

# HOW TO BE ELIGIBLE FOR SUBSTANTIAL TAX SAVINGS AS A TRADER

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(Interactive Brokers)

## Host & Author

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# Description

- Join Robert A. Green, CPA, of GreenTraderTax.com, explain the tax advantages of “trader tax status” (TTS).
- Learn the golden rules in detail for how to be eligible for and claim TTS, no election is required.
- Automated trading systems (ATS) can qualify for TTS, providing the trader is significantly involved with the ATS. Trade copying software might not be eligible.
- TTS traders deduct business expenses, startup costs, and home office expenses, whereas investors cannot.

# Description

- Learn how TTS traders use an S-Corp to deduct health insurance and retirement plan contributions.
- TTS traders are entitled to elect Section 475 MTM ordinary gain or loss treatment. Section 475 trades are exempt from wash sale losses on securities, and the \$3,000 capital loss limitation.
- Section 475 income, net of TTS expenses, is eligible for the 20% qualified business income (QBI) deduction if the trader is under the taxable income threshold.

# HOW TO QUALIFY FOR TRADER TAX STATUS

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A deep dive into our golden rules for TTS.

# Volume of trades

- The 2015 tax court case Poppe vs. Commission is a useful reference.
- Poppe made 720 total trades per year/60 per month.
- We recommend an average of four trades per day, four days per week, 16 trades per week, 60 trades a month, and 720 per year on an annualized basis.
- Count each open and closing trade separately, not round trips.
- Some traders scale into and out of trades, and you can count each of those trades separately.

# Example calculation of volume and frequency

- The securities markets are open approximately 250 days, but let's account for some personal days or holidays, and figure you're available to trade 240 days per year.
- A 75% frequency of 240 days equals 180 days per year, so 720 total trades divided by 180 trading days equals four trades per day.

# Volume of trades: What counts?

- If you initiate a trade order and the broker breaks down the lot sizes without your involvement, it's wise not to count the extra volume of trades in this case.
- Options traders have multi-legged positions on “complex trades.” We believe you may count each trade confirmation of a complex options trade if you enter the trades separately, although the tax court has not addressed that issue yet.
- Most traders enter a complex options trade and the broker breaks down the legs, so you cannot count the legs separately.
- Trade executions count; not unexecuted trades.

# Frequency of trades

- Execute trades on close to four days per week, around a 75% frequency rate.
- The tax courts require “regular, frequent, and continuous” qualification for TTS. If you enter or exit a trading business during the year, then maintain the frequency rate during the TTS period.
- Time off from the execution of trades should be for a reasonable amount of vacations and other non-working days.
- Think of TTS like it’s a job, only the markets are your boss.

# Frequency of trades: Tax court cases

- In the following trader tax court cases, the IRS denied TTS to options traders, including Holsinger, Assaderaghi, Endicott, and Nelson.
- They only traded on two to three days per week; hence, I suggest executing trades on close to four days per week.

# Holding period

- The IRS stated that the average holding period is the most crucial TTS factor.
- In the Endicott court, the IRS said the average holding period must be 31 days or less. That's a bright-line test.
- If your average holding period is more than 31 days, it's disqualifying for TTS, even if all your other TTS factors are favorable.
- It's more natural for day traders and swing traders to meet the holding period requirement.

# Holding period

- In the holding period analysis, don't count segregated investment accounts and retirement accounts; only count TTS positions.
- Monthly options traders face challenges in holding periods. They may have average holding periods of over one month if they trade monthly and longer expirations and keep them over a month.
- Holsinger was a monthly options trader, and his holding periods averaged one to two months. More often now, TTS traders are focused on trading weekly options expirations, and many of them are eligible for TTS.

# Holding period: Example

- Consider the following example of a trader in equities and equity options.
- If he holds 80% of his trades for one day and the other 20% for 35 days, then the average holding period is well under 31 days.
- It's not evident if the IRS might apply weighted averages to the average holding period.

# Trades full time or part time

- Part-time and money-losing traders face more IRS scrutiny, and individuals face more scrutiny than entity traders.
- Full-time options traders actively trading significant portfolios may not qualify because they don't have enough volume and frequency, and their average holding period is over 31 days.
- On the other hand, a part-time trader with a full-time job may qualify as a day and swing trader in securities meeting all our golden rules.

