

TIPS FOR TRADERS ON PREPARING 2019 TAX RETURNS



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Interactive Brokers Webinar

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Webinar description

- There are several new and revised 2019 tax forms based on the implementation of the 2017 Tax Cuts and Jobs Act.
- Learn how traders, eligible for trader tax status (TTS), maximize business, home office, and start-up expenses using critical tax-reporting strategies.
- Make vital 2020 tax elections on time like Section 475.

Webinar description

- Don't solely rely on broker 1099-Bs: There might be opportunities to switch to lower 60/40 capital gains rates in Section 1256, use Section 475 ordinary loss treatment if elected on time, and report wash sale losses differently.
- Learn common errors on tax returns for TTS traders, which can lead to an IRS or state exam.
- Learn tips for filing extensions and paying taxes due April 15, 2020.

REVISED TAX FORMS

Form 1040 and supporting schedules

- The redesigned two-page 2018 Form 1040 resembled a postcard because the IRS moved many items to six new 2018 Schedules (Form 1040). It was a block-building approach with the elimination of Form 1040-EZ and 1040-A.
- With the 2019 Form 1040, the IRS backtracks a bit, with three supporting schedules, not six. The IRS moved some major items back onto the Form 1040.
- **Darren Neuschwander** will show us around the [2019 Form 1040](#) and supporting [Schedules 1](#), [2](#), and [3](#).

Suspended itemized deductions on Schedule A

- TCJA suspended “certain miscellaneous itemized deductions subject to the 2% floor.” These deductions were included in “Job Expenses and Certain Miscellaneous Deductions” on the 2017 Schedule A.
- The revised 2018 and 2019 Schedule A deleted these deductions, including job expenses, investment fees and expenses, and tax compliance fees and expenses.
- For most investors, the only itemized deduction is investment interest on Schedule A line 9. Many traders choose the standard deduction instead.

Other itemized deductions

- The 2017 Schedule A also had “Other Miscellaneous Deductions,” not subject to the 2% floor, on line 28. There are limited types of expenses included on line 28.
- It’s where investors report stock-borrow fees, which are not investment fees and expenses.
- The 2018 and [2019 Schedule A](#) changed the name to “Other Itemized Deductions” on line 16.
- **Darren Neuschwander** will show us around Schedule A and line 16.

Virtual currency (cryptocurrency)

- On Form 1040/Schedule 1, the IRS added a new question about virtual currency:
 - “At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?”
(Check a box for Yes or No.)
- **Darren Neuschwander** will discuss the implications.
- See the IRS resources on [Virtual Currencies](#).

DEDUCT BUSINESS EXPENSES, START-UP & HOME OFFICE EXPENSES

Traders eligible for trader tax status (TTS) can include a Schedule C for these business deductions.

Assess eligibility for TTS

- Many traders don't claim trader tax status (TTS) when entitled to, or they claim it when they should not.
- The IRS does not require an election for TTS, as they do for Section 475 MTM.
- TTS gives many benefits; the first is business expense treatment.
- Learn the golden rules for qualification in [How To Qualify For Substantial Tax Savings As A Trader.](#)

Deduct TTS expenses on Schedule C

- If you traded an individual account and are eligible to claim TTS for all or part of 2019, then add a [2019 Schedule C](#) (Profit or Loss From Business) to Form 1040.
- Deduct business expenses, start-up costs, and home office expenses.
- A TTS trader does not report revenue or cost of goods sold on a Schedule C, expenses only.

Trading gains & losses on other tax forms

- Use Form 8949 for securities and make wash sale loss adjustments. Report each securities trade separately. Consider Tradelog software to download your trades from brokers.
- Use Form 6781 for Section 1256 contracts (futures). Use the summary amount from the 1099-B line “Aggregate profit or (loss) on contracts.” It’s mark-to-market (MTM).
- Use Schedule 1, “Other Income” for forex ordinary gain or loss if using Section 988. Use the broker’s P&L report with summary reporting.
- Include brokerage commissions in trading gain or loss as done on 1099-Bs. Do not report commissions as expenses on Schedule C or Schedule A.

TTS business expenses on Schedule C

- Tangible personal property up to \$2,500 per item.
- Section 179 (100%) depreciation. Otherwise, bonus and regular depreciation.
- Amortization of start-up costs (Section 195), organization costs (Section 248), and software.
- Education expenses paid and courses taken after the commencement of TTS. Otherwise, pre-business education may not be deductible or include it in Section 195 start-up costs.

