# HOW TO ACHIEVE TAX SAVINGS AS A TRADER

greenTraderTax

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# Description

- Join Robert A. Green, CPA, of GreenTraderTax.com as he explains the tax advantages of “trader tax status” (TTS).

- Learn the golden rules for eligibility for TTS for full-time or part-time traders. You can claim TTS for all or part of 2021 and 2020; the IRS does not require an election for TTS.

- Automated trading systems (ATS) can qualify for TTS, providing the trader is significantly involved with creating the ATS. Using software or services that mimic other people’s trades is not eligible for TTS.

# Webinar description

- TTS traders deduct business expenses, startup costs, organization costs, and home office expenses, whereas investors cannot under TCJA.
- Learn how TTS traders use an S-Corp to deduct health insurance premiums and high-deductible retirement plan contributions.
- TTS is a pre-requisite for using Section 475 MTM accounting which exempts securities trades from wash sale loss adjustments, navigates around the capital loss limitation, and unlocks a qualified business income deduction.

# HOW TO QUALIFY FOR TRADER TAX STATUS

A deep dive into our golden rules for TTS.

# Volume of trades: 15 per week

- The 2015 tax court case Poppe vs. Commissioner T.C. Memo. 2015-205 is a useful reference. Poppe made 720 total trades per year/60 per month.
- We believe an average of four trades per day, four days per week, 16 trades per week, 60 trades a month, and 720 per year on an annualized basis is adequate for TTS.
- Count each open and closing trade separately, not round trips.
- Some traders scale into and out of trades, and you can count each of those trades separately.

# Example calculation of volume and frequency

- The securities markets are open approximately 250 days, but let’s account for some personal days or holidays, and figure you’re available to trade 240 days per year.

- A 75% frequency of 240 days equals 180 days per year, so 720 total trades divided by 180 trading days equals four trades per day.

# Frequency of trades should be 75% or more

- Execute trades on close to four days per week, around a 75% frequency rate.
- The tax courts require "regular, frequent, and continuous" qualification for TTS. If you enter or exit a trading business during the year, then maintain the frequency rate during the TTS period.
- Time off from the execution of trades should be for a reasonable amount of vacations and other non-working days.
- Think of TTS like it's a job, only the markets are your boss.

# Average holding period should be less than 31 days

- The IRS stated that the average holding period is the most crucial TTS factor.
- In the Endicott court, the IRS said the average holding period must be 31 days or less. That's a bright-line test.
- If your average holding period is more than 31 days, it's disqualifying for TTS, even if all your other TTS factors are favorable.
- It's more natural for day traders and swing traders to meet the holding period requirement.

# How to analyze average holding period

- Consider the following example of a trader in equities.

- If he holds 80% of his trades for one day and the other 20% for 35 days, then the average holding period is well under 31 days.

- It's not evident if the IRS might apply weighted averages to the average holding period.

# Trading and investing in one account can undermine TTS holding period

- Traders often combine trading with long-term investing in one brokerage account.
- That can cause ineligibility for TTS, with the holding period on investments dragging the average holding period above the 31-day requirement.
- Why combine these activities? Traders use portfolio margining to borrow funds on long-term investments to trade derivatives around those positions for enhancing income.

# Segregation can shorten holding period

- To qualify for TTS, consider a separate brokerage account for trading vs. investing. But that will restrict the use of portfolio margining as brokers do not allow it across multiple accounts.

- If you invest in big tech and trade derivatives on the same symbols, consider further segregation. A trading entity with TTS and Section 475, so the IRS cannot apply 475 MTM to your investments.

- One individual account might be okay if you invest in ETFs and trade equities. It can work because there is no overlap on symbols. Be careful to identify your investments on a contemporaneous basis.

# A full-time or part-time trader can qualify for TTS

- Part-time and money-losing traders face more IRS scrutiny, and individuals face more scrutiny than entity traders. However, all can qualify for TTS.
- Full-time traders actively trading significant portfolios may not qualify because they don’t have enough volume and frequency, and their average holding period is over 31 days.
- On the other hand, a part-time trader with a full-time job may qualify as a day and swing trader in securities, meeting all our golden rules.
- It might not be fair, but it’s the current state of IRS rules.

