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present:

Highlights From Green's 2021 Trader Tax Guide

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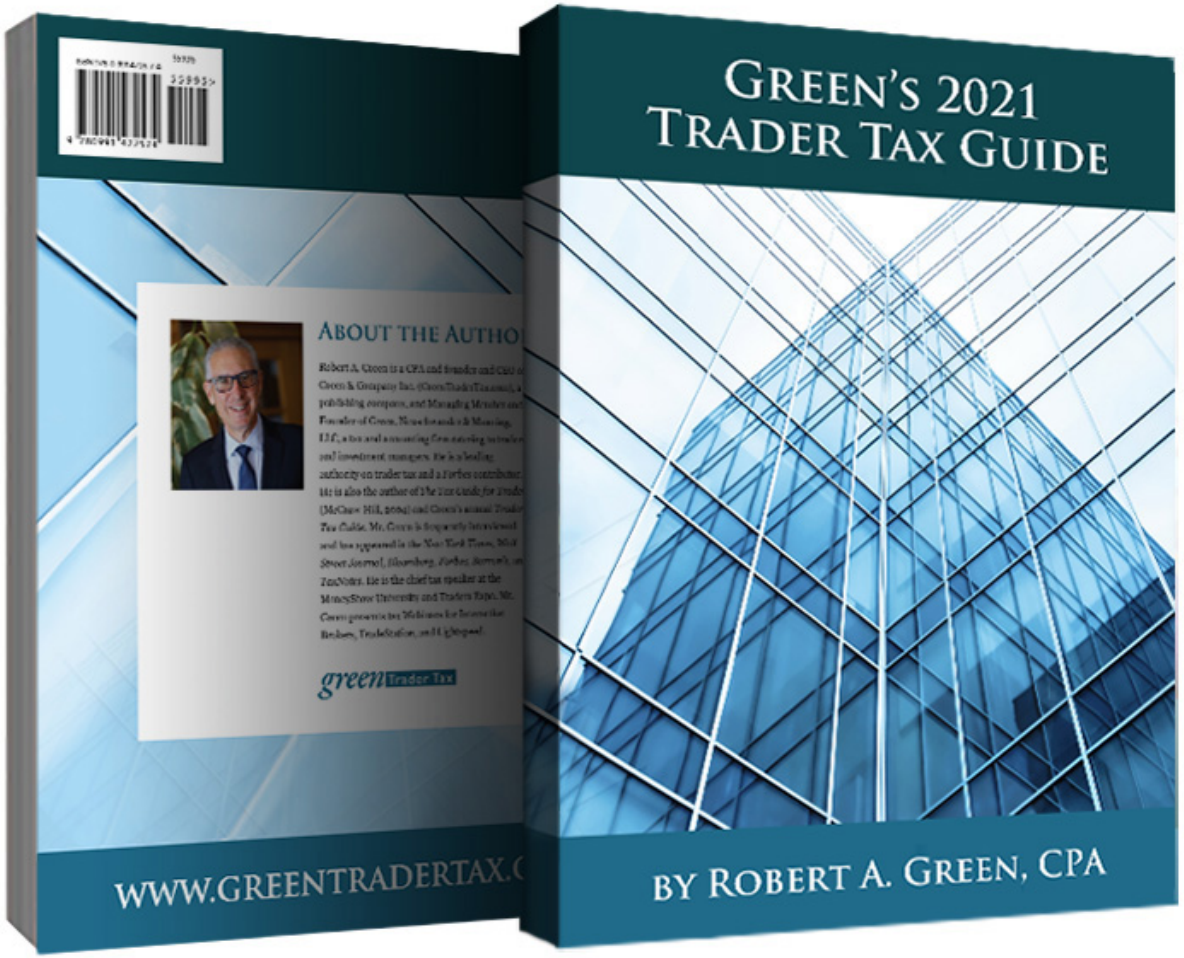
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Description

- *Green's 2021 Trader Tax Guide* focuses on traders' unique tax needs and is updated to include the latest tax law changes, strategies, pitfalls, tweaks, warnings, and benefits.