TTS business expenses on Schedule C

- Publications, market data, professional services, chat rooms, mentors, coaches, supplies, phone, travel, seminars, conferences, assistants, and consultants.
- Home-office expenses for the business portion of your home.
- Margin interest expenses.
- Stock borrow fees for short-sellers.
- Internal-use software for self-created automated trading systems.

Home office expenses on Form 8829

- HO is one of the most significant tax deductions for traders. It requires trading gains to unlock most of the deduction.
- Mortgage interest and real estate tax portions of HO do not require income.
- The HO deduction might help navigate around Schedule A limitations for SALT and mortgage interest.
- However, there are complications in the HO deduction when using the itemized vs. standard deduction.

Start-up costs

- When you establish TTS, look back six-months to capitalize Section 195 start-up costs, including trading education expenses.
- You can expense (amortize) up to \$5,000 in the first year and the balance over 15-years.

Tax return footnote

- TTS traders should include a tax return footnote supporting Schedule C, which is a red flag on its own, showing a net loss from expenses.
- The note should explain TTS law and how you qualify.
- It should also tell your tax reporting strategies so the IRS can fully understand the TTS trading business.
- Tie all the various tax forms together to show you might have a net profit from trading.

Discussion with GNM members

Darren Neuschwander:

-What tips do you have for TTS traders in maximizing tax deductions on Schedule C?

Adam Manning:

- How should traders keep track of their expenses?
- Do they need an accounting program?
- What resources do we provide to our clients?

SECTION 475

Section 475 is tax loss insurance, and it might provide a QBI deduction.

Tax loss insurance

- Before 2018, the chief tax benefit of Section 475 was deducting trading losses without limit. Only TTS traders can use 475, not investors.
- Section 475 trades are exempt from wash sale loss adjustments on securities, which can lead to phantom income. Section 475 ordinary losses are also not subject to the capital loss limitation.
- TCJA introduced new limitations: An “excess business loss” limitation, and it suspended NOL carrybacks, allowing NOL carryforwards with 80% limits.

QBI deduction

- Profitable traders now also might benefit from Section 475.
- TCJA introduced a 20% deduction on qualified business income (QBI) in pass-through businesses, and TTS traders with 475 elections are eligible for the deduction. QBI excludes capital gains.
- Trading is a “specified service activity,” so the taxable income threshold, phase-out range, and income cap apply.

Section 475 election procedures

- Existing taxpayer individuals that qualify for TTS and want Section 475 must file a 2020 Section 475 election statement with their 2019 tax return or extension by April 15, 2020. (It's too late to elect 475 for 2019.)
- Existing partnerships and S-Corps file an election statement in the same manner by March 15, 2020.
- “New taxpayers” like new entities file an internal Section 475 MTM election resolution within 75 days of inception.
- If you filed a 475 election for 2019, then complete the process with a Form 3115 included with your 2019 tax return.

Discussion with GNM tax partners

Darren Neuschwander:

- What are some of the accounting challenges in converting from the realization (cash) method to 475 reporting?

Adam Manning:

- Brokers provide different types of annual tax reports. Are they adequate for filing tax returns?
- Should securities traders use trade accounting software?
- Do some brokers use 475 reporting on 1099-Bs?
- If yes, what are some of the issues that arise?

NEW TAX FORMS FOR QBI DEDUCTION

If a TTS trader elects 475, they might become eligible for the 20% QBI.

New 2019 tax forms for QBI deductions

- TCJA introduced a 20% deduction on qualified business income (QBI) in pass-through businesses, starting with 2018.
- For 2018 tax returns, the IRS requested taxpayers to use a worksheet for the “qualified business income deduction” reported on the 2018 Form 1040, page 2, line 9.
- For 2019 taxes, the IRS introduced [Form 8995](#) (Qualified Business Income Deduction Simplified Computation) and [Form 8995-A](#) (Qualified Business Income Deduction).
- **Darren Neuschwander** will show us these new forms.

