

# INVESTMENT FEES ARE NOT DEDUCTIBLE BUT BORROW FEES ARE

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# 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.

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## Webinar overview

- The Tax Cuts and Jobs Act suspended “certain miscellaneous itemized deductions subject to the two-percent floor,” which includes “investment fees and expenses.”
- However, the new law retained “other miscellaneous deductions” not subject to the two-percent floor, including short-selling expenses like stock borrow fees.
- While individual taxpayers may no longer deduct investment fees and expenses on Schedule A starting in 2018, they are still entitled to deduct investment interest expenses, up to net investment income, as calculated on Form 4952.

# Short-selling expenses

- The [new law](#) (page 95) has a complete list of suspended miscellaneous itemized deductions including “expenses for the production or collection of income.”
- That list does not include short-selling expenses.
- [Section 67\(b\)](#) excludes certain deductions from the “2-percent floor on miscellaneous itemized deductions;” including (8) “any deduction allowable in connection with personal property used in a short sale.”

# CARRYING CHARGES VS. ITEMIZED DEDUCTIONS

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# Investment fees and expenses

- Because investment fees and expenses are no longer deductible, accountants might consider a Section 266 election to capitalize investment expenses as “carrying charges” to deduct them from capital gains and losses.
- But that won't work: The IRS said taxpayers could not capitalize investment management fees under Section 266 because they are managerial rather than transactional.



# Short-selling expenses

- Short-sellers probably could capitalize borrow fees under Section 266 because they are transactional.
- However, it's safer to deduct these short-sale costs as "Other Misc. Deductions" on Schedule A line 28.
- The new tax law suspended the Pease itemized deduction limitation, so the deduction has full effect on lowering taxable income.
- One concern: The IRS lists all Section 67(b) exclusion items in the instructions for Schedule A line 28, but it left out (8) for short-sale expenses. That seems to be an inadvertent omission.

# STOCK BORROW FEES

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# Stock borrow fees

- Short selling is not free; a trader needs the broker to arrange a loan of stock.
- Brokers charge short sellers “stock borrow fees” or “loan premiums.”
- Tax research indicates these payments are “fees for the temporary use of property.”
- Watch out: Many brokers refer to stock borrow fees as “interest expense,” which confuses short sellers.

# Tax treatment for borrow fees

- For tax purposes, stock borrow fees are “other misc. deductions” on Schedule A line 28 for investors.
- Borrow fees are business expenses for traders qualifying for trader tax status (TTS).
- Borrow fees are not interest expense, so investors should not include them in investment interest expense deductions on Schedule A line 14.

# Impact of tax treatment

- It's a significant distinction that has a profound impact on tax returns because investment expenses face greater limitations in 2017, and suspension in 2018 vs. investment interest expenses which are deductible up to investment income.
- Other miscellaneous deductions on line 28 remain fully deductible.

# INVESTMENT MANAGEMENT FEES CANNOT BE CAPITALIZED

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## The IRS said no to an alternate tax treatment

- In a 2007 [IRC Chief Counsel Memorandum](#), the IRS denied investors from capitalizing investment management fees paid to a broker as carrying charges under Section 266.
- Investors wanted to avoid alternative minimum tax (AMT) and other limitations on miscellaneous itemized deductions, the rules in effect before 2018.
- The problem is worse in 2018 with investment expenses entirely suspended.

## The IRS memo stated:

- “Consulting and advisory fees are not carrying charges because they are not incurred independent of a taxpayer’s acquiring property and because they are not a necessary expense of holding property.
- Stated differently, consulting and advisory fees are not strictly analogous to common carrying costs, such as insurance, storage, and transportation.”



**BORROW FEES MIGHT BE  
ABLE TO BE CAPITALIZED**

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## A rationale to capitalize borrow fees

- Borrow fees seem to meet the requirements raised in the 2007 IRS Chief Counsel Memorandum for capitalization as carrying charges under Section 266. (It's safer to deduct them as "other misc. deductions" on Schedule A line 28.)
- Treasury Regulations under 1.266-1(b)(1) highlight several types of expenses that qualify as carrying charges, including taxes on various types of property, loan interest for financing property, costs to construct or improve the property, and expenses to store personal property.

# A rationale to capitalize borrow fees

- A short seller cannot execute a short sale without borrowing securities and incurring borrow fees; they are a “necessary expense of holding” the position open, and “not independent” of the short-sale transaction.
- Borrow fees are not for the “management of property,” they are for the “acquisition, financing, and holding” of property.

