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Green Trader Tax

Tips for Traders on Preparing 2022 Tax Returns

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TIPS FOR TRADERS ON PREPARING 2022 TAX RETURNS

March 14, 2023, @ 12:00 pm ET
for 60 minutes
(Interactive Brokers)

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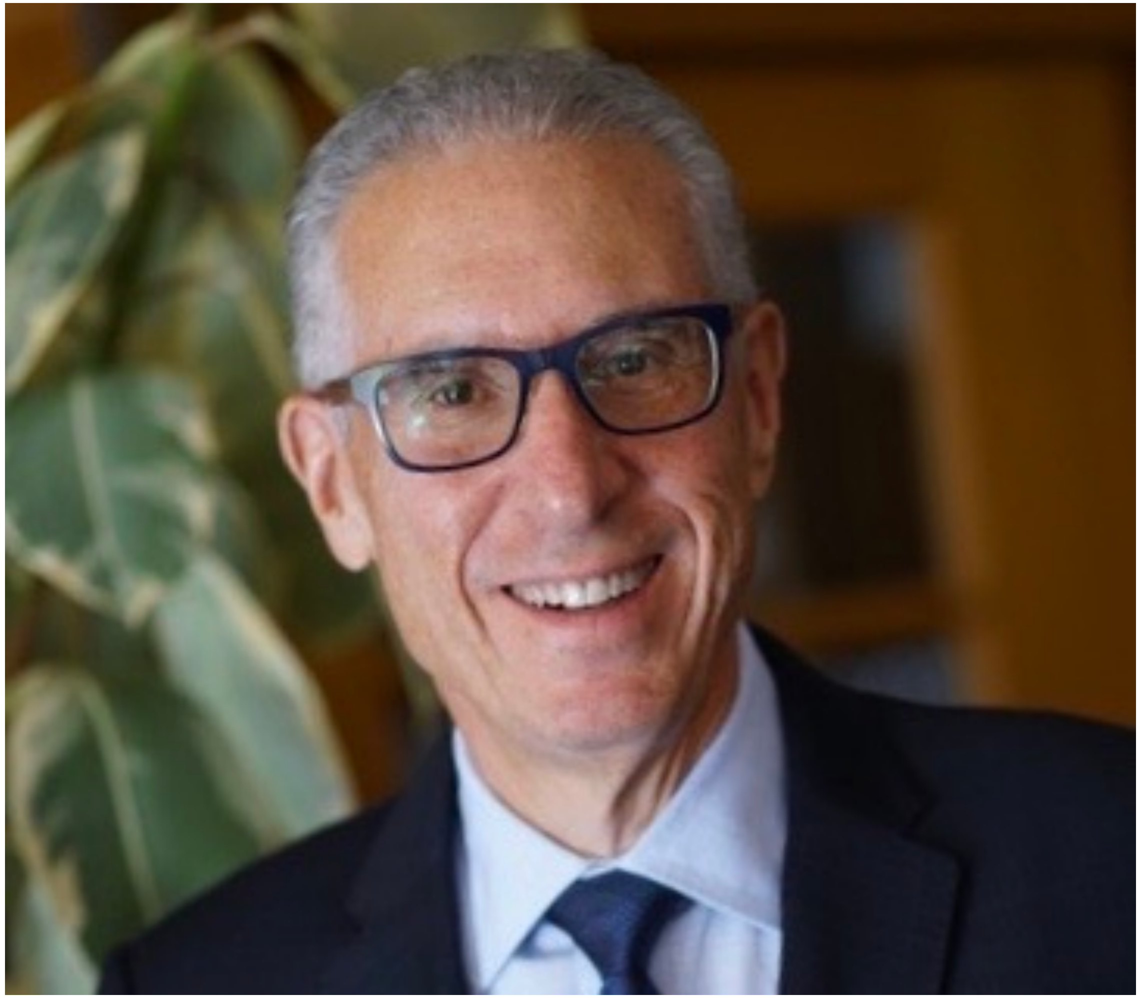

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Overview

- Join Robert A. Green, CPA, from GreenTraderTax.com, for insights and information to help traders file their 2022 federal tax returns timely and accurately in 2023.
- 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.
- Learn all the various tax forms for multiple types of financial products, 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.

