YEAR-END TAX PLANNING FOR TRADERS

green TraderTax

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Description

- Join Robert A. Green, CPA of GreenTraderTax.com, in his Webinar on year-end tax planning for traders.

- Don’t wait until tax time in April; arrange tax savings before year-end.

- Learn about deferring income, accelerating deductions, tax loss selling, avoiding wash sale losses, paying Q4 estimated taxes, maximizing NOLs, Roth IRA conversions, S-Corp payroll with health and retirement benefits, and other tax-savings strategies.

Overview

- Year-end tax planning for traders varies based on eligibility for trader tax status (TTS) in 2020 and 2021.
- There are different strategies to consider for investors, TTS traders using the capital gains method, and TTS traders using Section 475 MTM ordinary gain and loss treatment.
- TTS traders operate as sole proprietors, spousal LLC/partnerships, or LLC/S-Corps.

INVESTORS

TCJA suspended investment expenses

- The 2017 Tax Cuts And Jobs Act (TCJA) suspended investment fees and expenses for investors, and the 2020 Coronavirus Aid, Relief, and Economic Security (CARES) Act did not change that.
- After TCJA, the only itemized deductions for investors are margin interest expense limited to investment income and stock borrow fees.
- TCJA roughly-doubled the standard deduction, and with an inflation adjustment for 2020, it’s $24,800 married, $12,400 single, and $18,650 head of household.
- TCJA’s $10,000 cap on state and local taxes (SALT) leads many taxpayers to use the standard deduction.

TCJA favors trader tax status (TTS)

- TTS traders are better off; they deduct trading business expenses, startup costs, and home office expenses from gross income – Schedule C for sole proprietors.

- Brokerage commissions are transaction costs deducted from trading gains or losses; they are not separately-stated expenses.

Transitioning from investor to TTS trader

- In 2020 with Covid stay-at-home orders and remote work, many new traders entered the markets.

- Some achieved TTS for a partial year in 2020, whereas others won't qualify until 2021.

- If your TTS commences in January 2021, you can capitalize on some hardware, software, and other intangible costs made in 2020 for depreciation and amortization expense with TTS's commencement in early 2021.

Capitalize costs for deductions in 2021

- For example, on computers, monitors, and home office furniture contribute these costs at fair market value for TTS expensing in 2021.

- For some expenses like subscriptions, education, and software, capitalize those Section 195 startup costs.

- Section 195 allows expensing up to $5,000 in 2021, with the rest deducted straight-line over 15 years.

- We allow TTS traders to go back six-months before TTS inception for Section 195 costs and even further back for hardware costs.

Tax-loss selling with avoiding wash sale losses

- Investors, and TTS traders using the default realization method (not Section 475 MTM), should consider “tax-loss selling” before year-end to reduce capital gains income and the related tax liability.

- However, be careful to avoid wash sale loss adjustments on securities at year-end 2020, which defer the tax loss to 2021.

- For example, suppose you realize a capital loss on December 15, 2020, in Exxon and repurchase a substantially-identical position (Exxon stock or option) 30-days before or after that date.

Wash sales apply to securities

- In that case, it's a wash sale loss adjustment (WS).
- The WS loss defers to 2021 by adding the WS loss to the replacement position's cost basis.
- WS rules are different for brokers vs. taxpayers, so avoid permanent WS between taxable and IRA accounts.
- Section 1256 contracts have MTM by default, so WS is a moot point on futures. (See more on WS on our website.)

Capital loss limitation and capital loss carryovers

- If you expect a net capital loss for 2020 over the $3,000 capital loss limitation against other income, then you'll have a capital loss carryover (CLCO) to 2021 and subsequent years.

- You can use up a CLCO with capital gains in the following years.

- For example, if your CLCO is $25,000 going into 2021, and you have 2021 capital gains of $30,000, then you'll have $5,000 of net capital gains for 2021.

Section 1256 loss carryback election

- If you incur a significant capital loss in Section 1256 contracts, consider a 1256 loss carryback election made on Form 6781 filed with your 2020 tax return.

- That allows you to amend the prior three-year tax returns to apply the 1256 loss against 1256 gains only.

Take advantage of the 0% long-term capital gains rate

- If your 2020 taxable income is considerably under the capital gains tax bracket of $80,000 for married and $40,000 for unmarried individuals, then your long-term capital gains (LTCG) tax rate is 0%.

- For example, assume your taxable income for the married-filing joint is $50,000 as of late December 2020.

- You can sell investments held over 12-months with up to $30,000 of capital gains at a 0% tax rate. Don’t cut it too close: If your taxable income is $80,500, it will trigger the 15% LTCG rate on all LTCG.

- The 0% rate applies to Section 1256 contracts: 60% uses the LTCG rate, and 40% the short-term rate, which is the ordinary rate.

Affordable Care Act 3.8% net investment tax

- There is also the Affordable Care Act (ACA) 3.8% net investment tax (NIT) on net investment income (NII) for upper-income taxpayers with modified AGI above $250,000 married and $200,000 single.