# Time spent on TTS activities should be significant

- Spends more than four hours per day, almost every market day working on his trading business.
- All-time counts, including execution of trade orders, research, administration, accounting, education, travel, meetings, and more.
- Most active business traders spend more than 40 hours per week in their trading business.
- Part-time traders usually spend more than four hours per day.

# Trading is not a passive loss activity

- In one tax exam our firm handled many years ago, the IRS agent brought up the "material participation" standard in the passive loss activity rules (Section 469), which require 500 hours of work per year (as a general rule).
- Many business traders surpass 500 hours of work. However, Section 469 doesn't apply to trading businesses, under its "trading rule" exemption.
- Without this exemption, taxpayers could generate passive-activity income by investing in hedge funds and the IRS did not want that.

# Avoid too many sporadic lapses in trading

- A trader has few to no sporadic lapses in the trading business during the year.
- The IRS has successfully denied TTS in a few tax court cases by arguing the trader had too many sporadic lapses in trading, such as taking several months off during the year.
- Traders can take vacations, sick time, and personal time off just like everyone else.
- Some traders take a break from active trading to recover from recent losses and learn new trading methods and markets.

# Explain sporadic lapses to the IRS

- Breaks from trading should be carefully explained to the IRS in tax-return footnotes.
- We believe retooling and education during a lapse in trade executions still may count for the continuous business activity (CBA) standard, although the IRS currently does not give credence to CBA.
- We recommend traders keep proper records of their time spent as support.
- If you need time off, take it, don't have the tax tail wag the dog by pushing the envelope on TTS.

# Duration of TTS activity is essential for the IRS

- Comments from an IRS official about the Chen tax court case point out the IRS doesn’t respect individual traders who are brand new to a trading activity and who enter and exit it too quickly — especially if the trader seeks a large IRS refund by deducting a Section 475 MTM ordinary loss on an individual tax return.

- Some traders must temporarily stop for several months for health reasons. It’s not clear if the IRS will respect that as a valid interruption of a trading business activity. That seems unfair, but it may be the reality.

# TTS requires the intention to run a business

- Traders must intend to run a trading business — trading their own money — but it doesn’t have to be one’s exclusive or primary means of making a living. The critical word is “a” living, which means it can be a supplemental living.

- Many traders enter an active trading business while still working a full-time job. Advances in technology and flexible job schedules make it possible to carry on both activities simultaneously.

- With the Covid pandemic in 2020 and 2021, many traders work remotely from home and conduct a trading business. What happens when they return to the office?

# Don't combine TTS in another business entity

- It's not a good idea to try to achieve TTS within a business entity already principally conducting a different type of business activity.
- It's better to form a new trading entity.
- Trading an existing business's available working capital seems like a treasury function and sideline, which can deny trader tax breaks if the IRS takes a look.
- Combining TTS and another business in an entity will confuse the IRS, leading to questions and lost benefits.

# An entity looks better for TTS

- Filing as a sole proprietor on a Schedule C is allowed and used by many, but it may not be the best tax filing strategy for a part-time trader.
- An individual tax return shows a taxpayer’s job and other business activities or retirement, which may undermine TTS in the eyes of the IRS.
- The IRS tends to think trading is a secondary activity, and it may seek to deny TTS.
- It’s best to form a new, separate entity dedicated to trading only.
- However, consider the entity's costs, which might outweigh the benefit of an entity, especially if it's just for window dressing.

# Trading is not a hobby loss activity

- Several years ago, we spoke with one IRS agent who argued the trader did not make a living since he had perennial trading losses.

- That's okay because the hobby loss rule speaks to taxpayer intention, not the actual results.

- The hobby-loss rules don't apply to TTS traders because trading is not recreational or personal in nature.

- Part-time traders often tell me they operate a business to make a supplemental living and intend to leave their job to trade full-time when they become profitable enough.

# TTS traders usually have significant business operations

- Many TTS traders have multiple monitors, computers, mobile devices, trading services, subscriptions, education expenses, high-speed broadband, wireless, and a home office.

