Rockwell Trading Q&A

Questions:

- Can I deduct the PowerX software from my taxes?
- Can I deduct the Mastermind program (education) cost from my taxes?
- Do I need to set up an LLC? If not, what should I do?
- How can I make sure that I'm eligible for trader tax status?
- What is the best way to get access to my 401k for trading?
- Are binary options considered straddles for tax purposes?
- What is a wash sale? Should I avoid wash sales and how?
- What are deductible expenses as a Trader?
- Are there any time deadlines for Traders?
- Are there any specific taxes to which Traders are subject?

Answers:

➢ **Can I deduct the PowerX software from my taxes?**

To answer that we first need to determine what type of trader you are. There are three types of traders and we can define them as follows:

▶ Investor – which by definition is not a "trader" at all, as the word implies. The goal of the Investor is the long-term appreciation of their respective security holdings, supplemented by dividend and/or interest income. The Investor does not perform security transactions on a daily, weekly or perhaps even a monthly basis.

▶ Trader – termed in the Internal Revenue Code ("IRC") as a "Trader in Securities". This is also called by some tax pundits as having attained "Trader Tax Status" which is a term nowhere found in the Internal Revenue Code, Regulations or Case law. A Trader in Securities ("TIS") is an active trader with multiple trades on potentially a daily and/or weekly basis. The primary goal of a TIS is to profit on short-term swings in the market, or even day-trading the market, either to the upside or the downside. Those swings may last a few days or a few weeks and may entail multiple securities during the "swing". A TIS is considered in the trade or business of trading securities.

▶ Mark-to-Market Trader – is an active trader that engages in trading as a trade or business, according to the IRC, and is essentially electing to be taxed as a dealer in securities except that the Mark-to-Market Trader ("MTM" or "MTMT") does not

consider the securities owned as "inventory" for sale to other traders. The MTMT seeks to profit from short-term movements in the market whereas the dealer profits both from the holdings in its account but also on the bid-ask spread.

Now to the question at hand, can you deduct the PowerX software from your taxes? The answer depends on what type of trader you are.

If you consider yourself an **Investor**, then any investment expenses are deductible only as Miscellaneous Itemized Deductions on Schedule A of your Form 1040. [IRC Sec 212] Unfortunately, Miscellaneous Itemized Deductions, at this point (as of Feb 2021), no longer exist. However, they are scheduled to re-appear in tax year 2026.

If you trade as a **Trader in Securities**, then the answer is "Yes you can". As a TIS you can deduct your trading expenses on Schedule C of Form 1040. Schedule C is the tax form for sole proprietors or single-member LLCs (more on the subject of LLCs later). [IRC Sec 162] It is important that you use the Business Code of 523110 and as a single-member LLC, you will also have a separate employer identification number ("EIN") obtained from IRS.

If you are a Trader in Securities who has made a **Mark-to-Market** election under IRC Sec 475, then you will report all trading expenses on Schedule C of Form 1040 with the same Business Code and potentially a separate EIN from your social security number ("SSN"), but that is not necessary.

One important note would be that on Schedule C, *no items of income are reported*! Yes, that is correct. So where are they reported ...

As a TIS, you are still subject to the capital loss limit of $3000 and subject to wash sales and your gain or loss from trading is reported on Form 8949 which flows to Schedule D of Form 1040.

However, as a MTMT, you are no longer subject to either the capital loss limit noted above or the wash sale issue. Your reporting gains or losses are reported on Form 4797 Part II, thus, they are all taxed as short-term.

- **Can I deduct the Mastermind program (education) cost from my taxes?**

Fortunately, the same criteria exists for trading education as for software since they are both considered "trading expenses" or expenses incident to the production of income.

Education expenses, to further hone your trading skills are deductible. However, typically education that will qualify you for a new profession is not. Since there is no professional designation as a "trader" like there would be for a Certified Public

Accountant that was previously a biologist and decided to get into accounting, the education is deductible.

