TRADER TAX STRATEGIES 2019 YEAR-END UPDATE

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Webinar description

- Trader tax status benefits, how to qualify, and business expenses.
- Tax treatment of securities, 1256 contracts, options, ETFs, ETNs, forex, foreign futures, precious metals, volatility products, and cryptocurrencies.
- Wash sale loss adjustments on securities.
- Section 475 is tax loss insurance, and it unlocks a QBI deduction.

TRADER TAX STATUS

With eligibility for TTS, traders get several tax benefits that investors do not.

Trader tax status benefits

- Deduct trading business expenses, startup costs (Section 195), and home-office expenses.
- Elect Section 475 on securities for exemption from wash sale losses, and the $3,000 capital loss limitation (tax loss insurance).
- With Section 475 ordinary income, traders are eligible for a 20% QBI deduction; not with capital gains.
- With a TTS S-Corp, deduct health insurance and a retirement plan contribution.

Investors have few tax deductions

- The new tax law TCJA suspended investment fees and expenses along with all other miscellaneous itemized deductions subject to the 2% floor.
- Two itemized deductions for investors remain; investment-interest expense limited to investment income, and stock-borrow fees as “Other Itemized Deductions” on Schedule A.
- Investors are stuck with wash sale loss adjustments, and the $3,000 capital loss limitation. Short-term capital gains are subject to the ordinary tax rate.

Golden rules to qualify for TTS

- Substantial volume – at least four total trades per day, 15 per week, 60 per month, and 720 per year annualized (Poppe court).
- Frequency – a trade execution on 75% of available trading days. That’s close to four days per week.
- Average holding period under 31 days (Endicott court).
- Continuous with no sporadic lapses.

Golden rules to qualify for TTS

- Time – four hours per day including trading, research and administration.
- Intention to run a business and to make a living.
- Business setup (multiple trading devices, monitors and a home office).
- Materiality (PDT $25,000 for securities; $15,000 otherwise).
- See How To Qualify For Trader Tax Status For Huge Savings

Claim TTS; it's not elected

- Assess your facts and circumstances for TTS towards year-end.

- If you rise to the level of TTS, then you can deduct business expenses on Schedule C, a partnership, or S-Corp tax return.

- The IRS does not require an election statement for TTS.

- If you also want to use Section 475 MTM ordinary treatment, then you had to file a timely election statement with the IRS by April 15, 2019, or an earlier year.

TTS business expenses

- Tangible personal property up to $2,500 per item, including computers, monitors, desks, and mobile devices.
- Section 179 (100%) depreciation, 100% bonus depreciation and/or regular depreciation.
- Amortization (expensing) of startup costs (Section 195), organization costs (Section 248), and software.
- Education expenses after the commencement of TTS.

TTS business expenses

- Section 195 startup costs may include education expenses within six months of commencement of TTS.

- Publications, subscriptions, market data, charting services, self-created automated trading systems, cloud computing, professional services (accountants and attorneys), chat rooms, mentors, coaches, supplies, media, communications, travel, meals, seminars, conferences, supplies, assistants, office rent, and consultants.

TTS business expenses

- Home-office expenses for the business portion of your home. See Home Office Tax Deductions Are Fantastic: Learn How To Do It.
- Margin interest expense. (It's not limited to investment income like investment interest expense.)
- Stock-borrow fees and other costs for short-sellers.
- See Top 10 Tax Deductions For Active Traders.

Schedule C vs. entity tax returns

- If you are eligible for TTS in 2019, then file a Schedule C as a sole proprietor.
- Consider forming an LLC to be taxed as a partnership or S-Corp for 2020.
- Year-end strategy: Form an SMLLC taxed as a “disregarded entity” in December 2019. Become a partnership or elect S-Corp status as of January 1, 2020. That can break the chain on wash sales at year-end 2019, and it’s a convenient time to switch business structures.

SECURITIES

Securities traders have ordinary tax rates on short-term capital gains, wash sale loss adjustments, capital-loss limitations, and accounting challenges.