TRADER TAX STATUS

Trader tax status is the ticket to tax savings

- Trader tax status (TTS) constitutes business expense treatment and unlocks meaningful tax benefits for active traders who qualify.

- The first step is to determine eligibility.

- If you qualify for TTS, you can claim some tax breaks, such as business expense treatment, after the fact and elect and set up other tax breaks — like Section 475 MTM and employee-benefit plans (health and retirement) — on a timely basis.

TTS versus Section 475 MTM accounting

- If you qualified for TTS in 2022, you could claim business expenses on Schedule C. No IRS election was required.
- Don’t confuse that with a Section 475 MTM accounting election that a TTS trader could have submitted by April 18, 2022, for the tax year 2022.
- The 475 election is like graduate school, and TTS is like undergraduate university; you need TTS to make and use a 475 election.
- Bottom line: It’s not too late to use TTS business expenses on your 2022 tax return, but it is too late to use Section 475 MTM to avoid wash sale losses.

HOW TO QUALIFY FOR TRADER TAX STATUS

How to qualify for TTS

- Volume: We recommend an average of four transactions per day, four days per week, 16 trades per week, 60 a month, and 720 per year on an annualized basis. Count each open and closing transaction separately, not round trip. Scaling in and out counts, too.

- Frequency: Execute trades on nearly four weekly days, around a 75% frequency rate.

- Holding period: The IRS said the average holding period must be 31 days or less. That's a bright-line test.

How to qualify for TTS

- Trades full-time or part-time for a good portion of the day; the markets are open almost daily. Part-time and money-losing traders face more IRS scrutiny, and individuals face more scrutiny than entity traders.

- Hours: Spends more than four hours daily, almost every market day, working on their trading business — all-time counts.

- Avoid sporadic lapses: A trader has few to no intermittent stoppages in the trading business during the year. Vacations are okay.

How to qualify for TTS

- Intention: Has the intention to run a business and make a living. It doesn't have to be your primary living.
- Operations: Has significant business equipment, education, business services, and a home office.
- 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.
- Trader Tax Status: How To Qualify.

TAX REPORTING FOR A SOLE PROPRIETOR TRADING BUSINESS

Multiple tax forms for traders

- The IRS uses multiple tax forms for trading businesses eligible for trader tax status (TTS).

- It can be confusing to taxpayers, accountants, and the IRS. Traders enter gains and losses, portfolio income, and business expenses in various tax forms.

- Which tax form or schedule should a forex trader use? It depends on their circumstances. Which form is correct for securities traders using the Section 475 MTM method? Can trading gains be reported directly on Schedule C? The different reporting strategies for the various types of traders make tax time not so cut and dry.

Schedules C for expenses only

- Most sole-proprietorship businesses report revenue, cost of goods sold, and expenses on Schedule C. The IRS can easily see if they are profitable; they cannot do so with sole proprietor traders.
- TTS traders qualifying for TTS report only trading business expenses on Schedule C.
- Trading gains and losses are reported in other tax forms, depending on the situation.
- If possible, it's helpful to include a tax return footnote tying the trader schedules together to show profitability. Entity tax returns do that.

Schedule D and Form 8949

- Sales of securities for each trade (no summary reporting) are reported on Form 8949, which feeds into Schedule D (cash method) with net 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.

- See IRS instructions for Form 8949 and Form 8949 for 2022 taxes.

  "Note: You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions)."

- Most traders have WS loss adjustments, so they must report each trade on Form 8949.

- See Securities and Form 8949 & 1099-B Issues. Cost-basis reporting has complicated tax compliance, and traders use trade accounting software for help.

Schedule 4797 for MTM accounting

- TTS traders who elected and used Section 475 MTM on securities report each securities trade on Form 4797 Part II. MTM means open securities trades are marked-to-market at year-end prices.
- Traders still report sales of segregated investments in securities (without MTM) on Form 8949 and Schedule D.
- Form 4797 Part II receives ordinary gain or loss treatment avoiding the capital loss limitation and wash-sale loss rules. (It's "tax loss insurance.")
- Profitable traders also can benefit from Section 475 using the qualified business income (QBI) deduction.