- **Do I need to set up an LLC? If not, what should I do?**

Essentially what this is asking is "Do I need an entity in which to trade?" and there are a number of issues with this determination that we will explore. I have heard it said by investors, with no actual knowledge of the law, "just incorporate and deduct everything." Nothing could be further from the truth!

An LLC can be formed in any state and is, by default, a single-member LLC if only an individual owns and manages it and a partnership if owned and managed by two or more individuals. In fact, all LLCs are formed at the state level. An LLC can further elect to be taxed as either a C Corporation or an S Corporation. The principal difference between a C Corporation and an S Corporation is that a C Corporation pays its own income tax whereas an S Corporation flows its net income – or loss – through to its shareholder(s) and they pay the tax or receive the tax benefit, subject to several constraints, the discussion of which is outside the scope of this Q&A.

One of the big questions with forming an entity is whether there is *liability protection* with an entity. The answer to that is, for the most part, yes. The definition of LLC is "Limited Liability Company" — not "Limited Liability Corporation" as many people believe, even popular radio talk-show hosts.

However, no type of entity can protect one from personal negligence.

So, if you place your assets (securities) into an entity in which to trade, the issue becomes, can a potential litigant reach those assets in the entity, or can the owner of the entity, on behalf of the entity itself be sued and the assets lost? Those are questions for an attorney in your state.

So what can an entity do for my trading?

Well, first off, it adds some legitimacy to your trading *business* because it is indeed a separate entity from you as an individual. From a strictly "trading" perspective, the TIS or MTMT will not trade any differently than if they were trading without an entity. That is the key point, since we are in the business of trading and an entity neither enhances nor detracts from our trading style.

As discussed above with regard to the deductibility of expenses and income reporting, an entity simplifies this because it captures all the income and expense and "flows it through" to the individual for inclusion on their tax return, typically on Schedule E page 2 of Form 1040.

The downside of an entity is that it costs money to form and there is compliance associated with it. Unless it is a single-member LLC, there is another federal tax return to file and typically another state income, business or franchise tax return to file. Some states, such as California, have a minimum tax per year, even if the LLC is dormant. So a California LLC could cost as much as $2500 to $3000 per year in compliance and tax costs. And I know what you are thinking, incorporate (form the LLC) in a no minimum tax state and just file there ... good thinking, you are well on your way to becoming a CPA ... oh no!! Unfortunately there is a concept called "nexus" which basically means that you file where you cast a shadow, or in the state in which you are domiciled.

So now you know about the pros and cons of entities, do you even need one?

If you are a TIS or a MTMT, I think it is a great idea because it adds legitimacy to your trading business. Additionally, if you have some securities in your "trading" account that have sentimental value – left to you by a deceased relative – it provides the opportunity to segregate your accounts into an investing account, owned individually and the trading account owned by the entity. That can be done anyway, but it adds one level of separation in order to help you satisfy your TIS or MTM criteria.

However, keep in mind one critical point – having an entity will NOT qualify you as a TIS or MTMT if you do not satisfy the other criteria of regular and consistent trading.

So if you decide not to form an entity and trade in a regular and consistent manner a satisfactory volume of trades based on transactions or dollar volume, you may still qualify as a TIS or MTMT whereas the person with an entity that trades irregularly and without the requisite volume will not.

- **How can I make sure that I'm eligible for trader tax status?**

As mentioned above, there is no such thing as "trader tax status". It is never mentioned in the Internal Revenue Code, Regulations or Tax Court decisions.

It is also a misnomer in that it intimates that there is a "status" to which one can attain, conferred by IRS as legitimate ... and that is simply not the case.

What is mentioned in the Code, Regs and court decisions is "Trader in Securities". And as a review, a Trader in Securities

> is an active trader with multiple trades on potentially a daily and/or weekly basis. The primary goal of a TIS is to profit on short-term swings in the market, or even day-trading the market, either to the upside or the downside.