Securities include:

- U.S. and international equities (stocks)

- U.S. and foreign equity (stock) options

- narrow-based indexes (an index made up of nine or fewer securities)

- options on narrow-based indexes

- ETFs structured as RIC and PTP

- options on securities ETFs structured as RIC

- volatility ETNs structured as debt instruments

- bonds

- mutual funds

- single-stock futures

Securities *don't* include:

- Section 1256 contracts (commodities)
- precious metals (collectibles)
- ETFs structured as PTTs
- QBE-listed options on ETF PTPs, on ETF PTTs, and on ETNs
- volatility ETNs structured as prepaid forward contracts
- cryptocurrencies (intangible property)
- forex (ordinary gain or loss)
- swap contracts (ordinary gain or loss)

Realization method

- The IRS taxes securities transactions when a taxpayer closes an open trade – hence the term “realization.”
- Taxpayers can defer capital gains by holding open securities positions at year-end. Conversely, with “tax-loss selling,” investors realize losses before year-end.
- The mark-to-market (MTM) method is different: It taxes both realized *and* unrealized capital gains and losses at year-end. TTS traders are entitled to elect Section 475 MTM ordinary gain or loss on securities and or commodities. Section 1256 is MTM by default.

Short-term vs. long-term capital gains

- STCG use ordinary tax rates, currently up to 37% for 2019 and 2020.

- LTCG rates are significantly lower, and they apply to sales of securities held for 12 months or longer.

- The LTCG rates are 0% for the 10% and 12% ordinary brackets,15% in the middle ordinary brackets, and 20% in the top 37% ordinary bracket.

- See 2019 Tax Brackets and projected 2020 tax brackets.

Using capital loss carryovers

- Capital losses, including carryovers, offset capital gains without a limitation. A net capital loss for the year is limited to $3,000 against ordinary income.
- Capital loss carryovers don’t expire; they are deferred tax assets.
- TTS traders should not rush to elect Section 475 ordinary income as they need capital gains to use up capital loss carryovers.
- Trading entities and hedge funds can pass capital gains to the owner’s tax return.

WASH SALE LOSSES

Wash sale losses cause headaches and potentially higher tax bills. Learn how to avoid these problems.

Wash sale losses on securities

- If a taxpayer repurchases a substantially identical security within 30 days before or after realizing a tax loss, the IRS applies the wash sale (WS) loss rule.

- The WS rule defers a tax loss to the replacement position’s cost basis. That can cause deferral of losses at year-end.

- For example: If you sell AAPL at a tax loss on December 15, 2019, and repurchase a substantially identical position in AAPL or Apple options on January 10, 2020, the 2019 wash sale loss is triggered.

How to avoid WS losses on securities

- It's critical to avoid WS at year-end in taxable accounts by breaking the 31-day chain. Sell by year-end and don't repurchase a substantially identical position for 31 days.
- It's essential to prevent WS losses *throughout* the year between taxable and IRA accounts because its a *permanent* WS loss.
- TTS traders can elect Section 475 on securities to be exempt from WS.
- See How To Avoid Taxes On Wash Sale Losses.

WS rules are different for taxpayers vs. brokers

- Taxpayers must calculate WS losses based on substantially identical positions in securities (i.e., Apple equity vs. Apple options), across *all* taxpayer's brokerage accounts, including IRAs and spousal accounts if married/filing joint.
- Conversely, brokers calculate WS based on identical positions (an exact symbol) per the one brokerage account.
- This apples vs. oranges is problematic since the IRS seeks to match broker 1099-Bs to Form 8949 prepared by taxpayers.
- Consider trade accounting software that is compliant with IRS rules for taxpayers.

SECTION 475 MTM

TTS traders should consider electing Section 475 on securities to avoid wash sale loss adjustments, get refunds faster, and be eligible for a QBI deduction.

Section 475 election for securities

- TTS traders may elect Section 475 ordinary gain or loss treatment on securities and or commodities. Section 475 trades are exempt from WS and the $3,000 capital loss limitation. I call it "tax loss insurance."

- Short-term capital gains and Section 475 use the ordinary rate. Section 475 income is eligible for the QBI deduction; whereas, capital gains are not.

- There are significant tax benefits on ordinary losses vs. capital losses. Deduct a 475 loss against wages in full without the capital loss limitation.

