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2022 YEAR-END TAX PLANNING FOR TRADERS

Nov. 15, 2022 @ 2:45 pm ET
for 30 minutes
(Money Show)

Presenter

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Description

- Join Robert A. Green, CPA of GreenTraderTax.com, in his webinar on year-end tax planning for traders.
- Don’t wait until tax time in April; arrange tax savings before year-end.
- Learn about deferring income, accelerating deductions, tax-loss selling, avoiding wash sale losses, paying estimated taxes, and trader entity tax-savings strategies.

Inflation adjustments

- Recent years' tax acts don't change trader tax status (TTS), Section 475 MTM accounting, wash-sale losses on securities, or the tax treatment on financial products, including futures (Section 1256 contracts) and cryptocurrencies (intangible property).

- It's helpful to consider IRS inflation adjustments in income and capital gains tax brackets, various income thresholds and caps, retirement plan contribution limits, standard deductions, and more.

- See IRS provides tax inflation adjustments for tax year 2022, and IRS provides tax inflation adjustments for tax year 2023. The IRS increase for 2023 is about 7%.

EXCESS BUSINESS LOSSES AND NET OPERATING LOSSES

Excess business losses and net operating losses

- Some traders eligible for trader tax status (TTS) and who filed a timely Section 475 election incurred ordinary business losses for 2022.
- Before the Tax Cuts and Jobs Act (TCJA) started in 2018, a TTS/475 trader could carry back a net operating loss (NOL) for two years, generating a tax refund.
- TCJA introduced an “excess business loss” (EBL) limitation, with the excess being an NOL carryforward.
- TCJA repealed NOL carrybacks (except for farmers) and limited NOL carryforwards to 80% of the subsequent year’s taxable income.

Excess business losses and net operating losses

- CARES suspended TCJA's EBL and NOL changes for 2018, 2019, and 2020 and allowed five-year NOL carrybacks (i.e., a 2020 NOL carryback to 2015).

- TCJA's EBL and NOL carryforward rules apply for tax years 2021 through 2028.

- See How Traders Elect 475 To Maximize Their Tax Savings.

DEFER INCOME AND ACCELERATE TAX DEDUCTIONS

Defer income and accelerate tax deductions

- Consider deferring income and accelerating tax deductions if you don't expect your taxable income to decline in 2023.

- Traders eligible for trader tax status in 2022 should consider accelerating trading business expenses, such as purchasing business equipment with first-year expensing using Section 179 or bonus depreciation.

- Consider delaying sales of investments to defer capital gains. Defer bonuses at work.

ACCELERATE INCOME AND DEFER CERTAIN DEDUCTIONS

Accelerate income and defer certain deductions

- A TTS trader with substantial Section 475 ordinary losses should consider accelerating income to soak up the EBL.
- Try to advance enough income to use the standard deduction and take advantage of lower tax brackets.
- Stay below the threshold for unlocking various AGI-dependent deductions and credits.
- A higher income can lead to an IRMA adjustment raising Medicare premiums.

ROTH IRA CONVERSION

Roth IRA conversion

- Consider a “Roth IRA Conversion,” changing a traditional IRA or 401(k) into a Roth IRA.
- Distributions from a standard retirement plan are taxed as ordinary income (not capital gains), whereas with a Roth IRA, distributions are tax-free.
- On the conversion date, the market value of the traditional retirement account is conversion income taxed at ordinary rates.
- Futures growth and capital in the Roth IRA account are tax-free.
- If your retirement portfolio is depressed in value, you might enjoy recovery of values inside a Roth IRA.

Roth IRA conversion

- Generally, there's a 10% excise tax on "early withdrawals" from retirement plans before age 59½.

- With a Roth IRA conversion, you can avoid excise tax by paying conversion taxes outside the Roth plan.

- TCJA repealed the recharacterization option, so you can no longer reverse the conversion if the plan assets decline.

- Roth IRA conversions have no income limit, unlike regular Roth IRA contributions.

