HOW TO STRUCTURE A TRADING BUSINESS FOR SIGNIFICANT TAX SAVINGS

August 14, 2019 @ 12:00 pm EST
(Interactive Brokers Webinar)

CPA Presenter:

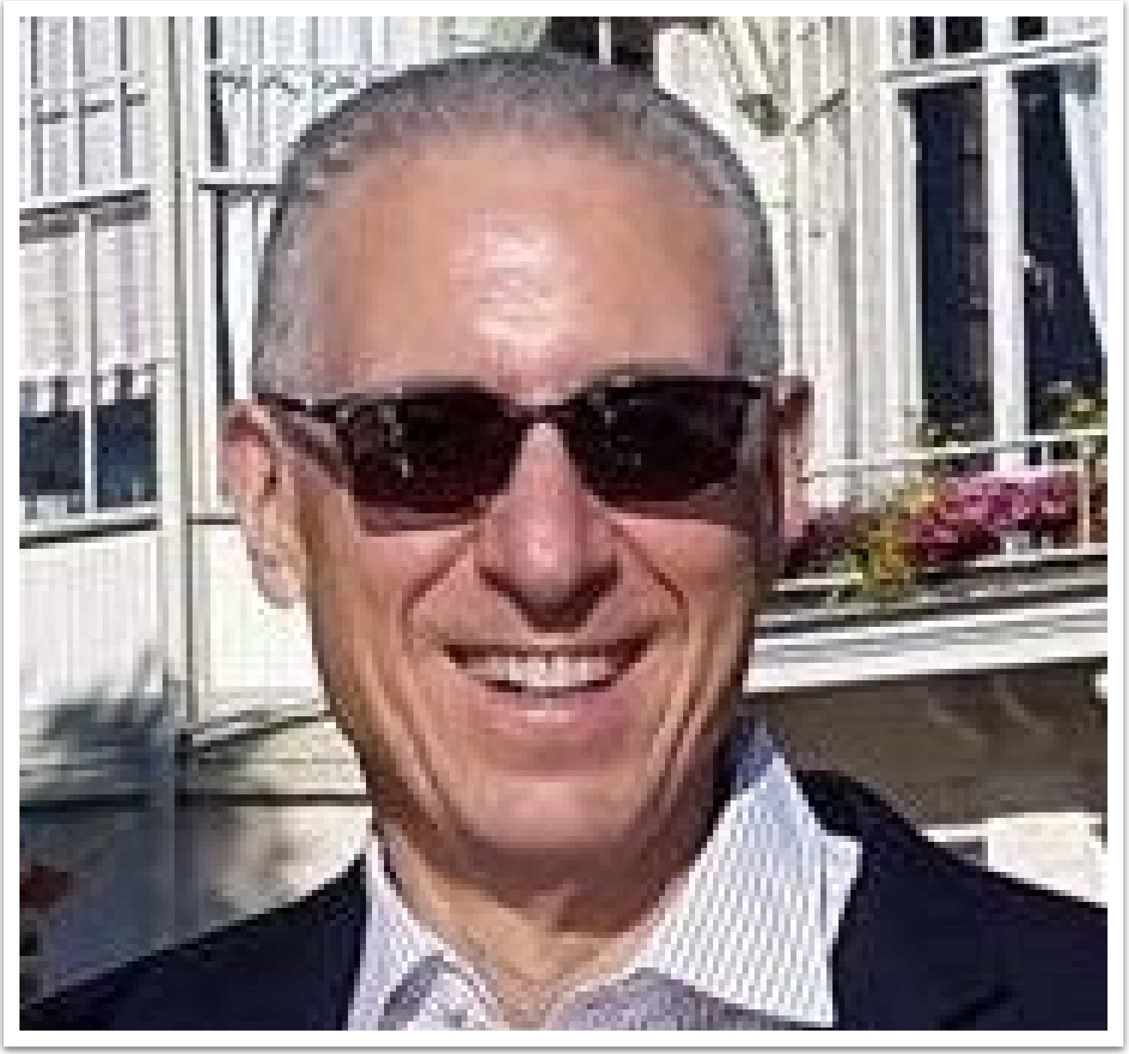
Robert A. Green

Managing Member

GNM TraderTax

GREEN, NEUSCHWANDER & MANNING, LLC

green TraderTax



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.

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.

