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WILL THE IRS DENY TAX BENEFITS TO TRADERS DUE TO COVID?

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COVID TRADERS

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Trading proliferated during the pandemic

- So far, 2020 has been a highly volatile year in the financial markets due to significant uncertainty over Covid-19, a shock to the economy, and job losses.
- As the virus spread in the U.S, millions of displaced Americans turned to trading in financial markets as a means of making a new living.
- Some became active enough to qualify for trader tax status (TTS) benefits, which requires regular, frequent, and continuous trading.
- However, will the IRS deny TTS to Covid-19 traders if they only carry on a trading business during the pandemic for a short time?

Existing traders have TTS and 475 tax loss insurance

- I'm not as worried about existing traders from 2019 who incurred massive trading losses in Q1 2020 during the Covid correction and stopped trading at that time.
- Hopefully, they made a Section 475 ordinary loss election due by the July 15, 2020 deadline, which is conditional on eligibility for TTS.
- These pre-Covid traders were in business for more than 15 months, so their TTS/475 ordinary loss deduction should be safe.

New traders might not qualify for TTS, and others missed the 475-election deadline

- I am more concerned with the millions of newcomer traders who opened online trading accounts offering free or low commissions in 2020. Many rookies have significant trading gains year-to-date, even after the recent sell-off.

- In the trading business, gains can turn into losses with a substantial correction and volatility. When that happens, TTS traders count on Section 475 for tax-loss or fire-loss insurance: The trading house burns down, and you can file for a refund with the IRS. (A 475-election was due by July 15, 2020.)

- The CARES Act permits five-year net operating loss (NOL) carryback refund claims for 2020, 2019, and 2018 tax returns. NOLs include 475 ordinary losses and TTS expenses.

There are issues for new traders in qualification for TTS

- Some rookie traders start off meeting the IRS requirements for TTS. Those rules are vague, so see GreenTraderTax's golden rules for TTS. I wonder how IRS agents will consider the Covid pandemic when assessing TTS.
- Consider a furloughed worker who started trading at home full time in mid-2020.
- Was the trader's intention to create a new business for the long-term, or to buy time and make some extra money before returning to his or her career after the pandemic subsides?
- TTS requires the intention to run a business from catching daily market movements, not from making investments for appreciation.

The IRS might require Covid traders to have longevity in the business

- If a new trader started trading on June 1, 2020, but stops or significantly slows down trading when returning to work in November 2020, I wonder if the IRS would deny TTS because he only traded actively for five months.

- The IRS agent might cite the landmark tax court case Chen vs. Commissioner, where the court denied TTS to Chen.

- Chen only carried on TTS for three months.

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CHEN VS. COMMISSIONER

The tax court denied TTS & 475 MTM to Chen

- Comments from a senior IRS official at an industry forum about the Chen tax court case point out the IRS doesn’t respect individual traders who are brand new to trading activity and who enter and exit it too quickly.
- Chen only traded for three months before losing his trading money, thereby leaving his trading activity.
- Chen kept his software engineering job during his three months of trading.

Chen might make precedent a time requirement for TTS

- The Chen case indicates the IRS wants to see a more extended time to establish TTS.
- Some IRS agents like to intimidate taxpayers with a full year requirement, but the law does not require that.
- Hundreds of thousands of businesses start and fail within three months, and the IRS doesn't challenge them on business status.
- The IRS is rightfully more skeptical of traders vs. investors, perhaps even more so during the pandemic.

Trading in the prior and subsequent year helps

- The longer a trader can continue his business trading activity, the better his chances are with the IRS.

- We often ask clients about their trading activities in the prior and subsequent years as we prepare their tax returns for the year that just ended. Vigorous subsequent-year trading activities and gains add credibility to the tax return being filed.

- We mention these points in tax return footnotes, too.

- Traders can start their trading business in Q4 and continue it into the subsequent year.

Chen messed up many things in his case

- Chen lied to the IRS about electing Section 475 MTM ordinary loss treatment on time and then used 475 MTM when he wasn't eligible.