# Time spent

- Spends more than four hours per day, almost every market day working on his trading business.
- All-time counts, including execution of trade orders, research, administration, accounting, education, travel, meetings, and more.
- Most active business traders spend more than 40 hours per week in their trading business.
- Part-time traders usually spend more than four hours per day.

# Trading is not a passive loss activity

- In one tax exam our firm handled, the IRS agent brought up the “material participation” standard in the passive loss activity rules (Section 469), which require 500 hours of work per year (as a general rule).
- Most business traders easily surpass 500 hours of work. However, Section 469 doesn’t apply to trading businesses, under its “trading rule” exemption.
- Without this exemption, taxpayers could generate passive-activity income by investing in hedge funds and the IRS did not want that.

# Avoid sporadic lapses

- A trader has few to no sporadic lapses in the trading business during the year.
- The IRS has successfully denied TTS in a few tax court cases by arguing the trader had too many sporadic lapses in trading, such as taking several months off during the year.
- Traders can take vacations, sick time, and personal time off just like everyone else.
- Some traders take a break from active trading to recover from recent losses and learn new trading methods and markets.

# Explain sporadic lapses

- Breaks should be carefully explained to the IRS in tax-return footnotes.
- We believe retooling and education during a lapse in trade executions still may count for the continuous business activity (CBA) standard, although the IRS currently does not give credence to CBA.
- We recommend traders keep proper records of their time spent as support.

## Avoid sporadic lapses

- Comments from an IRS official about the Chen tax court case point out the IRS doesn't respect individual traders who are brand new to a trading activity and who enter and exit it too quickly — especially if the trader seeks a large IRS refund by deducting a Section 475 MTM ordinary loss on an individual tax return.
- Some traders must temporarily stop for several months for health reasons.
- It's not clear if the IRS will respect that as a valid interruption of a trading business activity. That seems unfair, but it may be the reality.

# Intention to run a business

- Traders must have the intention to run a trading business — trading his or her own money — but it doesn't have to be one's exclusive or primary means of making a living.
- The key word is “a” living, which means it can be a supplemental living.
- Many traders enter an active trading business while still working a full-time job. Advances in technology and flexible job schedules make it possible to carry on both activities simultaneously.
- Many traders are home from their day jobs with Covid-19 and can carry on a trading business now. But will that continue?

# Don't combine TTS with another business

- It's not a good idea to try to achieve TTS within a business entity already principally conducting a different type of business activity.
- It's better to form a new trading entity.
- Trading an existing business's available working capital seems like a treasury function and sideline, which can deny trader tax breaks if the IRS takes a look.

# A entity looks better than a sole proprietorship

- Filing as a sole proprietor on a Schedule C is allowed and used by many, but it's not the best tax filing strategy for a part-time trader.
- An individual tax return shows a taxpayer's job and other business activities or retirement, which may undermine TTS in the eyes of the IRS.
- The IRS tends to think trading is a secondary activity, and it may seek to deny TTS.
- It's best to form a new, separate entity dedicated to trading only.

# Trading is not a hobby loss

- Several years ago, we spoke with one IRS agent who argued the trader did not make a living since he had perennial trading losses.
- That's okay because the rule speaks to intention, not the actual results. The hobby-loss rules don't apply to TTS traders because trading is not recreational or personal in nature.
- Part-time traders often tell me they operate a business to make a supplemental living and intend to leave their job to trade full-time when they become profitable enough.

# Operations

- Has significant business equipment, education, business services, and a home office.
- Most business traders have multiple monitors, computers, mobile devices, cloud services, trading services and subscriptions, education expenses, high-speed broadband, wireless, and a home office and/or outside office. Some have staff.
- The IRS needs to see that a taxpayer claiming TTS has a serious trading business operation.

# Home office

- How can one run a business without a dedicated space? Casual investors rarely have as elaborate an office set up as business traders do. Why would a long-term investor need multiple monitors?
- If a trader uses a home-office space exclusively for business rather than personal use, the tax return should reflect this because it is not only a valid home-office deduction, but it also further supports the fact there is legitimate business activity being conducted.
- The home-office deduction is no longer a red flag with the IRS, and it is not a complicated calculation. Some TTS traders just use a laptop and that's okay.