- Whether you self-prepare your 2020 tax returns or engage a CPA firm; this guide can help you through the process of optimizing your tax savings for 2020 and tax planning for 2021.

- Join me, the author Robert A. Green, CPA, as I explain some tax tips featured in the guide.

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Tax law changes in 2017 and 2020

- Our 2021 guide covers tax law that impacts traders, including the 2017 Tax Cuts and Jobs Act (TCJA), the 2020 Coronavirus Aid, Relief, and Economic Security (CARES) Act, and the 2020 year-end emergency $900 billion pandemic relief legislation.

- TCJA applies starting in 2018; however, CARES overrode elements of TCJA for 2018, 2019, and 2020 taxes.

- For example, under CARES, a trader with a 2020 net operating loss (NOL) can file a five-year NOL carryback refund claim. Whereas, under TCJA for 2021, that trader would only carry forward a 2021 NOL.

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Tax law changes potentially coming in 2021

- The new Biden administration and Congress might enact tax legislation in 2021 that changes some of our guide's tax planning strategies for 2021.
- We plan to publish updated versions of the guide to address tax law changes in 2021 that affect traders.
- 2021 guide customers will have access to the updated versions online.

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TAX CUTS AND JOBS ACT (TCJA)

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TCJA

- Tax Cuts and Jobs Act (TCJA) was enacted on Dec. 22, 2017, and the law changes took effect in the 2018 tax year.
- Like many small business owners, traders eligible for trader tax status (TTS) restructured their business to take advantage of TCJA.
- Two tax changes caught their eye: The 20% deduction on qualified business income (QBI) in pass-through entities, and suspended investment fees and expenses, which makes TTS even more crucial. (TCJA continues to allow itemized deductions for investment-interest expenses.)

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TCJA

- TCJA didn’t change trader tax matters, including business expense treatment, Section 475 MTM ordinary gain or loss treatment, and wash-sale loss adjustments on securities; it didn’t change TTS S-Corps’, Solo 401(k) retirement contributions and health-insurance deductions, either.

- TCJA also retains the lower Section 1256 60/40 capital gains tax rates; the Section 1256 loss carryback election; Section 988 forex ordinary gain or loss; and tax treatment on financial products including options, ETFs, ETNs, swaps, precious metals, and more.

- Learn more about TCJA’s impact on traders in Chapter 17.

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CORONAVIRUS AID, RELIEF, AND ECONOMIC SECURITY ACT (CARES)

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CARES

- The 2020 Coronavirus Aid, Relief, and Economic Security Act (CARES) overrode TCJA's limitations on tax losses.
- CARES suspended TCJA's "excess business loss" limitation for 2018, 2019, and 2020.
- CARES also provided for five-year NOL carrybacks, whereas TCJA suspended NOL carrybacks. Traders with trader tax status and Section 475 ordinary loss treatment consider NOL carrybacks for 2018, 2019, and 2020.
- Learn more about CARES' impact on traders in Chapter 18.

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BUSINESS TRADERS FARE BETTER

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Investor tax status

- By default, the IRS lumps all traders into “investor tax status,” and investors get penalized in the tax code — more so with TCJA. Investors have restricted investment interest expense deductions, and investment fees and expenses are suspended.

- Investors have capital-loss limitations against ordinary income ($3,000 per year), and wash-sale loss deferrals; they do not have the Section 475 MTM election option or health insurance and retirement plan deduction strategies.

- Investors benefit from lower long-term capital gains rates (0%, 15%, and 20%) on positions held for 12 months or more before sale. If active traders have segregated long-term investment positions, this is available to them as well.

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Trader tax status (TTS)

- Business traders eligible for TTS are entitled to many tax breaks.
- A sole proprietor (individual) TTS trader deducts business expenses, startup costs, and home office expenses, and is entitled to elect Section 475 MTM ordinary gain or loss treatment.
- However, to deduct health insurance and retirement plan contributions, a TTS trader needs an S-Corp to create earned income with officer compensation.