QBI deduction for TTS traders

- Traders eligible for TTS are a “specified service activity,” which means if their taxable income is above an income cap, they won’t receive a QBI deduction. The taxable income (TI) cap is \$421,400/\$210,700 (married/other taxpayers) for 2019.
- The phase-out range below the cap is \$100,000/\$50,000 (married/other taxpayers), in which the QBI deduction phases out for specified service activities.
- The W-2 wage and property basis limitations also apply within the phase-out range.

QBI includes Section 475

- QBI for traders includes Section 475 ordinary income and loss minus trading business expenses. QBI excludes capital gains and losses, Section 988 forex and swap ordinary income or loss, dividends, and interest income.
- TCJA favors non-service businesses, which are not subject to an income cap.
- The W-2 wage and property basis limitations apply above the TI threshold of \$321,400/\$160,700 (married/other taxpayers) for 2019.

QBI information on 2019 Schedule K-1s

- See the [2019 Schedule K-1](#) for a partnership Form 1065. Look in box 20 “Other Information” for “Section 199A information” (all) marked code Z.
- See the [2019 Schedule K-1](#) for an S-Corp Form 1120S. It’s similar: Look in box 17 “Other Information” for “Section 199A information” (all) marked code V.
- The K-1 will delineate Section 199A (QBI) income, wages, and property on a worksheet that accompanies the K-1. You need these three factors separately.
- Enter Section 199A information on the QBI tax forms 8995 and 8995-A.

QBI for a sole proprietor trader with 475

- Sole proprietor TTS traders using Section 475 have QBI.
- QBI is the net trading gain or loss from Form 4797 Part I minus the Schedule C net loss from trading expenses.
- If the trader's taxable income is over the QBI taxable income threshold, then they won't get a QBI deduction in the phase-out range.
- Schedule C traders cannot pay themselves wages, so their wage limitation might be zero unless they aggregate QBI with other businesses that have plenty of salaries.

DON'T SOLELY RELY ON A BROKER FORM 1099-B

There might be opportunities to switch to lower 60/40 capital gains rates in Section 1256, use Section 475 ordinary loss treatment if elected on time, and report wash sale losses differently.

Wash-sale loss rules differ between brokers and taxpayers

- Per IRS rules for brokers, [1099-B](#) reports wash sales (WS) on identical positions per that one brokerage account. (That's a narrow view of WS.)
- The IRS rules for taxpayers are different: Calculate WS on substantially identical positions across all their accounts, including joint, spouse, and IRAs. (That's a broader view of WS.)
- In many cases, broker-issued 1099-Bs might report different WS losses than a taxpayer must indicate on [Form 8949](#).
- See [How To Avoid Taxes On Wash Sale Losses](#).

How to prevent wash sale losses

- “Break the chain” on WS losses at year-end in taxable accounts to avoid WS loss deferral to 2020. If you sold X equity on Dec. 20, 2019, at a loss, don’t repurchase X equity or X equity options until Jan. 21, 2020, avoiding the 30-day window for triggering a WS loss.
- Elect Section 475 MTM with TTS. (It’s too late for 2019).
- Consider a “Do Not Trade List” to avoid permanent wash sale losses between taxable and IRA accounts.
- Trade Section 1256 contracts, which are MTM by default, and not subject to WS.

Opportunities to depart from 1099-Bs

- Many brokers treat ETNs structured as prepaid forward contracts (i.e., VXX) as a security on 1099-Bs subject to WS loss adjustments. We found substantial authority to handle ETN prepaid forward contracts as not a security, so they are not subject to WS losses or Section 475 ordinary gain or loss treatment. (ETN debt instruments are securities.)
- Many brokers treat CBOE-listed options on ETNs as a security on 1099-Bs. Still, we found substantial authority to interpret them as non-equity options in Section 1256 so a taxpayer can use lower 60/40 capital gains rates.
- Some foreign futures are eligible for Section 1256 treatment.

Cost-basis adjustments on Form 8949

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

Discussion with GNM tax partners

Darren Neuschwander:

- Traders often get alarmed when they see massive WS loss amounts reported on 1099-Bs. How should they deal with WS loss adjustments, 1099-Bs, and their tax returns?

Adam Manning:

- In what circumstances can a trader rely on a 1099-B and other tax reports provided by the broker?

COMMON ERRORS ON TAX RETURN FILINGS FOR TRADERS

Traders are unique, and their tax reporting is confusing for many preparers.

