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Green Trader Tax

How To Achieve Tax Savings As A Trader

Robert A. Green
CPA
Green Trader Tax

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HOW TO ACHIEVE TAX SAVINGS AS A TRADER

green TraderTax

October 4, 2022 @ 12:00 pm ET
for 60 minutes
(Interactive Brokers)

Presenter

Robert A. Green, CPA

CEO GreenTraderTax

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Overview

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.
- TTS traders deduct business, startup, organization, and home office expenses, whereas investors cannot.
- TTS is a pre-requisite for using Section 475 MTM accounting which exempts securities trades from wash sale loss adjustments, navigates around the $3,000 capital loss limitation, and unlocks a 20% qualified business income (QBI) deduction.

Overview

- If you did not elect Section 475 on time, learn to avoid wash sale loss adjustments at year-end.
- Learn how TTS traders use an S-Corp to deduct health insurance premiums and high-deductible retirement plan contributions.
- Learn how to use a TTS partnership or S-Corp for a SALT cap workaround and segregate trading vs. investments.

HOW TO QUALIFY FOR TRADER TAX STATUS

Learn our golden rules for TTS.

Volume of trades

- The 2015 tax court case Poppe vs. Commissioner is a helpful reference.
- Poppe made 720 total trades per year/60 per month.
- We recommend an average of four trades per day, four days per week, 16 transactions per week, 60 a month, and 720 per year on an annualized basis.
- 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.

What counts for volume of trades

- If you initiate a trade order and the broker breaks down the lot sizes without your involvement, it’s wise not to count the extra volume of trades in this case.

- Trade executions count; not unexecuted trades, expirations, or assignments.

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 daily transactions.

Frequency of trades

- Execute trades four weekly days, around a 75% frequency rate.

- The tax courts require "regular, frequent, and continuous" qualifications 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 a job; only the markets are your boss.

Average holding period

- 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 unclear whether the IRS might apply weighted averages to the average holding period.

Trading and investing in one account can undermine TTS

- Sometimes, traders 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.

- Traders use portfolio margining to borrow funds on long-term investments.

Separate trading from investing

- 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. Use a trading entity for TTS and Section 475 and hold investments personally. Then the IRS cannot apply 475 MTM to your assets.
- One individual account might be okay if you invest in ETFs, trade equities, and equity derivatives. It can work because there is no overlap in 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

- Spends more than four hours per day, almost every market day, working on their trading business.
- All-time counts, including the 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.

Duration of TTS activity is essential for the IRS

- The IRS doesn’t respect individual traders who are brand new to trading and who enter and exit it too quickly — primarily 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 unclear if the IRS will respect that as a valid interruption of a trading business activity. That seems unfair, but it may be the reality.

- https://greentradertax.com/will-the-irs-deny-tax-benefits-to-traders-due-to-covid/

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 supplemental living.
- Many traders enter an active trading business while working full-time. Technology advancements and flexible job schedules make it possible to carry on both activities simultaneously.
- During the Covid pandemic, many traders worked remotely from home, making it easier to operate a trading business. What happens when they return to the office several days per week?

Business operations

- Most 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.

Home office deduction

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

- The home-office deduction is no longer a red flag with the IRS and is not a complicated calculation.

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, they can day trade using up to 4:1 margin rather than 2:1.

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

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

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

- Automated trading systems without much involvement by the trader (but a trader creating their program qualifies).
- A trade copying software or service. (Cherry-picking trades might qualify).
- Engaging a professional outside investment manager or Robo-advisor.
- Trading in retirement funds.

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.

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, professional 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.
- There are excess business loss (EBL) and net operating loss (NOL) limitations.
- https://greentradertax.com/how-traders-elect-475-to-maximize-their-tax-savings/

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, interest, and dividends.

- 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 has wage and property limitations, too.

How to make the Section 475 election

- The deadline for an individual TTS trader to elect Section 475 for 2022 has passed; it was April 18, 2022.

- Existing pass-through entities had to elect 475 by March 15, 2022.

- 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 2022. I like to see TTS for all of Q4 at a minimum.

WASH SALE LOSS ADJUSTMENTS

Wash sale loss adjustments

- Day and swing traders inevitably trigger many wash sale loss adjustments (WS) amounting to tens or hundreds of thousands of dollars. Take a loss on a security, repurchase it within 30 days (after or before), and that creates a WS loss.

- A WS reduces the cost basis on the position sold and adds the WS loss to the replacement position's cost basis. That defers the WS loss, creating phantom taxable income and capital gains taxes.

- It's okay to incur WS losses during the year but try to avoid delaying the WS losses to the following year. Deferring a loss from November to December is acceptable; however, postponing a loss from December 2022 to January 2023 is not.

Break the chain on WS at year-end

- Learn how to “break the WS chain” at year-end.
- For example, sell your entire position in security A by December 20, 2022, and don’t repurchase security A for 30 days to around January 21, 2023.
- That doesn’t provide a WS bridge from the tax year 2022 to 2023. Deduct the whole year of WS losses in 2022, with no deferral of WS losses to 2023.

WS losses on the 1099-B

- When you get your broker-issued Form 1099-B showing massive WS loss adjustments, don't panic.

- What's critical is the number of WS open at year-end for which you repurchased positions within 30 days in January 2023.

- For example, suppose the WS loss adjustments column on the 1099-B is $500,000. If you avoided all WS at year-end by refraining from repurchases in January, the Cost Basis column should be $500,000 greater than your actual purchase price.

- On the 1099-B, calculate taxable income by Proceeds, minus Cost Basis, plus WS loss adjustments.

WS rule for IRAs

- There's a quirky WS rule between taxable and IRA accounts.
- The WS loss becomes permanent if you take a loss in a taxable account and repurchase the security position within 30 days in an IRA.
- The IRS does not allow you to add the WS loss adjustment to the IRA cost basis. Yet, the IRS requires a reduction of the cost basis in the taxable account.

WS rule for IRAs

- Avoid this problem with a “do not invest list” in the IRAs vs. what you trade and invest in taxable accounts.

- This WS rule applies to taxable vs. IRA accounts; an IRA account on its own is not subject to WS losses.

- Learn more about WS loss rules at https://greentradertax.com/trader-tax-center/tax-treatment/wash-sale-losses/.

LLC TAXED AS AN S-CORP

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

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.

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 because it's not "earned income."

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; $20,500 for 2022). Pay it through a formal payroll and include it 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 annually.
- Contribute the elective deferral to a Solo 401(k) Roth or traditional account.

Solo 401(k) profit-sharing plan

- Consider a Solo 401(k) profit-sharing plan (PSP) contribution.
- The maximum PSP amount is $40,500 on wages of $162,000. The total limit for a Solo 401(k) is $67,500 ($20,500 ED, $6,500 catch-up ED, and $40,500 PSP).
- If you have a job and contribute the elective deferral maximum, then you can contribute $61,000 to your TTS S-Corp PSP.

LLC TAXED AS A PARTNERSHIP

LLC 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 helpful for ring-fencing TTS/475 trading from individual taxable and IRA accounts to avoid wash sale losses and to prevent the IRS from reclassifying investment positions.

SALT cap workaround

- Many states offer a workaround to TCJA's $10,000 cap on SALT itemized deductions.
- A business filing a partnership or S-Corp tax return can pay state income taxes on the entity level, treated as a business expense. They are "pass-through entity" (PTE) payments.
- The state credits the individual owner on their tax return for the PTE.
- Elect and pay the PTE payments on a timely basis.

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