HOW THE TAX CUT AND JOBS ACT IMPACTS INVESTORS, TRADERS AND INVESTMENT MANAGERS

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Presenter:

Robert A. Green, CPA

Managing Member

GNM TraderTax

GREEN, NEUSCHWANDER & MANNING, LLC

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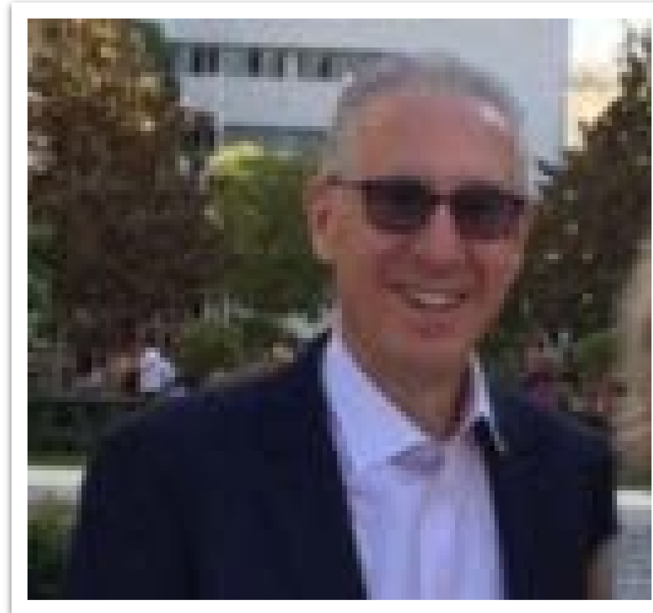

Robert A. Green CPA

Job:

- Managing Member of Green, Neuschwander & Manning, LLC, a tax and accounting firm catering to traders and investment managers. CEO of GreenTraderTax.com.

Focus on traders:

- Trading is a real profession, and other tax professionals and solution providers underserve them. Traders deserve tax advice from CPAs and tax attorneys who are acutely aware of different tax laws and regulations that apply to them.

Robert Green's content

- Mr. Green is a leading authority on trader tax.

- He is the author of Green's 2018 Trader Tax Guide, which GreenTraderTax published as an annual tax guide every year since 1997. The 2018 edition discusses the Tax Cuts and Jobs Act's impact on investors, traders, and investment managers.

- Mr. Green has been a contributor to Forbes.com since 2010. Leading brokerage firms and other financial media feature Mr. Green's blog posts and Webinar content.

Robert Green's media

- Mr. Green is frequently interviewed and has appeared in Barron's, New York Times, Wall Street Journal, and several other media. Mr. Green has also appeared on CNBC, Bloomberg Television, and Forbes.com Video Network.

- Mr. Green is the chief tax speaker at Traders Expo and taught "Trader Tax 101" for CCH to tax professionals.

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Tax Cuts and Jobs Act

- The Act impacts investors in many ways, some negative and others positive. Investors with significant investment expenses will decry the suspension of that miscellaneous itemized deduction.

- Like many small business owners, traders eligible for trader tax status, and investment managers are considering to restructure their business for 2018 to take maximum advantage of the new law. Two tax benefits catch their eye: The 20% deduction on pass-through qualified business income (QBI), and the C-Corp 21% flat tax rate.

- The new law suspended or trimmed several cherished tax deductions that individuals count on for savings. So, exactly how bad is it and what can you do about it?

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INVESTORS

The Act impacts investors in many ways, some negative and others positive.

Investment expenses suspended

- The new law suspends "all miscellaneous itemized deductions that are subject to the two-percent floor under present law." These include investment expenses.
- Investment expenses include trading expenses when the trader is not eligible for trader tax status (TTS), stock borrow fees and related costs for short sellers without TTS, and investment advisory fees and expenses paid to investment managers.
- TTS traders have business expense treatment, so qualification for that status is essential in 2018.

