

TOP 11 TAX DEDUCTIONS FOR ACTIVE TRADERS

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April 5, 2017 @ 12:00 pm EST
(Interactive Brokers Webinar)

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Job:

- Managing Member of Green, Neuschwander & Manning, LLC, a tax and accounting firm catering to traders and investment managers. CEO of GreenTraderTax.com.

Focus on traders:

- Trading is a real profession, and other tax professionals and solution providers underserve them. Traders deserve tax advice from CPAs and tax attorneys who are acutely aware of different tax laws and regulations that apply to them.

Robert Green's Content

- Mr. Green is a leading authority on trader tax. He is the author of Green's 2017 Trader Tax Guide, which GreenTraderTax published as an annual tax guide every year since 1997.
- Mr. Green has been a contributor to Forbes.com since 2010. Mr. Green wrote the "Business of Trading" column for Active Trader magazine for 14 years until the magazine closed in 2015. Leading brokerage firms and other financial media feature Mr. Green's blog posts and Webinar content.

Robert Green's Media

- Barron's recommended GreenTraderTax every year since 1999.
- Mr. Green is frequently interviewed and has appeared in the New York Times, Wall Street Journal, and several other media. Mr. Green has also appeared on CNBC, Bloomberg Television, and Forbes.com Video Network.
- Mr. Green is the chief tax speaker at Traders Expo and taught "Trader Tax 101" for CCH to tax professionals.

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- Where specific advice is necessary or appropriate, you may wish to consult with a qualified tax advisor, CPA, attorney, financial planner, or investment manager.
- Robert A. Green and the Green companies are not affiliated with Interactive Brokers.
- This presentation is based on current tax law, and tax reform changes are expected in 2017.

TRADING BUSINESS EXPENSES VS. INVESTMENT EXPENSES

Business expenses are superior to investment expenses for generating tax savings.

Trader Tax Status Vs. Investor Tax Status

- The key to maximizing my top 11 deductions for active traders is to qualify for trader tax status (TTS) business expense treatment.
- Otherwise, investment interest and investment expense treatment apply, which disallows 8 of my top 11 deductions. The three deductions the IRS allows are subject to various limitations.

Investment Interest Expense & Investment Expense Limitations

- Investment interest and investment expenses face significant limitations “below the line” as itemized deductions.
- Investment expenses exclude home office, start-up business expenditures, organization costs, employee benefits (health insurance and retirement) and education. They are part of miscellaneous itemized deductions, which must first exceed a 2% of AGI threshold.
- Investment interest expense is limited to investment income minus investment expenses. The rest is carried over.
- Upper-income taxpayers face additional limitations: a Pease itemized deduction phase-out and AMT taxes since investment expenses are an AMT preference item.

How To Qualify For Trader Tax Status

- Qualification for TTS requires an average of four total trades per day (volume), close to 4 days per week (frequency), for 15 trades per week, 60 per month and 720 per year (Poppe tax court case).
- Have an average holding period of fewer than 31 days (Endicott court), spend four hours per day, and have the intention to run a business to make a primary or supplemental living.
- It helps to have several computers and monitors, other trading business expenses, material account size and a home office.

COMPARE THE SAVINGS

TTS traders save far more taxes than investors.

Top 11 Deductions For Traders: Compare TTS Traders To Investors

- In the following two tables, I compare tax savings for a highly-profitable trader.
- In Table 1, the trader qualifies for TTS and receives full business expense treatment, maximizing tax savings.
- In Table 2, the trader does not qualify for TTS and receives no tax savings from the top 11 deductions. The 2% AGI threshold, Pease limitation, and AMT preferences entirely limit the three allowed investment expenses.

Table 1: TTS Tax Savings = \$38,500

Top 11 Deductions For Trader w/ TTS	Estimate Of Tax Deductions
Home-office (HO) deduction	\$5,000 (12% of home expenses)
Additions/improvements depreciation	\$2,000 (renovated HO)
Tangible property expenses	\$4,000 (items each under \$2,500)
Section 179 (100%) depreciation	\$3,000 (items each over \$2,500)
Automated trading systems	\$6,000 (paid programmer)
Education, mentoring and seminars	\$5,000 (post commencement)
Section 195 start-up expenditures	\$5,000 (pre-business education)
Organization expenses	\$1,000 (trading entity costs)
Health insurance premiums with S-Corp	\$15,000 (family coverage)
Retirement plans with S-Corp	\$59,000 (Solo 401k over age 50)
Short selling: Stock borrow fees	\$5,000
Total deductions and tax savings	\$110,000 x 35% = \$38,500 savings