Section 475 election

- Existing taxpayers file a Section 475 election statement by the due date of the prior year's tax return or extension with the IRS and perfect it later with a Form 3115 (change in accounting method) filing by the tax return deadline, including extension.

- Learn about making a Section 481(a) adjustment to convert from the realization to the MTM method of accounting.

- A Section 475 election for 2022 was due by April 18, 2022. The next opportunity to elect 475 is for 2023, by April 18, 2023. Learn the nuances of making a 475 election here.

- "New taxpayers" (like a new entity) can elect Section 475 by internal resolution (not with the IRS) within 75 days of inception. New taxpayers don't file Form 3115 since they have adopted the 475 MTM accounting method.

Excess business losses and net operating losses

- The net Section 475 losses and TTS business expenses are subject to the excess business loss (EBL) limitation for the tax year 2022. You can aggregate EBL from all pass-through businesses.

- The inflation-adjusted 2022 EBL threshold is 540,000 (married)/$270,000 (other taxpayers).

- The amount over the EBL threshold is a net operating loss (NOL) carryforward.

  TCJA repealed net operating loss (NOL) carrybacks (except for farmers) and limited NOL carryforwards to 80% of the subsequent year's taxable income.

- See IRS Form 461.

Qualified business income (QBI) deduction

- There's also a tax benefit on net Section 475 gains: the 20% QBI deduction. In a simple scenario, on a QBI of $100,000, the owner can deduct $20,000. That's a tax deduction without spending any money.
- Trading is a "specified service trade or business" (SSTB), which means an income cap applies. If your taxable income is over that cap, there is no QBI deduction.
- QBI includes Section 475 ordinary income, less TTS expenses, and excludes capital gains, portfolio income, and forex trading income.

QBI thresholds

- Because TTS traders are considered a “specified service trade or business” (SSTB), taxable income above the following thresholds is not deductible: $340,100/$170,050 (married/other taxpayers) for 2022.
- There is also a phase-out range above the threshold of $100,000/$50,000 (married/other taxpayers).
- The W-2 Wage 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.
- See IRS Form 8995 and 8995-A.

Schedule 6781 for futures

- Section 1256 contract traders (i.e., futures) should use Form 6781 (unless they elected Section 475 for commodities/futures; those are reported on Form 4797). 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). That amount is entered in summary format on Form 6781 Part I.

- Section 1256 contracts enjoy 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 2022, the blended 60/40 rate is 26.8% — 10.2%, lower than the highest regular bracket of 37%.

- Most futures traders skip a Section 475 election to retain 60/40 capital gains rates.

- See Section 1256 Contracts.

Section 1256 loss carryback election

- If a trader or investor has a significant Section 1256 loss, they should consider carrying back the loss three tax years but only apply it 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 filed on a timely basis.

Cryptocurrencies

- For sales of cryptocurrencies, use Form 8949, but not wash sales or Section 475 MTM. See Cryptocurrencies.

- The IRS updated its question about digital assets on the 2022 Form 1040.

- Instead of asking about "virtual currency," for 2022 the question asks: "At any time during 2022, did you: (a) receive (as a reward, award or payment for property or services); or (b) sell, exchange, gift or otherwise dispose of a digital asset (or a financial interest in a digital asset)?" (IR 2023-12, 1/24/2023).

Cryptocurrencies: recent bankruptcies

- The IRS is considering issuing broader guidance and tax relief for crypto investors “if the crypto is no longer traded on an exchange or the taxpayer is locked out of accessing the currency due to bankruptcy.”

- See Chief Counsel Memorandum (Number 202302011) and Crypto Investors Facing Losses Could Get IRS Guidance to Help (Bloomberg Law Feb. 10, 2023)

Tax treatment for financial products

- We cover U.S. and international equities, U.S. futures, and other Section 1256 contracts, options, ETFs, ETNs, forex, precious metals, foreign futures, cryptocurrencies, and swap contracts.