- Tax-loss selling and other deductions lower AGI and NII, which can help avoid or reduce NIT.

President-elect Joe Biden's Tax Plan

- President-elect Joe Biden's Tax Plan proposed raising the top LTCG rate of 20% to a maximum ordinary rate of 39.6% (up from 37%), applying only to taxpayers with income over $1 million.

- Passing Biden's Tax Plan will be difficult if the Senate remains under Republican control.

- Democrats need to win both Senatorial runoff elections in Georgia on January 5, 2021, to control the Senate.

- Tax hikes are rarely made on a retroactive basis.

Future Covid aid and tax relief bills

- There may be further Covid aid and tax relief bills enacted during the lame-duck session, impacting year-end tax planning.
- (See How Covid-19 Tax Relief & Aid Legislation Impacts Traders.)

2020 Q4 Estimated Taxes Due January 15, 2021

- Many traders have massive trading gains in 2020, and they should focus on 2020 Q4 estimated taxes due January 15, 2021.

- Using the safe-harbor exception to cover 2019 tax liabilities, some traders can defer much of their tax payments to April 15, 2021.

- Just don’t lose the tax money in the markets in Q1 2021; consider setting it aside.

- (See Traders Should Focus On Q4 Estimated Taxes Due January 15.)

TRADERS ELIGIBLE FOR TRADER TAX STATUS

TTS for all or part of the year

- If a trader qualifies for TTS in 2020, they can deduct trading business expenses, startup costs, and home office expenses.

- The trader did not have to elect TTS or create an entity. (Section 475 required a timely election by July 15, 2020.)

- It's okay to commence TTS during the year, although we prefer not later than September 30; otherwise, the IRS could challenge TTS for Q4 or less.

- (See How To Be Eligible For Substantial Tax Savings As A Trader.)

TTS traders can accelerate deductions

- TTS traders planning to upgrade computers and other expenses should consider accelerating business expenses before the year-end.

- For equipment and furniture, you'll need to take possession and place the items into use before the year-end.

- TCJA mostly provides full expensing with tangible property expense up to $2,500 per item, Section 179 (100%) depreciation, or bonus depreciation.

TTS TRADERS WITH SECTION 475 MTM

Section 475 MTM

- TTS traders using section 475 mark-to-market (MTM) accounting use ordinary gain or loss treatment reported on Form 4797.

- Section 475 trades are not subject to WS or a capital loss limitation so that an ordinary loss can offset income of any kind.

- MTM reports unrealized gains and losses at year-end, so the taxpayer doesn’t have to do tax-loss selling on TTS trading positions.

Segregate investment positions

- Many TTS traders also have segregated investment positions, so they should consider WS and tax-loss selling on investment positions.
- Investments are not subject to Section 475, meaning you can defer capital gains and achieve the LTCG rate on investment positions if held 12-months.
- If you trade in substantially identical positions that you also invest in, the IRS can play havoc in an exam by attempting to recharacterize TTS trades vs. investments.
- Avoid that issue by considering a TTS LLC/partnership or TTS LLC/S-Corp for 2021 to ring-fence trading positions.

CARES allows NOL carrybacks

- If you have significant Section 475 ordinary losses for 2020, the CARES Act provides substantial relief.
- The CARES Act allows a five-year net operating loss (NOL) carryback applied against income of any kind.
- CARES also temporarily reversed TCJA's "excess business loss" (EBL) limitation of $500,000 married and $250,000 for other taxpayers (2018 limits and adjusted each year for inflation). Under TCJA, you add EBL amounts to NOL carryforwards.

NOL carryback example

- For example, a TTS/475 trader filing single with a $300,000 trading ordinary loss and TTS expenses of $25,000, and with no other income, would have a 2020 NOL of approximately $325,000.
- The $250,000 EBL limitation does not apply.
- This trader can carry back the 2020 NOL five years and use it against any type of income.
- Alternatively, if preferred, the taxpayer can elect to forgo the NOL carryback and carry it forward instead.

TCJA vs. CARES

- TCJA NOL rules apply again in 2021, limiting NOLs to 80% of taxable income with the remainder carried over to subsequent years.
- Under its latest Covid relief bills, the House proposed revising the NOL and EBL rules, reapplying EBL to all years, and limiting the number of NOL carryback years.
- Many taxpayers already filed NOL carryback returns under CARES, so it’s hard to reverse those rules now.

Qualified business income (QBI) deduction

- If a TTS trader has significant TTS/475 income, they might be eligible for a 20% "qualified business income" (QBI) deduction.

- Sole proprietors only get this QBI deduction if they are under the QBI taxable income threshold of $326,600 married and $163,300 for other taxpayers (2020 threshold adjusted for inflation).

- Determine the QBI deduction on the lower of taxable income or QBI.

- Suppose you have a TTS S-Corp with officer compensation. In that case, there is also a phase-out/phase-in range based on wages and qualified property for an additional $100,000 for married and $50,000 for other taxpayers, above the QBI thresholds.