Family offices

- A family office (FO) refers to a wealthy family with substantial investments, across multiple asset classes.
- The FO hires staff, leases office space, and purchases computers and other fixed assets for its investment operations.
- An FO produces investment income, and the majority of its operating costs are investment expenses.
- Losing the investment expense deduction comes as a shock to them.

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Family offices

- Some FOs are evaluating which activities might qualify for business expense treatment to convert non-deductible investment expenses into business deductions from gross income.

- Some FOs investing in securities and Section 1256 contracts might ring-fence an active trading program into a separate TTS entity for business expenses.

- Other FOs invest in rental real estate, which might have business expense treatment. The goal is to allocate general and administrative expenses to business expenses.

Investment interest expenses retained

- The present law remains in effect for itemizing investment interest expense.
- Investment interest expense is deductible up to the extent of investment income.
- The excess is carried over to the subsequent tax year. (See Form 4952 and instructions.)

Short sellers

- If a short seller does not qualify for TTS, the stock borrow fees are considered investment expenses.
- Some brokers use the term “interest charges” — in reality, these expenses are stock borrow fees.
- (See Short Selling: How To Deduct Stock Borrow Fees.)

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Interest expense modified

- TTS traders have business interest deductions for margin interest on TTS trading positions.
- According to the new law, "The conference agreement follows the House in exempting from the limitation taxpayers with average annual gross receipts for the three-taxable year period ending with the prior taxable year that do not exceed $25 million."
- A TTS trading company will likely not trigger the 30% income limitation on business interest expenses.

Carried interest modified for managers

- The new law changed the carried interest tax break for investment managers in investment partnerships, lengthening their holding period on profit allocation of long-term capital gains (LTCG) to three years from one year.
- The three-year rule only applies to the investment manager's profit allocation — carried interest.
- Investors still have LTCG based on one year.

Carried interest helps investors

- Had the new tax law repealed carried interest outright, investment partnerships without TTS would be stuck passing investment advisory fees (incentive fees) through on Schedule K-1 as non-deductible investment expenses.

- Carried interest fixes that: The partnership allocates capital gains to the investment manager instead of paying incentive fees.

- The investor winds up with a lower capital gain amount vs. a higher capital gain coupled with a non-deductible expense.

FIFO is not required

- The Act did not demand First-In-First-Out (FIFO) accounting on the sale of securities.
- FIFO is the default method, but sellers of securities may also use "specific identification."
- The specific identification method requires a contemporaneously written instruction to the broker and a written confirmation of that execution by the broker.
- For sales of financial products other than securities, specific identification may not be possible.

Long-term capital gains rates retained

- The new tax law maintains the LTCG rates of 0%, 15%, and 20%, and the capital gains brackets are the same for 2017 and 2018.
- LTCG rates apply if an investor holds a security for more than12 months before sale or exchange.
- The new law did not change the small $3,000 capital loss limitation against other income, or capital loss carryovers to subsequent tax years.
- The new law also retains LTCG rates on qualified dividends.

Section 1256 capital gains rates retained

- The 60/40 capital gains rates on Section 1256 contracts are intact.
- At the maximum tax bracket for 2018, the blended 60/40 rate is 26.8% — 10.2% lower than the top ordinary rate of 37%.
- The new law did not mention any changes to the Section 1256 loss carryback election.

Wash sale loss rules and Section 475

- The new law did not fix wash sale loss rules for securities in Section 1091.
- The new law does not make any changes to Section 475 MTM ordinary income or loss.
- It does not change tax treatment for various financial products including spot forex in Section 988, ETFs, ETNs, volatility options, precious metals, swap contracts, foreign futures and more.

Section 1031 like-kind exchanges restricted to real property

- The new law limits Section 1031 like-kind exchanges to real property, not for sale.
- Investors may no longer use Section 1031 to defer income recognition on exchanges in artwork, collectibles, and other tangible and intangible property.
- Section 1031 was not previously allowed on marketable securities.

