

TIPS FOR TRADERS ON PREPARING 2018 TAX RETURNS

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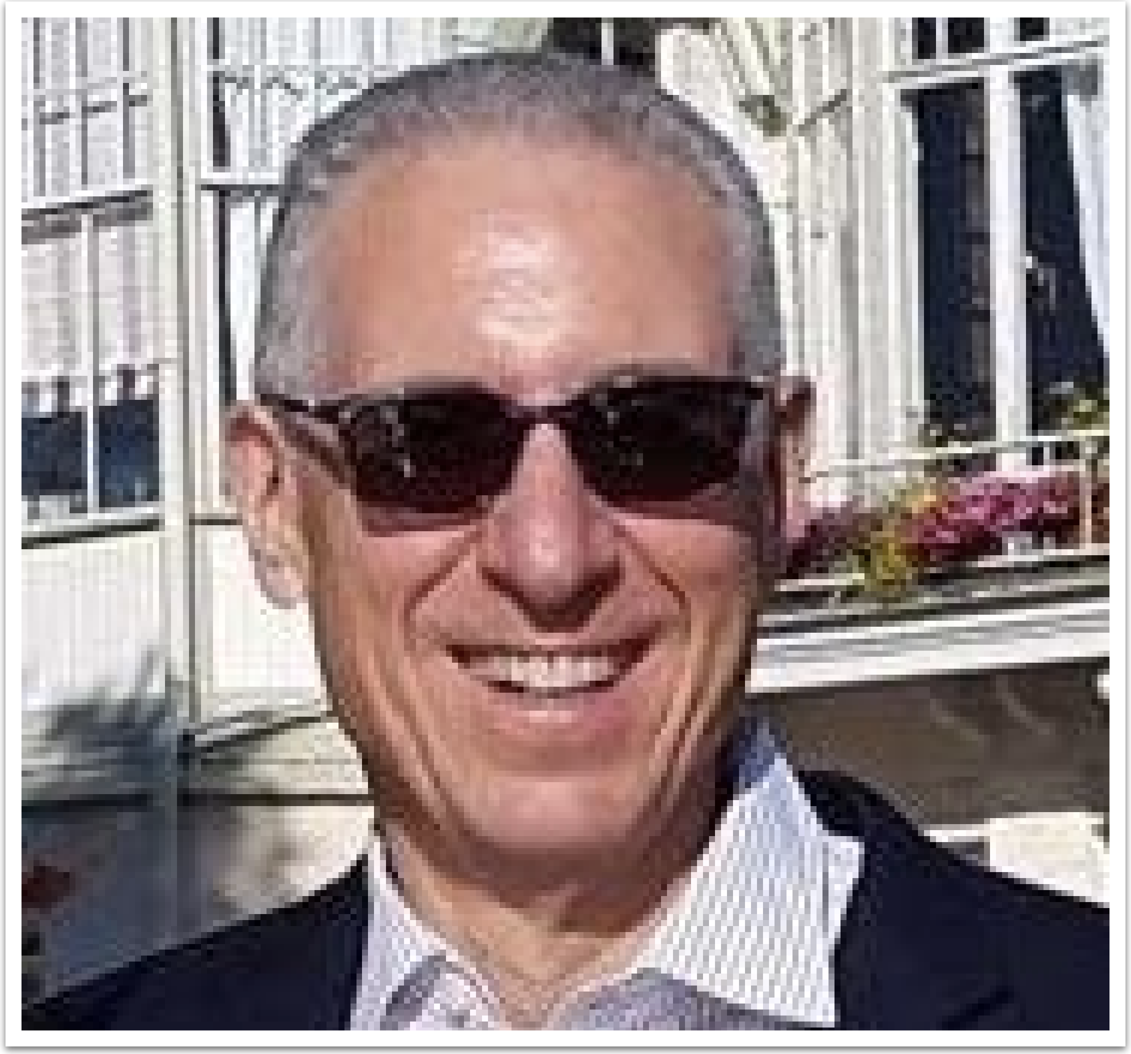