- He should have been subject to a $3,000 capital loss limitation rather than deducting a massive 475 ordinary loss triggering a huge tax refund.

- Chen brought a losing case to tax court and made the mistake of representing himself.

- Once Chen was busted on the phony MTM election, he caved in on all points, including TTS. Chen did not have many TTS business expenses, so he figured it wasn't worth continuing to fight.

Chen might have been able to win TTS

- Even though he only traded for three months while keeping his full-time job, it doesn’t mean he didn’t start a new business — intending to change careers to business trading — and make a substantial investment of time, money, and activity.

- Tax code or case law doesn’t state that a business must be carried on for a full year or as the primary means of making a living.

Many businesses don’t survive long

- Countless businesses startup and fail in a few short months, and many times the entrepreneur hasn’t left his or her job while experimenting as a businessperson.
- Chen may have won TTS had he been upfront with the IRS and engaged a tax attorney or trader tax expert to represent him in court.

TRADER TAX STATUS BENEFITS

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Business expenses

- TTS traders deduct business expenses, startup costs, and home office expenses.

- Business expenses include home-office, education, startup expenses, organization expenses, margin interest, tangible property expense, Section 179 (100%) or 100% bonus depreciation, amortization on software, self-created automated trading systems, chat rooms, mentors, seminars, market data, charting services, stock borrow fees, and much more.

Section 475 MTM

- TTS traders are entitled to elect the robust Section 475 mark-to-market accounting, which converts capital gains and losses into ordinary gains and losses.

- Short-term capital gains on securities are ordinary income; whereas, 475 ordinary business losses generate tax refunds much faster than a $3,000 capital loss limitation.

- Section 475 also exempts securities trades from onerous wash sale loss rules, a headache for active traders, which causes phantom income and potentially excess tax liability.

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Section 475 MTM

- The 20% qualified business income (QBI) deduction applies to 475 net income if the taxpayer is under a taxable income threshold.

- QBI excludes capital gains.

- Individuals had to elect 475 for 2020 by the postponed deadline of July 15, 2020.

- A new LLC partnership or S-Corp can select 475 within 75 days of inception.

Health and retirement plan deductions

- With a TTS S-Corp, traders can deduct health insurance and retirement plan contributions.
- Investors do not have self-employment income for these deductions.
- Forming a new entity later in 2020 can work if it commences TTS by early October 2020. Starting the entity in November is probably too late to establish TTS.

TTS golden rules

- Volume of trades: four trades per day, counting open and closing transactions separately. Fifteen trades per week, and 60 a month per the Poppe court.
- Frequency: 75% of available trading days, close to four days per week.
- Holding period: Average under 31-days per Endicott court.
- Hours: four per day, all time included.
- Account size: 25k for pattern day trader, otherwise 15k minimum for futures, forex, or cryptocurrency.

TTS golden rules

- Intention to run a business to make a living.
- Multiple computers and monitors are helpful.
- Dedicated home office.
- Manual trading with own ideas or using a self-created automated trading system.
- Take a deep dive on TTS golden rules here:
- https://greentradertax.com/how-to-be-eligible-for-substantial-tax-savings-as-a-trader/

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INVESTOR TAX STATUS

Traders who don't qualify for TTS

- Investors can only deduct margin interest expense as an itemized deduction, and many taxpayers use the standard deduction. If you have a few trading costs, then TTS might not be crucial.

- Maybe you'll qualify for TTS in 2021 and can go back six-months to capitalize startup costs under Section 195.

- Without TTS and a Section 475 election, traders should avoid wash sales in taxable accounts at year-end and throughout the year between taxable and IRA accounts.

- If you do tax-loss selling in December 2020, don't buy back a substantially identical position 30 days before or after in January to avoid wash sale loss adjustments (deferral of cost basis).

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Traders who don't qualify for TTS

- Perhaps you have health insurance coverage in another job or business, or through your spouse and don't need a TTS S-Corp to arrange a health insurance deduction. Cobra is not deductible, anyway.