# INVESTMENT FEES VS. BROKERAGE COMMISSIONS

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# Investment fees and expenses

- Investors engage outside investment advisors and pay them advisory fees including management fees and/or incentive fees.
- Other investors may pay a broker a flat or fixed fee.
- These costs are managerial and not transactional, based on how many trades the manager makes.
- They cannot be capitalized under Section 266.

# Brokerage commissions

- Brokerage commissions are transaction costs deducted from sales proceeds and added to cost basis on brokers' trade confirmations and Form 1099-Bs.
- This tax reporting for brokerage commissions resembles a carrying charge.

# SHORT-SELLER PAYMENTS IN LIEU OF DIVIDENDS

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# Short-seller payments in lieu of dividends

- When traders borrow shares to sell short, they receive dividends that belong to the lender — the rightful owner of the shares.
- After the short seller gets these dividends, the broker uses collateral in the short seller's account to remit a “payment in lieu of dividend” to the rightful owner to make the lender square in an economic sense.



## Tax treatment for payments in lieu of dividends

- Section 263(h) “Payments in lieu of dividends in connection with short sales” require the mandatory capitalization of these payments if a short seller holds the short position open for 45 days or less (one year in the case of an extraordinary dividend).
- If a short seller holds the short sale open for more than 45 days, payments in lieu of dividends are deductible as investment interest expense.

# INVESTMENT INTEREST EXPENSES

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# Investment interest expenses

- Section 163(d)(3)(c) states, “For purposes of this paragraph, the term ‘interest’ includes any amount allowable as a deduction in connection with personal property used in a short sale.”
- A broad reading of “any amount” could be construed as opening the door to borrow fees, but I doubt that.
- “Any amount” refers to dividends in lieu of dividends held more than 45 days.

## Alternative tax treatment

- Under certain conditions, Section 266 allows capitalization of interest to finance a property.
- Short sellers and others might want to consider the possibility of a Section 266 election on investment interest expense, too — especially if they plan a standard deduction or don't have sufficient investment income.
- Excess interest is a carryover to subsequent tax years.

# TRANSACTIONAL VS. MANAGERIAL EXPENSES

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# Transactional expenses

- The following investment expenses seem transactional, and therefore eligible for capitalization in Section 266:
  - Storage of precious metals or cryptocurrency,
  - Borrow fees and excess risk fees on short sales, and
  - Margin interest expenses.

# Managerial expenses

- The following investment expenses seem to be managerial rather than transactional, and therefore cannot be treated as carrying charges under Section 266:
- Investment management fees, fixed or flat fees paid to brokers, computers, equipment, software, charting, education, mentors, coaching, monthly data feed fees, market information, subscriptions, travel, meals, supplies, chatrooms, office rent, staff salaries and employee benefits, accounting, tax and legal services, and most other trading-related expenses.

# SECTION 266 ELECTION STATEMENT AND TAX REPORTING

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## Section 266 election statement

- Consider filing a Section 266 election statement with your tax return, including on an extension.
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- “For tax-year 2018, taxpayer herewith elects under Code Section 266 and IRS Regulations 1.266-1 to capitalize short-selling expenses as carrying costs applied to capital gains and losses.”
- Explain the election and tax treatment in a tax return footnote.

## Tax reporting with a Section 266 election

- Report short-selling expenses for realized (closed) short sales as “expenses of sale or exchange” on Form 8949 (Sales and Other Dispositions of Capital Assets) in column (g) “adjustment to gain or loss.”
- Defer borrow fees paid on unrealized (open) short sales until realized (closed) in the subsequent year.
- If you get full deductibility on Schedule A, it’s safer to skip Section 266 capitalization, which the IRS might scrutinize.

# TRADER TAX STATUS

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# Trader tax status

- If a short-seller qualifies for trader tax status, then stock borrow fees and other short-selling expenses are deductible as business expenses from gross income.
- If a TTS trader engages an outside investment manager, then investment advisory fees remain investment expenses.

# CLOSING REMARKS, QUESTIONS & ANSWERS

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# Closing Remarks

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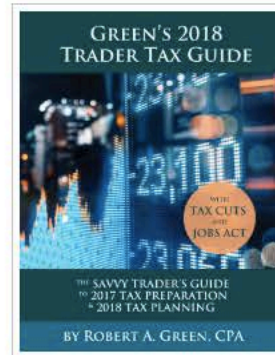
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