Essentially, a TIS is a facts and circumstances determination based on court case decisions. Attached is a summary of the most prominent Trader vs Investor court cases. The main criteria, as you will note, is consistency of trading throughout the tax

year and number of trades, measured in either number of trades, an open/close or buy/sell being two trades, or dollar volume.

With regard to the number of trades, as you will note, the absolute number decreases over the years but the consistency and regularity of trading seems to be the most deciding factor. So as the Poppe decision designates 60 trades per month, that translates into less than 3 trades per trading day, assuming 20-22 trading days per month.

- **What is the best way to get access to my 401k for trading?**

You can trade your 401(k) with the same activity as a TIS or MTMT but the expenses incident to the production of that income are only deductible as Miscellaneous Itemized Deductions on Schedule A of Form 1040 and those have been suspended through 2025.

The only other way to access 401(k) funds would be to take a distribution which is very tax inefficient, especially if you are younger than 59½.

- **Are binary options considered straddles for tax purposes?**

Again, this is one of those questions that need some preliminary explanation before we delve into the answer.

What are binary options?

For Nadex-traded options, there are two outcomes, either expiration at a gain or expiration at a loss, with $100 being the maximum payout per option. One can exit the trade early for a reduced gain or loss. With binary options, the holder does not have the opportunity to acquire the underlying security.

Now, what is a tax straddle?

The tax straddle rules are very complicated, but we will address the intention of them and then discuss their application to binary options.

Essentially, a tax straddle is an offsetting position that *substantially diminishes* the risk of loss from the holding of another position. And, as you might have guessed, the term "substantially diminishes" is not defined in the Internal Revenue Code or Regulations. However, substantially does not mean totally, in other words, the offsetting position is not completely neutral, meaning the movement of one security does not exactly offset the movement of the other.

The purpose of the tax straddle rules is to prevent a taxpayer from deducting losses before gains are recognized, and in that regard they are similar to the wash sale rule in that they prevent the taxpayer from deducting a loss while being in a position to profit from the immediate gain in the security due to a rapid rise in price.

The tax ramifications of entering into offsetting positions are:

- No current deduction for losses,
- The holding period can potentially be adjusted, and
- Any carrying charges, such as margin interest attributable to the position, are capitalized and added to the basis of the position

So, how do binary options impact the tax straddle rules?

I don't believe they do in general, but they could just as any other equity option could. For instance, a "short sale against the box" – long stock and the short sale of that same stock – are exactly offsetting positions since the movement of one exactly offsets the movement of the other.

I believe that the only time one can get into the position where an option can substantially diminish the risk of loss in the offsetting position is when the option position is so in the money ("ITM") that its delta approaches either 1 or -1.

For example, one is long stock and also long a put in the same security deep ITM. The delta of that put is probably 1, which would reflect an offsetting position. On the other hand, one is long stock and also short a call in the same security deep ITM. The delta of the short call is probably -1.

However, this is not exactly the position of IRS regarding long puts and short calls. In fact, there is a term for those, called "married puts" and "qualified covered calls", respectively. The question becomes, how "substantial" is "substantial"?

The discussion of married puts and qualified covered calls is beyond the scope of this Q&A but just know that they are something to consider when trading.

So, the answer to the question regarding whether a binary option is a tax straddle would rest on whether it substantially diminishes the risk of loss of the offsetting position. Therefore, if you are trading SPY, for instance, and you own units of that ETF at a brokerage and you also sell a call on Nadex that has a delta of -1, then you may have an offsetting position and therefore a tax straddle.

But given the volatility in the market and fact that positions can move a high percentage in a day, or even a few hours, how long will you be in that offsetting position?

Another issue regarding these rules is that when they were written, the products in the market were not as numerous or fluid as they are now. In other words, equity options did not have strikes for every dollar and the volume of orders were not nearly what they

are today. But, those are the rules we still have ... so what I am saying is that these concepts are somewhat subjective and rebuttable.

How substantial is a delta of 0.95 or perhaps 0.75?