- The IRS needs to see that a taxpayer claiming TTS has the trappings of a business.

# Many traders have a separate home office

- How can one run a business without a dedicated space? Casual investors rarely have as elaborate an office set up as business traders do. Why would a long-term investor need multiple monitors?

- If a trader uses a home-office space exclusively for business rather than personal use, the tax return should reflect this because it is not only a valid home-office deduction, but it also further supports the fact there is legitimate business activity being conducted.

- The home-office deduction is no longer a red flag with the IRS, and it is not a complicated calculation. Some TTS traders just use a laptop and that’s okay.

# TTS requires 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. With this status, he or she can day trade using up to 4:1 margin rather than 2:1.

- Without PDT status, securities traders will have a harder time qualifying for TTS.

- We like to see more than $15,000 account size for trading futures, forex or cryptocurrency.

# TTS activity should be material to you

- Adequate account size also depends on one's overall net worth and cash flow.
- Millionaires may need larger account sizes, whereas some unemployed traders without much cash flow or very young traders may get by with lower account sizes.
- A trader may also be able to factor in capital invested in equipment and startup costs.

# WHAT DOESN'T QUALIFY FOR TTS

# Four types of trading activity aren't counted for TTS qualification

- Automated trading systems without much involvement by the trader (but a trader creating his or her own program qualifies).
- A trade copying software or service.
- Engaging a professional outside investment manager or robo-advisor.
- Trading in retirement funds.

# Automated trading systems impact TTS

- These programs are becoming more popular. An entirely canned automated trading service (ATS) with little to no involvement by the trader doesn't qualify for TTS.

- The IRS may view an outside-developed ATS the same as a trader who uses a broker to make most buy/sell decisions and executions.

# Self-created ATS count for TTS

- If the trader can show he's very involved with creating the ATS — perhaps by writing the code or algorithms, setting the entry and exit signals, and turning over only execution to the program — the IRS will likely count the ATS-generated trades in the TTS analysis.

- Some traders don't have programming experience, but they have financial and trading experience. They design the ATS to do manually and hire an outside programmer to translate their specifications into a computer language.

# Tips for ATS being included for TTS

- It’s helpful if the trader can show he spends more than four hours per day working in his trading business, including time for ATS maintenance, back-testing, and modifications.
- We have not yet seen the IRS challenge ATS for TTS in exams or court cases, but we feel it may react this way when it comes up.
- Self-creation of the ATS needs to be significant to count for TTS. Just making a few choices in an outside-developed ATS building-block service does not qualify for TTS.

# More on ATS

- If traders spend a lot of money on an ATS that doesn't qualify as part of their trading business, then those expenses are suspended investment fees and expenses.
- Traders need to know the IRS may connect the dots and realize they are using an ATS. A full-scale exam can uncover these facts.
- Consider the analogy of an airplane pilot using manual and automated systems. A trader needs to be a pilot in the cockpit, not in the cabin as a passenger.

# Trade copying software or services undermine TTS

- Some traders use trade copying software or service (TCS). Trade copying is similar to using a canned ATS or outside adviser, where the copycat trader might not qualify for TTS on those trades.

- As an example, a trade coaching and education company offer a TCS that suggests several trades each day, with exact entry and exit points and stop-loss orders.

- The trader decides which trades to make and executes them manually.

# When TCS can count towards TTS

- If the trader follows the TCS tightly and does not significantly depart from its suggestions, then an IRS agent might feel they do not qualify for TTS.

- On the other hand, if the trader cherry-picks a minor percentage of the suggested trades, sets different stop-loss orders, and waits longer on entry and exit executions, they might qualify for TTS (if they meet all the TTS factors).

# Engaging an investment manager or robo-advisor does not count for TTS

- Hiring a registered investment adviser (RIA) or commodity trading adviser (CTA) — whether duly registered or exempt from registration — to trade one's account doesn't count toward TTS qualification.

- However, hiring an employee or independent contractor under the trader's supervision to help trade their funds should qualify, providing the taxpayer is a competent trader.