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TTS vs. Section 475

- Don’t confuse TTS with the related tax-treatment election of Section 475 MTM accounting.
- The 475 election converts new capital gains and losses into business ordinary gains and losses, avoiding the $3,000 capital loss limitation.
- Only qualified business traders may use Section 475 MTM; investors may not. Section 475 trades are also exempt from wash-sale loss adjustments.
- The 20% deduction on qualified business income includes Section 475 ordinary income but excludes capital gains, interest, and dividend income. The QBI deduction for TTS/475 traders is subject to a taxable income threshold and cap.

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Claim TTS and consider a 475 election

- A business trader can assess and claim TTS after year-end and even going back three open tax years.
- But business traders may only use Section 475 MTM if they filed an election on time, either by April 15 of the current year (July 15, 2020, for 2020, with three-month postponement under CARES) or within 75 days of inception of a new taxpayer (i.e., a new entity).
- For more on TTS and Section 475, see Chapters 1 and 2.

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CAN TRADERS DEDUCT TRADING LOSSES?

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Capital loss limitation

- Deducting trading losses depends on the instrument traded, the trader's tax status, and various elections.

- Many traders buy the guide hoping to find a way to deduct their 2020 trading losses. Maybe they qualify for TTS, but that only gives them the right to deduct trading business expenses. They might be stuck with a capital loss limitation.

- Capital losses offset capital gains without limitation, whether short-term or long-term, but a net capital loss on Schedule D is limited to $3,000 per year against other income. Excess capital losses are carried over to the subsequent tax year(s).

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Capital losses vs. ordinary losses

- Securities, Section 1256 contracts, ETNs, and cryptocurrency trading receive capital gain/loss treatment by default.
- If a TTS trader did not file a Section 475 election on securities and/or commodities on time (i.e., by July 15, 2020, or April 15, 2021, for 2021), or have Section 475 from a prior year, he is stuck with capital loss treatment on securities and Section 1256 contracts.
- Section 475 does not apply to ETN prepaid forward contracts, which are not securities, or cryptocurrencies, which are intangible property.

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Capital loss carryover trap

- Once taxpayers get in the capital loss carryover trap, a problem they often face is how to use up the carryover in the following year(s).

- If a trader elects Section 475 by April 15, 2021, the 2021 TTS trading gains will be ordinary rather than capital. Remember, only capital gains can offset capital loss carryovers. That creates a predicament addressed in Chapter 2 on Section 475 MTM.

- Once a trader has a capital loss carryover hole, she needs a capital gains ladder to climb out of it and a Section 475 election to prevent digging an even bigger one. The IRS allows revocation of Section 475 elections if a Section 475 trader later decides she wants capital gain/loss treatment again.

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TAX TREATMENT ON FINANCIAL PRODUCTS

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Securities vs. 1256 contracts

- There are complexities in sorting through different tax-treatment rules and tax rates. It's often hard to tell what falls into each category. To help our readers with this, we cover the many trading instruments and their tax treatment in Chapter 3. Here's a brief breakdown.
- Securities have realized gain and loss treatment and are subject to wash-sale rules and the $3,000 per year capital loss limitation on individual tax returns.
- Section 1256 contracts — including regulated futures contracts on U.S. commodities exchanges — are marked to market by default, so there are no wash-sale adjustments, and they receive lower 60/40 capital gains tax rates.
- Foreign futures are taxed like securities unless the IRS issues a revenue ruling allowing Section 1256 tax benefits.

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Options

- Options have a wide range of tax treatment. An option is a derivative of an underlying financial instrument and the tax treatment is generally the same.
- Equity options are taxed the same as equities, which are securities.
- Index options are derivatives of indexes, and broad-based indexes (stock index futures) are Section 1256 contracts.
- Simple and complex equity option trades have special tax rules on holding period, adjustments, and more.

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Forex, precious metals and cryptocurrencies

- Forex receives ordinary gain or loss treatment on realized trades (including rollovers), unless a contemporaneous capital gains election is filed. In some cases, lower 60/40 capital gains tax rates on majors may apply under Section 1256(g).