Take a look at Exhibit 1, which is an option chain for SPY with 18 days to expiration. When listing all the available options, no option will produce and exact offset to SPY. So does that mean there is not substantial diminution of risk for tax purposes?

I believe with the aid of an option pricing model, one can show that risk of loss may be reduced but not eliminated, due to the speed at which the market moves. Whether that is deemed to be substantial is for the Tax Court to decide.

- **What is a wash sale? Should I avoid wash sales and how?**

The best way to define a wash sale is the definition used by the IRS in Publication 550 – Investment Income and Expenses:

> A wash sale occurs when you sell or trade stock or securities **at a loss** and **within 30 days before or after** the sale you:
>
> - Buy *substantially identical* stock or securities,
> - Acquire *substantially identical* stock or securities in a fully taxable trade,
> - Acquire a contract or option to buy *substantially identical* stock or securities,
> - Acquire *substantially identical* stock for your individual retirement arrangement (IRA) or Roth IRA, and
> - If you sell stock and your spouse or a corporation you control buys *substantially identical* stock, you also have a wash sale. [Emphasis mine]

Wash sales are the bane of a Trader's existence!

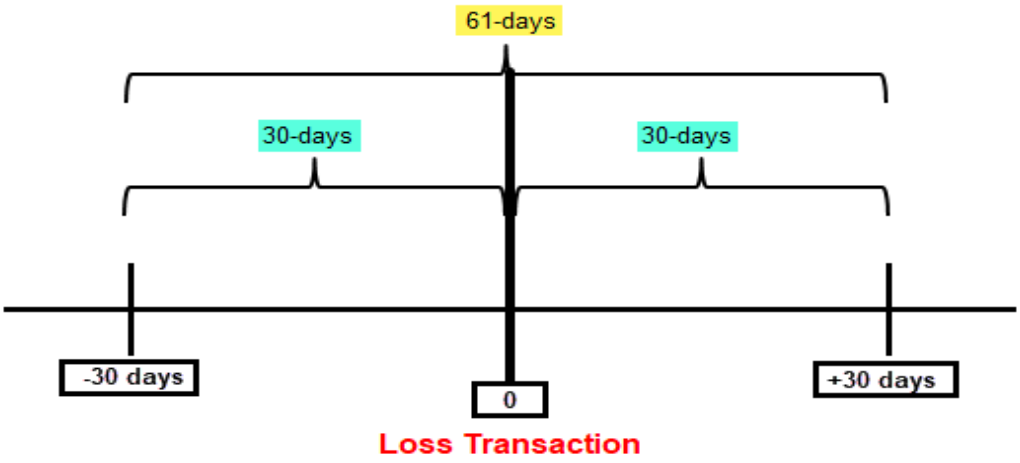
Essentially, if you have a loss on a trade – and only a loss – there is a 61-day window for which you are concerned that extends 30-days before the loss transaction and 30-days after the transaction, as follows:

Option chain on SPY as of 3/1/2021

SPY | SPDR S&P500 ETF TRUST UNITS SER 1 S&P ETF | 388.51 | +8.15 +2.14% | B: 388.51 A: 388.52 | ETB | NYSE | EXTO Eligible