Obamacare net investment tax retained

- The new law retained the Obamacare net investment tax (NIT) of 3.8% on net investment income (NII) over modified AGI of $200,000 single and $250,000 married, not indexed for inflation.

- The Act did not suspend deducting miscellaneous investment expenses, investment interest expenses, and state, local and foreign income taxes from NII. Continue to keep track of these costs.

Ordinary tax rates reduced

- The new law lowered tax rates on ordinary income for individuals for almost all tax brackets and filing status.
- It decreased the top rate to 37% in 2018 from 39.6% in 2017.
- Short-term capital gains are taxed at ordinary rates, so investors receive this benefit.

Repeal of the recharacterization option for Roth IRA conversions

- If a 2017 converted Roth account drops significantly in value in 2018, a taxpayer can reverse the Roth conversion with a “recharacterization” by the due date of the tax return including extensions (Oct. 15, 2018).

- That’s the last year to do a reversal. The new law repeals this recharacterization option starting in 2018.

PASS-THROUGHS

New tax law Section 199A allows a 20% deduction on qualified business income in pass-through entities, subject to many conditions, haircuts and thresholds.

20% QBI deduction

- The new tax law states, “An individual taxpayer generally may deduct 20 percent of qualified business income from a partnership, S-corporation, or sole proprietorship, as well as 20 percent of aggregate qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income.
- A limitation based on W-2 wages paid is phased in above a threshold amount of taxable income. A disallowance of the deduction with respect to specified service trades or businesses is also phased-in above the threshold amount of taxable income.”

Taxable income threshold

- The taxable income threshold is $315,000 (married) and $157,500 (other taxpayers), and the phase-out range is $100,000 (married) and $50,000 (other taxpayers).

- As an example, a securities hedge fund eligible for TTS with Section 475 ordinary income may have qualified business income (QBI), and the hedge fund is likely a specified service activity (SSA).

- If a non-active limited partner has taxable income under $315,000 (married) or $157,500 (other taxpayers), he or she might get a 20% deduction on the partnership share of QBI or taxable income less net capital gains (whichever is lower).

Other limitations

- In the $100,000/$50,000 phase-out range above the income threshold, the QBI deduction phase-out.
- Some investors may exceed the phase-out, and not qualify for the deduction, but others may have lower income and be eligible for the deduction.
- A passive investor in a non-SSA might be eligible for the 20% deduction above the income threshold, subject to a 50% wage limitation, or alternative 25% wage limitation plus 2.5% of the qualified property. The 20% deduction on pass-through entities applies to active, non-active and passive owners without distinction.

A TTS trading company

- For 2018, TTS traders should consider a partnership or S-Corp for business expenses, and a Section 475 election on securities for exemption from wash-sale losses and ordinary loss treatment (tax loss insurance).

- Consider a TTS S-Corp for employee benefit plan deductions including health insurance and a high-deductible retirement plan, since a TTS spousal partnership or TTS sole proprietor cannot achieve these deductions.

- This is the cake: It puts you in position to potentially qualify for a 20% QBI deduction on Section 475 or Section 988 ordinary income in a TTS trading pass-through entity – icing on the cake.

Specified service activity

- If a TTS trader's taxable income is under the specified service activity (SSA) threshold of $315,000 (married) and $157,500 (other taxpayers), he or she should get the 20% QBI deduction in partnerships or S-Corps.
- If the trader is within the phase-out range above the threshold — $100,000 (married) and $50,000 (other taxpayers) — he or she should get a partial deduction.

QBI includes ordinary income

- QBI likely includes Section 475 and Section 988 ordinary income and excludes capital gains (Section 1256 contracts and cryptocurrencies).
- It might be a challenge for a TTS sole proprietor to claim the pass-through deduction because Schedule C has trading expenses only; trading gains are on other tax forms.
- How Traders Can Get The 20% QBI Deduction Under New Law.

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C-CORPS

How to decide if a C-Corp is right for your trading business.

