HOW TRADING BUSINESSES CAN SAVE TAXES IN 2017 AND 2018

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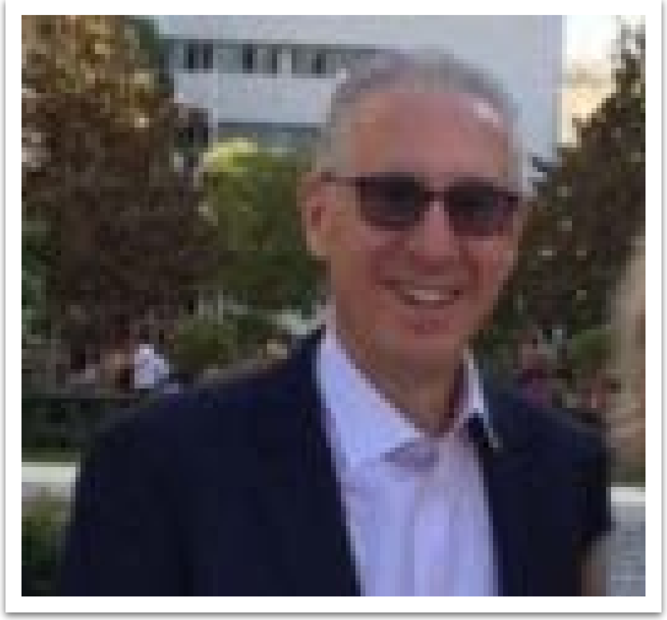
Presenter:

Robert A. Green, CPA



Managing Member

GNM TraderTax

GREEN, NEUSCHWANDER & MANNING, LLC

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Robert A. Green CPA

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

- Mr. Green is frequently interviewed and has appeared in Barron’s, 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.

Webinar disclaimers

- This information is educational. It is not intended to be a substitute for specific individualized tax, legal, or investment planning advice. 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.
- I prepared this presentation based on 2017 tax law and the Tax Cut & Jobs Act bills as of Nov. 30, 2017.

2017 YEAR-END PLANNING FOR BUSINESS

Trading businesses should do year-end tax planning, including execution of officer payroll and related employee benefits (health and retirement) in an S-Corp or C-Corp management company.

2017 year-end planning for a trading business

- With three weeks remaining in 2017, trading businesses should do year-end tax planning, including vital execution of officer payroll and related employee benefits (health and retirement) in an S-Corp or C-Corp management company.

- The Tax Cuts And Jobs Act bills lower tax rates on business in 2018, so it's wise to consider deferring income to 2018 and accelerate business expenses to 2017.

Execute officer compensation through payroll

- Traders, eligible for trader tax status (TTS), need an S-Corp trading company, or C-Corp management company, to deduct employee benefits for the owners, including health insurance and retirement plan contributions.

- It's too late to form a new S-Corp for 2017, as you need a few months activity to qualify for TTS. The entity tax return may only report trades made within an entity account.

- S-Corps need to execute 2017 officer compensation with these deductions included before year-end, so don’t miss the boat! We have a payroll service provider that works with our clients.

S-Corp officer health insurance premiums

- W-2 wages should include health insurance premiums for 2% or more owners of S-Corps, which means the trader/owner and spouse if both provide services. (Attribution rules apply.)
- If your spouse works in the business, they may have payroll and employee benefit deductions, too.
- The health insurance premium component is not subject to payroll taxes.
- The S-Corp owner takes an AGI deduction for health insurance premiums on the individual tax return.

Trading partnership with management company

- Some traders use a dual entity structure: A trading partnership and separate management company organized as a C-Corp or S-Corp.
- The management company should execute year-end payroll and health insurance deductions.
- A C-Corp management company may deduct health insurance premiums and health reimbursement accounts directly on the corporate tax return and don’t include it in payroll like the S-Corp.
- The trading partnership should pay administration fees to the management company before year-end.

Officer compensation for a non-trading business

- The IRS requires S-Corps with underlying earned income (i.e., investment advisory fees or consulting fees) to have "reasonable compensation." Current industry practice is 25% to 50% of net income before officer compensation.

- The IRS does not require a trading S-Corp to have reasonable compensation because it has underlying unearned income.

- However, the IRS does look for officer compensation on all S-Corp tax returns. At a minimum, include the health insurance component in officer wages.

