

***BURN NOTICE***

**YOUR TAXES:  
NOT A PENNY  
MORE**

In the U.S., the month of April generally means three things: warmer weather, the start of baseball and taxes. And the IRS comes in as one of the least-popular three-letter federal agencies in the country. Of course, no one is ever happy about handing over their hard-earned money. And the jargon-filled tax codes can make it feel as if they're out to confuse us on purpose.

This can be especially true for the 52% of American households invested in the markets. That's because many investors and traders aren't aware of the ins-and-outs of tax-filing strategies that could save them cash each spring.

So today we're looking to demystify a little of that puzzling topic.

If you buy and sell securities in your own account, you typically qualify as an investor or trader for tax purposes. Historically, most Americans only qualify for investor status. But in the digital age with discount online trading, more people are spending more time trading stocks on a regular basis.

## Special Status

It probably won't surprise you to learn that some traders are eligible for a special designation known as "trader tax status" (TTS). TTS traders deduct business expenses, startup costs and home office deductions.

Additionally, they may elect Section 475 for exemption from wash sale loss adjustments and the \$3,000 capital loss limitation. Section 475 also includes eligibility for a 20% qualified business income (QBI) deduction.



Trading income is not self-employment income, so TTS traders don't owe self-employment taxes. Using an S-Corp, TTS traders create earned income to maximize health insurance and/or retirement plan deductions.

It also probably won't surprise you to learn that lacking TTS, investors get peanuts in the tax code. The Tax Cuts and Jobs Act (TCJA) suspended investment fees and expenses. It also suspended all other miscellaneous itemized deductions, subject to the 2% floor.

Now, there are two itemized deductions for investors that survived tax reform. They're investment interest expense limited to investment income, and stock borrow fees. But, with the state and local tax limitation, and the roughly doubled standard deduction, many investors don't get any tax deductions for investment related expenses.

And since the IRS doesn't permit investors to elect Section 475, they're stuck with wash sale loss adjustments and the \$3,000 capital loss limitation.

Short-term capital gains are subject to ordinary tax brackets. So investors benefit from long-term capital gains, providing the investor holds a position open for 12-months or more. Long-term capital gains rates are 0%, 15% and 20% for 2019 and 2020.

Traders can have segregated investments for long-term capital gains, too.



## How To Qualify For Trader Tax Status

Here's how it works. In order to qualify for TTS, based on analysis of tax court cases and years of experience working with traders, you must meet the requirements below.

- Substantial volume – at least four total trades per day, 15 per week, 60 per month and 720 per year annualized (Poppe court). Count open and closing trades separately.
- Frequency – a trade execution on 75% of available trading days. That's close to four days per week.
- Average holding period under 31 days (Endicott court bright-line test).

**The above factors are the “big three.”** If you're short on any of those items, then your TTS status isn't likely to be upheld. Still, there are other factors that can help or hurt your case that include but aren't limited to:

- Continuous trading with few sporadic lapses.
- Time – four hours per day, including trading, research and administration.
- Intention to run a business and to make a living. It doesn't have to be a primary living.
- Business setup – multiple trading devices, monitors and a home office.
- Materiality – Pattern Day Trader minimum for securities of \$25,000; \$15,000 otherwise.



Assess your facts and circumstances for TTS toward year-end. If you rise to the level of TTS, you can deduct business expenses, startup costs and home office expenses. Do this on your Schedule C, partnership, or S-Corp tax return. TTS business expenses don't require an election with the IRS. And TTS does not convert capital losses into ordinary losses.

On the other hand, Section 475 does require a timely election. And a Section 475 election is necessary for ordinary gain or loss treatment.

## TTS Business Expenses

If you find you're eligible for TTS, then there's some good news for you. TTS traders are entitled to deduct the below items and more:

- Tangible personal property up to \$2,500 per item, including computers, monitors, desks and mobile devices.
- Section 179 (100%) depreciation, 100% bonus depreciation and or regular depreciation.
- Amortization of startup costs (Section 195), organization costs (Section 248) and software.
- Education expenses after the commencement of TTS.
- Section 195 startup costs may include education expenses within six months of beginning TTS.
- Publications, subscriptions, market data and charting services.
- Self-created automated trading systems, cloud computing and professional services like accountants and attorneys.
- Chat rooms, mentors and coaches.



