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Green Trader Tax

Tips for Traders on Preparing 2021 Tax Returns

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TIPS FOR TRADERS ON PREPARING 2021 TAX RETURNS

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for 60 minutes
(Interactive Brokers)

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Description

- Join Robert A. Green, CPA, from GreenTraderTax.com, for insights and information to help traders file their 2021 federal tax returns timely and accurately in 2022.

- Mr. Green interviews Darren L. Neuschwander, CPA, head of tax compliance services for Green, Neuschwander & Manning, LLC.

- Learn how traders, eligible for trader tax status (TTS), maximize business expenses, make vital tax elections, and utilize pass-through entities for further tax benefits, including health insurance, retirement plans, QBI, EBL, NOL, and SALT deductions.

Description

- Learn all the various tax forms to use for multiple types of financial products, dealing with wash sales, and other accounting methods.
- Learn tips for filing tax extensions and paying taxes on time to avoid penalties.
- Learn common errors on TTS traders' tax returns, leading to an IRS or state exam.
- Learn how new tax legislation impacts 2021 tax filings for traders.

DARREN NEUSCHWANDER CPA

Mr. Green interviews Darren L. Neuschwander, CPA.

Darren L. Neuschwander, CPA

- Managing Member
- Green, Neuschwander & Manning, LLC

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.

Sole proprietor traders

- Most 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 (realization method)

- 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.

Wash sale losses on securities

- Wash sale losses (WS) on securities confuse taxpayers, and traders have many WS.
- Repurchasing losing trades from December in January 2022 can trigger WS losses at year-end 2021.
- WS rules for brokers differ from WS rules for taxpayers, leading to further confusion.

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.

Sales of securities (MTM method)

- 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.

- Business traders still report sales of segregated investments in securities (without MTM) on Form 8949.

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

Sales of futures contracts

- 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 don’t use Form 8949 — they 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.

Carryback election for futures losses

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

Forex traders

- Forex traders with Section 988 ordinary gains or losses who don’t qualify for TTS should use line 8(z) (other income or loss) on 2021 Schedule 1 (Form 1040).
- TTS traders should use 2021 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.

Forex traders

- 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.

Business expenses on Schedule C

- 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.
- Because of this, the IRS 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. This is one reason why we recommend an entity.

Transfer strategy

- 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.)

Transfer strategy

- 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. It also has the effect of allowing Schedule C losses in states like New Jersey that don't allow losses.

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

- 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.

BUSINESS EXPENSES

Business deductions include:

- Tangible personal property like a computer, up to $2,500 per item, providing the taxpayer files a Sec. 1.263(a)-1(f)) safe harbor election with the tax return.
- Section 179 (100%), 100% bonus, and/or regular depreciation on computers, equipment, furniture, and fixtures (over $2,500 per item).
- Amortization of startup costs (Section 195), organization costs (Section 248), and software.
- Education expenses paid and courses taken after commencement of the trading business activity.
- Section 195 startup costs may include education expenses within six months of beginning TTS.

Business deductions include:

- Books/publications, market data, charting services, online and professional services, cloud services, chat rooms, mentors, coaches, supplies, phone, internet, travel, meals, seminars, conferences, assistants, consultants, office rent, and more.
- Home-office expenses for the business use portion of a trader's home (share of rent, mortgage interest, real estate tax, depreciation on home, utilities, repairs, insurance, and all other home costs).
- Margin interest expenses (not limited to investment income).
- Interest expense on trading capital
- Stock-borrow fees and other costs for short sellers.
- Self-created software for automated trading systems.

Business deductions don’t include

- Vehicles
- Commissions, which are part of trading gain or loss.
- Employee-benefit plan deductions (TTS S-Corps can arrange health insurance and retirement plan contributions in connection with officer compensation)

SEPARATE ENTITIES ARE BETTER

Pass-through entities

- 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.

Pass-through entities

- Form 1065 is filed for a general partnership or multi-member LLC choosing to be taxed as a partnership. Form 1120-S is filed for an S-corporation.

- Forms 1065 and 1120-S issue Schedule K-1s to the owners, so taxes are paid at the owner level rather than at entity level, thereby avoiding double taxation.

- 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.

Trading rule

- 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.

Schedule K-1s

- 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.

More on Schedule K-1s

- 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.

S-Corp health insurance and retirement 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.

QBI on Schedule K-1s

- Per TCJA, the 2021 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).

- 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.