	PUTS						
Strike	Bid X	Ask X	Impl Vol	Prob.ITM	Delta	Theta	Volume
							23.42% (±16.
375	3.39 P	3.40 I	24.17%	27.45%	-.26	-.19	13,028
376	3.56 P	3.57 Z	23.79%	28.75%	-.27	-.19	2,116
377	3.74 Z	3.76 D	23.42%	30.13%	-.28	-.19	3,015
378	3.93 N	3.95 D	23.03%	31.56%	-.30	-.19	927
379	4.14 P	4.15 P	22.64%	33.08%	-.31	-.19	775
380	4.35 Q	4.37 D	22.26%	34.67%	-.33	-.19	7,436
381	4.58 E	4.60 Z	21.87%	36.33%	-.34	-.20	833
382	4.83 N	4.85 W	21.50%	38.09%	-.36	-.20	1,049
383	5.09 P	5.11 W	21.11%	39.93%	-.38	-.20	935
384	5.37 P	5.39 W	20.73%	41.86%	-.40	-.20	451
385	5.67 P	5.69 W	20.35%	43.87%	-.42	-.20	3,738
386	5.99 P	6.01 P	19.98%	45.98%	-.44	-.19	1,219
387	6.34 P	6.36 W	19.64%	48.17%	-.46	-.19	992
388	6.71 P	6.73 P	19.29%	50.45%	-.49	-.19	1,287
389	7.11 P	7.13 P	18.96%	52.80%	-.51	-.19	779
390	7.54 P	7.57 Q	18.66%	55.21%	-.53	-.18	1,540
391	8.01 P	8.04 P	18.39%	57.66%	-.56	-.18	109
392	8.51 Q	8.54 I	18.14%	60.15%	-.58	-.18	132
393	9.04 Q	9.09 Q	17.92%	62.63%	-.61	-.17	83
394	9.62 Q	9.67 I	17.75%	65.09%	-.64	-.17	3
395	10.24 Q	10.29 I	17.62%	67.48%	-.66	-.16	117
396	10.90 Q	10.95 I	17.53%	69.79%	-.68	-.16	6
397	11.60 Q	11.66 Q	17.52%	71.97%	-.71	-.15	9
398	12.32 Q	12.39 Q	17.50%	74.07%	-.73	-.15	87
399	13.09 Q	13.15 I	17.56%	76.00%	-.75	-.14	1
400	13.87 P	13.96 Q	17.65%	77.79%	-.77	-.14	135
401	14.70 Q	14.77 Q	17.78%	79.43%	-.78	-.14	0
402	15.51 P	15.62 Q	17.89%	81.00%	-.80	-.13	15
403	16.40 Q	16.49 Q	18.15%	82.27%	-.81	-.13	3
404	17.29 Q	17.36 I	18.36%	83.51%	-.82	-.12	0
405	18.19 Q	18.27 Q	18.65%	84.57%	-.83	-.12	24
406	19.11 Q	19.19 P	18.98%	85.51%	-.84	-.12	0
407	20.01 Q	20.11 Q	19.22%	86.48%	-.85	-.12	0
408	20.97 Q	21.04 I	19.60%	87.20%	-.86	-.12	0
409	21.88 P	21.98 P	19.86%	88.02%	-.87	-.11	0
410	22.86 Q	22.95 P	20.36%	88.50%	-.88	-.11	11
411	23.82 Q	23.93 P	20.82%	89.00%	-.88	-.11	0
412	24.79 Q	24.90 P	21.27%	89.47%	-.88	-.11	24
413	25.77 Q	25.87 I	21.73%	89.88%	-.89	-.11	24
414	26.76 Q	26.84 P	22.22%	90.25%	-.89	-.11	0
415	27.71 P	27.83 P	22.62%	90.67%	-.90	-.11	24
416	28.74 Q	28.81 P	23.24%	90.86%	-.90	-.11	0
417	29.72 Q	29.81 P	23.76%	91.12%	-.90	-.11	25
418	30.71 Q	30.79 I	24.24%	91.41%	-.90	-.11	0
419	31.70 Q	31.78 I	24.75%	91.65%	-.91	-.11	0
420	32.68 Q	32.77 I	25.21%	91.91%	-.91	-.11	25
421	33.68 Q	33.77 I	25.77%	92.08%	-.91	-.11	0
422	34.68 Q	34.77 P	26.33%	92.24%	-.91	-.11	0
423	35.67 Q	35.76 I	26.81%	92.44%	-.91	-.11	0
424	36.68 Q	36.76 I	27.39%	92.56%	-.92	-.11	0
425	37.66 P	37.75 I	27.83%	92.78%	-.92	-.11	0
426	38.22 Q	38.32 I	28.14%	92.83%	-.92	-.11	0
427	39.13 Q	39.44 Q	28.79%	92.88%	-.92	-.11	0
428	40.08 Q	40.55 Q	29.55%	92.86%	-.92	-.12	0
429	41.24 Q	41.53 Q	30.61%	92.66%	-.92	-.12	0
430	42.01 Q	42.47 Q	30.03%	93.47%	-.92	-.11	16
435	46.95 Q	47.61 Q	32.94%	93.80%	-.93	-.12	0
440	52.00 Q	52.38 Q	34.66%	94.63%	-.94	-.11	0
445	56.99 Q	57.46 Q	37.41%	94.85%	-.94	-.12	0
450	61.96 Q	62.61 Q	40.36%	94.94%	-.94	-.13	5
455	66.96 Q	67.60 Q	42.65%	95.25%	-.94	-.13	0
460	71.96 Q	72.59 Q	44.89%	95.53%	-.94	-.13	0
465	76.95 Q	77.59 Q	47.07%	95.77%	-.95	-.13	0
470	81.95 Q	82.59 Q	49.26%	95.98%	-.95	-.13	0
475	86.95 Q	87.58 Q	51.36%	96.18%	-.95	-.13	0
480	91.91 Q	92.62 Q	53.45%	96.35%	-.95	-.14	0
485	96.91 Q	97.62 Q	55.53%	96.51%	-.95	-.14	0
490	101.94 Q	102.59 Q	57.55%	96.65%	-.95	-.14	0
495	106.91 Q	107.62 Q	59.54%	96.78%	-.96	-.14	0
500	111.94 Q	112.59 Q	61.50%	96.90%	-.96	-.14	0
505	116.94 Q	117.57 Q	63.31%	97.04%	-.96	-.14	0
510	121.93 Q	122.59 Q	65.26%	97.13%	-.96	-.14	0
515	126.89 Q	127.61 Q	67.00%	97.25%	-.96	-.14	0

