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present:

Tips For Traders On Preparing 2020 Tax Returns

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TIPS FOR TRADERS ON PREPARING 2020 TAX RETURNS

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for 60 minutes
(Interactive Brokers)

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Description

- There are new and revised 2020 tax forms and tax preparation strategies based on implementing the 2017 Tax Cuts and Jobs Act and the 2020 CARES Act.

- Learn how TTS traders should prepare a 2020 tax return as a sole proprietor individual, partnership, or an S-Corp.

- Learn how traders, eligible for trader tax status (TTS), maximize business, home office, and startup expenses using critical tax-reporting strategies.

Description

- Make vital 2021 tax elections on time like Section 475.
- 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 2020 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, 2021.

TRADER TAX RETURN REPORTING STRATEGIES

Traders use various tax forms

- The IRS hasn't created specialized tax forms for individual trading businesses.
- Traders enter gains and losses, portfolio income, and business expenses on various forms.
- It's often confusing. Which form should be used if the taxpayer is a forex trader? Which form is correct for securities traders using the Section 475 MTM method? Can one report trading gains directly on a Schedule C? The different reporting strategies for the various types of traders make tax time not so cut-and-dry.

SOLE PROPRIETOR TRADING BUSINESS

Trader tax status

- Trader tax status (TTS) constitutes business expense treatment and unlocks an assortment of meaningful tax benefits for active traders who qualify.
- The first step is to determine eligibility.
- If you do qualify for TTS, you can claim some tax breaks such as business expense treatment after the fact and elect and set up other breaks — like Section 475 MTM and employee-benefit plans — on a timely basis.
- See Tax Center - Trader Tax Status: How To Qualify.

TTS expenses on Schedule C

- Other sole-proprietorship businesses report revenue, cost of goods sold, and expenses on Schedule C.
- But business traders qualifying for trader tax status (TTS) report only trading business expenses on Schedule C.
- Trading gains and losses are reported on various forms, depending on the situation.
- In an entity, all trading gains, losses, and business expenses are consolidated on the entity tax return — a partnership Form 1065 or S-Corp Form 1120-S. That’s one reason why we recommend entities for TTS traders.

Sales of securities on Form 8949

- Sales of securities must be first reported on Form 8949, which then feeds into Schedule D (cash method) with capital losses limited to $3,000 per year against ordinary income (the rest is a capital loss carryover).
- Capital losses are unlimited against capital gains.
- Some brokers provide Form 8949 in addition to Form 1099-Bs.
- Consider using trade accounting software to calculate wash sale loss adjustments.
- See Tax Center: Form 8949 & 1099-B Issues.

Section 475 trades on Form 4797

- Business traders who elect and use Section 475 MTM on securities report their business trades (line by line) on Form 4797 Part II. MTM means open business trades are marked-to-market at year-end based on year-end prices.

- Form 4797 Part II (ordinary gain or loss) has business ordinary loss treatment and avoids the capital loss limitation and wash-sale loss treatment. Form 4797 losses are counted in net operating loss (NOL) calculations.

- Consider using trade accounting software to generate Form 4797. Without wash sale losses, you'll be departing from the 1099-B.

- See Tax Center: Section 475 MTM Accounting.

Section 1256 contracts on Form 6781

- Section 1256 contract traders (i.e., futures) should use Form 6781 (unless they elected Section 475 for commodities/futures; in that case, Form 4797 is used).

- Section 1256 traders rely on a one-page Form 1099-B showing their net trading gain or loss ("aggregate profit or loss on contracts"). Simply enter that amount in summary form on Form 6781 Part I.

- Section 1256 contracts have lower 60/40 capital gains tax rates: 60% (including day trades) subject to lower long-term capital gains rates, and 40% taxed as short-term capital gains using the ordinary rate. At the maximum tax bracket for 2020 and 2021, the blended 60/40 rate is 26.8% — 10.2% lower than the highest ordinary bracket of 37%.