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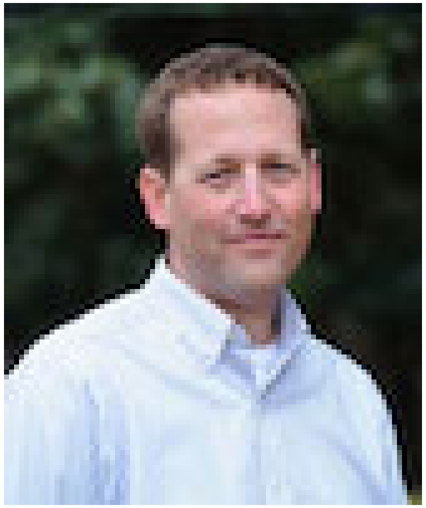
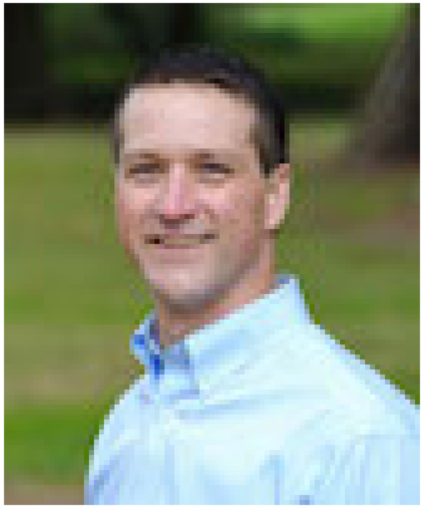
- Adam W. Manning





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Green, Neuschwander & Manning LLC

- GNM is a CPA firm dedicated to the needs of traders, investment managers and other types of clients.
- We focus on tax compliance (preparation/planning services), accounting, consultations, entity formations, and IRS/state tax controversy.
- Robert A. Green founded the firm in 1983, and we have clients throughout the U.S. and abroad using our virtual process.

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- Robert A. Green, Darren Neuschwander, and Adam Manning are not affiliated with Interactive Brokers.

Webinar description

- If you traded actively in 2018, you should watch this Webinar before preparing your 2018 tax returns.

- There are several new and revised 2018 tax forms based on the implementation of the 2017 Tax Cuts and Jobs Act (TCJA).

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

Webinar description

- 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.

- Make vital 2019 tax elections on time.

- Learn common errors on tax returns for TTS traders, which can lead to an IRS or state exam.

- Learn tips for Q4 estimates and April 15th planning.

REVISED & NEW 2018 TAX FORMS & SCHEDULES

The IRS made significant changes to 2018 tax forms and schedules to reflect the 2017 Tax Cuts and Jobs Act and related IRS regulations.

2018 Form 1040 Schedules

- The two-page Draft 2018 Form 1040 resembles a postcard because the IRS moved many sections to six new 2018 Schedules (Form 1040):

- 1 Additional Income and Adjustments to Income
- 2 Tax
- 3 Nonrefundable Credits
- 4 Other Taxes
- 5 Other Payments and Refundable Credits
- 6 Foreign Address and Third Party Designee

Revised 2018 Schedule A

- TCJA suspended "certain miscellaneous itemized deductions subject to the 2% floor," including investment fees and expenses, job expenses, and tax compliance fees.

- The 2018 Schedule A removed "Job Expenses and Certain Miscellaneous Deductions," which the 2017 Schedule A had allowed.

- The 2018 Schedule A has a section "Other Itemized Deductions," which 2017 Schedule A labeled "Other Miscellaneous Deductions." These include stock borrow fees.

QBI deduction & worksheet

- See the new “qualified business income deduction” on page two, line 9 of the Draft 2018 Form 1040. It’s below the standard or itemized deduction on line 8.

- The IRS does not currently provide a 2018 tax form or schedule for the complicated QBI deduction.

- Tax preparation software should generate a QBI deduction worksheet including QBI income/loss, 50% wage and property limitations, taxable income thresholds, and income caps.

2018 Schedule K-1

- See the Draft 2018 Schedule K-1 for a partnership tax return Form 1065. (The S-Corp Form 1120S Schedule K-1 is similar.)

- IRS form instructions require reporting QBI items on line 20 ”Other information:” Code Z for Section 199A income, code AA for Section 199A W-2 wages, and more codes for other 199A and TCJA related items.

- Due to complications and open questions in connection with QBI proposed regulations, taxpayers should expect delays in receiving final K-1s for 2018.

2018 Schedule K-1: QBI issues for TTS traders

- The Section 199A proposed/reliance regulations label TTS trading a "specified service activity," which means the taxable income cap applies ($315,000 married and $157,500 other taxpayers for 2018).

- QBI excludes capital gains and Section 988 ordinary income.

- We make a case for TTS QBI to include Section 475 ordinary income or loss and have asked the IRS chief counsel's office to confirm that treatment. Stay tuned!

Child/dependent tax credit

- See the "child tax credit/credit for other dependents" on the Draft 2018 Form 1040, page 2, line 12.
- TCJA provided a significantly higher income threshold enabling more taxpayers to be eligible for this credit, which is worth up to $2,000 per qualifying child.
- Even without an income tax liability, a taxpayer can receive a "refundable portion" up to $1,400 per child.
- TCJA repealed personal exemptions making this credit even more essential for many families.