- There are decades-old tax court cases that show using outside brokers and investment advisers to make trading decisions undermines TTS.

# Engaging an assistant trader is part of TTS

- There are nuances between engaging an independent outside manager vs. a supervised inside trader.
- If the engaged trader is a registered investment adviser, he’s clearly in the business of being an external manager, and TTS is not achievable.
- But if the assistant trader only operates under the trader’s direction, it may be possible to achieve TTS.

# Married couples should be careful naming accounts

- With married couples, if the wife has an individual brokerage account in her name only and gives power of attorney to the husband to trade it, the IRS won't grant TTS even if the husband meets all the golden rules for TTS.

- The husband is not deemed an owner of the account. In this case, the IRS will treat the wife as an investor and the husband as an investment manager.

- Married couples can solve this problem by using a joint individual account or trading in a spousal-member LLC. It's better to list the trader spouse first on a joint personal account.

# Trading retirement funds is not part of TTS

- Trading activity in non-taxable retirement accounts doesn’t count for purposes of TTS qualification.
- Trading in retirement plans can be an excellent way to build tax-free compounded returns, especially if the taxpayer doesn’t qualify for TTS in their taxable accounts.
- Roth IRAs and Roth 401(k) provider permanent tax-free growth.

# Trading IRA and taxable accounts side-by-side can trigger wash sale losses

- It is possible to trade retirement accounts and, at the same time, qualify for TTS in taxable accounts.

- Caution: it’s dangerous to trade substantially identical positions between an individual taxable account and IRA accounts since this can trigger a permanent wash-sale (WS) loss in a taxable account that moves into the IRA.

- Avoid permanent WS losses in IRAs with a Section 475 election on the taxable account or use a Do Not Trade List to avoid overlap.

# SOLE PROPRIETORSHIP

# TTS sole proprietors file a Schedule C

- An individual TTS trader deducts business expenses, startup costs, and home office deductions on a Schedule C (Profit or Loss From Business – Sole Proprietorship). That reduces gross income.
- Traders don’t have revenue, so Schedule C shows a net loss.
- Trading gains and losses go on other tax forms: Form 8949 for capital gains and losses, Form 6781 for 1256 contracts and Form 4797 for Section 475 trades.
- Consider transferring some trading gains to Schedule C “Other Income” to zero out Schedule C.

# SE tax vs. net investment tax

- Self-employment (SE) tax assessed on self-employment income (SEI) includes 12.4% social security tax up to a SSA base amount and 2.9% Medicare tax without a limit.

- Traders don't owe SE tax because trading gains and losses are not SEI. (Exception: full members of a commodities exchange have SEI).

- Trading gains and losses are net investment income (NII) for ACA's net investment tax (NIT): a 3.8% Medicare tax applied on upper-income taxpayers.

- How to handle a TTS Schedule C loss: First, reduce SEI from other businesses, and the excess reduces NII for NIT.

# There's no tax election for TTS

- There isn't a tax election for claiming TTS — it's determined based on facts and circumstances assessed at year-end

- You can claim TTS after-the-fact; you don't have to formalize it in advance.

# BUSINESS EXPENSES

# TTS business expenses

- Business expenses include home-office, education, startup expenses, organization expenses, margin interest, tangible property expense, Section 179 (100%) or 100% bonus depreciation, amortization on software, self-created automated trading systems, chat rooms, mentors, seminars, market data, charting services, stock borrow fees, and much more.

# SECTION 475 ELECTION

Tax loss insurance and the QBI deduction.

# Section 475 tax loss benefits

- TTS traders are entitled to make a Section 475 election, but investors may not.
- The election exempts securities trades from wash-sale loss (WS) adjustments, which can defer tax losses to the subsequent year and the $3,000 capital loss limitation.
- Consider the election on securities only, not commodities, to retain lower 60/40 capital gains rates on 1256 contracts (commodity futures).
- Ordinary loss treatment is better; it can generate tax refunds faster than capital loss carryovers.