Section 1256 loss carryback election

- If the trader has a large Section 1256 loss, he should consider carrying back those losses three tax years, but only applied against Section 1256 gains in those years. To obtain this election, check box D labeled “Net section 1256 contracts loss election” on the top of Form 6781.

- See Tax Center: Section 1256 Contracts with a table showing Section 1256 tax rates vs. ordinary rates (2020 rates) throughout the tax brackets.

Forex trades ordinary vs. capital gains

- Forex traders with Section 988 ordinary gains or losses who don't qualify for TTS should use line 8 (other income or loss) on 2020 Schedule 1 (Form 1040).

- TTS traders should use 2020 Form 4797, Part II ordinary gain or loss. What's the difference? Form 4797 Part II losses contribute to NOL carryforwards against any type of income, whereas Form 1040's "other losses" do not.

- The latter can be wasted if the taxpayer has negative income. In that case, a contemporaneous capital gains election is better on the Section 988 trades. If the taxpayer filed the contemporaneous Section 988 opt-out (capital gains) election, she should use Form 8949 for minor currencies and Form 6781 for major currencies. Forex uses summary reporting.

- See Tax Center: Forex.

DEDUCT BUSINESS EXPENSES, START-UP & HOME OFFICE EXPENSES

See Tax Center: Trading Business Expenses.

TTS business expenses on Schedule C

- “Tangible personal property” up to $2,500 per item for equipment and furniture.
- Section 179 (100%) depreciation on fixed assets. 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

- Subscriptions, scanners, 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.

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.

SCHEDULE C ISSUES

Make Schedule C look better

- Sole-proprietor business traders report business expenses on Schedule C and trading income/loss and portfolio-related income on other tax forms, which may confuse the IRS.
- It may automatically view a trading business's Schedule C as unprofitable even if it has significant net trading gains on other forms and is profitable after expenses.
- To mitigate this red flag, we advocate a special strategy to transfer a portion of business trading gains to Schedule C to "zero it out" if possible.

Transfer some business trading gains

- In some cases, a good strategy for sole proprietorship business traders is to transfer some business trading gains to Schedule C, using the “Other Income” line, to zero the expenses out, but not show a net profit.
- Showing a profit could cause the IRS to inquire about self-employment (SE) tax, from which trading gains are exempt.
- (Traders who are full members of a futures or options exchange are an exception here; they have self-employment income under Section 1402(i) on their exchange-generated trading gains reported on Form 6781.)

The transfer unlocks expenses

- This special income-transfer strategy can also unlock the home-office deduction and Section 179 (100%) depreciation deduction, both of which require income.
- While Section 179 depreciation can look to wage income outside the business, the bulk of home-office deductions can only look to business income.
- This transfer strategy isn't included on tax forms or form instructions. It's our suggested practice designed to deal with insufficient tax forms for sole-proprietorship trading businesses, and it must be carefully explained in tax-return footnotes.

An alternative strategy

- Report gains from trading (from Form 4797, Form 8949, and Form 6781) on Line 8 of the home-office Form 8829.

- It’s an alternative way to provide the necessary income required to generate a home office deduction, but it doesn’t fix the red flag of a Schedule C loss, as with the income-transfer strategy.

INCLUDE FOOTNOTES

Include tax return footnotes

- We recommend that business traders include well-written tax-return footnotes, explaining trader tax law and benefits, why and how they qualify for TTS, whether they elected Section 475 MTM or opted out of Section 988, and other tax treatment, such as the income-transfer strategy.

- If the taxpayer is a part-time trader, she needs to use the footnotes to explain how she allocates time between other activities and trading.

- Footnotes help address any questions the IRS may have about TTS qualification and the various aspects of reporting on the return before it has a chance to ask the taxpayer.