- Consider trading futures and other Section 1256 contracts for lower 60/40 capital gains rates, about one-third less than the ordinary rates. It's MTM, so wash sales are not applicable.

- Trading in retirement accounts doesn't qualify for TTS, but it defers taxes until retirement. Trading in a Roth IRA is permanently tax-free.

Retirement plan distributions under CARES Act

- Taxpayers negatively impacted by COVID-19 can take a withdrawal from an IRA or qualified retirement plan of up to a maximum of $100,000 in 2020 and be exempt from the 10% excise tax on “early withdrawals.”

- The taxpayer has the option of returning (rolling over) the funds within three years or paying income taxes on the 2020 distribution over three years.

- CARES also suspended required minimum distributions for 2020.

- (Update May 4, 2020: IRS Website Coronavirus-related relief for retirement plans and IRAs questions and answers.)

Many new traders are confident to continue

- I consult new traders on TTS, 475 and entities.
- It's incredible how many of these traders, from all walks of life, ages and careers, have made small fortunes since April 2020. Others incurred substantial losses.
- During my tax consultations, many clients tell me they don't want to return to their jobs, if called back, and that TTS trading is their new career, which they cherish.

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2020 ESTIMATED TAXES

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Traders owe quarterly estimated taxes

- Many traders have substantial trading gains for 2020 YTD, and they might owe 2020 estimated taxes paid to the IRS quarterly.
- Unlike wages, taxes aren't withheld from trading gains.
- Others can wait on tax payments until April 15, 2021, when they file their 2020 tax return or extension.

Focus now on a Q4 estimated tax payment

- The first two quarters of estimated tax payments were due July 15, 2020 (the postponed date due to Covid), Q3 was due on Sept. 15, 2020, and Q4 is due on Jan. 15, 2021.

- Many new traders didn't submit estimated payments for the first three quarters, waiting to see what Q4 brings. With full transparency at year-end, traders can make Q4 payments with more clarity. Some traders view estimated taxes similar to a margin loan with interest rates of 5% for Q1 and Q2, and 3% for Q3.

Safe harbor exception

- The safe-harbor rule for paying estimated taxes says there's no penalty for underpayment if the payment equals 90% of the current-year tax bill or 100% of the previous year's amount (whichever is lower).
- If your prior-year adjusted gross income (AGI) exceeded $150,000 or $75,000 if married filing separately, then the safe-harbor rate rises to 110%.

Example

- Suppose your 2019 tax liability was $40,000 and AGI was over $150,000. Assume 2020 taxes will be approximately $100,000, and you haven't paid estimates going into Q4.
- Using the safe-harbor rule, you can spread out the payment, submitting $44,000 (110% of $40,000) with a Q4 voucher on Jan. 15, 2021 and paying the balance of $56,000 by April 15, 2021. This is a nice option to consider instead of sending $90,000 in Q4 (90% of $100,000).
- Consider setting aside that tax money due April 15 rather than risking it in the financial markets in Q1 2021. I've seen some traders lose their tax money owed and get into trouble with the IRS.

Underpayment of estimated tax penalties

- In the above example, the trader should calculate the underpayment of estimated tax penalties for Q1, Q2, and Q3 on 2020 Form 2210.
- Consider using Form 2210’s Annualized Income Installment Method (page 4) if the trader generated most of his trading income later in the year.
- The default method on 2210 allocates the annual income to each quarter, respectively.

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Estimated tax payments based on the current year

- If your 2019 income tax liability is significantly higher than your 2020 tax liability, consider covering 90% of the current year's taxes with estimated taxes.

- Check your state's estimated tax rules, too.

- Learn more about estimated taxes at https://www.irs.gov/businesses/small-businesses-self-employed/estimated-taxes.

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Wage withholding

- Employees have another way to avoid underpayment of estimated tax penalties on non-wage income.
- They can ask employers to increase their wage tax withholding in November and December, which the IRS treats as equally made throughout the year.

QUESTIONS AND ANSWERS

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