Table 2: Investor Tax Savings = \$0

Top 10 Deductions For Investor	Estimate Of Tax Deductions
Home-office (HO) deduction	\$0 (not allowed for investor)
Additions/improvements depreciation	\$0 (not allowed for investor)
Tangible property expenses	\$4,000* (items each under \$2,500)
Section 179 (100%) depreciation	\$0 (not allowed for investor)
Automated trading systems	\$6,000* (paid programmer)
Education, mentoring and seminars	\$0 (not allowed for investor)
Section 195 start-up expenditures	\$0 (not allowed for investor)
Organization expenses	\$0 (not allowed for investor)
Health insurance premiums	\$0 (not allowed for investor)
Retirement plans	\$0 (not allowed for investor)
Short selling: Stock borrow fees	\$5,000*
Total: *Subject to 2% AGI limitation	\$15,000*, but disallowed for AMT

1. HOME OFFICE DEDUCTIONS

HO is one of the biggest deductions for profitable business traders. Converting personal expenses into business use is nice.

Home Office Deductions: It's Not A Red Flag

- Since 1999, the home-office deduction is no longer a red flag — millions of Americans benefit from this deduction each year. With the advent of computers and the Internet, many Americans run businesses from home, and the IRS understands this.
- Most traders operate their trading business from a home office. Some traders also trade from job locations using browser-based trading platforms or apps accessible on work computers, laptops, tablets, and smartphones. They can qualify for the home-office expense deduction as well.

Home Office Deductions: Exclusive Use & Allocation Percentage

- A home office must be exclusively and regularly used for business, meaning children and guests can't use this room. You may cordon off an area of a room.
- To calculate the home-office deduction, take the square footage of your home office (and all related business areas such as storage, hallways, and bathrooms) and divide by the total square footage of your home. Ten to 15% is customary.
- Alternatively, you can do the apportionment based on the room's method.

Home Office Deductions: Form 8829 & Pass-Through Entities

- Report “indirect expenses” on Form 8829 and include every expense and cost related to your home. Include mortgage interest, real estate taxes, rent, utilities, repairs and maintenance, insurance, lawn care, cleaning, and depreciation.
- If you file a partnership return, report home-office expenses as "unreimbursed partnership expenses" (UPE) on Schedule E.
- We prefer a home-office reimbursement plan in S-Corps. Do the reimbursement before year end.

Home Office Deductions: Income Limit Rule

- The IRS limits use of HO expenses by requiring business income to offset the deduction, except for the mortgage interest and real estate tax portion.
- Link the HO Form 8829 to TTS trading gains or transfer some to Schedule C to unlock the HO deduction.
- If you have trading losses, carry over unallowed HO deductions to subsequent tax year(s).

Home Office Deductions: Take Depreciation Expense

- Including depreciation of your home in the home office deduction doesn't reduce the gain exclusion you are currently allowed under Section 121 if you were to sell your principal residence.
- When you sell your principal residence, a portion of depreciation may have to be recaptured, but this is the case whether or not you take the depreciation expense deduction on Form 8829.

2. ADDITIONS & IMPROVEMENTS

Get a tax deduction for building an addition or improving your home office.

Additions & Improvements Inside Your Home

- Consider an addition or improvements to your home office like building more space, replacing windows, walls, cabinets, and flooring.
- Depreciate this addition or improvement to residential real property over 39 years on a straight-line basis.

Additions & Improvements Outside Office

- If you own an outside office, depreciation rules are more attractive than residential real property.
- The Protecting Americans From Tax Hikes (PATH) Act of 2015 created “qualified improvement property.” It’s a new class of nonresidential real property, excluding additions like increasing square footage.
- Use 50% bonus depreciation on qualified improvement property placed in service in 2016 or later. PATH extended bonus depreciation through 2019.

3. TANGIBLE PROPERTY EXPENSING

The IRS liberalized these rules making full expensing easier.

Tangible Property Expensing

- Expense new tangible property items up to \$2,500 per item.
- Before 2015, the IRS threshold for capitalization with depreciation vs. full expensing was \$500.
- Ask for invoice itemization to show separate items under \$2,500.
- Separate invoices are even better.

4. SECTION 179 (100%) DEPRECIATION

Few traders exceed the Section 179 limits allowed.