Married filing jointly vs. separately

- TCJA equalized the two filing status by reducing the MFS tax brackets to half of the MFJ brackets. There are other factors to consider, too.
- Entering 2018 tax information by each spouse is critical. Tax software should display a report comparing the two filing status. It's then easy to proceed with filing either way.
- Filing separately in 2018 might unlock a QBI deduction, where one spouse might price the other spouse out of a QBI deduction based on exceeding the income cap.

MAXIMIZE BUSINESS, HOME OFFICE, AND STARTUP EXPENSES

Traders eligible for trader tax status (TTS) can include a Schedule C for these valuable deductions.

Properly assess qualification for TTS

- Many traders don't claim TTS when entitled to, or they claim it when not entitled.
- TTS unlocks business expense treatment.
- Conversely, investors may not deduct investment expenses as an itemized deduction for regular tax, or Obamacare 3.8% net investment tax.
- TTS is more crucial than ever before.

Business expenses include:

- Tangible personal property up to $2,500 per item.
- Section 179 (100%) depreciation. Otherwise, bonus and/or regular depreciation.
- Amortization of start-up costs (Section 195), organization costs (Section 248), and software.
- Education expenses paid and courses taken after commencement of TTS. Otherwise, pre-business education may not be deductible or include it in Section 195 start-up costs.

Business expenses include:

- 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.

Business expenses don’t include:

- Vehicles aren’t usually deductible for at-home traders because traders don’t need a car to visit clients or companies.

- Brokerage commissions are not business or investment expenses; they are deductible against trading gains and losses.

Home office expenses

- 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 do not require income.
- An HO deduction is an excellent way to navigate around Schedule A limitations for SALT, mortgage interest and casualty losses.
- See 2018 Form 8829 line 16 “Excess mortgage interest,” line 17 “Excess real estate taxes,” and line 29 “Excess casualty losses.”

Start-up costs

- When you establish TTS, look back six-months to capitalize Section 195 start-up costs, including trading education expenses.

- Capitalize a reasonable amount, perhaps up to $15,000.

- You can expense (amortize) up to $5,000 in the first year, and the balance over 15-years.

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 per that one brokerage account based on identical positions.

- The IRS rules are different for taxpayers, who must calculate wash sales based on substantially identical positions across all their accounts including joint, spouse, and IRAs.

- In many cases, broker-issued 1099-Bs might report different wash-sale losses than a taxpayer must indicate on Form 8949.

How to prevent wash sale losses

- Break the chain on wash sale losses at year-end in taxable accounts to avoid wash sale loss deferral to 2019. If you sell Apple equity on Dec. 20, 2018, at a loss, don’t repurchase Apple equity or Apple equity options until Jan. 21, 2019, avoiding the 30-day window for triggering a wash sale loss.
- Elect Section 475 MTM with TTS. (It’s too late for 2018).
- 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 wash sales.

Opportunities to depart from 1099-Bs

- Many brokers treat ETN structured as prepaid forward contracts (i.e., VXX) as a security on 1099-Bs subject to wash sale loss adjustments. We found substantial authority to handle ETN prepaid forward contracts as not a security, so they are not subject to wash sale losses or Section 475 ordinary gain or loss treatment.

- Many brokers treat CBOE-listed options on ETNs as a security on 1099-Bs, but 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.

Margin interest vs. stock borrow fees

- Brokers should report margin interest expense and stock borrow fees separately since they are different itemized deductions for investors and business expenses for TTS traders.

- Some 1099-Bs report margin interest in multiple areas so be careful to include it all.

Form 1099-Bs with Section 475

- Some brokers allow TTS traders to request a 1099-B based on the application of Section 475 MTM. The 1099-B comes without wash sale loss adjustments.
- The broker does not generate the required Form 4797 Part II.
- The broker also does not check if the client has TTS or if they filed a 475 election on time.

MAKE VITAL 2019 TAX ELECTIONS ON TIME

Section 475 MTM election

- TTS traders are entitled to elect Section 475 MTM ordinary gain or loss treatment on securities only, which exempts them from wash sale loss adjustments and the $3,000 capital loss limitation.
- It also might make them eligible for a QBI deduction.
- Existing taxpayers attach a 2019 Section 475 election statement to their 2018 federal tax return or extension, filed by the original due date. (April 15, 2019, for individuals and March 15, 2019, for existing S-Corps and partnerships.)