- Physical precious metals are collectibles; if these capital assets are held for more than one year, sales are subject to the collectibles capital gains rate capped at 28%.

- Cryptocurrencies are intangible property taxed like securities on Form 8949, but wash-sale loss and Section 475 rules do not apply because they are not securities.

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ENTITIES FOR TRADERS

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Entities provide tax benefits to TTS traders

- Entities can solidify TTS, unlock health insurance and retirement plan deductions, gain flexibility with a Section 475 election or revocation, prevent wash-sale losses with individual and IRA accounts, and enhance a QBI deduction on Section 475 income less trading expenses.

- Trading in an entity allows individually held investments to be separate from business trading with a Section 475 election.

- An LLC with S-Corp election is generally the best choice for a single or married couple seeking health insurance and retirement plan deductions. See Chapter 7.

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RETIREMENT PLANS FOR TRADERS

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Solo 401(k) retirement plan

- Annual tax-deductible contributions up to $63,500 for 2020 and $64,500 for 2021 to a TTS S-Corp Solo 401(k) retirement plan generally save traders significantly more in income taxes when compared to the costs of payroll taxes (FICA and Medicare).

- Trading gains aren't earned income, so traders use an S-Corp to pay officer compensation.

- There's also an option for a Solo 401(k) Roth for the elective-deferral portion only: If you are willing to forgo the tax deduction, you'll enjoy permanent tax-free status on contributions and growth within the plan. See Chapter 8.

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20% DEDUCTION ON QUALIFIED BUSINESS INCOME

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QBI deduction for traders

- TCJA introduced a new tax deduction for pass-through businesses, including sole proprietors, partnerships, and S-Corps. Subject to haircuts and limitations, a pass-through business could be eligible for a 20% deduction on qualified business income (QBI).

- Traders eligible for TTS are a “specified service activity,” which means if their taxable income is above an income cap, they won’t receive a QBI deduction.

- The taxable income (TI) cap is $426,600/$213,300 (married/other taxpayers) for 2020, and $429,800/$214,900 (married/other taxpayers) for 2021. The phase-out range below the cap is $100,000/$50,000 (married/other taxpayers). The W-2 wage and property basis limitations also apply within the phase-out range.

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QBI includes 475 income

- QBI for traders includes Section 475 ordinary income and loss and trading business expenses. QBI excludes capital gains and losses, Section 988 forex ordinary income or loss, dividends, and interest income.

- Sole proprietor TTS traders cannot pay themselves wages, so they likely cannot use the phase-out range, and the threshold is their cap. For more information, see Chapter 7 and Chapter 17.

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AFFORDABLE CARE ACT

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3.8% Medicare tax on unearned income

- TCJA and CARES did not change the Affordable Care Act's (ACA) 3.8% Medicare tax on unearned income.
- The net investment tax (NIT) applies on net investment income (NII) for individual taxpayers with modified AGI over $250,000 (married) and $200,000 (single). The threshold is not indexed for inflation.
- Traders can reduce NIT by deducting TTS trading expenses, including salaries paid to them and their spouses. Traders may also reduce NII with investment expenses that are allowed on Schedule A, such as investment-interest expense.

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ACA's individual health insurance mandate

- ACA's individual health insurance mandate and shared responsibility fee for non-compliance, exchange subsidies, and premium tax credits continue to apply for 2020 and 2021.
- However, TCJA reduced the shared responsibility fee to $0 starting in 2019.
- For more information, see Chapter 9 and Chapter 15.

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INTERNATIONAL TAX MATTERS

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Traders live around the world

- When it comes to global tax matters, we focus on the following types of traders: U.S. residents living abroad, U.S. residents with international investments, U.S. residents moving to U.S. territories like Puerto Rico (with substantial tax breaks), U.S. residents surrendering citizenship or green cards, and nonresident aliens investing in the U.S. with individual U.S. brokerage accounts or through an entity. See Chapter 14.

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TRADER TAX STATUS

Chapter 1: Excerpts

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WHAT DOESN’T QUALIFY?