- Supplies, media and communications.
- Travel, meals, seminars and conferences.
- Supplies, assistants, office rent and consultants.
- Home-office expenses for the business portion of your home. (See Home Office Tax Deductions Are Fantastic: Learn How To Do It.)
- Margin interest expenses. (Not limited to investment income like investment interest is.)
- Stock-borrow fees and other costs for short-sellers.

## Wash Sale Loss Adjustments

Wash sale loss adjustments on securities cause headaches and potentially higher tax bills. Here's how it works. If a taxpayer repurchases substantially identical securities within 30 days before or after realizing a tax loss on securities, the IRS uses the wash sale (WS) loss rule. That defers a tax loss to the replacement position's cost basis.

For example, say you sell Apple stock at a tax loss on December 15, 2019. Then you repurchase a substantially identical position in Apple stock or options on January 10, 2020. The 2019 wash sale loss defers to 2020.

It's critical to avoid WS at year end in taxable accounts by breaking the 30-day chain. Sell the position by year end for a tax loss, and don't repurchase a substantially identical position for 31 days. If you want to catch a rally in January, then consider it may not be so bad to defer a loss as it's just a timing issue.



It's essential to prevent WS losses throughout the year between taxable and IRA accounts because it's a permanent WS loss. The IRS doesn't allow a WS loss to be added to cost basis in the IRA.

There are other ways to avoid WS too. TTS traders can elect Section 475 on securities to be exempt from WS. Traders can choose to trade instruments that are not considered securities. Things like futures, forex, precious metals and Cryptocurrencies.

Now, wash sale rules are different for taxpayers and brokers.

The IRS requires taxpayers to calculate WS losses based on substantially identical securities positions across all taxpayer's brokerage accounts. For example: Apple equity vs. Apple options. This includes IRAs and spousal accounts if married/filing joint.

The IRS requires brokers to calculate WS based on identical securities in an exact symbol per the one brokerage account. This apples vs. oranges is problematic since the IRS seeks to match broker 1099-Bs with taxpayer Form 8949s.

Many accountants and taxpayers don't know these differences in the rules. So perhaps consider trade accounting software that is compliant with IRS rules for taxpayers. And you should explain overall differences in tax return footnotes.



## Elect Section 475 For Additional Tax Benefits

The IRS permits TTS traders to elect Section 475 ordinary gain or loss treatment on securities and/or commodities. And Section 475 trades are exempt from wash sale loss rules and the \$3,000 capital loss limitation.

Short-term capital gains use the same ordinary rate as Section 475, except 475 also unlocks a potential QBI deduction. And there are significant tax benefits on Section 475 ordinary losses vs. capital losses. TTS traders can deduct a 475 ordinary business loss against wages and other income, bypassing the capital loss limitation. Excess ordinary losses are a net operating loss carry forward.

TCJA introduced a 20% QBI deduction for sole proprietors, partnerships and S-Corps. Since TTS trading is a “specified service trade or business” (SSTB) it’s subject to a taxable income threshold.

SSTBs are also subject to phase-in and phase-out range and taxable income cap. If you exceed the taxable income cap, you don’t get a QBI deduction on an SSTB. QBI includes Section 475 income/loss net of trading business expenses. Whereas, QBI excludes capital gains/losses, interest, dividends and other investment income.



Most futures traders prefer to skip a 475 election to retain Section 1256 60/40 capital gains rates because they don't want ordinary income. However, if you have a significant trading loss in 1256 contracts, then consider a 475 election on commodities. You can revoke a Section 475 election in a subsequent year, in the same manner, you elected it.

In conclusion, TTS can potentially result in substantial tax reductions. If you think you might qualify for TTS, consult with a qualified tax professional to determine the right course of action for your specific circumstances.

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