Section 475 election for commodities

- Most futures traders prefer to retain lower 60/40 capital gains rates on Section 1256 contracts; they don’t want Section 475 ordinary income.
- Section 1256 allows a capital loss carryback election against 1256 contract gains in the prior three tax years.
- However, if you have a significant trading loss in futures and don’t have a carryback opportunity, then consider a 475 election to use your trading losses against ordinary income.

QBI deduction includes Section 475

- TCJA introduced a 20% qualified business income (QBI) deduction for sole proprietors, partnerships, and S-Corps.
- TTS traders are a “specified service trade or business” subject to a taxable income threshold, phase-in and phase-out range, and taxable income cap.
- QBI includes Section 475 income/loss and trading business expenses, but it excludes capital gains/losses, interest, dividends, and other portfolio income.
- See A Rationale For Using QBI Tax Treatment For Traders.

Mark-to-market (MTM) accounting

- Section 475 uses mark-to-market (MTM) accounting, which imputes sales of open TTS positions at year-end. There's no need to do tax-loss selling with MTM. WS are a moot point on 475 trades, too.

- TTS traders can retain lower 60/40 capital gains rates on Section 1256 contracts by electing 475 on securities only.

- Traders can defer capital gains and use long-term capital gains treatment on duly segregated investment positions. An entity is better for ring-fencing TTS/475 trading vs. investments.

Section 475 election procedures: Existing taxpayers

- Individual sole proprietors with TTS had to make a 2019 Section 475 election by April 15, 2019 (March 15, 2019, for existing S-Corps and partnerships).

- The second step is to file a Form 3115 (Application for Change in Accounting Method) with your 2019 tax return and the IRS national office.

- Consider a Section 475 election for 2020 as an individual by April 15, 2020, or for a partnership or S-Corp by March 16, 2020.

Section 475 election procedures: New taxpayers

- If you missed the 2019 election deadline, consider forming a new entity for a “new taxpayer” election within 75-days from inception.
- However, November is likely too late to establish TTS in 2019.
- See Traders Elect Section 475 For Massive Tax Savings.

SECTION 1256 CONTRACTS

Section 1256 contracts enjoy lower 60/40 capital gains tax rates, summary tax reporting, and easier mark-to-market accounting.

Section 1256 contracts include:

- U.S. regulated futures contracts (RFCs)

- options on U.S. RFCs

- U.S. broad-based indexes made up of 10 or more securities – also known as stock index futures

- options on U.S. broad-based indexes

- foreign futures if granted Section 1256 treatment in an IRS revenue ruling (see list)

- non-equity options (a catchall)

Section 1256 contracts include:

- QBE-listed options on commodity ETF publicly traded partnerships (PTP)

- QBE-listed options on precious metals ETF publicly traded trusts (PTT)

- QBE-listed options on volatility ETN prepaid forward contracts or debt instruments

- forward forex contracts with the opt-out election into Section 1256(g) on the major pairs, for which futures trade (we make a case for spot forex, too)

- forex OTC options (Wright court)

Section 1256 tax advantages

- Section 1256 contracts have lower 60/40 tax rates: 60% (including day trades) subject to lower long-term capital gains rates, and 40% taxed at the ordinary rate.
- At the maximum tax bracket for 2019 and 2020, the blended 60/40 rate is 26.8% — 10.2% lower than the highest ordinary rate of 37%.
- There are significant tax savings throughout the income brackets. The LTCG rate in the lowest two ordinary brackets is 0%. (See our table for all the 60/40 brackets.)

Mark-to-market accounting

- Section 1256 contracts are marked-to-market (MTM) on a daily basis.

- MTM means gain/loss calculations report both realized activity from throughout the year and unrealized gains and losses on open trading positions at year-end.

Section 1256 loss carryback election

- On Form 6781, you can select the Section 1256 loss carryback election.
- Rather than use the capital loss in the current year, deduct 1256 losses on amended tax return filings, against Section 1256 gains only. (Form 1045 is preferred over 1040X.)
- It’s a three-year carryback, and unused amounts are then carried forward.
- TCJA repealed NOL carrybacks, so this is the only remaining carryback opportunity for traders.

OPTIONS

Tax treatment for options is diverse, including simple (outright) and complex trades with multiple legs.

