HOW TO SET UP A TRADING BUSINESS FOR OPTIMAL TAX SAVINGS

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Overview

- If you are eligible for trader tax status (TTS), consider setting up a trading business to maximize tax benefits.
  - Deduct trading business expenses.
  - Elect Section 475 MTM for exemption from wash sales and the capital loss limitation.
  - Be eligible for a 20% qualified business income QBI deduction on Section 475/TTS income.
  - Deduct health insurance and high-deductible retirement plan contributions.
  - Deduct state and local taxes (SALT) as a pass-through entity (PTE) business expense avoiding the $10,000 SALT cap.

HOW TO BE ELIGIBLE FOR TRADER TAX STATUS

Golden rules for TTS (1)

- *Volume*: Four trades per day, 16 trades per week, 60 a month, and 720 per year on an annualized basis (Poppe court). Count each open and closing trade separately.

- *Frequency*: Executes trades on close to four days per week, 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.

Golden rules for TTS (2)

- *Trades full time or part-time*, for a good portion of the day, almost every day the markets are open.
- *Hours*: Spends more than four hours per day, almost every market day working on the trading business — all time counts.
- *Avoid sporadic lapses*: Once TTS commences, avoid lapses in the trading during the year.

Golden rules for TTS (3)

- *Intention*: Has the intention to run a business and make a living. It doesn't have to be a primary living.
- *Operations*: Has significant business equipment, education, business services, 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. For the minimum account size, we like to see more than $15,000.
- https://greentradertax.com/trader-tax-center/trader-tax-status/how-to-qualify/

What doesn’t qualify for TTS?

- Automated trading system (ATS) created by a third-party with entry and exit signals, and automated execution. Some ATS don't come with automatic execution, and traders significantly depart from ATS signals so that the trader can count those trades. A self-created ATS counts for TTS.
- A trade copying service does not count for TTS unless you depart from recommended trades significantly.
- Engaging an investment advisor.
- Trading retirement funds.

CHOICE OF ENTITY FOR TRADERS

Choice Of Entity For Traders Eligible for Trader Tax Status	Sole Proprietor	LLC Partnership	LLC S-Corp
Deduct trading business expenses	Schedule C	Form 1065	Form 1120-S
Elect Section 475 MTM	By April 15	By March 15	By March 15
Ring-fence trading from investments	No	Yes	Yes
SALT cap workaround solution	No	Yes	Yes
Health insurance deduction	No	No	Yes
Retirement plan deduction	No	No	Yes
Payroll tax compliance	No	No	Yes
Separate income tax return	No	Yes	Yes

SOLE PROPRIETORSHIP

File a Schedule C with Form 1040

- An individual TTS trader deducts business expenses, startup costs, and home office deductions on a Schedule C (Profit or Loss From Business – Sole Proprietorship) as part of the 1040 filing.
- Traders don't have revenue on Schedule C; report trading gains and losses on other tax forms.
- Schedule C expenses are an above-the-line deduction from gross income.
- TTS Schedule C expenses also reduce self-employment income (SEI). However, trading income is not SEI unless you are a full member of a futures exchange.
- Trading income is net investment income (NII) for the 3.8% net investment tax on NII over ACA thresholds.

Individual brokerage account

- Open an individual brokerage account(s) in the trader's name and social security number.
- You can also use a joint individual account but first list the trader's name and social security number.
- If the husband trades the spouse's account, neither can qualify for TTS.
- Individuals pay non-professional rates for real-time data, whereas entities might owe higher professional rates.

No election or filing need 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.
- A TTS trader can elect Section 475 for MTM ordinary gain or loss treatment. But the 475 election is due early in the tax year.
- TTS is like undergraduate school, and Section 475 is like grad school. You can claim TTS after the fact, but not 475, which hurts many traders in 2022, especially if they rack up massive losses YTD and missed the 475-election deadline on April 18, 2022.