Guaranteed payments to partners

- An LLC with earned income filing a partnership return or general partnership should use “guaranteed payments” for officer compensation.

- A partnership tax return with underlying earned income may arrange health insurance and retirement plan deductions in a similar manner to S-Corps.

- The IRS does not permit an investment company, not eligible for TTS, to have guaranteed payments and employee benefit deductions. An S-Corp needs TTS, too.

- A spousal-owned trading partnership has significant difficulty achieving self-employment income for retirement plan deductions.

Establish a Solo 401(k) retirement plan before year-end

- If the S-Corp trading company or C-Corp management company is profitable, consider a Solo 401(k) retirement plan contribution. It must be established by year-end.

- Execute the 100% deductible elective deferral portion, through officer payroll before year-end. The 2017 maximum contribution is $18,000, or $24,000 with the catch-up provision for age 50, or older.

- If the company has sufficient income, consider the 25% deductible profit sharing plan (PSP) included in a Solo 401(k). The maximum PSP contribution is $36,000 for which you need officer compensation of $144,000.

Defined benefit plans have higher contribution limits

- Businesses that achieve consistently high income can arrange a $100,000+ contribution/deduction with a defined-benefit plan (DBP) if the owners are close to age 50.

- Business owners should work with an actuary on complex DBP calculations.

- A DBP must be established before year-end, but you can do most of the funding in the new year.

- Setting up a DBP can take several weeks, so get started by early December.

Convert a 2017 wash sale loss into a 2018 ordinary loss

- If you have wash sale loss deferrals at year-end on trading positions in your account, claim sole proprietor TTS for 2017 and 2018 if possible.
- A Section 475 election for 2018 will convert the wash sale loss deferral on TTS positions into an ordinary loss on Jan. 1, 2018.
- That’s much better than a capital loss in 2018.

Accounting methods

- Most small businesses, without inventory, choose the cash method, which reports revenues when collected and expenses when paid.
- Cash method taxpayers can defer gross revenues and accelerate expenses more easily than accrual method taxpayers.
- If you own a small business, consider postponing completion of client engagements and invoice them in 2018. Cash method taxpayers can hold off on collection efforts until 2018.
- Be aware of the “constructive receipt of income” rules.

Maximize tangible property expenses

- Businesses can expense new tangible property up to $2,500 per item, a great way to defer income.
- Purchase and begin using the tangible property before year-end.
- Arrange separate invoices for each item not exceeding $2,500 and be sure to make the de minimis safe harbor election with your tax return filing.

Section 179 (100%) depreciation

- For equipment, furniture and fixtures above the tangible property threshold ($2,500), use Section 179 depreciation allowing 100% depreciation expense in the first year.
- The 2017 limit is $510,000 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.

S-Corp accountable plans, home office deductions and UPE

- “Use or lose” an S-Corp accountable plan before year-end for reimbursing business expenses paid individually, including home office expenses.

- LLC Operating Agreements and partnership agreements may provide that partners should deduct home office expenses as “unreimbursed partnership expenses” (UPE) on their tax returns.

Capitalize expenses for a new business

- If you plan to become eligible for TTS or another type of business in early 2018, consider capitalizing late-year 2017 purchases for business expense deductions in 2018.

- I suggest this strategy for Section 195 start-up costs including training and mentors, Section 248 organization costs for a new entity, and internal-use software including automated trading systems.

- Otherwise, you might not get any tax deduction for these items in 2017.

HOW THE “TAX CUTS AND JOBS ACT” IMPACTS TRADER ENTITIES

The Senate's pass-through tax deduction is suitable for most traders, and the C-Corp may be ideal for a high-income trader living in a tax-free state.

Tax Cuts And Jobs Act

- Congressional Republicans are advancing the “Tax Cuts And Jobs Act” at a fast pace, and expect to pass the legislation by year-end.
- Traders are considering changes to their entity structure for 2018, preferably by Jan. 1, 2018.
- Should they continue trading in an S-Corp or LLC/partnership and perhaps qualify for pass-through tax cuts, or switch to a C-Corp for a new low 20% flat tax rate?

TAX CUTS FOR PASS-THROUGH ENTITIES

The Senate and House bills are different on pass-through tax cuts, and the Senate provision is better for TTS traders.