Overview

- If you actively trade securities, futures, forex or crypto, consider setting up a trading business to maximize tax benefits.
- With a sole proprietorship, a trader eligible for trader tax status (TTS) can deduct business expenses, startup costs, and home-office expenses. It’s easy to claim this tax treatment.
- TTS traders should also consider a Section 475 election on securities for exemption from wash sale losses, and the capital loss limitation. Section 475 also unlocks a potential qualified business income (QBI) deduction. (Individuals had to elect 475 by April 15.)

Overview

- A “new taxpayer” TTS partnership can elect Section 475 within 75 days of inception, which can be later in the year.
- By forming an LLC taxed as an S-Corp, a trader can claim TTS, elect 475, and deduct health insurance premiums and a retirement plan contribution. The S-Corp gets the full assortment of tax benefits.

Tax law favors a trading business

- The new tax law (TCJA) severely limits itemized deductions for investors, while expanding the standard deduction and improving business expensing.

- TCJA introduced a 20% deduction on QBI, which includes a TTS trading business with Section 475 income but excludes capital gains and portfolio income. A trading business is more valuable than ever before.

  There are three good choices: Sole proprietorship, partnership, or S-Corp. C-Corps don’t make sense for traders.

Choosing a TTS trading business structure

		TTS	TTS	TTS
	Investor	Sole prop	Partnership	S-Corp
Tax savings:				
Deduct trading business expenses, startup costs and home office deductions		X	X	X
Elect Section 475		X	X	X
Elect 475 late in year for new entities			X	X
20% QBI deduction on 475 income less business expenses		X	X	X
Enhanced QBI deduction with 199A Wages				X
Deduct officer/owner compensation				X
Deduct health insurance				X
Deduct retirement plan contribution				X
Additional costs:				
Professional data-feed fees might apply			X	X
Entity tax return required			X	X
Payroll compliance service				X
State minimum tax might apply			X	X

SOLE PROPRIETORSHIP

It’s easy to set up and operate.

File a Schedule C

- An individual TTS trader deducts business expenses, startup costs and home office deductions on a Schedule C (Profit or Loss From Business – Sole Proprietorship), which is part of a Form 1040 filing.

- Schedule C losses are an above-the-line deduction from gross income.

Use an individual brokerage account

- Open an individual brokerage account(s) in the trader’s name and social security number.
- You can also use a joint account but list the trader’s name and social security number first.
- You don’t need a separate employer identification number (EIN) unless you plan to have employees on the payroll.

No filings

- There is no state filing required for a sole proprietorship as there is for organizing an LLC or incorporating a corporation.
- You also don’t need a “doing business as” (DBA) name, although you can obtain one if you prefer.
- There isn’t a federal or state tax election for claiming TTS — it’s determined based on facts and circumstances assessed at year-end.
- You can claim TTS after-the-fact; you don’t have to formalize it in advance.

Don’t confuse TTS with a Section 475 election

- Only TTS traders can use Section 475 ordinary gain or loss treatment; however, many TTS traders don’t make a 475 election.
- For example, a TTS futures trader might skip a 475 election to retain lower 60/40 capital gains rates on 1256 contracts.
- You can elect Section 475 on securities only, commodities only, or both.

Example of claiming TTS

- Active trader Pete realized in mid-2019 that he qualified for TTS for all of 2018.
- Pete can add a Schedule C to his 2018 Form 1040 tax return due on an extension by October 15, 2019. (Traders can use TTS on amended tax returns, too.)
- A Schedule C provides tax benefits for 2018 and year-to-date in 2019.

Example of forming an S-Corp.

- Pete wants to form an S-Corp later in 2019 to unlock a health insurance deduction for the remainder of 2019 and a high-deductible retirement plan deduction.
- He realized he qualified for TTS for 2018 and 2019 after April 15, so it was too late to elect 475 on the individual level for 2019.
- However, a new S-Corp can elect Section 475 within 75 days of inception. With the S-Corp, Pete can also arrange health insurance and retirement deductions for 2019.

SECTION 475 ELECTION

Section 475 MTM ordinary gain or loss treatment is tax-loss insurance, and it provides an opportunity for a 20% QBI deduction.

Section 475 tax benefits

- TTS traders are entitled to make a Section 475 election, but investors may not.
- I call it “tax loss insurance” because the election exempts securities trades from onerous wash-sale loss adjustments, which can defer tax losses to the subsequent year, and the $3,000 capital loss limitation.
- Ordinary loss treatment is far better; it can generate tax refunds faster than capital loss carryovers.