ZERO TAX RATE ON LONG-TERM CAPITAL GAINS IN THE LOWEST TAX BRACKET

Zero tax rate on long-term capital gains in the lowest tax bracket

- If you have a low income, consider realizing long-term capital gains by selling open positions held for more than 12 months.

- The 2022 long-term capital gains rates are 0% for taxable income in the 10% and 12% ordinary tax brackets. The 15% capital gains rate applies to the regular middle brackets, and the top capital gains rate of 20% applies to the top 37% ordinary income bracket.

- See capital gains tax brackets at https://taxfoundation.org/2022-tax-brackets/.

- Remember, if you go $1 over the zero-rate bracket, all the long-term gains are subject to the 15% capital gains rate; it doesn't work like progressive marginal ordinary tax brackets.

BUSINESS EXPENSES AND ITEMIZED DEDUCTION VS. STANDARD DEDUCTION

Business expenses

- TTS traders are entitled to business expenses and home-office deductions.
- The home office deduction requires income, except for the mortgage interest and real property tax portion.
- TCJA expanded first-year expensing of business property; traders can deduct 100% of these costs in the year of acquisition, providing they place the item into service before year-end.
- Traders with TTS in 2022 may consider going on a shopping spree before January 1. There is no sense in deferring TTS expenses because you cannot be sure you will qualify for TTS in 2023.

SALT cap

- TCJA capped state and local income, sales, and property taxes (SALT) at $10,000 per year ($5,000 for married filing separately) and did not index it for inflation.
- About 25 states enacted SALT cap workaround laws. Search “(Your state) SALT cap workaround” to learn the details for your state.
- Most states follow a blueprint approved by the IRS.

SALT cap

- Generally, elect to make a “pass-through entity” (PTE) payment on a partnership or S-Corp tax return filed by your business. It doesn’t work with a sole proprietorship filing a Schedule C.
- PTE is a business expense deduction shown on the state K-1 like a withholding credit. Most states credit the individual’s state income tax liability with the PTE amount.
- Essentially, you convert a non-deductible SALT itemized deduction (over the cap) into a business expense deduction from gross income.
- Act well before year-end; otherwise, you might delay the benefit to next year.

Standard deduction

- TCJA roughly doubled the 2018 standard deduction and suspended and curtailed several itemized deductions.

- The standard deduction for married couples filing jointly for the tax year 2023 rises to $27,700, up $1,800 (about 7%) from $25,900 in 2022. For single and married individuals filing separately, the standard deduction rises to $13,850 for 2023, up $900 from $12,950 in 2022, and for heads of households, the standard deduction will be $20,800 for the tax year 2023, up $1,400 from $19,400 in 2022.

ESTIMATED INCOME TAXES

Estimated income taxes

- Those who have reached the SALT cap don’t need to prepay 2022 state-estimated income taxes by December 31, 2022 (a strategy before TCJA).

- Taxpayers should pay federal and state estimated taxes owed by January 17, 2023, and the balance by April 18, 2023.

Estimated income taxes

- Many traders skip making quarterly estimated tax payments during the year, figuring they might incur trading losses later in the year.
- They can catch up with the Q4 estimate due by January 17, 2023, but might still owe an underpayment penalty for Q1 through Q3 quarters.
- Some rely on the safe harbor exception to cover their prior year's taxes. (See Traders Should Focus On Q4 Estimated Taxes Due January 18.)
- See IRS announces interest rate increases for the fourth quarter of 2022; 6% rate applies to most taxpayers starting October 1.

AVOID YEAR-END WASH SALE LOSS ADJUSTMENTS

Avoid year-end wash sale loss adjustments

- Taxpayers should report wash sale (WS) loss adjustments on securities based on "substantially identical" positions across <u>all</u> accounts, including IRAs.
- Substantially identical means an equity, an option on that equity (equity option), and those equity options at different exercise dates.
- Conversely, brokers assess WS only on identical positions per the <u>one</u> account and report on the 1099-B for that account.
- Active securities traders should use a trade accounting program to identify potential WS loss problems across all their accounts, especially going into year-end.