- Four types of trading activity aren’t counted for TTS qualification:
  - Automated trading without much involvement by the trader (but a trader creating his or her own program qualifies);
  - a trade copying service or software;
  - engaging a professional outside investment manager;
  - and trading in retirement funds.
- These trades should not be included in the golden rule calculations.

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Trade copying service

- Some traders use trade copying software or service (TCS).
- Trade copying is similar to using a canned ATS or outside adviser, where the copycat trader might not qualify for TTS on those trades.
- As an example, a trade coaching and education company offers a TCS that suggests several trades each day, with exact entry and exit points and stop-loss orders.
- The trader decides which trades to make and executes them manually.

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Trade copying service

- If the trader follows the TCS tightly and does not significantly depart from its suggestions, then an IRS agent might feel that he or she does not qualify for TTS.
- On the other hand, if the trader cherry-picks a minor percentage of the suggested trades, sets different stop-loss orders, and waits longer on entry and exit executions, then she might qualify for TTS.
- The TCS vendor might state they are not providing investment management services, but that doesn’t mean their customer achieves TTS using the TCS.

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COVID-19 TRADERS

- The year 2020 was highly volatile 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 TTS. However, will the IRS deny TTS to Covid-19 traders if they only carry on a trading business during the pandemic?

- 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 by the 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.

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COVID-19 TRADERS

- 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. When that happens, TTS traders count on Section 475 for tax-loss or fire-loss insurance: The trading house burns down, and a tax refund can be filed.

- Some rookie traders start off meeting the IRS requirements for TTS, which are vague. As stated earlier in this chapter, we recommend following our “golden rules.”

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COVID-19 TRADERS

I wonder how IRS agents will consider the Covid pandemic when assessing TTS. If a new trader started trading on June 1 but stopped or significantly slowed down trading when returning to work in November 2020, will the IRS deny TTS because he only traded actively for five months? The IRS agent might cite the landmark tax court case Chen vs. Commissioner, where TTS was denied. (See Will The IRS Deny Tax Benefits To Traders Due To Covid?)

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SECTION 475 MTM

Chapter 2: Excerpts

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Segregation of investments vs. TTS trading

- Suppose a trader holds investment positions in equities and trades substantially identical securities positions in equities or equity options using TTS and Section 475.

- The IRS could recharacterize trades as investments, or vice versa, whichever suits them best. For example, the IRS could reclassify an investment position in Apple equity currently deferred for long-term capital gains into Section 475 MTM ordinary income at year-end.

- Alternatively, the IRS could recharacterize Section 475 MTM ordinary losses on Apple options as capital losses triggering a $3,000 capital loss limitation.

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Segregation of investments vs. TTS trading

- Traders with overlap between investing and trading activity should consider ringfencing TTS/475 trading into an entity and conducting their investment activity on the individual level.

- That solution would fix the potential IRS problem.

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Avoid wash sales with IRAs

- If there is an overlap in what is traded in taxable accounts vs. what is invested in IRAs, the trader has to avoid triggering permanent wash-sale losses throughout the year.
- If a trader takes a loss in a taxable account and buys back a substantially identical securities position 30 days before or after in an IRA account, the loss becomes permanent.
- Traders can fix this problem with a “do not invest” list to avoid such overlap. One strategy is to trade equities and equity options in taxable accounts and invest in ETFs, mutual funds, and REITs in IRAs.

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Avoid wash sales with IRAs

- TTS traders can make a Section 475 election to do away with wash sales between trades and the IRAs, so overlap is not a problem.

- Consider all IRA accounts for married filing joint, including traditional IRAs, Roth IRAs, rollover IRAs, and SEP IRAs. Qualified plans like 401(k) or solo 401(k) plans are not included.