Section 179 (100%) Depreciation

- For equipment, furniture, and fixtures above the tangible property threshold (\$2,500), TTS traders use Section 179 depreciation allowing 100% depreciation expense in the first year.
- PATH made permanent generous Section 179 limits. The 2016 and 2017 limit is \$500,000 on new and used equipment including off-the-shelf computer software.
- The IRS limits the use of Section 179 depreciation by requiring income to offset the deduction. Look to business trading gains, other business income or wages, from either spouse, if filing jointly.

5. AUTOMATED TRADING SYSTEMS

Many traders write algorithms and create automated trading systems.

Automated Trading Systems: Internal-Use Software

- Increasingly, traders are writing computer code for developing automated trading systems.
- The IRS allows a few different choices for expensing “internal-use software.”
- If you qualify for TTS before incurring software development costs, deduct them like other research expenses in Section 174(a) in the year paid.

Automated Trading Systems: Capitalize & Amortize

- If you *don't* qualify for TTS before incurring software development costs, capitalize them under Section 174(b).
- Two choices for amortization (expensing):
- When you *complete the software* and qualify for TTS, amortize (expense) the intangible asset over 60 months.
- Or, wait until you *place the software in service* with qualification for TTS to amortize (expense) the intangible asset over 36 months.

Automated Trading Systems: How It Affects Trader Tax Status

- Traders may qualify for TTS using automated trading systems (ATS) providing they write the code or have other significant involvement with creation and modification of the ATS. Many traders using ATS have sufficient volume and frequency to qualify for TTS business expense treatment.
- Conversely, if a trader purchases an off-the-shelf ATS providing entry and exit signals and trade execution, the trader probably doesn't get credit for the volume and frequency of trades made by the ATS. In that case, it's an investment expense.

6. EDUCATION, MENTORING & SEMINARS

Many new traders incur significant education expenses before qualifying for TTS, so deductibility is a challenge.

Trading Education Expenses

- Education business expenses paid after the start of your TTS business are allowed for “maintaining and improving” your business.
- Learning a new business before starting that business is not allowed as a business education expense.
- If you are learning about investing while carrying on an investment activity, that education expense is not allowed as a Section 212 investment expense by Section 274(h)(7).
- If you pay for trading education services before qualifying for TTS, consider using Section 195 start-up expenditures.

Cash Vs. Accrual Method Of Accounting

- A trading business may elect either cash or accrual accounting methods for business expenses only.
- Use other accounting methods for trading gains and losses, including the realization method on securities, Section 475 MTM, Section 1256, and Section 988.
- Most business traders choose the cash method for expenses, meaning expenses are deductible when paid, not when incurred.
- The accrual method deducts expenses when incurred.

Example

- Say a new trader purchases \$10,000 of trading training on Dec. 1, 2016. He or she starts classes in December and continues them through March 2017. The trader qualifies for TTS halfway through the training in January 2017.
- The cash method classifies the \$10,000 as a Section 195 start-up cost, with \$5,000 deducted in 2017 as “expense allowance” and the balance amortized over 15 years.
- With the accrual method, the trader will have the same Section 195 expense allowance (\$5,000) on his 2017 tax return, and he can deduct the other \$5,000 in full as a post-business-commencement education expense in 2017 because half took place after business commencement in January.

Mentors & Seminars

- Engaging a mentor is considered one-on-one education.
- If you travel to a trading seminar, expo or conference, after achieving TTS, it's a business deduction.
- Carve out personal expenses like extra days for personal use.

7. SECTION 195 START-UP EXPENDITURES

It's an excellent way to go back in time to capture some pre-business start-up costs.

Section 195 Start-Up Expenditures: Capitalize Start-Up Costs

- Go back a reasonable period (six months) before qualifying for TTS to capitalize a fair amount (up to \$15,000) of start-up costs.
- Start-up expenses include costs to “investigate and inquire” about a new business.
- Costs capitalized in Section 195 would have to qualify as a business expense if paid after business commencement.

Section 195 Start-Up Expenditures: Expensing & Amortization

- Section 195 allows an “expense allowance” in the first year up to \$5,000.
- Start a calendar year business late in the year and still get the full \$5,000 expense allowance.
- Amortize the remainder of the costs over 180 months on a straight-line basis.
- If you exit the trading business, you may write off the unamortized balance.

8. ORGANIZATION COSTS

Traders have organization costs for setting up a trading business and entity, and they use this code section to write off the expenses.