# The QBI deduction includes Section 475 income

- TCJA introduced a tax benefit for pass-through businesses, which includes a TTS trader with Section 475 income; whether doing business as a sole proprietor, partnership, or S-Corp. QBI excludes capital gains.

- Section 199A provides a 20% QBI deduction on a “specified service trade or business” (SSTB), and TTS trading is an SSTB.

- SSTBs are subject to a taxable income threshold, phase-out range, and income cap. The phase-out range has wage and property limitations, too.

# How to make the Section 475 election for 2021

- The deadline for an individual TTS trader to elect Section 475 for 2021 has passed; it was May 17, 2021, the COVID postponed deadline (June 15 for TX, OK, and LA).

- Existing pass-through entities had to elect 475 by March 15, 2021.

- A partnership or S-Corp formed during the tax year is considered a “new taxpayer,” which can elect Section 475 internally within 75 days of inception. A new entity comes in handy for selecting 475 later in the year.

- It’s getting late to consider a new entity for 2021. I like to see TTS for all of Q4 at a minimum.

# LLC TAXED AS AN S-CORP

A TTS trader needs an S-Corp to deduct health insurance premiums and retirement plan contributions.

# How to elect S-Corp tax status

- Organize a single-member or spousal-member LLC and elect S-Corp status with the IRS within 75 days of inception.
- Alternatively, in a subsequent year, the LLC can submit an S-Corp election by March 15.
- The S-Corp can elect Section 475 internally within 75 days of inception.

# How to deduct health insurance premiums

- TTS traders with significant health insurance (HI) premiums should consider an S-Corp to arrange a tax deduction through officer compensation.
- The trader or spouse might have another source of self-employment income to deduct HI. A spouse might have HI coverage for the family in their job.
- Cobra is not deductible HI since it’s employer-provided.
- A TTS sole proprietor or partnership cannot deduct HI premiums based on trading income.

# How to arrange a Solo 401(k) elective deferral

- If you have sufficient trading profits for the year in your S-Corp, consider establishing a Solo 401(k) retirement plan before year-end.
- Start with the 100% deductible elective deferral (ED; $19,500 for 2021) and pay it through payroll since it’s reported on the annual W-2.
- Taxpayers 50 years and older have a “catch up provision” of $6,500, raising the 2021 ED limit to $26,000 per year.
- Contribute the elective deferral to a Solo 401(k) Roth or traditional account.

# How to arrange a Solo 401(k) profit-sharing plan

- Consider a Solo 401(k) profit-sharing plan (PSP) contribution.
- The maximum PSP amount is $38,500 on wages of $154,000. The total limit for a Solo 401(k) is $64,500 ($19,500 ED, $6,500 catch-up ED, and $38,500 PSP).
- However, if you have a job and contribute the $19,500 elective deferral maximum, then you can contribute $58,000 to your TTS S-Corp PSP.
- See details on https://greentradertax.com/how-some-traders-double-up-on-retirement-plan-contributions/.

# LLC TAXED AS A PARTNERSHIP

# A two-member LLC can be taxed as a partnership

- A TTS trader can organize a spousal-member LLC and file as a partnership.
- LLC/partnerships must qualify for TTS; otherwise, they are investment companies.
- A partnership is useful for ring-fencing TTS/475 trading from individual taxable, and IRA accounts for avoiding wash sale losses and the IRS reclassifying investment positions.

# SALT CAP WORKAROUND

# Consider an entity for the SALT cap workaround strategy

- Are you disenfranchised from state and local tax deductions because you exceed the SALT cap of $10,000 per year?
- Organizing an LLC for your business can convert non-deductible SALT into a business expense on your federal return and a state tax credit on your tax return.
- Many states have enacted SALT cap workaround laws, and several others are working towards enactment.
- See https://greentradertax.com/how-to-deduct-state-and-local-taxes-above-salt-cap/.

# Contact us

- Thank you for attending this Webinar or watching the recording.
- 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 September 14, 2021

It's too close to the October 15, 2021 tax extension deadline for us to accept returning clients or new clients for preparing 2020 tax returns on time. See updates here and check back with us after October 15.

It's too late for our entity formation service to be effective for the tax year 2021. See updates here.

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