C-Corp taxes

- When taking into account the Tax Cuts and Jobs Act for 2018, don't focus solely on the federal 21% flat tax rate on the C-Corp level.

- There are plenty of other taxes, including capital gains taxes on qualified dividends, state corporate taxes in 44 states, and accumulated earnings tax assessed on excess retained earnings.

- C-Corp and related taxes might be considerably higher vs. trading in a pass-through.

Double taxation

- When a C-Corp pays qualified dividends to the owner, double taxation occurs with capital gains taxes on the individual level (capital gains rates are 0%, 15% or 20%).
- If an owner avoids paying sufficient qualified dividends, the IRS is entitled to assess a 20% accumulated earnings tax (AET).
- It's a fallacy that owners can retain all earnings inside the C-Corp.

C-Corp vs. individual tax rates

- Starting in 2018 under the new tax law, C-Corps may benefit from a 21% flat tax rate vs. individual graduated rates of 10% to 37%.

- Don’t confuse your tax bracket with your tax rate, which is less.

- For example, the average individual tax rate is 27% for a married couple entering the top 37% tax bracket of $600,000 and 30% for a single filer approaching the top bracket of $500,000; so the actual rate difference is 6% and 9% in these two examples.

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Qualified dividends

- When C-Corps make a cash or property distribution to owners, it's a taxable dividend if there are "earnings and profits" (E&P).
- If the individual holds the C-Corp stock for 60 days, it's a "qualified dividend," subject to lower long-term capital gains rates of 0%, 15%, and 20%.
- The 0% capital gains bracket applies to taxable income up to $77,200 (married) and $38,600 (single).
- A 15% dividends tax offsets the difference in individual vs. corporate tax rates.

State double taxation

- According to Tax Foundation, "Forty-four states levy a corporate income tax. Rates range from 3 percent in North Carolina to 12 percent in Iowa." (See your state on the Tax Foundation map:State Corporate Income Tax Rates and Brackets for 2017.)

- States don't use lower capital gains rates for taxing individuals; they treat qualified dividends as ordinary income.

Accumulated earnings tax

- If the C-Corp does not pay dividends from E&P, the IRS can assess a 20% “accumulated earnings tax” (AET) if the C-Corp E&P exceeds a threshold and company management cannot justify a business need for retaining E&P.
- The IRS is trying to incentivize C-Corps to pay dividends to owners.
- The IRS AET threshold is $250,000, or $150,000 for a personal service corporation.

An investment company triggers AET

- If the IRS treats a trader tax status (TTS) trading company as an "investment company," then it may assess 20% AET on all E&P and therefore undermine the C-Corp strategy for traders.
- But I don't think a TTS trading company with Section 475 ordinary income is an investment company.
- A TTS trading C-Corp needs to demonstrate a business need for E&P above the $250,000 threshold.

Personal holding company tax

- "Personal holding company" (PHC) status is triggered when a closely held C-Corp has at least 60% of gross income coming from certain passive income (including interest, dividends, rents, and royalties), and has not made sufficient distributions to shareholders.
- The IRS is entitled to assess a 20% PHC tax penalty.
- Capital gains and Section 475 ordinary income are not passive income, so a successful TTS trader C-Corp will likely not meet the definition.

INDIVIDUAL DEDUCTIONS

The Tax Cuts and Jobs Act suspended or trimmed several cherished tax deductions that individuals count on for savings.

State and local taxes capped at $10,000 per year

The Act allows any combination of state and local income, sales or domestic property tax. SALT may not include foreign real property taxes.

The Act prohibited a 2017 itemized deduction for the prepayment of 2018 estimated state and local income taxes.

Individuals are entitled to pay and deduct 2017 state and local income taxes by year-end 2017.

Prepayment of real property taxes

- The Act permits a 2017 itemized deduction for the advance payment of 2018 real property taxes, providing the city or town assessed the taxes before 2018.

- For example, a taxpayer could pay real property taxes before Dec. 31, 2017, and deduct it in 2017, on an assessment for the fiscal year July 1, 2017, to June 30, 2018.

