HOW TO SET UP A TRADING BUSINESS FOR OPTIMAL TAX SAVINGS

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Overview (1)

If you are eligible for “trader tax status” (TTS), consider setting up a trading business to maximize tax benefits.

- Learn how to qualify for and claim TTS.
- An individual with TTS can deduct business expenses, startup costs, and home-office expenses on a Schedule C, with no entity required.

Overview (2)

- With TTS, an individual can elect Section 475 MTM accounting for 2020 with the IRS by July 15, 2020.

- Section 475 trades are exempt from wash sale loss adjustments on securities, the $3,000 capital loss limitation, and 475 income is eligible for a qualified business income (QBI) deduction.

- You can carryback a 2020 NOL/475 loss five years under the CARES Act.

Overview (3)

- A TTS trader uses an S-Corp to deduct health insurance premiums and a Solo 401(k) retirement plan contribution up to $63,500.
- Learn different TTS entity formation strategies and whether to form an LLC taxed as a disregarded entity, partnership, or S-Corp.
- An investor without TTS cannot get any of these tax benefits.

Recent tax laws favor TTS/475

- TCJA restricted itemized deductions for investors; only allowing investment interest expenses, and stock borrow fees. TCJA improved business expenses with TTS.

- TCJA introduced a 20% deduction on qualified business income (QBI), which includes Section 475 income less TTS expenses, but excludes capital gains and portfolio income. 475 is also “tax loss insurance” for TTS traders.

  There are three good choices of TTS structure: Sole proprietorship, partnership, or S-Corp.

CARES tax relief on business losses

- TCJA repealed NOL two-year carrybacks and limited NOL carryforwards to 80% of the subsequent year’s income.

- CARES overrides TCJA and allows NOL five-year carrybacks for 2018, 2019 and 2020, and 100% NOL carryforwards.

- TCJA introduced “excess business loss” (EBL) limitations, whereas CARES suspended EBL rules for 2018, 2019, and 2020.

- CARES allows 475 elections by July 15, 2020, three months later than usual (April 15).

HOW TO BE ELIGIBLE FOR TRADER TAX STATUS

Golden rules for TTS (1)

- *Volume*: Four trades per day, 16 trades per week, 60 a month, and 720 per year on an annualized basis (Poppe court). Count each open and closing trade separately.

- *Frequency*: Executes trades on close to four days per week, around a 75% frequency rate.

- *Holding period*: In the Endicott court, the IRS said the average holding period must be 31 days or less. That's a bright-line test.

Golden rules for TTS (2)

- *Trades full time or part-time*, for a good portion of the day, almost every day the markets are open.
- *Hours*: Spends more than four hours per day, almost every market day working on the trading business — all time counts.
- *Avoid sporadic lapses*: Has few to no intermittent lapses in the trading business during the year.

Golden rules for TTS (3)

- *Intention*: Has the intention to run a business and make a living. It doesn't have to be a primary living.

- *Operations*: Has significant business equipment, education, business services, and a home office.

- *Account size*: Has a material account size. Securities traders need to have $25,000 on deposit with a U.S.-based broker to achieve pattern day trader (PDT) status. For the minimum account size, we like to see more than $15,000.

What doesn’t qualify for TTS?

- Automated trading system (ATS) created by a third-party with entry and exit signals, and automated execution. Some ATS don't come with automatic execution, and traders significantly depart from ATS signals so that the trader can count those trades. A self-created ATS counts for TTS, too.
- A trade copying service does not count for TTS unless you depart from recommended trades significantly.
- Engaging an investment advisor.
- Trading retirement funds.

SOLE PROPRIETORSHIP

File a Schedule C with Form 1040

- An individual TTS trader deducts business expenses, startup costs, and home office deductions on a Schedule C (Profit or Loss From Business – Sole Proprietorship) 1040 filing.

- Traders don’t have revenue on Schedule C; report trading gains and losses on other tax forms.

- Schedule C losses are an above-the-line deduction from gross income.

- TTS Schedule C expenses reduce self-employment income (SEI).

Individual brokerage account

- Open an individual brokerage account(s) in the trader’s name and social security number.

- You can also use a joint individual account but list the trader’s name and social security number first.

- You don’t need a separate employer identification number (EIN) unless you plan to have employees on the payroll.

No election or filing need for TTS

- There is no filing required with most states for a TTS sole proprietorship.

- There isn't a tax election for claiming TTS. — it's determined based on facts and circumstances assessed at year-end

- You can claim TTS after-the-fact; you don't have to formalize it in advance.

Consider a Section 475 election

- Only TTS traders can use Section 475 ordinary gain or loss treatment; however, many TTS traders don't make a 475 election. For example, a TTS futures trader might skip a 475 election to retain lower 60/40 capital gains rates on 1256 contracts.