How to elect 475 later in the year

- A partnership or S-Corp formed during the tax year is considered a “new taxpayer,” which can elect Section 475 internally within 75 days of inception.

- An individual TTS trader had to choose Section 475 with the IRS by April 15, 2019, so a new partnership or S-Corp comes in handy after the April 15 deadline.

Capital loss carryovers

- Prior capital-loss carryovers on the individual level still carry over on Schedule Ds.
- The new entity can pass through capital gains if the taxpayer skips the Section 475 MTM election to use up those capital loss carryovers.
- Then, the entity can elect Section 475 MTM in a subsequent tax year.
- It’s easy to revoke a 475 election in a manner that mirrors making a 475 election.

QUALIFIED BUSINESS INCOME DEDUCTION

TTS traders with Section 475 income, net of trading business expenses, might be eligible for a 20% QBI deduction if under taxable income thresholds for specified service businesses.

Qualified business income deduction

- TCJA introduced a tax benefit for pass-through businesses, which includes a TTS trader with Section 475 income; whether doing business as a sole proprietor, partnership, or S-Corp.
- Section 199A provides a 20% QBI deduction on a “specified service trade or business” (SSTB), and TTS trading is an SSTB.
- However, SSTBs are subject to a taxable income threshold, phase-out range, and income cap. The phase-out range has wage and property limitations, too.

SSTB threshold and cap

- For 2019, the taxable income (TI) cap is $421,400 /$210,700 (married/other taxpayers). It's indexed for inflation.
- The phase-out and phase-in range below the cap is $100,000/$50,000 (married/other taxpayers).
- The TI threshold is $321,400/$160,700 (married/other taxpayers).

QBI limitations

- The 20% deduction is on whichever is lower: QBI or taxable income minus "net capital gains" defined as net long-term capital gains over net short-term capital losses, and qualified dividends.

- QBI includes Section 475 ordinary income and trading business expenses and excludes capital gains and losses, dividends, interest income, forex and swap ordinary income, and investment expenses.

- See my blog post: A Rationale For Using QBI Tax Treatment For Traders.

PASS-THROUGH ENTITIES

Partnerships and S-Corps.

Pass-through entities

- A pass-through entity means the company is a tax filer, but it's not a taxpayer. The owners are the taxpayers.

- Taxpayers should consider marriage, state residence, and state tax rules, including annual reports, minimum taxes, franchise taxes, excise taxes, and more when setting up an entity.

- In most states, these taxes are nominal costs. (In *Green's 2019 Trader Tax Guide*, I address state taxes for S-Corps in California, Illinois, other states, and New York City.)

PARTNERSHIPS

Partnerships include LLCs, LPs, and general partnerships, which all file a Form 1065 partnership tax return.

TTS partnerships

- A trader can organize a spousal LLC and file as a partnership.
- Alternatively, the trader can form a marital general partnership without liability protection afforded by an LLC.
- Partnerships file a Form 1065 partnership tax return.
- Establishing a separate legal entity does not alone generate tax benefits; it’s critical for the organization to qualify for TTS.

Investment partnerships

- Without TTS, the company is considered an investment partnership with suspended investment fees and expenses.

- An investment partnership cannot have business expenses, officer compensation, and employee benefits, including health insurance and retirement plans.

Form 1065 and Schedule E

- A TTS partnership deducts business expenses on Schedule K-1 line one (ordinary business income/loss). Section 475 income or loss is also reported on line one. The owner reports line one on Schedule E in the active column – it's not a passive activity.

- Capital gains and portfolio income is separately stated on Schedule K-1.

- If the partnership agreement provides for it, the partner can also deduct "unreimbursed partnership expenses" (UPE) including home office expenses, on Schedule E page 2 (Supplemental Income and Loss).

Partnership looks better than Schedule C

- A partnership tax return looks better to the IRS vs. a Schedule C with different tax forms for trading gains and losses.
- The partnership return consolidates Section 475 ordinary income/loss with business expenses in line one of Schedule K-1.
- TTS capital gains are easy to see on the partnership return.
- On the contrary, there is a red flag with a Schedule C displaying business expenses, only.