# Account size

- Securities traders need to have \$25,000 on deposit with a U.S.-based broker to achieve “pattern day trader” (PDT) status. With this status, he or she can day trade using up to 4:1 margin rather than 2:1.
- Without PDT status, securities traders, which include equities and equity options, will have a harder time qualifying for TTS.
- We like to see more than \$15,000 account size for trading futures, forex or cryptocurrency.

# Materiality counts

- Adequate account size also depends on one's overall net worth and cash flow.
- Millionaires may need larger account sizes, whereas some unemployed traders without much cash flow or very young traders may get by with lower account sizes.
- A trader may also be able to factor in capital invested in equipment and startup costs.

# WHAT DOESN'T QUALIFY FOR TTS

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# What doesn't qualify for TTS

- Four types of trading activity aren't counted for TTS qualification:
  - Automated trading systems without much involvement by the trader (but a trader creating his or her own program qualifies);
  - a trade copying software or service;
  - engaging a professional outside investment manager;
  - and trading in retirement funds.
- These trades should not be included in the golden rule calculations.

# Outside-developed automated trading systems

- These programs are becoming more popular. An entirely canned automated trading service (ATS) with little to no involvement by the trader doesn't qualify for TTS.
- The IRS may view an outside-developed ATS the same as a trader who uses a broker to make most buy/sell decisions and executions.

## ATS creation by the trader

- If the trader can show he's very involved with the creation of the ATS — perhaps by writing the code or algorithms, setting the entry and exit signals, and turning over only execution to the program — the IRS may count the ATS-generated trades in the TTS analysis.
- Some traders don't have programming experience, but they have financial and trading experience. They design the ATS to do what they do manually and hire an outside programmer to translate their specifications into a computer language.

## ATS: Other issues

- It's helpful if the trader can show he spends more than four hours per day working in his trading business, including time for ATS maintenance, back-testing, and modifications.
- We have not yet seen the IRS challenge ATS for TTS in exams or court cases, but we feel it may react this way when it comes up.
- Self-creation of the ATS needs to be significant to count for TTS. Just making a few choices among options offered in an outside-developed ATS building-block service does not qualify for TTS.

# ATS expenses

- If traders spend a lot of money on an ATS that doesn't qualify as part of their trading business, then those expenses are suspended investment expenses.
- Traders need to know the IRS may connect the dots and realize they are using an ATS. A full-scale exam can uncover these facts.
- Consider the analogy of an airplane pilot using manual and automated systems. A trader needs to be a pilot in the cockpit, not in the cabin as a passenger.

# Trade copying software or service

- Some traders use trade copying software or service (TCS). Trade copying is similar to using a canned ATS or outside adviser, where the copycat trader might not qualify for TTS on those trades.
- As an example, a trade coaching and education company offer a TCS that suggests several trades each day, with exact entry and exit points and stop-loss orders.
- The trader decides which trades to make and executes them manually.

## When TCS counts towards TTS

- If the trader follows the TCS tightly and does not significantly depart from its suggestions, then an IRS agent might feel that he or she does not qualify for TTS.
- On the other hand, if the trader cherry picks a minor percentage of the suggested trades, sets different stop-loss orders, and waits longer on entry and exit executions, then he or she might qualify for TTS (providing all the TTS factors are met).

# Engaging a money manager

- Hiring a registered investment adviser (RIA) or commodity trading adviser (CTA) — whether they are duly registered or exempt from registration — to trade one's account doesn't count toward TTS qualification.
- However, hiring an employee or independent contractor under the trader's supervision to help trade his or her own funds should qualify providing the taxpayer is a competent trader.
- There are decades-old tax court cases that show using outside brokers and investment advisers to make trading decisions undermines TTS.

# Engaging an assistant trader

- When a trader sets up an LLC, there are nuances between engaging an independent outside manager vs. a supervised inside trader.
- If the engaged trader is a registered investment adviser, he's clearly in the business of being an external manager, and TTS is not achievable.
- But if the trader only trades inside the LLC under the trader's direction, it may be possible to achieve TTS.