Senate pass-through tax deduction

- The Senate bill provision for pass-through entities has many limitations, especially for service businesses.
- A trading business eligible for trader tax status (TTS) is a service business.
- Qualified business income includes Section 475 ordinary income, and excludes investment-related capital gains.
- Section 475 Traders May Be Eligible For Pass-Through Tax Cuts.

Limitations on pass-through deduction

- In the Senate bill, a pass-through service business owner is eligible for the 23% deduction on qualified business income, providing his or her taxable income is under $500,000 married and $250,000 other taxpayers.
- The deduction phases-out up to $600,000 married and $300,000 other taxpayers.
- How To Setup The Best Trading Entity For Tax Cuts
- Senate's Five Haircuts On The Tax Deduction For Pass-Through Entities

House pass-through tax rate

- The House bill allows service businesses to use the 11% pass-through tax rate vs. the 12% ordinary bracket for 2018, on the first $75,000 of business income, for taxable income under $150,000 married and $75,000 other taxpayers.
- There is a phase-out range up to $225,000 married and $112,500 other taxpayers.
- A service business can qualify for the maximum 25% pass-through tax rate if it has an “alternative capital percentage” of 10% from a significant investment in business equipment (and perhaps “internal-use software”).

TAX CUTS ON C-CORPS

A C-Corp was not a suitable choice for a trading company in the past, but with the new 20% tax rate, it could be for some high-income traders in states without a corporate tax. If the trader doesn't qualify for a pass-through tax cut, consider the C-Corp.

A C-Corp sounds attractive

- In the Senate bill, C-Corps benefit from a 20% flat tax rate vs. individual rates up to 38.5%, plus 3.8% Obamacare net investment tax (NIT).
- The maximum difference could be a whopping 22.3% in federal tax rates.
- The Senate bill delays the 20% corporate rate to 2019, whereas, the House bill commences it in 2018. The Senate will probably prevail in conferencing between chambers.

The 20% corporate rate is not as good as it seems at first look

- The average marginal individual tax rate is closer to 30% for high-income taxpayers, and with the inclusion of the 3.8% NIT, the actual difference is 14%.

- Double taxation on the federal level can wipe out that savings with a 15% or 20% capital gains tax on “qualified dividends” plus 3.8% NIT.

- Double taxation on the state level can lead to a C-Corp paying higher taxes than a pass-through entity.

Qualified dividend income

- A C-Corp pays taxes first on the entity level and owners pay a second time on the individual level on dividends and capital gains.
- When C-Corps make a cash or property distribution to owners, it's a taxable dividend if there are "earnings and profits" (E&P).
- If the individual holds the stock for 60 days, it's a "qualified dividend," subject to lower long-term capital gains rates of 0%, 15%, and 20%.
- A high-income trader will likely pay the 15%, or 20% rates, plus Obamacare 3.8% NIT on unearned income over the modified AGI threshold.

Accumulated earnings tax

- If the C-Corp does not pay dividends from E&P, the IRS can assess a 20% “accumulated earnings tax” (AET) if the C-Corp exceeds a threshold and cannot justify a business need for retaining E&P.
- The IRS AET threshold is $250,000, or $150,000 for a personal service corporation.
- Perhaps, a TTS trading C-Corp can demonstrate it has a business need for E&P over the threshold.

Officer compensation avoids double taxation

- Historically, C-Corps paid higher officer compensation to avoid the 35% C-Corp tax rate.

- Traders also like customizing officer compensation to their retirement plan contribution strategy.

- But now, C-Corps may prefer the 20% C-Corp tax rate over the individual tax rates of 35%, and 38.5% on wage income instead.

State double taxation can ruin the C-Corp strategy

- If you live in a high tax state for corporate and individual taxes, the C-Corp may be the wrong choice of entity.
- According to Tax Foundation, “Forty-four states levy a corporate income tax. Rates range from 3 percent in North Carolina to 12 percent in Iowa.”
- States don’t use lower capital gains rates; they treat qualified dividends as ordinary income.
- See the Tax Foundation map, State Corporate Income Tax Rates and Brackets for 2017.