- You can elect Section 475 on securities only, commodities only, or both. I generally recommend 475 for securities traders.

- CARES allows an individual to submit a 2020 Section 475 with the IRS by July 15, 2020, the postponed deadline.

- See How Recent Tax Relief & Aid Legislation Impacts Traders

Example of claiming TTS

- Active trader Josh realized in mid-2020 that he qualified for TTS for all of 2019.
- Josh can add a Schedule C to his 2019 Form 1040 tax return due July 15, 2020. Josh can file an extension to October 15, 2020.
- A Schedule C provides tax benefits for 2019 and year-to-date in 2020 with business expenses, and the right to elect 475 for 2020.

Example of forming an S-Corp

- Josh wants to form an S-Corp later in 2020 to unlock a health insurance deduction for the remainder of 2020 and a high-deductible retirement plan deduction.

- A “new taxpayer” LLC/S-Corp can elect Section 475 within 75 days of inception.

- With the S-Corp, Josh can also arrange health insurance and retirement deductions for 2020.

BUSINESS EXPENSES

TTS business expenses

- Business expenses include home-office, education, startup expenses, organization expenses, margin interest, tangible property expense, Section 179 (100%) or 100% bonus depreciation, amortization on software, self-created automated trading systems, mentors, seminars, market data, charting services, stock borrow fees, and much more.

- TCJA suspended “certain miscellaneous itemized deductions subject to the 2% floor,” including investment fees and expenses, commencing in 2018.

SECTION 475 ELECTION

Section 475 tax benefits

- TTS traders are entitled to make a Section 475 election, but investors may not.
- I call it "tax loss insurance" because the election exempts securities trades from wash-sale loss (WS) adjustments, which can defer tax losses to the subsequent year, and the $3,000 capital loss limitation. (WS with taxable accounts and IRAs are permanent.)
- Ordinary loss treatment is better; it can generate tax refunds faster than capital loss carryovers.

How to elect 475 for 2020

- An individual TTS trader can choose Section 475 for 2020 with the IRS by July 15, 2020, the postponed deadline.
- A partnership or S-Corp formed during the tax year is considered a “new taxpayer,” which can elect Section 475 internally within 75 days of inception.
- A new entity comes in handy for electing 475 later in the year.
- It’s too late to elect 475 for 2019, which was due by April 15, 2019.

Capital loss carryovers vs. 475

- Report capital-loss carryovers on Schedule D.
- A new partnership or S-Corp can pass through capital gains to use up those capital loss carryovers.
- The entity can elect Section 475 MTM in a subsequent tax year by March 15.
- It’s easy to revoke a 475 election in a manner that mirrors making a 475 election.

QUALIFIED BUSINESS INCOME DEDUCTION

QBI deduction

- TCJA introduced a tax benefit for pass-through businesses, which includes a TTS trader with Section 475 income; whether doing business as a sole proprietor, partnership, or S-Corp.

- Section 199A provides a 20% QBI deduction on a “specified service trade or business” (SSTB), and TTS trading is an SSTB.

- SSTBs are subject to a taxable income threshold, phase-out range, and income cap. The phase-out range has wage and property limitations, too.

SSTB threshold, phase out, and cap

- The 2020 taxable income (TI) threshold is $326,600/$163,300 (married/other taxpayers). Wages and or property are not needed for this threshold.

- The phase-out and phase-in range below the cap is $100,000/$50,000 (married/other taxpayers). Wages and or property are needed for the phase-out.

- The 2020 TI cap is $426,600/$213,300 (married/other taxpayers). It’s indexed for inflation.

QBI includes 475, not capital gains

- QBI includes Section 475 ordinary income and trading business expenses and excludes capital gains and losses, dividends, interest income, forex and swap ordinary income, and investment expenses.

- The 20% deduction is on whichever is lower: QBI or taxable income minus “net capital gains.”

Example of 475 and QBI deduction

- A TTS trader has 2020 YTD capital gains of $60,000. He skips a 475 election, due July 15, to fully utilize his $45,000 capital loss carryover.
- Now he has a clean slate to form a general partnership with his spouse and elect 475 on the company level within 75 days of inception.
- The spouses will likely receive a 20% QBI deduction on partnership's 475 income as they project taxable income under the threshold.

PASS-THROUGH ENTITIES

Pass-through entities

- A pass-through entity means the company is a tax filer, but it's (mostly) not a taxpayer. The individual owners are the taxpayers.

- In most states, entity-level taxes are nominal costs. (In *Green's 2020 Trader Tax Guide*, I address state taxes for S-Corps in California, Illinois, other states, and New York City.)

- Taxpayers should consider marriage, state residence, and state tax rules, including annual reports, minimum taxes, franchise taxes, excise taxes, and more when setting up an entity.