SINGLE-MEMBER LLC

Single-member LLC

- If you want asset protection, consider a single-member LLC (SMLLC) taxed as a “disregarded entity.” That’s a tax nothing in the eyes of the IRS. You still file as a TTS sole proprietor on Schedule C.
- Traders don’t have investors or clients; that would be an investment management business subject to liability concerns.
- A TTS trader might hire employees, lease an office, co-locate automated trading equipment with a broker, and use massive leverage. These traders should consider liability protection using an SMLLC. Consult an attorney.
- A SMLLC can also elect S-Corp or C-Corp tax status.

BUSINESS EXPENSES WITH TRADER TAX STATUS

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, mentors, seminars, market data, charting services, stock borrow fees, and much more.

- https://greentradertax.com/trader-tax-center/trader-tax-status/trading-business-expenses/

SECTION 475 ELECTION

Section 475 tax benefits: Tax losses and QBI deduction

- 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. Ordinary loss treatment is better; it can generate tax refunds faster.

- A TTS trader is eligible for a 20% qualified business income (QBI) deduction if under the taxable income threshold for a “specified service trade or business” (SSTB). QBI includes 475 ordinary income less TTS expenses, excluding capital gains and portfolio income.

Section 475 election process

- The deadline for an individual TTS trader to elect Section 475 for 2022 has passed; it was April 18, 2022. It's also too late to select 475 for 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 electing 475 later in the year.
- https://greentradertax.com/how-traders-elect-475-to-maximize-their-tax-savings/

QUALIFIED BUSINESS INCOME DEDUCTION

QBI deduction

- 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.
- 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.

QBI income threshold

- As an SSTB, TTS traders have a taxable income (TI) cap of $440,100/$220,050 (married/other taxpayers) for 2022.
- The phase-out range below the cap is $100,000/$50,000 (married/other taxpayers), in which the QBI deduction phases out for SSTB.
- The W-2 wage and property basis limitations also apply within the phase-out range.

LLC TAXED AS A PARTNERSHIP

LLC taxed as a partnership

- A TTS trader can organize a spousal-member LLC and file as a partnership. Only one spouse needs to be an active trader.
- LLC/partnerships file a Form 1065 partnership tax return and issue Schedule K-1s to owners.
- LLC/partnerships must qualify for TTS; otherwise, they are investment companies.
- With TTS, report business expenses on page one of 1065. List net 475 income or loss, less TTS expenses on line one of the Schedule K-1 “ordinary business income (loss).” Use separate K-1 line items for portfolio income, including capital gains and losses, interest, and dividends.

Form 1065 and owner’s Schedule E

- The owner reports Schedule K-1 ordinary business income (loss) on Form 1040 Schedule E in the active column.
- It’s not a passive activity in Section 469 under the “trading rule” exception. However, losses are limited to "basis" (your net investment in the partnership).
- Report capital gains/losses and portfolio income separately on 1040. Schedule B for interest and dividend income, and Schedule D for capital gains and losses from partnerships.
- If the partnership agreement provides for it, the partner can also deduct “unreimbursed partnership expenses” (UPE), including home office expenses, on Schedule E page 2. (It’s more formal with an S-Corp.)

Ring-fence trading from investments with an entity solution

- If you trade substantially-identical positions that you also invest in a taxable account, it could invite the IRS to play havoc with reclassification. It can also undermine eligibility for TTS.

- A partnership or S-Corp can fix this problem. The entity can ring-fence TTS/475 trading positions, segregating them from overlapping investments on the individual level. But that isn't easy if you want to maximize portfolio margining.

- This entity solution prevents the IRS from reclassifying TTS positions out of Section 475 ordinary losses into a capital loss limitation. Alternatively, reclassifying unrealized long-term capital gains into MTM income.

- If you don't have overlapping investments, you don't need a ring-fencing entity solution.

Avoid permanent wash sale losses between taxable and IRA accounts

- If you trade substantially-identical positions that you also invest in IRAs, it could trigger losses for permanent wash sale adjustments (WS). Brokers don't recognize this problem on 1099-Bs; they have a narrow view of WS.

- Take a loss on X in a taxable account and repurchase X within 30 days before or after in an IRA, and it's a permanent WS loss. There is no way to record the WS cost basis adjustments in the IRAs.