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.
- 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 included an "excess business loss" (EBL) limitation of $500,000/$250,000 (married/other taxpayers) for 2018.
- The inflation-adjusted limit is $524,000/$262,000 (married/other taxpayers) for 2021, and $540,000/$270,000 (married/other taxpayers) for 2022.
- EBL can be aggregated from all pass-through businesses: A profitable company can offset another business with losses to remain under the limit. Wage income is included, too. Other types of income and non-business losses do not affect the EBL calculation (i.e., capital gains and losses).
- EBL over the limit is a NOL carryforward.

TCJA's EBL and NOL rules apply for 2021

- The CARES Act suspended TCJA's EBL rules for 2018, 2019, and 2020. The TCJA EBL rules return in 2021 through 2025 when TCJA changes expire.
- EBL is applied at the partner or shareholder's level. The provision kicks in after implementing the passive loss rules, which don't apply to a trading company or hedge fund.

QBI deduction

- The 2017 TCJA introduced a new tax deduction for pass-through businesses, including sole proprietors, partnerships, and S-Corps. Subject to haircuts and limitations, a pass-through business could be eligible for a 20% deduction on qualified business income (QBI).
- Traders eligible for TTS are a “specified service activity,” which means if their taxable income is above an income threshold, they won’t receive a QBI deduction.
- The taxable income (TI) threshold is $329,800/$164,900 (married/other taxpayers) for 2021 and $340,100/$170,050 (married/other taxpayers) for 2022. The IRS adjusts the threshold for inflation each year.

QBI deduction

- There is also a phase-out range above the threshold, which is $100,000/$50,000 (married/other taxpayers).
- The W-2 wages and property basis limitations apply within the phase-out range. TTS traders with an S-Corp usually have wages, whereas sole proprietor traders do not.
- QBI for traders includes Section 475 ordinary income and loss and trading business expenses. QBI excludes capital gains and losses, Section 988 forex ordinary income or loss, dividends, and interest income.
- QBI is reported on on Form 8995 or 8995-A.

Section 475 election procedures

- Existing taxpayer individuals that qualify for TTS and want Section 475 must file a 2022 Section 475 election statement with their 2021 tax return or extension due by April 18, 2021. (It's now too late to elect 475 for 2021.)

- Existing partnerships and S-Corps file an election statement in the same manner by March 15, 2022.

- "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 2021 due by May 17, 2021, then complete the process with a Form 3115 included with your 2021 tax return.

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.

- Section 988 capital gains elections are only filed internally on a contemporaneous basis.

FILING AS AN INVESTOR

Filing as an investor

- If a taxpayer is filing as an investor, he should report trading gains and losses as explained earlier.

- The taxpayer can't elect and 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.

SALT cap

- The TCJA SALT cap of $10,000 and suspension of all miscellaneous itemized deductions, including investment fees and expenses, means most investors will receive little to no tax reduction from investing related expenses paid.
- Many states limit or do not allow itemized deductions.
- Business expense treatment with TTS is much better.

TAX EXTENSIONS AND TAX PAYMENTS DUE

Tax extensions

- The 2021 income tax returns for individuals are due by April 18, 2022 — 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, 2022, and don't issue final Schedule K-1s to investors until after April 18.
- The good news is traders don't have to rush completion of their tax returns by April 18. They should take advantage of a simple one-page automatic extension along with payment of taxes owed to the IRS and state. Most active traders file extensions, and it's helpful to them on many fronts.

Pay taxes with extensions

- Traders can request an automatic six-month extension to file individual federal and state income tax returns up until Oct. 15, 2022.
- The 2021 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 2021 based on the tax information he received.

Avoid penalties

- 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 18 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 2021 Form 4868 page two for an explanation of how these penalties are calculated.

Protecting taxes owed

- Many traders made massive trading gains in 2021 with an explosion of new pandemic-fueled traders and market volatility.

- Some used the estimated tax payment "safe harbor" exception to cover their 2020 tax liability with a Q4 2021 estimated tax payment made by Jan. 15, 2022.

- They plan to pay the balance of taxes owed by April 18, 2022, and should consider setting aside and protecting those funds. Some will risk the funds they plan to use for tax payments in the markets. Taxpayers should be careful because losing the funds will cause them significant tax trouble later in the year. See Traders Should Focus On Q4 Estimated Taxes Due January 18.

SALT CAP WORKAROUND

SALT cap workaround laws

- Twenty-plus states enacted SALT cap workaround laws to deal with blowback from TCJA's SALT cap of $10,000 implemented in 2018.
- With the workaround, states entitle partnership and S-Corp business owners to make "pass-through entity payments" (PTEP) that can be treated as business expenses.
- The payment is accounted for as a "tax payment" on the individual state income tax return. The SALT cap workaround converts excess payments over the SALT cap into a business deduction from gross income.
- Most states require a timely election to make PTE payments. Many states begin this workaround in 2022, but some commenced it earlier.