PARTNERSHIPS

TTS partnerships

- A trader can organize a spousal LLC and file as a partnership.
- Alternatively, the trader can form a marital general partnership without liability protection afforded by an LLC.
- Partnerships file a Form 1065 partnership tax return.
- Establishing a separate legal entity does not alone generate tax benefits; the organization must qualify for TTS.

Investment partnerships

- Without TTS, the company is considered an investment partnership with suspended investment fees and expenses under TCJA.
- An investment partnership cannot have business expenses, officer compensation, and employee benefits, including health insurance and retirement plans.
- An investment partnership cannot use Section 475 MTM accounting.

TTS Form 1065 and Schedule E

- A TTS partnership enters Section 475 income or loss and business expenses on Schedule K-1 line one. The owner reports line one on Schedule E in the active column – it's not a passive activity.

- Report capital gains/losses and portfolio income separately on Schedule K-1.

- If the partnership agreement provides for it, the partner can also deduct "unreimbursed partnership expenses" (UPE), including home office expenses, on Schedule E page 2.

Segregate trading from investing

- If you trade substantially-identical positions that you also invest in; it could invite the IRS to play havoc with the reclassification of TTS/475 vs. investment positions.
- A partnership can ring-fence TTS/475 trading positions segregating them from investment positions done on the individual level.
- That can prevent the IRS from reclassifying TTS positions out of Section 475 ordinary loss treatment into a capital loss limitation on investment positions. Alternatively, reclassifying deferred long-term capital gains to MTM ordinary income.

Portfolio margining vs. Section 475

- Some traders have a portfolio of equity investments, which they leverage with portfolio margining to trade equity options (i.e., collecting option premium.)

- They should choose between 475 or portfolio margining, as the IRS can play havoc on reclassification between investments and TTS/475 positions.

S-CORPS

S-Corps

- Organize an LLC or incorporate a corporation, and the entity has the option to file an IRS Form 2553 (Election by a Small Business Corporation) within 75 days of inception. In most states, we prefer the LLC structure.

- Alternatively, in a subsequent year, the entity can file an S-Corp election by March 15.

- All the owners must be U.S. residents.

Elections for S-Corp and 475

- Most states accept the federal S-Corp election, although some states, including but not limited to New York and New Jersey, require a separate state election.

- There is IRS relief for late S-Corp elections; however, you had to have the intention of making the S-Corp election on time.

- New S-Corps and partnerships can elect Section 475 within 75 days of inception.

- Existing S-Corps and partnerships must elect 475 by March 15 of the current year. CARES did not provide postponement relief.

SMLLC/S-Corp

- Unlike a partnership, an S-Corp doesn't require two or more owners.

- An unmarried trader can form a single-member LLC (SMLLC) to elect S-Corp status.

- Otherwise, a single-member LLC is a "disregarded entity" (a "tax nothing" in the eyes of the IRS), which takes you back to using sole proprietor status on a Schedule C.

Health and retirement benefits

- An essential tax benefit of an S-Corp is to arrange tax deductions for health insurance premiums and a high-deductible retirement plan contribution through officer compensation.

- These employee benefits require the execution of a formal S-Corp payroll before year-end.

- Year-end tax planning is paramount.

Need for earned income

- Sole proprietors and partnerships cannot achieve health insurance and retirement deductions in connection with trading income, which is unearned income.

- A Schedule C cannot pay the owner wages, and partnerships must use “guaranteed payments” instead of salaries for partners.

- Partnership expenses flow through, including a guaranteed payment, creating negative self-employment income (SEI).

TTS S-Corps create earned income

- Negative SEI makes a health insurance and retirement plan deduction challenging to achieve for a TTS partnership.

- Conversely, S-Corps don’t pass through negative SEI, and the employee benefit deductions work tax efficiently on officer compensation.

HEALTH INSURANCE

Health insurance premiums

- TTS traders with significant self-employed health insurance (HI) premiums should consider an S-Corp to arrange a tax deduction through officer compensation; otherwise, they cannot deduct HI without SEI.

- Not everyone needs a HI deduction; your spouse might have HI coverage for the family in her job. Cobra is not deductible HI since it’s employer-provided.

- An S-Corp is worthwhile if the HI tax deduction is meaningful, and the tax savings exceed the entity costs of formation and maintenance.

Example of HI deduction

- A married securities trader in a high-tax state might have a $24,000 HI deduction for family coverage, and with a 30% combined federal and state tax bracket, the tax savings for the HI deduction is $7,200.
- There is no payroll tax on the health insurance component of wages.
- An S-Corp is a good idea for this TTS trader.

Health Savings Accounts

- Taxpayers can deduct Health Savings Accounts (HSA) without the need for TTS or earned income.