# Spousal brokerage accounts

- With married couples, if spouse A has an individual brokerage account in his or her name only and gives power of attorney to spouse B to trade it, the IRS won't grant TTS even if spouse B meets all the golden rules for TTS.
- Spouse B is not deemed an owner of the account. In this case, the IRS will treat spouse A as an investor and spouse B as an investment manager.
- Married couples can solve this problem by using a joint individual account or trading in a spousal-owned entity. It's best to list the trader spouse first on a joint individual account.

# Trading retirement funds

- TTS is achieved through trading taxable accounts.
- Trading activity in non-taxable retirement accounts doesn't count for purposes of TTS qualification.
- Trading in retirement plans can be an excellent way to build tax-free compounded returns, especially if the taxpayer doesn't qualify for TTS in their taxable accounts.

# Trading retirement and taxable accounts

- It is possible to trade retirement accounts and, at the same time, qualify for TTS in taxable accounts.
- Caution: it's dangerous to trade substantially identical positions between an individual taxable account and IRA accounts since this can trigger a permanent wash-sale (WS) loss in a taxable account that moves into the IRA.
- Avoid permanent WS losses in IRAS with a Section 475 election on the taxable account or use a Do Not Trade List to avoid overlap.

# SOLE PROPRIETORSHIP

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# 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 expenses are an above-the-line deduction from gross income.
- TTS Schedule C expenses reduce self-employment income (SEI).

# No election or filing need for TTS

- 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.

# BUSINESS EXPENSES

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# 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.

# SECTION 475 ELECTION

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# Section 475 tax benefits

- TTS traders are entitled to make a Section 475 election, but investors may not.
- 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.
- Ordinary loss treatment is better; it can generate tax refunds faster than capital loss carryovers.
- Benefits on 475 income: 20% QBI deduction if under the taxable income threshold for a service business.

## Section 475 election for 2020

- The deadline for an individual TTS trader to elect Section 475 for 2020 has passed; it was July 15, 2020, the postponed CARES Act 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 after July 15, 2020.
- It's also too late to select 475 for 2019, the election deadline was April 15, 2019.

# QUALIFIED BUSINESS INCOME DEDUCTION

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# 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.

# LLC TAXED AS AN S-CORP

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# S-Corp election

- Organize a single-member or spousal-member LLC and elect S-Corp status with the IRS within 75 days of inception.
- Alternatively, in a subsequent year, the LLC can submit an S-Corp election by March 15.
- Owners must be U.S. residents.
- The S-Corp can elect Section 475 internally within 75 days of inception.

# Health insurance premiums

- TTS traders with significant health insurance (HI) premiums should consider an S-Corp to arrange a tax deduction through officer compensation.
- The trader or spouse might have another source of self-employment income to deduct HI. A spouse might have HI coverage for the family in their job.
- Cobra is not deductible HI since it's employer-provided.
- A TTS sole proprietor or partnership cannot deduct HI based on trading income.

# Officer compensation for employee benefits

- Traders need earned income to make and deduct retirement plan contributions and health insurance; however, trading income is unearned.
- TTS sole proprietors and partnerships cannot create earned income, whereas S-Corps can pay officer compensation, generating earned income.
- Payroll taxes apply on officer compensation (wages): 12.4% FICA capped on salaries up to \$137,700 for 2020, and the 2.9% Medicare is unlimited.

# Year-end payroll

- TTS traders 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.
- Contribute the elective deferral to a Solo 401(k) Roth or traditional account.

## 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).

# LLC TAXED AS A PARTNERSHIP

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# LLC taxed as a partnership

- A TTS trader can organize a spousal-member LLC and file as a partnership.
- LLC/partnerships file a Form 1065 partnership tax return and issue Schedule K-1s to owners.
- LLC/partnerships must qualify for TTS; otherwise, they are investment companies.
- A partnership is useful for ring-fencing TTS/475 trading from individual taxable, and IRA accounts for avoiding wash sale losses and the IRS reclassifying investment positions.

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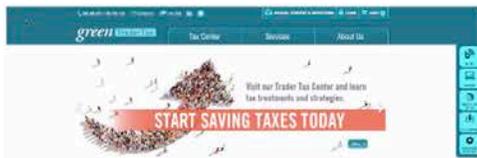
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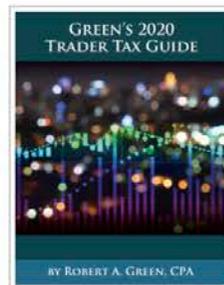
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