Options taxed as securities

- equity (stock) options
- options on narrow-based indexes
- options on securities ETFs organized as registered investment companies (RIC)

General rule: Options listed on a QBE are a 1256 contract unless the reference is a single stock or a narrow-based stock index. RICs are like a stock.

Options taxed as 1256 contracts

- options on U.S. regulated futures contracts and broad-based indexes

- QBE-listed options on commodity ETF publicly traded partnerships (PTP)

- QBE-listed options on precious metals ETF publicly traded trusts (PTT)

- QBE-listed options on volatility ETN prepaid forward contracts or debt instruments

- forex OTC options (Wright appeals court)

Option transactions

- Three things can happen with outright option trades:

  - Trade option (closing transaction).
  - Option expires (lapses).
  - Exercise the option.

- There are special rules for the holding period for long-term capital gains.

- See Tax Treatment Can Be Tricky With Options and ETFs.

EXCHANGE-TRADED FUNDS (ETF)

Securities, commodities and precious metals ETFs use different structures and tax treatment varies.

Securities ETFs

- Securities ETFs are registered investment companies (RICs).
- Selling a securities ETF is deemed a sale of a security, calling for short-term and long-term capital gains tax treatment on the realization method.
- Wash sale loss adjustments apply on securities ETFs.
- A Section 475 election on securities applies to securities ETFs.

Commodities ETFs

- Commodities ETFs use the publicly traded partnership (PTP) structure.

- PTPs issue annual Schedule K-1s passing through Section 1256 tax treatment on Section 1256 transactions to investors, as well as other taxable items.

- Selling a commodity ETF is deemed a sale of a security, calling for short-term and long-term capital gains tax treatment using the realization method.

Adjust cost basis on commodities ETFs

- Taxpayers invested in commodities ETFs should adjust cost-basis on Form 8949 (capital gains and losses), ensuring they don't *double count* Schedule K-1 pass through income or loss.

- Form 1099-B and trade accounting software does not make this adjustment, so you need to make a manual adjustment.

Physically backed precious metals ETFs

- They usually choose the publicly traded trust (PTT) structure (also known as a grantor trust).

- A PTT issues an annual Schedule K-1, passing through tax treatment to the investor, which in this case is the “collectibles” capital gains rate on sales of physically backed precious metals (such as gold bullion).

- Selling a precious metal ETF is deemed a sale of a precious metal, which is a collectible.

Physically backed precious metals ETFs

- If collectibles are held over one year (long-term), sales are taxed at the “collectibles” capital gains tax rate — capped at 28%.
- Short-term capital gains are taxed at the ordinary rate.
- Precious metals and ETFs backed by precious metals are not securities, so they are not subject to wash-sale loss adjustments, or Section 475 ordinary gain or loss treatment.

FOREX

The default tax treatment for forex is ordinary gain or loss, and traders can make a capital gains election.

Forex ordinary gains and losses

- Forex transactions start off receiving an ordinary gain or loss treatment, as dictated by Section 988 (foreign currency transactions).
- Ordinary losses are generally better than capital losses, providing the trader qualifies for TTS business losses, or if they have other income to absorb a non-business loss.
- Avoid wasting non-business losses that exceed the standard deduction by considering a capital gains election.

Forex capital gains election

- Section 988 allows investors and traders to internally file a contemporaneous “capital gains election” to opt-out of Section 988 into a capital gain or loss treatment.

- Make, or retract, the opt-out election on a "good to cancel" basis at any time during the year.

- If you have a capital loss carryover, then consider a capital gains election.

60/40 capital gains rates on forex

- The capital gains election on forex forwards allows the trader to use Section 1256(g) treatment with lower 60/40 capital gains rates on *"major currencies"* if the trader doesn't take or make delivery of the money.

- "Major currencies" means currency pairs, which also trade as futures on U.S. futures exchanges.

- We make a case for including "spot" forex in Section 1256(g). (See A Case For Retail Forex Traders Using Section 1256(g) Lower 60/40 Tax Rates.)

OTHER FINANCIAL INSTRUMENTS

Foreign futures, precious metals, and volatility products including exchange traded notes (ETNs).