ENTITY TAX RETURNS

Entity tax returns

- Partnership and S-Corp trading business tax returns show trading gains, losses, and business expenses on one set of forms, plus the IRS won't see the taxpayer's other activities on the same return as the trading activity. That looks better.

- Form 1065 is filed for a general partnership or multi-member LLC choosing to be taxed as a partnership.

- Form 1120S is filed for an S-corporation.

Partnerships and S-Corps

- Forms 1065 and 1120S issue Schedule K-1s to the owners, so taxes are paid at the owner level rather than at entity level, thereby avoiding double taxation. (There are minor taxes for S-Corps in some states.)

- Ordinary income or loss (mostly business expenses) is summarized on Form 1040 Schedule E rather than in detail on Schedule C (hence less IRS attention).

- Section 179 is broken out separately on Schedule E, along with unreimbursed partnership expenses (UPE) including home-office expenses.

Schedule K-1 pass-through

- Portfolio income (interest and dividends) is stated separately on the partnership or S-Corp Schedule K-1s and passed through to the individual owner's Schedule B.

- Capital gains and losses are passed through to Schedule D in summary form. A pass-through entity draws less IRS attention than a detailed Schedule C filing. Net taxes don't change; they're still paid on the individual level.

- Pass-through entities file Form 8949 and/or Form 4797 at the entity level. Schedule K-1 line one "ordinary business income (loss)" consolidates Form 4797 ordinary income or loss with business expenses, and it's a net income amount if trading gains exceed business expenses. That looks better than a sole proprietor trader.

TTS is not a passive-activity loss

- Under the “trading rule” exception in Section 469 passive-activity loss rules, trading business entities are considered “active” rather than “passive-loss” activities, so losses are allowed in full on Form 1040 Schedule E in the non-passive income column.

S-Corp employee benefits

- TTS S-Corps provide opportunities for deducting retirement plan contributions and health-insurance premiums; two breaks sole-proprietor traders and partnership traders can't use unless they have earned income.

- The S-Corp had to execute employee benefits before year-end, including payroll for health insurance reimbursement and the Solo 401k retirement plan arrangements.

QBI on Schedule K-1s

- Per TCJA, the 2020 partnership and S-Corp Schedule K-1s report QBI (Section 199A) income, wages, and property factors, and whether the business is a specified service trade or business (SSTB) or not.

- A sole proprietor using Section 475 is also eligible for the QBI deduction. Look to TTS trading gains on Form 4797 Part II less Schedule C expenses.

TAX TREATMENT ELECTIONS

Tax treatment elections

- Tax treatment elections can be confusing because the Section 475 MTM and Section 988 elections don’t have tax forms.

- New taxpayers — such as a new entity — file Section 475 MTM elections internally within 75 days of inception, but existing taxpayers file an election statement by the due date of the prior year tax return or extension with the IRS and perfect it later with a Form 3115 filing by the tax return deadline.

- Forex capital gains elections are only filed internally on a contemporaneous basis.

SECTION 475

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

Tax losses with Section 475 MTM accounting

- Only TTS traders can elect and use Section 475, not investors.
- Section 475 trades are exempt from wash sale loss adjustments on securities, leading to phantom income.
- Section 475 ordinary losses are also not subject to the $3,000 capital loss limitation against ordinary income.
- Section 475 ordinary business losses and TTS expenses contribute to net operating losses (NOLs).

Excess business losses and net operating losses

- TCJA introduced an "excess business loss" limitation: $500,000 married and $250,000 other taxpayers for 2018, and it's indexed for inflation each year. Losses exceeding the EBL limitation are an NOL carryforward.
- TCJA suspended NOL carrybacks, allowing NOL carryforwards with 80% limits against subsequent year's taxable income. The rest carries forward indefinitely.
- The 2020 CARES Act provided temporary tax relief: It suspended TCJA's EBL rules for 2018 through 2020 and allowed five-year NOL carrybacks for 2018, 2019, and 2020. TCJA EBL and NOL rules apply again in 2021.

