. The White House hasn’t embraced Wyden’s plan, instead proposing to raise the top capital gains rate and start taxing unrealized assets at death.” (Bloomberg Tax).

TTS traders elect 475 MTM for “tax loss insurance” and the QBI deduction.

Financial-transaction taxes

H.R.328: Wall Street Tax Act of 2021

<https://www.congress.gov/bill/117th-congress/house-bill/328/>

Introduced in House (01/15/2021). 27 cosponsors.

Senate Bill 817: identical to H.R. 328

<https://www.congress.gov/bill/117th-congress/senate-bill/817/cosponsors>

Introduced in Senate (03/18/2021). 5 cosponsors.

“This bill imposes a 0.1% excise tax on certain purchases of stocks, bonds, and derivatives.”

Biden’s Green Book and the Chairs of Senate Finance Ron Wyden (D) and House Ways & Means Richard Neal (D) do not currently sponsor FTT legislation.

Financial-transaction taxes

- With zero to low commissions, there's little sand left in the system to slow down massive trading volumes and windfall capital gains this past year. Congress sees opportunities for tax hikes on upper-income investors.
- FTT is a dangerous shotgun approach that hits Main Street investors and small-business traders rather than just Wall Street banks and wealthy hedge funds.
- “(Treasury Secretary Janet Yellen) Asked about a financial-transactions tax, she said, “One would have to examine closely what effect it would have” on ordinary investors.” (Bloomberg News).

BEEFING UP TAX COMPLIANCE

Increasing IRS enforcement

- Republican leadership in the Senate draws a red line around raising tax rates on corporations, pass-through businesses, and upper-income taxpayers.
- To gain bipartisan support for his infrastructure bill, President Biden proposed increasing IRS enforcement to close the “tax gap” rather than raising tax rates on corporations and upper-income individuals.
- The media has been reporting on U.S. tax avoidance by Big Tech and billionaires.
- Biden’s Green Book has several proposals to increase tax compliance.

QUESTIONS AND ANSWERS

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- Visit www.GreenTraderTax.com for additional information.
- Call us toll free at 888.558.5257 or 203.456.1537
- Email us your questions at info@greentradertax.com



Update June 16, 2021

We plan to accept new clients eligible for [trader tax status](#) (TTS) for our 2021 [tax compliance service](#). A few requirements: Start the process with a [50-minute consultation](#) (\$350) in 2021, where we establish if you sound eligible for TTS and should benefit from our 2021 tax compliance service. We accomplish much more in this consultation, too. Next, at your request, we schedule a new client evaluation (NCE) using our 15-minute add-on consultation service. See [details](#).

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Unlock State & Local Tax Deductions With A SALT Cap Workaround

Updates: As states progress on SALT cap workaround legislation, I will update that news at the bottom of this post. Since 2018, taxpayers living

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