Avoid year-end wash sale loss adjustments

- In taxable accounts, a trader can “break the chain” by selling the position before year-end and not repurchasing a substantially identical position 30 days before or after in any taxable or IRA accounts.
- Avoid WS between taxable and IRA accounts throughout the year, as that is a permanent WS loss.
- Starting a new entity effective January 1, 2023, can break the chain on individual account WS at year-end 2022, provided you don’t purposely avoid WS with the related party entity. The new entity can also elect Section 475 MTM.

Avoid year-end wash sale loss adjustments

- WS losses might be preferable to capital loss carryovers at year-end 2022 for TTS traders.

- A Section 475 election in 2023 converts year-end 2022 WS losses on TTS positions (not investment positions) into ordinary losses in 2023. That's better than a capital loss carryover into 2023, which might give you pause when making a 2023 Section 475 election. You want a clean slate with no remaining capital losses before electing Section 475 ordinary income and loss.

- Learn how to read a broker 1099-B in connection with wash sale loss adjustments at How To Avoid Phantom Income From Wash Sale Loss Adjustments.

TRADER TAX STATUS AND SECTION 475

Trader tax status and section 475

- Traders who qualified for TTS in 2022 may accelerate trading expenses into that qualification period as sole proprietors or entities.
- Those who don’t qualify until 2023 should try to defer trading expenses until then.
- Traders may also capitalize and amortize (expense) Section 195 startup costs and Section 248 organization costs in the new TTS business, going back six months before commencement.
- TTS is a prerequisite for electing and using Section 475 MTM.

Trader tax status and section 475

- TTS traders choose Section 475 on securities to be exempt from wash-sale loss rules and the $3,000 capital loss limitation and be eligible for the 20% QBI deduction.
- To make a 2022 Section 475 election, individual taxpayers had to file an election statement with the IRS by April 18, 2022 (March 15, 2022, for existing S-Corps and partnerships).
- Those who missed the 2022 election deadline may want to consider the election for 2023.
- Capital loss carryovers are a concern — they can be used against capital gains but not Section 475 ordinary income.
- The 475 election remains in effect each year until it is revoked in the same manner as the election was made.

SUSPENDING TTS AND SECTION 475

Suspending TTS and Section 475

- Tens of thousands of new TTS traders joined the profession during the Covid pandemic in 2020 and 2021, and many did well in those years.

- With the advent of a bear market correction in 2022, some “Covid traders” incurred substantial losses, and several stopped TTS trading.

- Perhaps, they are eligible for TTS and Section 475 for part of the year.

Suspending TTS and Section 475

- Assume a TTS/475 trader stopped trading on June 30, 2022. They must use Section 475 through June 30, 2022, but may not use it for the remainder of the year.
- TTS and 475 are "suspended" until and unless the trader is eligible again for TTS in a subsequent year.
- The trader can also revoke the 475 election for 2023 by April 18, 2023, in a mirror process to making a 475 election.
- Without 475 going into year-end, the trader should try to avoid wash sale loss adjustments at year-end.
- See Will The IRS Deny Tax Benefits To Traders Due To Covid?

S-CORP OFFICER COMPENSATION

S-Corp officer compensation

- TTS traders use an S-Corp to arrange health insurance and retirement plan deductions.
- These deductions require earned income or self-employment income.
- Unlike trading gains which are unearned income, a TTS S-Corp salary is considered earned income.

S-Corp officer compensation

- S-Corps pay officer compensation in conjunction with employee benefit deductions through payroll tax compliance done before year-end 2022.
- A trading S-Corp is not required to have "reasonable compensation," so a TTS trader may determine officer compensation based on how much to reimburse for health insurance and how much they want to contribute to a retirement plan.
- Remember, sole proprietor and partnership TTS traders cannot pay salaries to 2% or more owners; hence the S-Corp is needed.