NEW TRADERS

Covid traders

- Assess and claim TTS after-the-fact for 2020.
- Perhaps, you started January 1, or after the Covid crash beginning in late February. Many other new TTS traders got started in summer-time.
- You can claim TTS eligibility and add a Schedule C for the TTS expense deductions for all or part of the year.
- (See Will The IRS Deny Tax Benefits To Traders Due To Covid?)

Consider a 475 election for 2021

- Many new traders missed submitting a Section 475 election to the IRS due by July 15, 2020, after Covid postponement.
- A “new taxpayer” entity like an LLC/partnership or LLC/S-Corp may elect section 475 within 75 days of inception by internal resolution.
- However, it’s now too late in 2020 to form a new entity that can qualify for TTS as we like to see entity trading for at least Q4.
- Consider a Section 475 election for 2021, due by April 15, 2021, for individuals and March 15, 2021, for existing partnerships and S-Corps.
- (See Traders Elect 475 For Enormous Tax Savings.)

S-CORPS FOR EMPLOYEE BENEFITS

Health insurance deduction

- A TTS S-Corp can unlock officer health insurance (HI) and retirement plan deductions using officer payroll.
- Add officer's health insurance premiums to officer payroll on the W-2.
- That opens an AGI deduction for HI on the officer's tax return.
- The officer HI compensation is not subject to payroll tax (social security and Medicare).

Solo 401(k) retirement plan

- If profitable as of early December 2020, the S-Corp can pay additional compensation up to a maximum of $150,000 to maximize a Solo 401(k) retirement plan contribution.

- For 2020, it combines a 100% deductible “elective deferral” (ED) contribution of $19,500 with a 25% deductible profit-sharing plan contribution (PSP) up to a maximum of $37,500.

- There is also an ED “catch-up provision” of $6,500 for 2020 for taxpayers age 50 and over.

Solo 401(k) retirement plan

- Together, the maximum 2020 tax-deductible contribution is $57,000, and including the catch-up provision, it’s $63,500.

- The ED portion can be a Roth, so there would be no tax deduction but permanent tax-free status.

- The PSP must be traditional, not a Roth.

Payroll tax

- Payroll tax includes 12.4% social security taxes but not exceeding the social security base amount of $137,700 for 2020.

- Medicare tax of 2.9% is unlimited without a base.

- The employer and employee each pay half the payroll taxes, and the employer deducts its 50% share.

Joe Biden's Tax Plan

- Joe Biden's Tax Plan proposes to subject earned income over $400,000 to payroll taxes.

- Social security taxes (FICA) only apply to the SSA base amount of $137,700 for 2020 and $142,800 for 2021.

- Biden's plan creates a donut hole, but it should not affect traders since they only need $150,000 of wages to maximize a Solo 401(k) retirement plan.

- A TTS S Corp is not subject to IRS "reasonable compensation" rules as its underlying income is unearned.

S-Corp accountable reimbursement plan

- Use an S-Corp accountable reimbursement plan to pay the officer shareholder for home-office and other employee expenses. The IRS requires reimbursement before the year-end 2020.

- Partners in LLCs taxed as partnerships can deduct “unreimbursed partnership expenses” (UPE). That is how they usually deduct home office expenses.

- UPE is more convenient than using an S-Corp accountable plan because the partner can arrange the UPE after year-end.

ROTH IRA CONVERSIONS

Roth IRA conversions

- You may wish to convert a traditional IRA into a Roth IRA before the year-end.
- The conversion income is taxable in 2020.
- Avoid the 10% excise tax on early withdrawals before age 59 ½ by paying the Roth conversion taxes outside the Roth plan.
- One concern is that TCJA repealed the recharacterization option, so you can no longer reverse the conversion if the plan assets decline.
- Roth IRA conversions have no income limit, unlike regular Roth IRA contributions.

NAVIGATING AROUND THE SALT CAP

Navigating around the SALT cap

- According to Bloomberg Law's SALT Cap Workarounds May Catch On in More States After IRS OK (November 10, 2020):

- "More states are expected to pass laws letting businesses avoid the limit on personal tax deductions for state and local taxes, following IRS guidance approving the workaround. Already, states including New Jersey and Connecticut softened the blow of the $10,000 SALT cap with provisions for pass-through businesses like partnerships and S corporations, which are taxed normally at the owner level. The IRS said Monday in a notice that forthcoming proposed rules will allow the states' workaround, which involves an entity-level tax that is offset by a corresponding individual income tax credit."

Navigating around the SALT cap

- “The agency in 2019 killed off (T.D. 9864) a different workaround some states tried, which would have allowed state tax credits for donations made to charitable funds.”
- More states might enact this workaround before the year-end 2020.
- Before you pay Q4 2020 estimated taxes due by January 15, 2021, see if your state allows or requires your partnership or S-Corp to pay taxes for your benefit.
- Connecticut’s workaround law is mandatory.

QUESTIONS AND ANSWERS

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