Reporting trading gains/losses on Schedule C

- Some accountants intuitively think that TTS traders should enter trading income, loss, and expenses like other sole proprietors on [Schedule C](#). That's wrong, and it often causes an IRS notice or exam.
- Some traders try to deduct significant capital losses on Schedule C after missing the Section 475 MTM election deadline for ordinary gain or loss treatment. They are evading WS loss adjustments and capital loss limitations.
- Section 475 trades are reported in detail on [Form 4797](#) Part II ordinary gains and losses, not on Schedule C.

Schedule C transfer strategy

- Only trading business expenses are reportable on Schedule C for TTS traders, and the net loss might be a red flag for IRS computers and agents.
- To erase the red flag, consider transferring enough TTS trading gains, if any exist, to Schedule C line 6 “Other Income” to make Schedule C zero net income or loss.
- That also unlocks the home office deduction and Section 179 depreciation, which requires income.
- Explain this TTS treatment in a tax return footnote.

SE tax errors

- Some traders and preparers treat TTS trading gains as self-employment income (SEI) subject to self-employment (SE) tax.
- That's incorrect unless the trader is a full-scale member of an options or futures exchange and trading Section 1256 contracts on that exchange (Section 1402i).

AGI deduction errors

- Some sole proprietor TTS traders incorrectly contribute to a retirement plan based on trading income, and they wind up with an “excessive contribution” subject to tax penalties.
- Some mistakenly take an AGI deduction for self-employed health insurance premiums, which also requires SEI, and trading income is not SEI.
- A TTS trader needs an S-Corp to arrange retirement and health insurance deductions before the year-end.

NIT tax errors

- Include trading gains and losses in net investment income (NII) for calculating Obamacare 3.8% net investment tax (NIT).
- Some traders omit to deduct TTS trading expenses from NII.
- You cannot deduct investment fees and expenses from NII.

Overlooking a 1256 loss carry back election

- Many taxpayers and accountants don't know about the Section 1256 loss carryback election on top of Form 6781.
- Carry back the current year's 1256 loss three tax years against Section 1256 gains in those years.
- Many traders miss this election and wind up with unused capital loss carryforwards instead.
- If trading in a partnership, make the election on the partnership level.

Errors on TTS entity tax returns

- A TTS S-Corp needs officer compensation to unlock the health insurance and retirement plan deduction. Many S-Corp owners miss the formal payroll deadline by year-end and miss out on these deductions.
- Some TTS partnerships attempt health insurance and retirement plan deductions, but it's tough to arrange. The company passes through negative SEI to offset an administration fee, trying to create SEI.
- Having the right structure and year-end planning is paramount.

Discussion with GNM tax partners

Darren Neuschwander:

- When you review tax returns for traders, what are some of the most common errors that you identify?
- Tell us about GNM's [Tax Compliance Service](#) vs. our [Trader Tax Return Review Service](#).

Adam Manning:

- What are some of the errors you find on TTS entity tax returns, including partnerships and S-Corps?

EXTENSIONS

File for an automatic extension to get six-months of additional time to file your tax return but pay what you owe by April 15, 2020.

Consider filing an extension

- Individual tax returns for 2019 are due April 15, 2020. However, most active traders aren't ready to file on time.
- Some brokers issue corrected 1099-Bs right up to the deadline, or even beyond.
- Many partnerships and S-Corps file extensions by March 15, 2020, and don't issue Schedule K-1s to partners until after April 15.
- Many securities traders struggle with accounting for wash sale loss adjustments.

Automatic extension

- The excellent news is traders don't have to rush completion of their tax returns by April 15.
- They should take advantage of a simple one-page automatic extension along with payment of taxes owed to the IRS and state.
- Learn how to avoid late-filing and late-payment penalties.
- See [Tax Extensions: 12 Tips To Save You Money and March 15 Is Tax Deadline For S-Corp And Partnership Extensions And Elections.](#)

Discussion with GNM tax partners

Darren Neuschwander:

- Why do TTS traders often file extensions and what should they focus on for April 15?

Adam Manning:

- What's involved with filing extensions for partnerships and S-Corps?

Closing Remarks

- Thank you for attending this Webinar or watching the recording.
- Visit www.GreenTraderTax.com for additional information.
- Call us toll free at 888.558.5257 or 203.456.1537
- Email us your questions at info@greentradertax.com



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