- IRS Advisory: Prepaid Real Property Taxes May Be Deductible in 2017 if Assessed and Paid in 2017.

SALT in home office deduction

- Many business owners deduct home-office expenses (HO), which include a portion of real property taxes and that allocation is not subject to the $10,000 SALT limit, and the home office deduction is not an AMT preference item.
- Here's a tip: Report 100% of real property taxes on home office form 8829, to maximize the HO deduction.
- Deduct state and local income taxes, and the remainder of real property taxes, to reach the $10,000 SALT limit on Schedule A.

Medical expenses modified

- The Act retained the medical-expense itemized deduction, which is allowed if it's more than the AGI threshold.
- In 2017, the AGI threshold was 10% for taxpayers under age 65, and 7.5% for age 65 or older.
- The Act uses a 7.5% AGI threshold for all taxpayers in 2018, and a 10% threshold for all taxpayers starting in 2019.
- Medical expenses are an AMT preference item.

Mortgage debt lowered on new loans

- As of Dec. 15, 2017, new acquisition indebtedness is limited to $750,000 ($375,000 in the case of married taxpayers filing separately), down from $1 million, on a primary residence and second home.

- Mortgage debt incurred before Dec. 15, 2017 is subject to the grandfathered $1 million limit ($500,000 in the case of married taxpayers filing separately). Refinancing debt from before Dec. 15, 2017 keeps the grandfathered limit providing the mortgage is not increased.

- The conference report “suspends the deduction for interest on home equity indebtedness” starting in 2018.

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Unreimbursed employee business expenses suspended

- The Act suspends unreimbursed employee business expenses deducted on Form 2106.

- Speak with your employer about implementing an accountable reimbursement plan and "use it or lose it" before year-end 2018.

Tax preparation and planning fees suspended

- Miscellaneous itemized deductions include tax compliance (planning and preparation) fees.
- If you operate a business, ask your accountant to break down their invoices into individual vs. business costs.
- The business portion is allowed as a business expense.

Personal casualty and theft losses suspended

- The Act suspends the personal casualty and theft loss itemized deduction, except for losses incurred in a federally declared disaster.

- If a taxpayer has a personal casualty gains, he or she may apply the loss against the gain.

Gambling loss limitation modified

- The Act added professional gambling expenses to gambling losses in applying the limit against gambling winnings.
- Professional gamblers may no longer deduct expenses more than net winnings.

Charitable contribution deduction limitation increased

- The Act raised the 50% limitation for cash contributions to public charities, and certain private foundations to 60%. Excess contributions can be carried forward for five years.

- With a higher standard deduction and suspension of many itemized deductions, some taxpayers won't feel the deduction effect from making charitable contributions.

- Consider a bunching strategy, to double up on charity one year to itemize, and contribute less the next year to use the standard deduction. Another bunching strategy is to set up a charitable trust.

Alimony and moving expenses suspended

- The Act suspends alimony deductions for divorce or separation agreements executed in 2019, and the recipient does not have taxable income.

- The Act suspends the AGI deduction for moving expenses, and employees may no longer exclude moving expense reimbursements, either. "Except for members of the Armed Forces on active duty who move pursuant to a military order and incident to a permanent change of station."

Expanded use of 529 account funds

- The Act significantly expands the permitted use of Section 529 education savings account funds. “Qualified higher education expenses” include tuition at an elementary or secondary public, private, or religious school.

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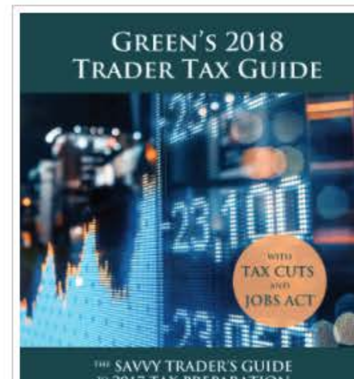

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