- It's important to distinguish between securities vs. Section 1256 contracts with lower 60/40 capital gains rates vs. other financial products such as forex or swaps with ordinary income or loss treatment. Various elections are available to change tax treatment.

- See Tax Treatment On Financial Products.

FORM 1099-B AND WASH SALE LOSS ADJUSTMENTS

Form 1099-B and wash sale loss adjustments

- Proceeds, minus cost basis, plus wash sale loss adjustments equal net trading gain or loss using the realization method.

- For example, the WS loss column could be $500,000, but most of that amount might be included in the cost basis column, so most wash sales are closed out. What matters is how much WS loss is open and deferred to the subsequent tax year.

- Buying back a losing December 2022 trade within 30 days into January 2023 triggers a 2022 WS loss added to the WS column on the 2022 Form 1099-B. The 2022 WS loss amount is removed from the 2022 cost basis column and is deferred to the 2023 cost basis. That reduces a December 2022 capital loss.

Form 1099-B and wash sale loss adjustments

- See our blog post, How To Avoid Phantom Income From Wash Sale Loss.
- A TTS trader using Section 475 MTM accounting avoids WS loss adjustments and the $3,000 capital loss limitation. It's okay to depart from the 1099-B.
- See 1099-B and instructions.
- Some brokers provide a Form 8949 worksheet, which can be imported into TurboTax.

Trade accounting using TradeLog

- We had recommended TradeLog (TL) every year since 2001, when we helped bring Section 475 MTM accounting to the program.
- Use TL to download your trade history from your broker's Website (not the 1099-B) and calculate WS according to IRS rules for taxpayers. TradeLog can also calculate WS according to IRS rules for brokers and should match broker 1099-Bs.
- TL generates Form 8949 or Form 4797 (for Section 475 MTM).
- You can license the TL software to do the trade accounting. Alternatively, TL can do this trade accounting for you as a service.
- Green, Neuschwander & Manning, LLC (GNM) offers trade accounting services using TradeLog to clients of GNM's tax compliance service.

BUSINESS EXPENSES IF QUALIFIED FOR TTS

Trader business expenses include:

- Tangible personal property like a computer, up to $2,500 per item.
- Section 179 (100%), bonus, and regular depreciation on computers, equipment, furniture, and fixtures.
- Amortization of start-up costs (Section 195), organization costs (Section 248), and software.
- Education expenses paid and courses taken after the commencement of the trading business activity. (Otherwise, pre-business education may not be deductible or included a portion in Section 195 start-up costs.)

Trader business expenses

- Books, publications, subscriptions, market data, online and professional services, chat rooms, mentors, coaches, supplies, phone, internet, travel, seminars, conferences, assistants, consultants, and accountants.
- Home-office expenses for the business use portion of a trader's home (share of the 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).
- Stock-borrow fees for short-sellers.
- Internal-use software for automated trading systems.

Other costs

- Business deductions don’t include the following:
- Vehicles. (Traders don’t use autos daily for business.)
- Commissions are part of the trading gain or loss.

LLC PARTNERSHIPS AND S-CORPS

Forms 1065 and 1120-S

- Submit Form 1065 for a general partnership or multi-member LLC choosing partnership treatment. Submit Form 1120-S 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 the entity level, thereby avoiding double taxation. (Partnership K-1, S-Corp K-1.)
- Ordinary income or loss (primarily business expenses) is summarized on Form 1040 Schedule E rather than in detail on Schedule C.
- Section 179 depreciation is broken out separately on Schedule E, along with unreimbursed partnership expenses (UPE), including home-office expenses. For an S-Corp, use an accountable reimbursement plan before year-end rather than UPE.

Trading is not a passive loss activity

- 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-1

- Portfolio income (interest and dividends) is stated separately on the partnership and S-Corp Schedule K-1s and passed through to the individual owner’s Schedule B.
- Capital gains and losses pass through to Schedule D in summary form.