Exhibit 1



So what are the consequences of a wash sale?

The LOSS is added to the cost basis of the new securities purchased. The IRS instructions exempt the LOSS addition to the cost of new securities purchased inside an IRA, which would create non-taxable return of basis inside the IRA. Further, the IRS instructions do not address a "loss" transaction inside an IRA with new securities purchased in a taxable account.

Let's take a look at a few non-IRA examples just to get an understanding of the mechanics of this loss deferral. Essentially that is what the IRS is forcing the Investor or Trader in Securities to do, defer the loss so that a loss cannot be recognized in one period while participating in the gain in subsequent periods.

<u>Example 1:</u> A TIS buys SPY at 394 on 3/22/2021. SPY declines in price for several weeks to 389 and is sold on 4/16/2021 for a $5 loss. SPY starts moving up and is repurchased at 392 on 4/30/2021. The new basis of SPY is not $392 but $397 (the purchase price of 392 plus the $5 loss on the 4/16/2021 sale) because the "replacement" shares were purchased within the 61-day window or 14 days after the loss transaction.

So can the $5 loss be recognized in 2021. Not as long as the "replacement" shares are held because that $5 loss is "buried" in the basis of SPY.

Example 2: For this example, we need to look at the following table of transactions:

	Date	Shares	Price
	02/17/2021	100	$ 394
	03/03/2021	100	$ 392
	03/10/2021	100	$ 393
	03/17/2021	100	$ 391
Sale >	03/24/2021	-100	$ 389
	03/31/2021	100	$ 385
	04/07/2021	100	$ 384
	35		$ 390

For several weeks a TIS has been accumulating SPY using a dollar-cost averaging strategy. On 3/24/2021 100 shares are sold. Based on FIFO (First-In First-Out) cost basis methodology, the 2/17/2021 purchase is sold at a $5 loss ($389 - $394). Later, the TIS resumes the strategy and purchases more shares. The basis of the shares purchased on 3/31/2021 INCLUDES the loss from the sale of the 2/17/2021 shares. Why? ... the purchase was more than 30 days from the purchase of the 2/17/2021 shares (35 days). The 30-day window is measured from the date of the LOSS transaction which is 3/24/2021. Thus, the LOSS transaction occurred 7 days previous and the new basis of the 3/31/2021 shares is $390 (purchase price of $385 + the $5 loss from the sale of the 2/17/2021 shares)