S-Corp health insurance

- S-Corps may only deduct health insurance for the months it was operational and qualified for TTS.
- Employer-provided health insurance, including Cobra, is not deductible.
- The S-Corp reimburses the employee/owner through the accountable reimbursement plan before year-end.
- Add the health insurance reimbursement to taxable wages but do not withhold social security or Medicare taxes from that portion of W-2 compensation.
- The officer/owner takes an AGI deduction for health insurance on their tax return.

Solo 401(k) retirement plan

- TTS S-Corps can unlock a retirement plan deduction by paying sufficient officer compensation in December 2022 when results for the year are evident. Net income after deducting wages and retirement contributions should be positive.
- If desired, you must establish a Solo 401(k) retirement plan for a TTS S-Corp with a financial intermediary before the year-end.
- Plan to pay the 100%-deductible “elective deferral” amount up to a maximum of \$20,500 (or \$27,000 if age 50 or older with the \$6,500 catch-up provision) with the December 2022 payroll.
- That elective deferral is due by the end of January 2023.

Solo 401(k) retirement plan

- You can fund the 25% profit-sharing plan (PSP) portion of the S-Corp Solo 401(k) up to a maximum of $40,500 by the 2022 S-Corp tax return, including an extension, which means September 15, 2023.
- The maximum PSP contribution requires wages of $162,000 ($40,500 divided by 25% defined contribution rate).
- Tax planning calculations will show the projected outcome of income tax savings vs. payroll tax costs for the various options.

More on retirement plans

- The IRS raised the 401(k) elective deferral for 2023 to $22,500, up by $2,000 (9.8%) from 2022. The catch-up contribution limit is increased to $7,500, up by $1,000 from 2022. See IRS site 401(k) limit increases to $22,500 for 2023, IRA limit rises to $6,500.
- Consider a Solo 401(k) Roth for the elective-deferral portion only, where the contribution is not deductible, but the contribution and growth within the Roth are permanently tax-free. Traditional plans have a tax deduction upfront, and all distributions are subject to ordinary income taxes in retirement.
- Traditional retirement plans have required minimum distributions (RMD) by age 72, whereas Roth plans don't have RMD. CARES waived RMD for 2020, but RMD applies for 2021, 2022, and subsequent years.

TAX-LOSS HARVESTING

Tax-loss harvesting

- If you have an investment or trading portfolio, you can reduce capital gains taxes via “tax-loss harvesting” before the year-end.

- If you realized significant capital gains year-to-date in 2022 and have open positions with substantial unrealized capital losses, consider selling some of those losing positions to reduce 2022 taxes on capital gains.

- Be sure to wait 30 days to repurchase those securities to avoid wash sale loss adjustments, which would postpone the 2022 year-end tax loss to 2023, thereby defeating the concept of tax loss selling.

Tax-loss harvesting

- You don’t have to wait if you buy a similar security, providing it’s not “substantially identical.”

- For example, an exchange-traded fund (ETF) like SPY is substantially identical to options on SPY (the derivative) but not to other ETFs that track the S&P 500.

- The symbol SPX is a stock index future, a Section 1256 contract, which is not a security, so that’s okay to use to avoid wash sales.

TAX EFFICIENT SALES

Tax efficient sales

- If you want to sell some of your portfolios, consider taking long-term capital gains subject to lower tax rates (0%, 15%, and 20%) vs. short-term capital gains taxed at ordinary rates.

- That might require you to use the "specific identification accounting method" vs. first-in-first-out (FIFO).

- See FIFO vs. Specific Identification Accounting Methods.

CHARITABLE CONTRIBUTIONS

Charitable contributions

- Consider a charitable remainder trust to bunch philanthropic contributions for itemizing deductions.
- Another option is: Donate appreciated securities to charity. You get a charitable deduction at the fair market value and avoid capital gains taxes. (This is a favorite strategy by billionaires, and you can use it, too.)
- Consider directing your traditional retirement plan to make “qualified charitable distributions.” That satisfies the RMD rule, and it’s not taxable income. It’s the equivalent of an offsetting charitable deduction, allowing you to take the standard deduction rather than itemize charitable contributions.

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- In 2020 and 2021, the limit on charitable contributions increased to 100% of AGI. The limit reverts to the 50% limit for 2022.