- HSA contribution limits for 2020:
  - Individual $3,550
  - Family coverage $7,100
  - Age 55 or older, additional $1,000 a year

- You can make the 2019 contribution until July 15, 2020, the postponed deadline under Covid-19 relief.

RETIREMENT PLAN CONTRIBUTIONS

Officer compensation and payroll tax

- Traders need earned income to make and deduct retirement plan contributions; however, trading income is unearned income.

- TTS sole proprietors and partnerships cannot create earned income, whereas S-Corps can pay officer compensation through payroll.

- There are payroll taxes on S-Corp wages: 12.4% FICA capped on salaries up to $137,700 for 2020, and the 2.9% Medicare is unlimited.

Wait until December to pay wages

- You should fund retirement plan contributions from net income, not losses.

- It’s best to wait on the execution of an annual paycheck until early December when there is transparency for the year.

Solo 401(k) elective deferral

- If you have sufficient trading profits for the year, consider establishing a Solo 401(k) retirement plan before year-end.
- Start with the 100% deductible elective deferral (ED; $19,500 for 2020) and pay it through payroll since it's reported on the annual W-2.
- Taxpayers 50 years and older have a "catch up provision" of $6,500, raising the 2020 ED limit to $26,000 per year.

Solo 401(k) profit-sharing plan

- If you have significant trading gains, consider increasing payroll in December for a performance-based bonus to unlock a 25% deductible Solo 401(k) profit-sharing plan (PSP) contribution that you don’t have to pay into the retirement plan until the due date of the S-Corp tax return (including extensions by September 15).

- The maximum PSP amount is $37,500 on wages of $150,000 ($37,500 divided by 25% equals $150,000).

- The total limit for a Solo 401(k) is $63,500 ($19,500 ED, $6,500 catch-up ED, and $37,500 PSP).

Example of maximizing a Solo 401(k)

- Assume an unmarried trader, age 51, has S-Corp net trading income of approximately $225,000 and individual taxable income of $200,000.
- That puts her in a 32% marginal federal tax bracket, and her state rate is 5%.
- On officer compensation of $26,000, she contributes the maximum Solo 401(k) ED of $26,000, saving $9,620 in federal and state income taxes.

Example of maximizing a Solo 401(k)

- Her 15.3% payroll tax on $26,000 wages is $3,978. The employer's 50% share of the payroll tax is deductible, which generates tax savings of $736.
- She has federal unemployment insurance (FUI) of $50 and is exempt from state workmen's compensation insurance.
- Her net overall tax savings is $6,328 ($9,620 - $3,978 + 736 – 50).
- She will enjoy tax-free compounding of growth in the retirement plan until she must begin taking required minimum distributions by age 72, which will be ordinary income.

Roth Solo 401(k) elective deferral

- Consider a Roth Solo 401(k) elective deferral contribution in the years when you can skip an income tax deduction from a traditional Solo 401(k) contribution.
- Roth Solo 401(k)s and Roth IRAs are permanently tax-free for growth and contributions.
- There are no income limits for contributing to a Roth Solo 401(k), as there are for a Roth IRA.
- The profit-sharing plan contribution cannot go to a Roth plan; it must be a traditional plan.

Miscellaneous

- Employees need to use an “accountable reimbursement plan” before year-end for reimbursing their employee business expenses.

- Form a pass-through entity in your state of residence since it passes income to that state, anyway.

C-Corps

- C-Corps are not ideal for traders since the IRS might charge a 20% “accumulated earnings tax” (AET) on top of the 21% flat tax rate.
- It’s hard for a trader to have a war chest plan to justify retaining earnings and profits (E&P). Otherwise, AET applies to E&P.
- There’s double state taxation to consider, too.

Choosing a TTS trading business structure

	Investor	TTS Sole prop	TTS Partnership	TTS S-Corp
Tax savings:				
Deduct trading business expenses, startup costs and home office deductions		X	X	X
Elect Section 475		X	X	X
Elect 475 late in year for new entities (after 7/15/20)			X	X
20% QBI deduction on 475 income less business expenses		X	X	X
Enhanced QBI deduction with 199A Wages (phase out range)				X
Deduct officer/owner compensation				X
Deduct health insurance				X
Deduct retirement plan contribution				X
Additional costs:				
Professional data-feed fees might apply			X	X
Entity tax return required			X	X
Payroll compliance service				X
State minimum tax might apply			X	X

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QUESTIONS & ANSWERS

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Services:

- Consider a 45-minute consultation with Robert A. Green, CPA, to review eligibility for TTS, an entity plan, Section 475 election, and more.
- If an entity is a good idea for you, then consider our entity formation service.
- We also offer our tax compliance service.

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