Example 3: Let's complicate things a little. A TIS sells a 395 put on SPY for $4.00 on 3/22/2021 expiring on 3/26/2021. SPY finishes below the 395 strike and SPY is assigned. Over several weeks calls are sold against SPY as SPY declines. For the 4/16/2021 expiration a 394 call is sold and SPY is exercised. Has a wash sale been created?

At first blush one would say that indeed a wash sale has been created since SPY was purchased at 395 and sold for 394 for a loss of $1.

But what is the cost basis of SPY? The actual cost basis of SPY is $391 because the premium received from the sale of the put ($4) is included in the cost basis of the assigned shares/units. So even though SPY was assigned at 395 the true basis is $395 minus the $4 premium from the sale of the put, or $391.

So, again, has a wash sale been created. The answer to that question is "No". However, what is the broker going to report? The basis should be reported as $391 but that is not always the case. Therefore, on Form 8949 a basis adjustment, Code "B" would need to be used in the adjustment column and then the amount of the adjustment entered in order to properly calculate the gain.

Form **8949**

Department of the Treasury
Internal Revenue Service

Sales and Other Dispositions of Capital Assets

▶ Go to *www.irs.gov/Form8949* for instructions and the latest information.

▶ File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.

OMB No. 1545-0074

2020

Attachment Sequence No. **12A**

Name(s) shown on return | **Social security number or taxpayer identification number**

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are generally short-term (see instructions). For long-term transactions, see page 2.

Note: You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box A, B, *or* C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☐ **(A)** Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)

☐ **(B)** Short-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS

☐ **(C)** Short-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	**Adjustment, if any, to gain or loss.** If you enter an amount in column (g), enter a code in column (f). **See the separate instructions.** (f) Code(s) from instructions	(g) Amount of adjustment	(h) **Gain or (loss).** Subtract column (e) from column (d) and combine the result with column (g)
					B		

Let's take a closer look at that wash sale definition again. The term "substantially identical" is mentioned in every wash sale-causing transaction. So what does "substantially identical" mean?

Back to IRS Publication 550, which states:

> In determining whether stock or securities are substantially identical, you must consider all the *facts and circumstances* in your particular case.

Most taxing authorities hedge on definitions to their benefit when a particular issue could go either way, which is why the phrase "facts and circumstances" is used. And as is the case when dealing with the IRS, there is no presumption of innocence in tax matters ... the taxpayer is presumed guilty and it is the taxpayer's responsibility to prove themselves innocent.

So these two well-known actresses are definitely "substantially identical" but I believe that most people, including the IRS, would agree they are very different.

Olsen twins from ABC's "Full House"

Obviously shares of Apple are substantially identical to other shares of Apple and shares of SPY are identical with other shares of SPY but are shares of SPY substantially identical with shares of IVV? SPY is a product of the State Street and IVV is a product of iShares by BlackRock.

SPDR STATE STREET GLOBAL ADVISORS ≠ iShares by BLACKROCK

So if SPY is NOT substantially identical to IVV that means there would be no wash sale from a loss transaction in SPY followed within 30 days by a purchase of IVV. The facts and circumstances that would make this determination would center around the number of holdings of each S&P security in each, the amount of cash held, perhaps the expense ratio and various other factors.

The biggest issue with substantially identical securities revolves around the stock's relation to its options. IRS specifically states that:

> The wash sale rules apply to losses from sales or trades of contracts and <u>options to acquire</u> or sell stock or securities.

This definition means that if there is a loss transaction and the TIS sells a put on the same underlying security within 30 days, a wash sale has been created. Now, quite frankly, I question that blanket conclusion, based on having traded options a number of years and substantial research on the characteristics of options over a 30-day period. For instance:

- What if the option has an expiry more than 30 days hence?
- What if the option is not in the money when entering the transaction? There is no guarantee that it will be ITM at expiration and trigger assignment.
- What if the option is ITM when entered but not at expiration?