SALT cap workaround laws

- Partnerships and S-Corps should make PTE payments due with state tax extensions filed by March 15.

- What used to be a simple pass-through entity extension process with no balance owing will now be more complicated.

- Some states require quarterly estimates, too.

- Learn the rules of your state.

- See our blog posts at https://greentradertax.com/category/salt/.

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 ACA 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: ACA Net Investment Income Tax and Form 8960.

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.

- 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 2021 Form 1040 page one lists the following question up top:
    - "At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency?"
- Current rules do not require FBAR reports to include foreign-held cryptocurrencies, although that might change soon.

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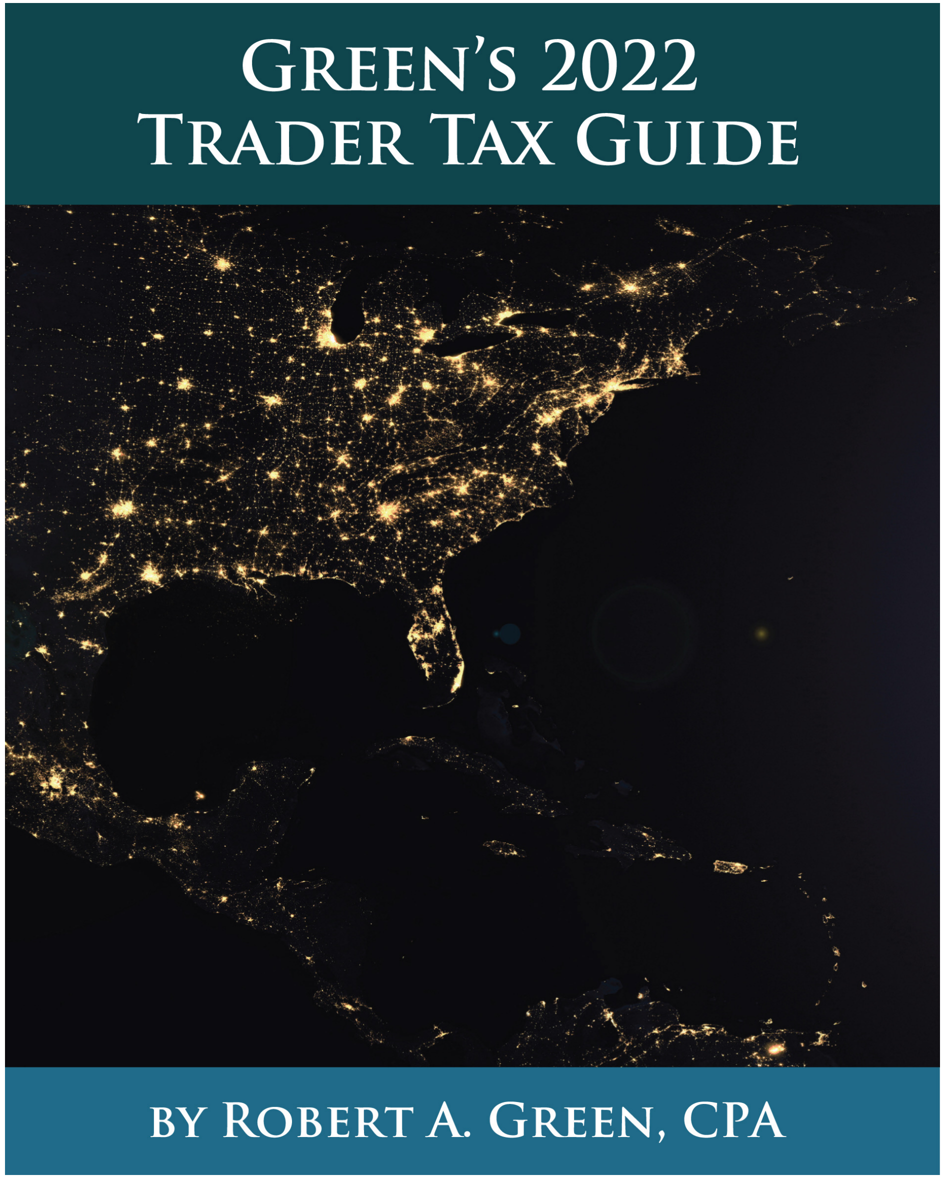

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