- There are three ways to avoid these WS. Use a do not trade or invest list, elect 475 on trades, or use a ring-fencing entity solution.

SALT CAP WORKAROUND

SALT cap workaround laws

- TCJA capped SALT at $10,000 per year on Schedule A as an itemized deduction. Many traders use the roughly-doubled standard deduction. SALT includes state and local income taxes, property taxes, and sales taxes.
- Over 20 states enacted SALT cap workaround laws allowing taxpayers to covert non-deductible SALT into business expenses.
- It's arranged through a pass-through entity (PTE), including partnerships and S-Corps, but not Schedule Cs.
- Search "SALT cap workaround" with your state. Act on time to get this deduction; it requires planning.
- https://greentradertax.com/category/salt/

LLC TAXED AS AN S-CORP

S-Corp election

- Organize a single-member or spousal-member LLC and elect S-Corp status with the IRS within 75 days of inception (date on the certificate of formation).
- Alternatively, in a subsequent year, the LLC can submit an S-Corp election by March 15.
- Owners must be U.S. residents.
- An LLC/S-Corp can achieve the ring-fencing and SALT cap workaround solutions of partnerships previously discussed.
- https://greentradertax.com/trader-tax-center/entity-solutions/

HEALTH INSURANCE DEDUCTION WITH AN S-CORP

Health insurance premiums using an S-Corp

- TTS traders with significant health insurance (HI) premiums should consider an S-Corp to arrange an AGI tax deduction.
- 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.
- Add reimbursement of HI premiums to officer compensation, and that portion of salary is not subject to payroll taxes (social security and Medicare).
- A TTS sole proprietor or partnership cannot deduct HI based on trading income.

RETIREMENT PLAN CONTRIBUTION/DEDUCTION WITH AN S-CORP

Officer compensation

- Traders need earned income to make and deduct retirement plan contributions and health insurance premiums; however, trading income is unearned.
- TTS sole proprietors and partnerships cannot create earned income, whereas S-Corps can pay officer compensation, generating earned income.
- Payroll taxes apply on officer compensation (wages): 12.4% FICA capped on salaries up to $147,000 for 2022, and the 2.9% Medicare is unlimited. There’s a 0.9% surtax over the ACAI income threshold.
- Upper-income traders convert Medicare tax on unearned income into Medicare on earned income, so it's not redundant.

Annual payroll at year-end

- TTS traders should fund retirement plan contributions from net income, not losses.
- It's okay to have a loss generated by the HI reimbursement portion of compensation.
- It's best to wait on the execution of an annual paycheck until early December, when there is transparency for the year.

Solo 401(k) elective deferral

- If you have sufficient trading profits for the year, consider establishing a Solo 401(k) retirement plan before year-end.
- Start with the 100% deductible elective deferral (ED; $20,500 for 2022) 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 2022 ED limit to $27,000 per year.
- The ED can be contributed to a Roth IRA, forgoing the tax deduction on the contribution.

Solo 401(k) profit-sharing plan

- If you have significant trading gains, consider increasing payroll in December 2022 for a performance-based bonus to unlock a 25% deductible Solo 401(k) profit-sharing plan (PSP) contribution that you don't have to pay into the retirement plan until the due date of the S-Corp tax return (including extensions by September 15).
- The maximum PSP amount for 2022 is $40,500, increased $2,000 from 2021.
- The total 2022 limit for a Solo 401(k) is $67,500 ($20,500 ED, $6,500 catch-up ED, and $40,500 PSP).
- https://greentradertax.com/trader-tax-center/retirement-solutions/
- https://greentradertax.com/how-some-traders-double-up-on-retirement-plan-contributions/

C-Corps are not suitable for traders

- C-Corps are not ideal for traders since the IRS might charge a 20% “accumulated earnings tax” (AET) on top of the 21% flat tax rate.
- It’s hard for a trader to have a war chest plan to justify retaining earnings and profits (E&P). Otherwise, AET applies to E&P.
- There’s double state taxation to consider, too.
- https://greentradertax.com/how-to-decide-if-a-c-corp-is-right-for-your-trading-business/

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