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CARES ACT

Chapter 18: Excerpts

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CARES impact on traders

- The Coronavirus Aid, Relief, and Economic Security (CARES) Act was passed by Congress and signed into law on March 27, 2020. CARES temporarily affected 2018, 2019, and 2020 taxes by overriding elements of the 2017 Tax Cuts and Jobs Act (TCJA). For example, CARES provided five-year NOL carryback refund claims, whereas TCJA allowed NOL carryforwards only. CARES also waived TCJA's excess business limitation. These changes are temporary; TCJA applies again in 2021.

- The CARES Act provides tax relief and economic aid to employees, independent contractors, sole proprietors, and other types of small businesses. However, traders don't fit into usual small-business categories, so there are issues in applying for some CARES aid.

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Traders benefits are limited under CARES

- Traders eligible for trader tax status (TTS) operating in an S-Corp might be able to receive state and federal unemployment benefits. TTS S-Corps do not qualify for a forgivable loan under the Small Business Administration Paycheck Protection Program because trading is a “speculative business.” TTS traders structured as sole proprietors, partnerships, or S-Corps might be eligible for CARES five-year NOL carrybacks, relaxed retirement plan distributions, and recovery rebates.

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Trading income is not earned income

- A trader's capital gains and Section 475 ordinary income are different from wages, earned income, and self-employment income (SEI) required for many of the business-related benefits under CARES. TTS sole proprietors report business expenses on Schedule C, but trading gains and losses go on other tax forms, including Schedule D (capital gains and losses) or Form 4797 (Section 475 ordinary gain or loss). In the eyes of government agencies, trading generates investment income derived from the sale of capital assets; it's not a usual small business with revenue.

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Retirement plan distributions in 2020 under CARES

- The CARES Act provides that 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" before age 59½.

- 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.

- (See the IRS Website Coronavirus-related relief for retirement plans and IRAs questions and answers, https://tinyurl.com/irs-covid-relief.)

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Charitable deductions improved

- CARES created an above-the-line charitable deduction for 2020 (not to exceed $300). It also modified the AGI limitations on charitable contributions for 2020 to 100% of AGI for individuals (raised from 60% in TCJA).

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$900 billion pandemic relief bill

- On Dec. 21, 2020, Congress passed an emergency $900 billion pandemic relief bill, extending CARES to people in need. On Dec. 27, 2020, the President signed the legislation, part of a government funding package. The new Covid-19 legislation includes:

- **Direct payments:** The maximum amount is $600 for individuals and $1,200 for married couples filing jointly, plus an additional $600 per qualifying child. Subject to phase out for individuals making more than $75,000 modified adjusted gross income and married couples over $150,000. It's a 2020 advanced recovery rebate with eligibility based on 2019 tax returns. These direct payments are non-taxable income.

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$900 billion pandemic relief bill

- **Extension of federal pandemic unemployment compensation:** Restores FPUC supplement to all state and federal unemployment benefits at $300 per week, starting after Dec. 26, 2020, and ending March 14, 2021. These unemployment benefits are taxable income.

- **Small business PPP forgivable loans:** The new legislation clarifies tax treatment under the CARES Act. Borrowers may deduct PPP business expenses financed with PPP loans, and loan forgiveness is not taxable income. New funding allows “PPP second-draw” loans for smaller and harder-hit businesses, with a maximum of $2 million.

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$900 billion pandemic relief bill

- **Business meals tax deduction raised to 100% through 2022, increased from 50%.** Traders don't have many business meals.
- TTS traders might qualify for direct payments but not unemployment benefits since they don't have earned income from trading. The SBA labels trading a speculative business precluding it from SBA loans, including PPP loans.
- Full details have yet to be released, so stay tuned on our blog to see how this impacts TTS traders.
- We will update the 2021 guide for tax law changes in 2021.

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QUESTIONS AND ANSWERS

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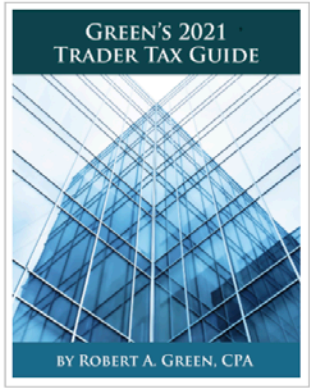

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