Profitable traders 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 includes Section 475 income less TTS expenses. However, QBI excludes capital gains and other portfolio income.
- See Tax Center: TCJA QBI deduction.

QBI deduction on Form 8995

- TTS traders with Section 475 income might have a 20% qualified business income (QBI) deduction reported on Form 8995 or Form 8995-A.
- 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 $426,600/$213,300 (married/other taxpayers) for 2020, and $429,800/$214,900 (married/other taxpayers) for 2021. The phase-out range below the cap is $100,000/$50,000 (married/other taxpayers). The W-2 wage and property basis limitations also apply within the phase-out range.

Section 475 election procedures

- Existing taxpayer individuals that qualify for TTS and want Section 475 must file a 2021 Section 475 election statement with their 2020 tax return or extension due by April 15, 2021. (It's now too late to elect 475 for 2020.)
- Existing partnerships and S-Corps file an election statement in the same manner by March 15, 2021.
- "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 2020 due by July 15, 2020, then complete the process with a Form 3115 included with your 2020 tax return.

FILING AS AN INVESTOR

Capital gains and suspended investment expenses

- If a taxpayer is filing as an investor, he should report trading gains and losses as explained earlier (Form 8949 for securities and Form 6781 for 1256 contracts).

- The taxpayer can't use Section 475 MTM with Form 4797 ordinary gain or loss treatment, as that election requires TTS.

- Investment interest expense (margin interest) is reported on Form 4952. It's limited to net investment income. The excess is a carryover to the subsequent tax year(s). The deduction is taken on Schedule A as an itemized deduction. It's also deductible on Form 8960 for net investment tax.

TAX EXTENSIONS AND TAX PAYMENTS DUE

Tax extensions with payments

- The 2020 income tax returns for individuals are due by April 15, 2021 — however, most active traders aren't ready to file a complete tax return by then.

- Some brokers issue corrected 1099-Bs right up to the deadline, or even beyond. Many partnerships and S-Corps file extensions by March 15, 2021, and don't issue final Schedule K-1s to investors until after April 15.

- The good news is traders don't have to rush completion of their tax returns by April 15.

- Consider a one-page automatic extension along with payment of taxes owed to the IRS and state.

Not an extension of time to pay

- Traders can request an automatic six-month extension to file individual federal and state income tax returns up until Oct. 15, 2021.
- The 2020 Form 4868 instructions point out how easy it is to get this automatic extension — no reason is required.
- It’s an extension of time to file a complete tax return, not an extension of time to pay taxes owed.
- The taxpayer should estimate and report what he thinks he owes for 2020 based on the tax information he received.

Tips for filing an extension

- We suggest taxpayers learn how the IRS and states assess late-filing and late-payment penalties so they can avoid or reduce them.
- If a taxpayer cannot pay the taxes owed, he should at least estimate the balance due by April 15 and report it on the extension.
- Be sure to at least file the automatic extension on time to avoid the late-filing penalties, which are much higher than the late-payment penalty.
- See the 2020 Form 4868 page two for an explanation of how these penalties are calculated. Tax Extensions: 12 Tips To Save You Money.

Set aside taxes due April 15, 2021

- Many traders made massive trading gains in 2020 with an explosion of new pandemic-fueled traders and market volatility.

- Some used the estimated tax payment “safe harbor” exception to cover their 2019 tax liability with a Q4 2020 estimated tax payment made by Jan. 15, 2020. They plan to pay the balance of taxes owed by April 15, 2020.

- They should consider setting aside and protecting those tax payments due April 15, 2021.

- Some will risk those tax payments in the markets, and they should be careful not to lose it because that will cause them significant tax trouble later in the year. See Traders Should Focus On Q4 Estimated Taxes Due January 15.

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 Tax Center: Wash Sale Losses.