Forex capital gains election

- The election to opt out of Section 988 ordinary gain or loss treatment into capital gains treatment must be filed internally on a contemporaneous basis.

- The capital gains election on forex forwards allows the trader to use Section 1256(g) treatment with lower 60/40 capital gains rates on major currencies if the trader doesn’t take or make delivery of the underlying currency.

Forex capital gains election

- “Major currencies” means currencies for which currency RFCs trade on U.S. futures exchanges. There are lists of currency contracts including pairs that trade on U.S. futures exchanges available on the Internet.

- Section 1256(g) does not mention the inclusion of spot forex, so we make a case for including spot forex in Section 1256(g) in our blog post, A Case For Retail Forex Traders Using Section 1256(g) Lower 60/40 Tax Rates.

COMMON ERRORS ON TAX RETURN FILINGS

Schedule C errors for TTS traders

- 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 wash sale loss adjustments and capital loss limitations.
- Section 475 trades are reported on Form 4797 Part II ordinary gains and losses, not on Schedule C.

Schedule C errors for TTS traders

- Only trading business expenses are reportable on Schedule C for TTS traders, and the net loss might be a red flag for IRS computers and agents.
- To erase the red flag, consider transferring enough TTS trading gains, if any exist, to Schedule C line 6 “Other Income” to make Schedule C zero net income or loss.
- That also unlocks the home office deduction and Section 179 depreciation, which require income.
- Explain this TTS treatment in a tax return footnote.

SEI and 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 member of an options or futures exchange and trading Section 1256 contracts on that exchange (Section 1402i).

AGI deduction errors

- Some preparers compound this error by having the sole proprietor trader contribute to a retirement plan based on net trading income. Contributions may only be made on SEI, and trading gains are not SEI. The trader is deemed to have an "excessive contribution" subject to tax penalties.

- Some preparers also mistakenly take an AGI deduction for self-employed health insurance premiums, which requires SEI.

- A TTS trader needs an S-Corp to arrange retirement and health insurance deductions.

Missing a Section 1256 loss carry back election

- Many taxpayers and accountants don't know about the Section 1256 loss carryback election on top of Form 6781.

- A current year loss can be carried back three tax years against Section 1256 gains.

- Many traders miss this election and wind up with unused capital loss carryforwards instead.

Errors on TTS entity tax returns

- A TTS S-Corp needs officer compensation to unlock the health insurance and retirement plan deduction. Many S-Corp owners miss the formal payroll deadline by year-end and miss out on these deductions.

- Some TTS partnerships attempt health insurance and retirement plan deductions, but it's tough to arrange. The company passes through negative SEI to offset an administration fee trying to create SEI.

- Having the right structure and year-end planning is paramount.

INCORRECT TAX RETURNS CAN LEAD TO AN IRS OR STATE EXAM

Use our tips to avoid that inconvenience.

The IRS might focus on these issues

- Schedule C errors like reporting trading gains and losses on Schedule C as revenues.
- Not explaining TTS law, qualification for TTS, and TTS tax return reporting in a tax return footnote.
- Claiming 475 without having filed a 475 election or a Form 3115 to perfect the election on time.
- Not attempting to reconcile Form 1099-B with Form 8949 and explain the detailed or general differences in a footnote.

The IRS might focus on these issues

- Using incorrect tax treatment for various financial products including options, ETFs, ETNs, cryptocurrencies, foreign futures, and more.
- Misreporting wash sale loss adjustments on securities can lead to questions.
- Overstating business expenses on Schedule C.
- The hobby loss and passive-activity loss rules don’t apply TTS, so don’t let the IRS go down that path in an exam questionnaire.

Q4 2018 ESTIMATES & APRIL 15TH PLANNING

Avoid underestimated tax penalties, consider an automatic extension, and try to pay what you owe by April 15, 2019.

Q4 2018 estimates are due Jan 15, 2019

- If you skip Q4 2018 estimated taxes due by January 15, 2019, then you might owe interest calculated at 5% for 2018 underpayments. It's non-deductible.

- Some traders use the safe harbor exception to cover the prior year taxes to avoid interest expense.

- Others, skip Q1 to Q3 to see if they are profitable as of year-end.

- It would help if you had your P&L handy now before the Q4 deadline.

Set aside tax money owed the IRS

- Some traders don't owe 2018 taxes until April 15, 2019.
- Consider setting aside the IRS and state tax monies and not risking it in the financial markets.
- Expect K-1s to come late, requiring you to file an automatic extension for six-months additional time to submit your complete tax return.
- Try to pay taxes owed by April 15, 2019, to avoid late-payment penalties and interest expense.