Use a partnership to segregate trading from investment positions

- A partnership (or S-Corp) helps segregate investment positions from TTS/Section 475 trading positions.
- If you trade substantially-identical positions that you also invest in, it could invite the IRS to play havoc with the reclassification of TTS vs. investment positions.
- Using a TTS company prevents the IRS from reclassifying TTS positions out of Section 475 ordinary loss treatment into a capital loss limitation on investment positions. Alternatively, reclassifying deferred long-term capital gains to MTM ordinary income.

S-CORPS

Get the full assortment of tax benefits: TTS, 475, health insurance, and retirement plan deductions.

S-Corps

- Organize an LLC or incorporate a corporation, and the entity has the option to file an IRS Form 2553 (Election by a Small Business Corporation) within 75 days of inception.

- Alternatively, in a subsequent year, the S-Corp election is due by March 15. All the owners must be U.S. residents.

Elections

- Most states accept the federal S-Corp election, although some states including but not limited to New York and New Jersey require a separate state election.

- There is IRS relief for late S-Corp elections; however, you had to have the intention of making the S-Corp election on a timely basis.

- New S-Corps (and partnerships) can elect Section 475 within 75 days of inception.

One owner is allowed

- Unlike a partnership, an S-Corp doesn't require two or more owners.

- An unmarried trader can form a single-member LLC to elect S-Corp status.

- Otherwise, a single-member LLC is a "disregarded entity" (a "tax nothing" in the eyes of the IRS), which takes you back to using sole proprietor status on a Schedule C.

Employee benefits

- An essential tax benefit of an S-Corp is to arrange tax deductions for health insurance premiums and a high-deductible retirement plan contribution through officer compensation.

- These employee benefits require the execution of a formal payroll before year-end.

- Year-end tax planning is paramount.

Why an S-Corp is required

- Sole proprietors and partnerships cannot achieve these employee-benefit deductions in connection with trading income.

- A Schedule C cannot pay the owner wages, and partnerships must use "guaranteed payments" instead of salaries for partners.

- Partnership expenses flow through, including a guaranteed payment, creating negative self-employment income (SEI). Partnership trading gains are not earned income.

Why an S-Corp is required

- Negative SEI makes a health insurance and retirement plan deduction challenging to achieve for a TTS partnership.
- Conversely, S-Corps don't pass through negative SEI, and the employee benefit deductions work tax efficiently on officer compensation.

HEALTH INSURANCE

How to arrange a health insurance deduction using an S-Corp.

Health insurance premiums

- TTS traders with significant self-employed health insurance (HI) premiums should consider an S-Corp to arrange a tax deduction through officer compensation; otherwise, they cannot deduct HI without SEI.
- Not everyone needs a health insurance deduction, but if you do, crunch the numbers.
- An S-Corp is worthwhile if the HI tax deduction is meaningful, and the tax savings exceed the entity costs of formation and maintenance.
- A retirement plan deduction adds icing on the cake.

Example of HI deduction

- A married securities trader in a high-tax state might have a $24,000 HI deduction for family coverage, and with a 40% combined federal and state tax bracket, the tax savings for the HI deduction is $9,600.

- There is no payroll tax on the health insurance component of wages.

- An S-Corp is a good idea for this trader.

How to execute the HI deduction

- The health insurance deduction is complicated for officer/owners: Add health insurance premiums paid by the entity or individually during the entity period to wages in box 1 on the officer/owner's W-2.

- The health insurance amount in salary is not subject to payroll taxes, so omit this amount from Social Security wages in box 3, and Medicare wages in box 5.

- The officer deducts health insurance premiums as an adjusted gross income (AGI) deduction on his Form 1040 personal tax return.

Health Savings Accounts

- Taxpayers can deduct Health Savings Accounts (HSA) without the need for TTS or earned income.

- HSA contribution limits for 2019:
  - Individual $3,500
  - Family coverage $7,100
  - Age 55 or older, additional $1,000 a year

- See How To Maximize Tax Savings Using Tax-Favored Health Plans.

Health Reimbursement Accounts (HRA)

- For TTS traders with out-of-pocket costs well more than HSA limits, consider an HRA in a C-Corp management company, alongside a trading partnership.

- Sole proprietors, partners, and more-than-2% S-Corp owners may not participate in an HRA because they are “self-employed individuals.”

RETIREMENT PLAN CONTRIBUTIONS

How to arrange a retirement plan contribution and deduction using a TTS S-Corp.

Traders need wages for earned income

- Taxpayers need self-employment income (SEI) to make and deduct retirement plan contributions; however, trading income is not SEI. That's why traders need wages in an S-Corp.