How to prevent wash sale losses

- "Break the chain" on WS losses at year-end 2021 in taxable accounts to avoid WS loss deferral to 2022. If you sell X equity on Dec. 20, 2021, at a loss, don't repurchase X equity or X equity options until Jan. 21, 2022, avoiding the 30-day window for triggering a WS loss.
- Elect Section 475 MTM for 2021 with TTS. (It's too late for 2020).
- 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 ETN PFCs 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.

- See Tax Center: ETFs.

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.

- Some traders use TTS and 475 when they should not.

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.

Net investment 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.
- See Tax Center: Net Investment Tax

TAX CUTS AND JOBS ACT

Tax Cuts and Jobs Act

- The 2017 Tax Cuts and Jobs Act (TCJA) impacts investors, traders, and individuals positively and negatively, beginning in the tax year 2018.
- TCJA suspended investment fees and investment expenses, unreimbursed employee business expenses (job expenses), and tax compliance fees for non-business taxpayers. Investment interest expenses retained.
- 20% QBI deduction. Traders with 475 income are eligible.
- Excess business loss limitation and suspended NOL carrybacks.
- Lower tax rates, and higher standard deduction.
- See Tax Center: Tax Cuts and Jobs Act.

CARES ACT

CARES Act

- The Coronavirus Aid, Relief, and Economic Security (CARES) Act was passed by Congress and signed into law on March 27, 2020.

- CARES temporarily affected 2018, 2019, and 2020 taxes by overriding elements of the 2017 Tax Cuts and Jobs Act (TCJA). For example, CARES provided five-year NOL carryback refund claims, whereas TCJA allowed NOL carryforwards only. CARES also waived TCJA's excess business limitation. These changes are temporary; TCJA applies again in 2021.

- See Tax Center: CARES Act

Retirement plan distributions

- Taxpayers negatively impacted by Covid-19 could take a withdrawal from an IRA or qualified retirement plan of up to a maximum of $100,000 in 2020 and be exempt from the 10% excise tax on “early withdrawals.”
- The taxpayer has the option of returning (rolling over) the funds within three years or paying income taxes on the 2020 distribution over three years.
- CARES also suspended required minimum distributions (RMD) for 2020.
- (See this May 4, 2020 update on the IRS Website, https://tinyurl.com/coronavirus-tax-qa.)

VIRTUAL CURRENCY

Capital gains and losses on cryptocurrencies

- Selling, exchanging, or using cryptocurrency triggers capital gains and losses for traders. The IRS treats cryptocurrencies as intangible property. The realization method applies to short-term vs. long-term capital gains and losses. The default accounting method is FIFO.

- Traders who invested in cryptocurrencies and sold, exchanged, or spent some during the year, have to report a capital gain or loss on each transaction. This includes cryptocurrency-to-currency sales, crypto-to-alt-crypto trades, and purchases of goods or services using crypto.

- See Tax Center: Cryptocurrencies

Question about virtual currency on Form 1040

- The 2020 Form 1040 page one lists the following question up top.
- ”At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?” Yes or No.

Form 1040 instructions

- The final version of the 1040 instructions has revised the list of virtual currency transactions. The final 1040 instructions read:
- "A transaction involving virtual currency includes, but is not limited to:
  - The receipt or transfer of virtual currency for free (without providing any consideration), including from an airdrop or hard fork;
  - An exchange of virtual currency for goods or services;
  - A sale of virtual currency;
  - An exchange of virtual currency for other property, including for another virtual currency; and
  - A disposition of a financial interest in virtual currency."

QUESTIONS AND ANSWERS

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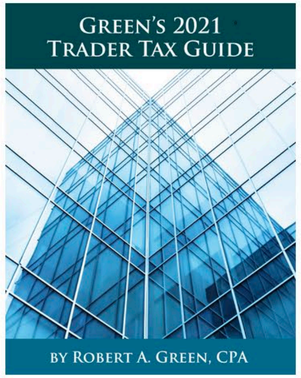

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