Organization Costs

- Under Section 248 for corporations and Section 709 for partnerships, treat expenses to organize or form an entity in a similar manner as Section 195 start-up expenditures.
- There is a separate first-year expense allowance up to \$5,000, and the balance is amortizable over 180 months on a straight-line basis.
- Organization costs include accounting, tax, and legal fees to form a trading business entity.

9. HEALTH INSURANCE PREMIUMS

Health insurance premiums are escalating in price, and traders may arrange a business deduction using an S-Corp, without any offsetting payroll or SE taxes.

Health Insurance Premiums: Keys To Deductibility

- Deduct health insurance premiums from individual AGI if you have an S-Corp trading company paying you W-2 wages which include your premiums.
- Otherwise, there is no earned income from trading gains, and you cannot deduct health insurance premiums unless you have another source of earned income.
- The insurance must be an individual plan, or in association with your small business, and not a third-party employer plan for you or your spouse. There is no deduction for an employer-COBRA plan.
- Deduct health insurance premiums during the entity period, not before.

Health Insurance Premiums: Traders Need Officer Compensation

- This S-Corp wage component for health insurance premiums is not subject to social security and Medicare taxes, so enjoy the income tax savings with no offsetting payroll tax costs.
- A C-Corp management company deducts health insurance premiums on the corporate tax return.

10. RETIREMENT PLAN CONTRIBUTIONS

Profitable traders can arrange significant deductions for contributions to a retirement plan, and grow the account tax-free until retirement.

Retirement Plans Require Earned Income

- Retail traders need an entity like an S-Corp trading company or C-Corp management company to arrange retirement plan deductions since sole proprietor traders don't have earned income required for employee benefit plan deductions.
- With one exception: Futures traders using full exchange membership have self-employment income (Section 1402i).

Solo 410(k) Retirement Plan

- S-Corp officer wages of \$144,000 unlock the maximum \$54,000 contribution/deduction or \$60,000 if age 50 or older with the \$6,000 catch-up provision.
- The 100%-deductible elective deferral up to \$18,000, or \$24,000 with the catch-up provision, provides the greatest income tax savings vs. payroll tax costs. If the marginal federal and state income tax rate is above the 15.3% payroll tax cost, there are net tax savings.
- The 25%-deductible profit-sharing plan up to \$36,000 is good if you have sufficient cash flow to fund it.

Defined-Benefit Retirement Plan

- Consistently high-income business owners, including trading businesses with owner/employees close to age 50, should consider a defined-benefit retirement savings plan (DBP) for significantly higher income tax and payroll tax savings vs. a defined-contribution retirement savings plan (DCP) like a Solo 401(k).
- You may be able to arrange a \$100,000 plus contribution/deduction with a defined-benefit plan (DBP). An actuary is required to consider various factors in calculating retirement benefits and annual contributions to the DBP.
- Learn more at <https://greentradertax.com/defined-benefit-plans-offer-huge-tax-breaks/>

11. SHORT SELLING EXPENSES

Stock borrow fees and margin interest expenses are significant business expenses for short sellers. Investors face limitations.

Stock Borrow Fees Are Not Interest Expense

- Short selling is not free; a trader needs the broker to arrange a loan of stock from another account holder. Brokers charge short sellers “stock borrow fees” or “loan premiums.”
- Tax research indicates these payments are “fees for the temporary use of property.”
- Watch out: Many brokers refer to stock borrow fees as “interest expense,” which confuses short sellers.

Stock Borrow Fees: Business Vs. Investment Expenses

- For tax purposes, stock borrow fees are Section 212 “investment expenses” for investors and Section 162 business expenses for traders qualifying for TTS.
- Stock borrow fees are not “interest expense” so investors can’t include them in Section 212 “investment interest expense” deductions.
- It’s a significant distinction that has a profound impact on tax returns because investment expenses face greater limitations vs. investment interest expenses.

CLOSING REMARKS, QUESTIONS & ANSWERS

Closing Remarks

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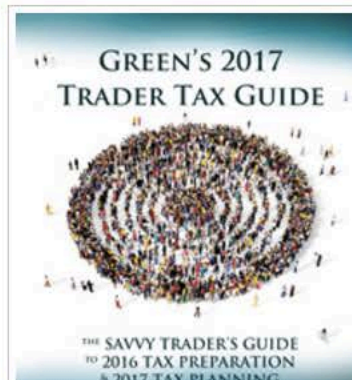
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