- There are tax costs and benefits to SEI: It triggers SE tax but also unlocks the HI and retirement plan deductions.

- SE tax is the same as payroll tax (FICA and Medicare).
  12.4% FICA is capped at $132,900 for 2019.
  2.9% Medicare is unlimited.

Limit wages to what you need

- A TTS trader uses an S-Corp to pay officer compensation for these employee benefit deductions.

- The trader is in control of how much to run through payroll, picking an amount to maximize employee benefit deductions but not to pay too much in the payroll tax.

Wait until December to pay wages

- You should fund retirement plan contributions from net income, not losses.
- It's best to wait on the execution of an annual paycheck until early December when there is transparency for the year.
- A trader should not have a base salary throughout the year.
- Some traders make money during the year, only to lose it before year-end.

Solo 401(k) elective deferral

- If you have sufficient trading profits by Q4, consider establishing a Solo 401(k) retirement plan before year-end.
- Start with the 100% deductible elective deferral (ED; $19,000 for 2019) and pay it through payroll since it’s reported on the annual W-2.
- Taxpayers 50 years and older have a “catch up provision” of $6,000, raising the ED limit to $25,000 per year.

Solo 401(k) profit-sharing plan

- If you have large trading gains, consider increasing payroll in December for a performance-based bonus to unlock a 25% deductible Solo 401(k) profit-sharing plan (PSP) contribution that you don't have to pay into the retirement plan until the due date of the S-Corp tax return (including extensions by September 15).

- The maximum PSP amount is $37,000.

- The total limit for a Solo 401(k) is $62,000 ($19,000 ED, $6,000 catch-up ED, and $37,000 PSP).

Roth Solo 401(k)

- Consider a Roth Solo 401(k) contribution in the years when you can skip an income tax deduction.

- Roth Solo 401(k)s and Roth IRAs are permanently tax-free for growth and contributions.

- There are no income limits for a Roth Solo 401(k), as there are for a Roth IRA.

Blog post

See How To Structure A Trading Business For Significant Tax Savings for more information:

- Examples of retirement plans.
- S-Corp officer compensation and payroll.
- Avoiding wash sales with an entity.
- S-Corp accountable reimbursement plans.
- How to qualify for trader tax status.
- Investment vs. TTS business expenses.

QUESTIONS & ANSWERS

GNM TraderTax
GREEN, NEUSCHWANDER & MANNING, LLC

- Consider a 45-minute consultation with Robert A. Green, CPA, to review eligibility for TTS, an entity plan, Section 475 election, and more.
- If an entity is a good idea for you, then consider our entity formation service.
- We also offer our tax compliance service, starting with year-end planning in December.