Foreign futures

- By default, futures contracts listed on exchanges located outside of the U.S. are not Section 1256 contracts.
- If the foreign-futures exchange wants Section 1256 tax breaks, they must obtain CFTC approval *and* an IRS Revenue Ruling granting 1256 treatment.
- Only a handful of foreign futures exchanges have Section 1256 treatment. (See a list, which includes Eurex, LIFFE, ICE Futures Europe, and ICE Futures Canada.)
- Foreign futures are otherwise ST or LT capital gains and taxed similar to securities with the realization method.

Precious metals

- Physical precious metals are “collectibles,” which are a particular class of capital assets.
- If you hold collectibles over one year (long-term), sales are taxed at the “collectibles” tax rate — capped at 28%. (If your ordinary rate is lower, use that.)
- If you hold collectibles one year or less, the short-term capital gains ordinary tax rate applies no different from the regular STCG tax rate.

Volatility financial products

- There are many different types of volatility-based financial products to trade, and tax treatment varies.
- CBOE Volatility Index (VIX) futures are Section 1256 contracts with lower 60/40 MTM tax rates.
- The NYSE-traded SVXY is an exchange-traded fund (ETF), taxed as a security.
- The iPath S&P 500 VIX Short-Term Futures (VXX) is an exchange-traded note (ETN) prepaid forward contract (PFC), and while tax treatment is similar to an ETF, there are some critical differences.

Volatility ETNs: prepaid forward contracts (PFC) vs. debt instruments

- Many issuers structure volatility ETNs as "prepaid forward contracts," which provides a deferral of taxes until sale (realization). Long-term capital gains rates apply if held 12 months or longer. (i.e., VXX)
- However, ETN PFCs are not securities, which means they are not subject to WS loss adjustments and Section 475 if elected.
- Some ETNs are debt instruments taxed as securities; subject to WS losses and Section 475 if selected. (i.e., UGAZ).
- Read the ETN prospectus tax treatment section.

CRYPTOCURRENCIES

Selling, exchanging or using cryptocurrency triggers capital gains and losses for traders and investors.

Crypto capital gains and losses

- The IRS treats cryptocurrencies as “intangible property;” not a security, commodity, or currency.
- The realization method applies to short-term vs. long-term capital gains and losses.
- If you invested in cryptocurrencies and sold, exchanged, or spent some during the year, you have to report a capital gain or loss on each transaction.
- Include cryptocurrency-to-currency sales, crypto-to-alt-crypto trades, and purchases of goods or services using crypto.

Crypto accounting and tax reporting

- U.S. crypto exchanges issue a Form 1099-K to accounts with transactions over a certain threshold.
- The problem for the IRS is that many crypto transactions on exchanges around the world are not evident for tax reporting.
- Crypto investors should download *all* crypto transactions worldwide into a crypto accounting program that is IRS-compliant.

Crypto accounting and tax reporting

- Wash sales do not apply to intangible property.
- TCJA restricted Section 1031 like-kind exchanges to real property, starting in 2018.
- It’s questionable whether crypto traders could use Section 1031 before 2018.
- The IRS has not yet issued guidance on how to handle hard-forks (chain splits).