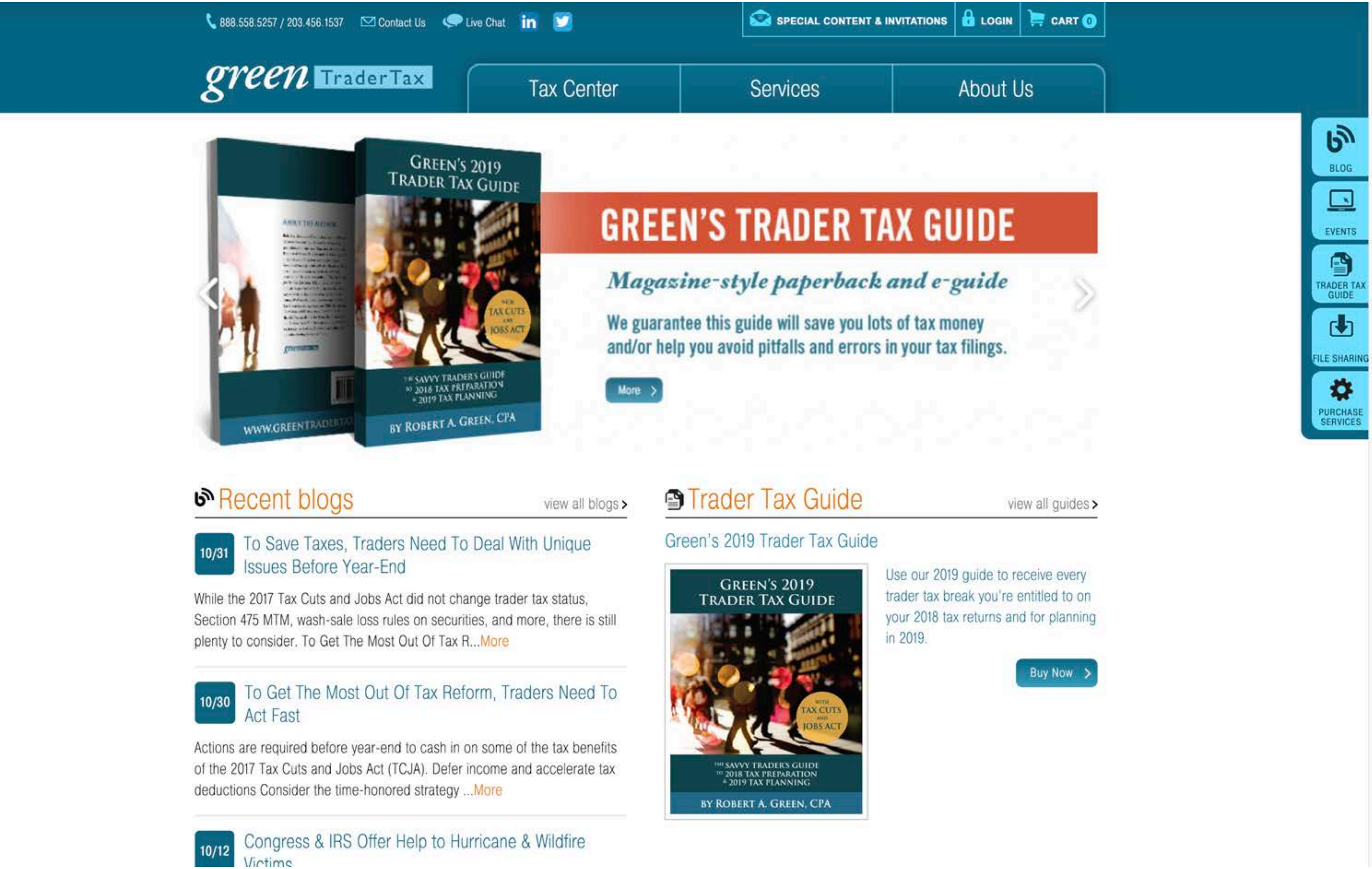
Delays this tax season

- It’s the first year of implementing the new tax law TCJA.
- The IRS is late in finalizing new regulations, 2018 tax forms, instructions, and publications.
- The 2018 year-end government shutdown affected parts of the IRS, including the processing of tax refunds.
- Most of the tax forms in this presentation created on Jan. 3, 2019, are in draft form, only.

QUESTIONS & ANSWERS

Closing Remarks

- Thank you for attending this Webinar or watching the recording.
- Visit www.GreenTraderTax.com for additional information and consider our 2018 tax compliance service.
- Call us toll free at 888.558.5257 or 203.456.1537
- Email us your questions at info@greentradertax.com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