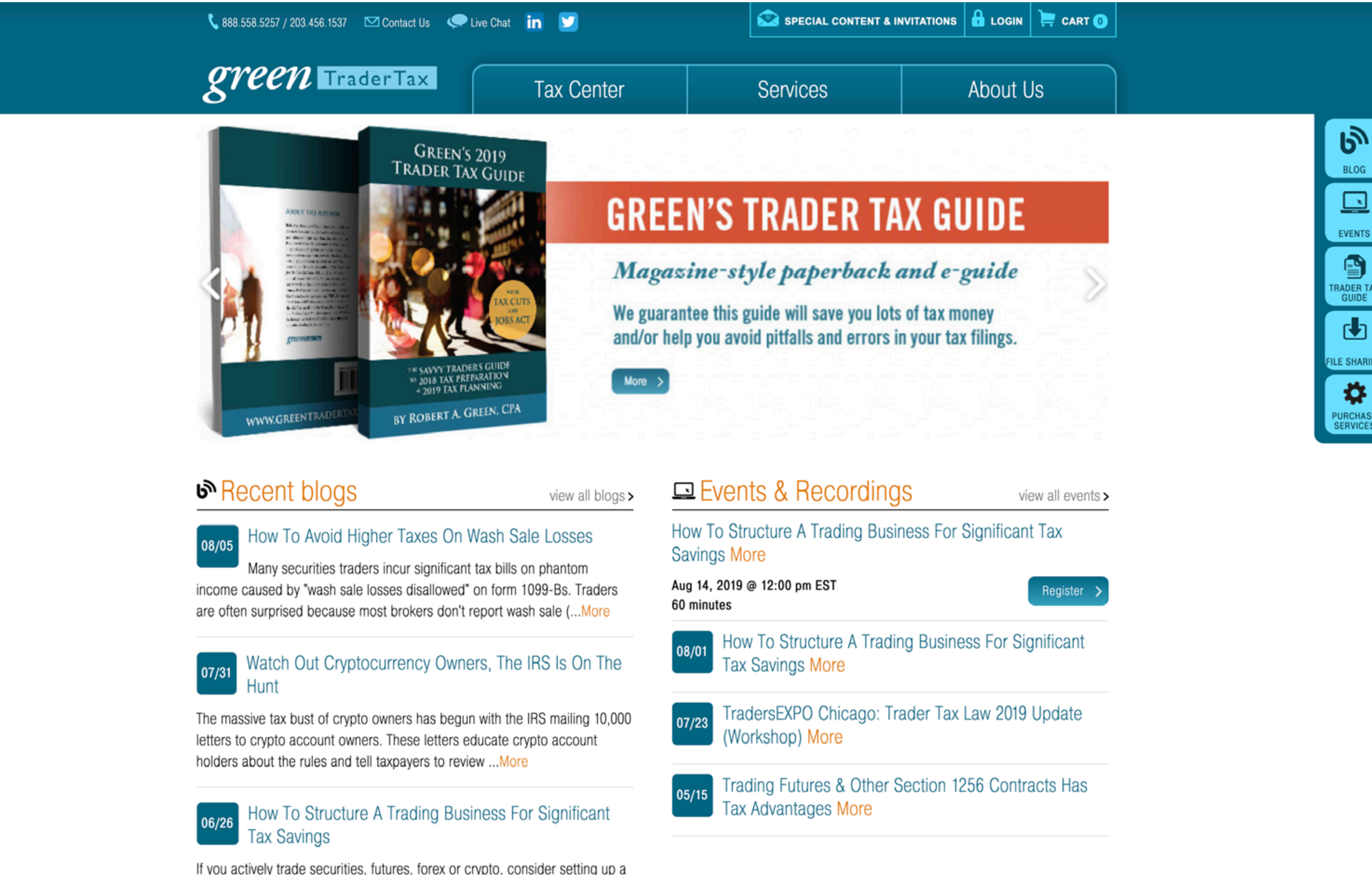
Contact us

- Thank you for attending this Webinar or watching the recording.

- Visit www.GreenTraderTax.com for additional information.

- Call us toll free at 888.558.5257 or 203.456.1537

- Email us your questions at info@greentradertax.com


888.558.5257 / 203.456.1537
Contact Us
Live Chat
SPECIAL CONTENT & INVITATIONS
LOGIN
CART 0
green TraderTax
Tax Center
Services
About Us
GREEN'S 2019 TRADER TAX GUIDE
THE SAVVY TRADERS GUIDE TO 2018 TAX PREPARATION & 2019 TAX PLANNING
BY ROBERT A. GREEN, CPA
WWW.GREENTRADERTAX
GREEN'S TRADER TAX GUIDE
Magazine-style paperback and e-guide
We guarantee this guide will save you lots of tax money and/or help you avoid pitfalls and errors in your tax filings.
More
BLOG
EVENTS
TRADER TAX GUIDE
FILE SHARING
PURCHASE SERVICES
Recent blogs
view all blogs
08/05
How To Avoid Higher Taxes On Wash Sale Losses
Many securities traders incur significant tax bills on phantom income caused by "wash sale losses disallowed" on form 1099-Bs. Traders are often surprised because most brokers don't report wash sale (...More
07/31
Watch Out Cryptocurrency Owners, The IRS Is On The Hunt
The massive tax bust of crypto owners has begun with the IRS mailing 10,000 letters to crypto account owners. These letters educate crypto account holders about the rules and tell taxpayers to review ...More
06/26
How To Structure A Trading Business For Significant Tax Savings
If you actively trade securities, futures, forex or crypto, consider setting up a
Events & Recordings
view all events
How To Structure A Trading Business For Significant Tax Savings More
Aug 14, 2019 @ 12:00 pm EST
60 minutes
Register
08/01
How To Structure A Trading Business For Significant Tax Savings More
07/23
TradersEXPO Chicago: Trader Tax Law 2019 Update (Workshop) More
05/15
Trading Futures & Other Section 1256 Contracts Has Tax Advantages More