Schedule K-1

- Net taxes don’t change; pay them on the individual level.
- Pass-through entities file Form 8949 and 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.
- The entity also reports Section 1256 contracts and passes through lower 60/40 capital gains rates to the owners.

S-Corps arrange deductions for health insurance and retirement plan contributions

- 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.

- See Entity Solutions, Retirement Plan Solutions, and 2022 Year-End Tax Planning For Traders.

The 20% qualified business income deduction

- Per TCJA, the 2022 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).
- S-corp wages can take advantage of the QBI phase-out range.
- 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 TTS expenses.

S-Corp basis

- See About Form 7203, S Corporation Shareholder Stock and Debt Basis Limitations (www.irs.gov/forms-pubs/about-form-7203).

SALT CAP WORKAROUND

SALT cap workaround

- TCJA capped state and local income, sales, and property taxes (SALT) at $10,000 per year ($5,000 for married filing separately) and did not index it for inflation.
- About 25 states enacted SALT cap workaround laws.
- Search “(Your state) SALT cap workaround” to learn the details for your state.
- Most states follow a blueprint approved by the IRS.

SALT cap workaround

- Generally, you should elect to make a “pass-through entity” (PTE) payment on a partnership or S-Corp tax return filed by your business.
- It doesn’t work with a sole proprietorship filing a Schedule C.
- PTE is a business expense deduction shown on the state K-1, like a withholding credit.

SALT cap workaround

- Most states credit the individual's state income tax liability with the PTE amount.

- Essentially, you convert a non-deductible SALT itemized deduction (over the cap) into a business expense deduction from gross income.

- Act well before year-end; otherwise, you might delay the benefit to next year. Learn the rules of your state.

COMMON ERRORS ON TAX RETURN FILINGS FOR TRADERS

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 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 try to evade wash sale (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).

Adjusted gross income (AGI) 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 IRS Form 8960.
- See Tax Center: ACA Net Investment Income Tax

TAX EXTENSIONS AND TAX PAYMENTS ARE DUE

Extensions

- The 2022 income tax returns for individuals are due by April 18, 2023 — 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, 2023, and don't issue final Schedule K-1s to investors until after April 18. (See IRS Form 7004).
- Traders don't have to rush to complete their tax returns by April 18. They can take advantage of a simple one-page automatic extension and pay taxes owed to the IRS and state. Traders can request an automatic six-month extension to file individual federal income tax returns until Oct. 16, 2023.
- Most states offer the same extension terms (pay them, too), or they might accept the federal extension if no balance is due the state. Check with your state beforehand.

Extensions

- Traders can request an automatic six-month extension to file individual federal and state income tax returns until Oct. 16, 2023.

- The 2022 Form 4868 instructions indicate how easy it is to get this automatic extension — no reason is required.

- It's an extension to file a complete tax return, not an extension to pay taxes owed.

- The taxpayer should estimate and report what they think they owe for 2022 based on the tax information received.

Avoid late-filing and late-payment 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 taxpayers cannot pay the taxes owed, they should 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 2022 Form 4868, page two, for an explanation of how to calculate these penalties.

Avoid underestimated tax penalties

- Some traders made significant trading gains in 2022. Some used the estimated tax payment “safe harbor” exception to cover their 2021 tax liability with the fourth quarter (Q4) 2022 estimated tax payment made by January 17, 2023.

- They plan to pay the balance of taxes owed by April 18, 2023, and should consider setting aside and protecting those funds.

- Some will risk their tax funds in the markets. Taxpayers should be careful because losing the funds will cause significant trouble later in the year.

Tax relief in disaster situations

- There have been many federal disaster situations around the U.S. these past years.
- See if you qualify to pay taxes and file tax returns after the original deadline.
- See Tax Relief in Disaster Situations. For example:
- IRS: May 15 tax deadline extended to Oct. 16 for disaster area taxpayers in California, Alabama and Georgia.
- Check with your state(s) to see if they follow the IRS extensions.

Contact us

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- Email us your questions at info@greentradertax.com

- For tax consultations, tax compliance (preparation) services, and trade accounting, consider Green, Neuschwander & Manning, LLC.
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