- See the IRS site for Charitable Contribution Deductions.

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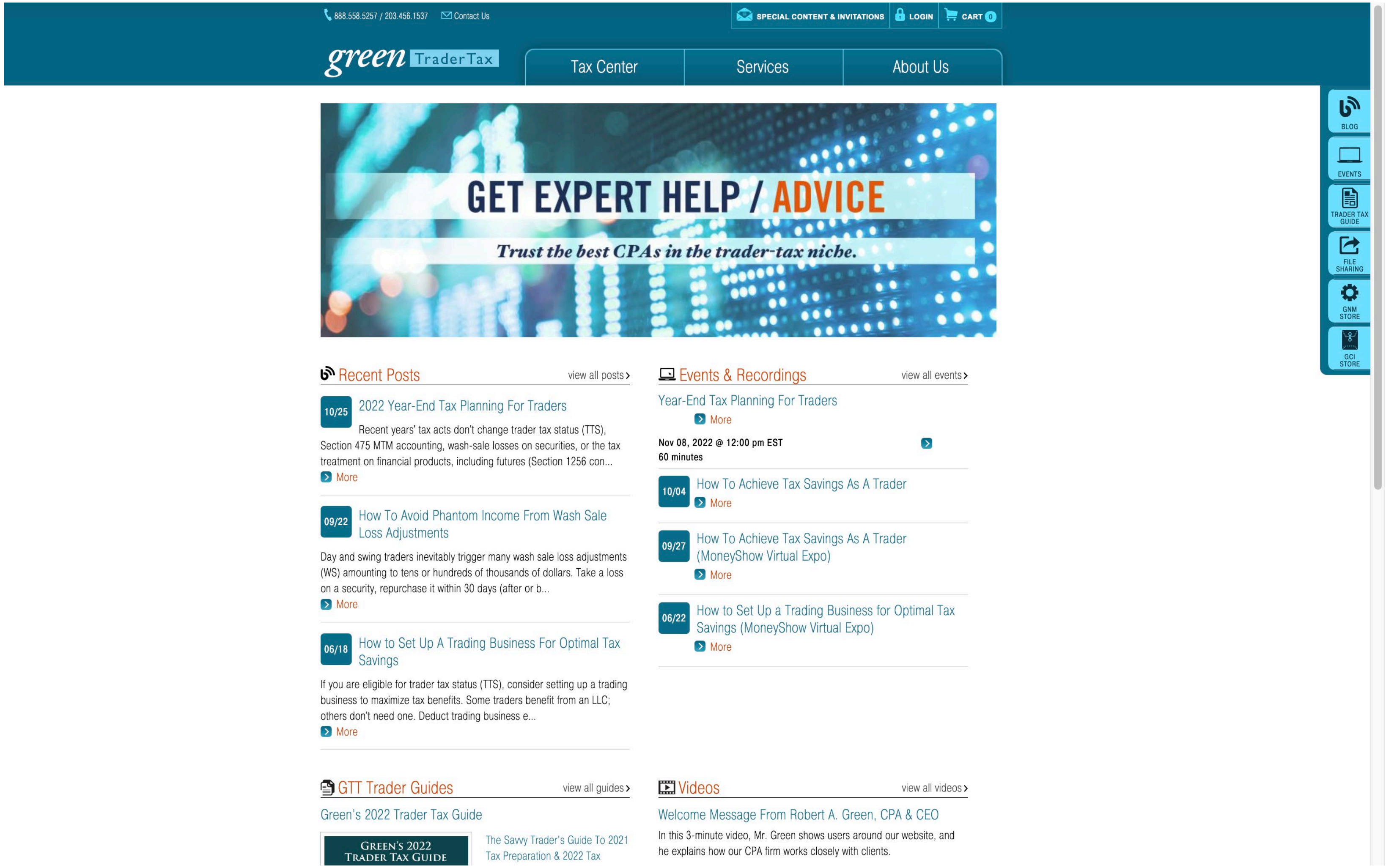
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