C-Corp in California vs. Texas

- A C-Corp is a wrong choice for a trader entity in California with an 8.84% corporate tax rate, and high individual tax rates.
- But it could be the right choice for a trader in Texas without corporate taxes.
- The Texas 0.75% franchise tax applies to all types of companies with limited liability, including LLCs, and C-Corps, and the “No Tax Due Threshold” is $1.11 million.
- Most traders won’t trigger the Texas franchise tax.

Don’t try to avoid filing a C-Corp tax return in your resident state

- You are entitled to form your entity in a tax-free state, like Delaware, but your home state requires registration of a “foreign entity,” if you operate it in your resident state.
- Setting up a mail forwarding service in a tax-free state does not achieve nexus in that state.
- Conducting your trading business from your resident state constitutes nexus.

C-Corp Cons

- No lower 60/40 capital gains tax rates on Section 1256 contracts.
- Ordinary losses do not pass-through to the owner’s tax return.
- A C-Corp investment company without trader tax status may not deduct investment expenses.
- If you liquidate a C-Corp to realize the loss trapped inside it, you might qualify for Section 1244 ordinary loss treatment up to $50,000 single, or $100,000 married, with the remainder of the loss treated as a capital loss.

AN S-CORP IS AN EXCELLENT CHOICE FOR MOST TTS TRADERS

TTS traders use an S-Corp to arrange employee benefit plan deductions in 2017 (cake), and also for pass-through tax cuts in 2018 (icing on the cake).

S-Corp employee benefit plan deductions

- In 2017, TTS traders can arrange to deduct health insurance and retirement plan contributions in an S-Corp.
- The maximum Solo 401(k) retirement plan deduction is $54,000 or $60,000 if age 50 or older. For 2018, the IRS raised the limit by $1,000. Health insurance premiums for a family could easily be $20,000 per year.
- Sole proprietor traders and spousal-partnership traders cannot achieve these significant employee-benefit deductions.
- Consider the S-Corp employee benefit plan strategy the “cake” for TTS traders in 2018.

S-Corp pass-through tax cuts

- The tax cut bills bring potential icing on that cake for a securities TTS trader with Section 475 ordinary income, starting in 2018.

- They may qualify for the Senate's pass-through deduction on qualified business income.

- The pass-through deduction works with a partnership or S-Corp return.

- But, it may be difficult to claim this deduction for a sole proprietor trader, since Section 475 trading gains are on Form 4797 Part II, not Schedule C.

Most TTS traders should consider an S-Corp for 2018

- A new trading business wanting to deduct health insurance and a retirement plan contribution should consider an S-Corp for 2018.

- That was our advice for 2017 and prior years, and it remains our advice for 2018, whether tax cuts are enacted or not.

- If there are business losses from business expenses and Section 475 trading losses, using a pass-through structure will offset other income, and possibly generate a net operating loss (NOL) carry forward.

When to consider a C-Corp

- If you are a high-income trader in a tax-free state and or don't qualify for pass-through tax cuts, the C-Corp's 20% rate may be attractive.
- But, the Senate bill delayed the effective date for the C-Corp 20% rate until 2019. The House commences the 20% corporate rate in 2018, but the Senate will likely prevail.
- Hopefully, we will see the final legislation after conferencing by mid December.

Dual entity solutions

- There will be opportunities for tax advisers to conceive other ideas based on final legislation and its anti-abuse provisions.

- For example, a trading company is a “specified service activity” with limits on pass-through tax cuts, but a second entity set-up to receive royalties for licensing trading systems may not be.

- A dual-entity solution with trading partnership and management company C-Corp could generate savings, too.

YOU CAN GET STARTED SOON

Start with an SMLLC and select entity type afterward

- Traders planning to be eligible for trader tax status in 2018 can form a single-member LLC in December, and remain a “disregarded entity” for 2017, so there is no 2017 LLC tax return.

- On Jan. 1, 2018, admit a spouse for a partnership tax return, and/or file an S-Corp election by March 15, 2018, or choose to be taxed as a C-Corp.

- That plan provides time to make the best assessment of your tax situation and planning, and it facilitates account openings in time for trading on Jan. 1.

CLOSING REMARKS, QUESTIONS & ANSWERS

Stay tuned to my blog posts covering the "Tax Cut And Jobs Act."

Closing Remarks

- Thank you for attending this Webinar or watching the recording at IB.
- Visit www.GreenTraderTax.com for additional information.
- Call us toll free at 888.558.5257 or 203.456.1537
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