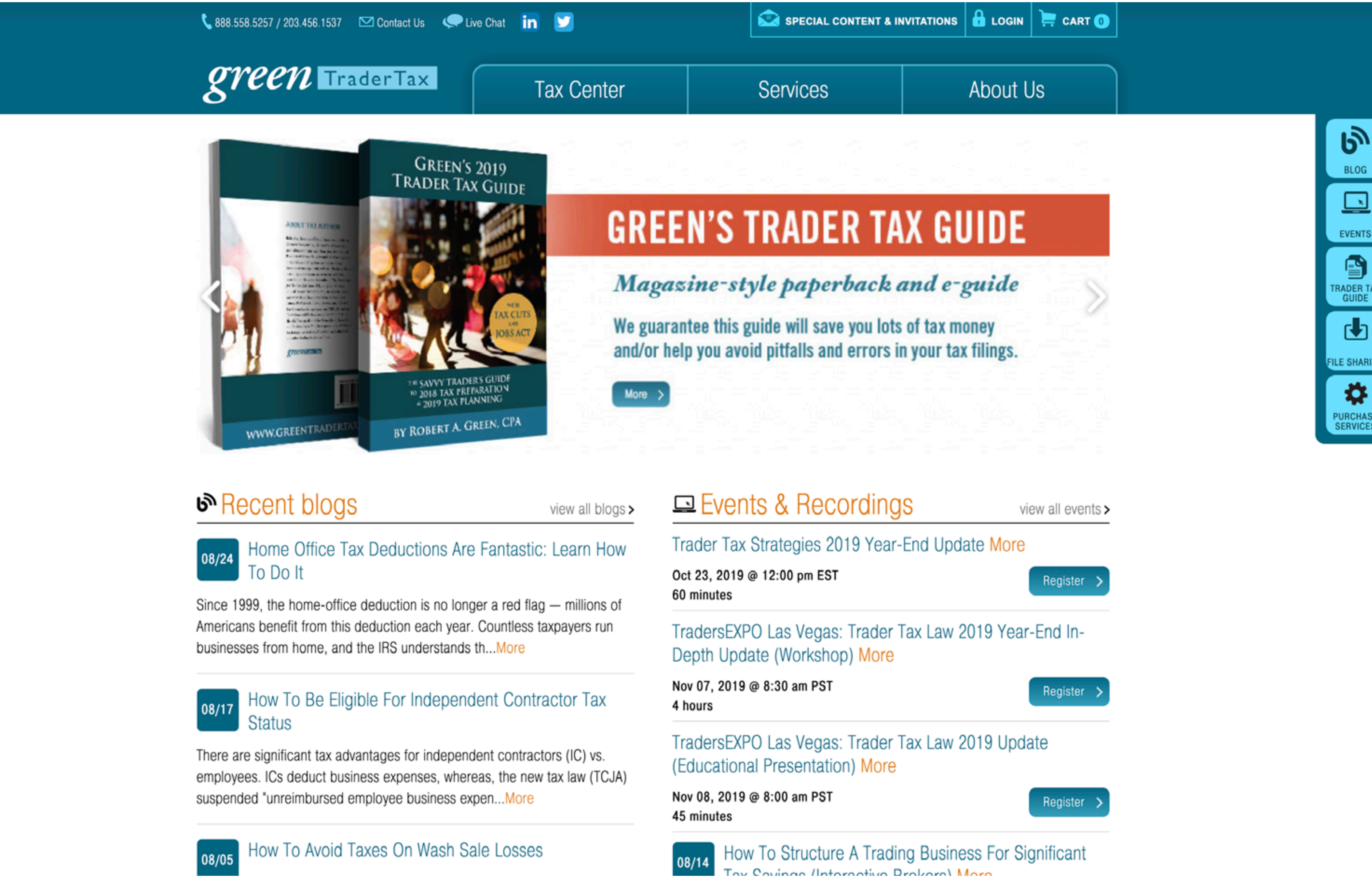
Crypto accounting and tax reporting

- Use the first-in-first-out (FIFO) accounting method.
- Intangible property should use the specific identification method, but that requires broker confirmation of each trade, which is not possible with crypto exchanges.
- The IRS Should give the public more guidance, and it has started to send tax ("education") notices to crypto traders.
- See Watch Out Cryptocurrency Owners, The IRS Is On The Hunt.

QUESTIONS AND ANSWERS

Closing Remarks

- Thank you for attending this Workshop.
- Visit www.GreenTraderTax.com for additional information.
- Call us toll free at 888.558.5257 or 203.456.1537
- Chat with us.
- Email us your questions at info@gnmtradertax.com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Since 1999, the home-office deduction is no longer a red flag — millions of Americans benefit from this deduction each year. Countless taxpayers run businesses from home, and the IRS understands th...More
08/17
How To Be Eligible For Independent Contractor Tax Status
There are significant tax advantages for independent contractors (IC) vs. employees. ICs deduct business expenses, whereas, the new tax law (TCJA) suspended "unreimbursed employee business expen...More
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How To Avoid Taxes On Wash Sale Losses
Events & Recordings
view all events
Trader Tax Strategies 2019 Year-End Update More
Oct 23, 2019 @ 12:00 pm EST
60 minutes
Register
TradersEXPO Las Vegas: Trader Tax Law 2019 Year-End In-Depth Update (Workshop) More
Nov 07, 2019 @ 8:30 am PST
4 hours
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Nov 08, 2019 @ 8:00 am PST
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