- What if a long put is purchased and ITM at expiration and the TIS is now short stock. Does a Buy to Cover satisfy the wash sale requirements?

The next big issue concerning wash sales and options is whether a loss on an option itself can initiate the potential of a wash sale?

Again, there are multiple considerations. It seems pretty obvious that a SPY 400 Call expiring 3/18/2022 sold at a loss and then re-entered into within 30 days would create a wash sale on that option.

However, would a loss on the same SPY 400 Call expiring 3/18/2022 potentially create a wash sale if rolled down and out to a SPY 390 Call expiring 9/16/2022? It is my opinion that it would not and that opinion is based on the movement of the two options, after the loss transaction as measured using an option pricing model, such as Black-Scholes-Merten. I believe you will see similar movement, since they are both LEAPS (Long-term Equity AnticiPation Securities) on the same underlying but as they approach expiration of the near-term LEAPS that similarity will diverge. Thus, they are not substantially identical and no wash sale is created after a loss and subsequent purchase. The downside, the nearer-term option does not approach expiration until after tax year-end.

Should wash sales be avoided at all costs? Maybe not at "all" costs, but they can result in quite a shock when receiving your consolidated Form 1099 from your broker at year-end and the wash sale adjustment converts you from having a small loss to a large – and unexpected – gain.

One way to check is to download all your raw trades from your broker into an Excel spreadsheet. Separate the proceeds from the cost basis by placing them into two columns. Sum the columns and compare the net to the net reported on Form 1099-B. If you stop trading that security at least 30 days before year-end, the wash sales should be absorbed in the last trade of that security during the year. Even though the wash sale is reported, the corresponding increase in basis will be also and it will not impact your tax liability.

As to how to avoid wash sales, the easiest way is simply to stop trading any securities in which a loss has been realized by December 1.

➢ **What are deductible expenses as a Trader?**

As mentioned previously, as a TIS you are considered to be in a trade or business so any expense incident to the production of that income is deductible. Some examples of

specific expenses for traders could be found in IRS Publication 535 – Business Expenses and the Instructions for Form 1040 Schedule C.

Here is a list of the type of expenses a TIS can expect to have. These expenses may be taken in full or partially based on their applicability to the trading business on a percentage basis. There is a tax adage that goes – *Pigs get fat while hogs get slaughtered*. That is a warning against deducting everything including the kitchen sink.

- Computers and software already loaded
- Multiple monitors for trading
- Specific software for your trading
- Mobile information device – cell phone or hot spot
- Trading research services – but not robo-trading, trade following automated trading or self-created trading systems (your time is not deductible)
- Office supplies
- Coaching and mentoring services
- Reference materials
- Seminars/webinars
- Travel to seminar – where the primary purpose is business not personal
- Continuing education – but not education that would qualify you for another business
- Interest – credit cards used to purchase trading items
- Interest – margin interest charged by a brokerage
- Office furniture conducive to trading
- Home office – if used *regularly and exclusively* for your trading business; this represents a pro-rata share of you home costs or a flat rate of $5 per square foot up to 300 sf; If qualified business use for a month is less than 15 days then that month is excluded.
- Entity formation fees – from your secretary of state and the third-party fees
- Brokerage data fees – typically for "professional" designated entities
- Accounting/legal fees – tax compliance and planning
- Franchise/business tax associated with the trading business
- Vehicle expense for business use – all trading business mileage must be substantiated with a mileage log or other method (not percentage estimates)

This does not represent an exhaustive list. However, as noted in the vehicle section, these expenses must be substantiated according to IRS rules and regulations and the home office must be used "regularly and exclusively" for the trading business. If two businesses are run out of the same area, each must be allocated up to a maximum of 300 square feet for the safe-harbor/simplified method.

As a TIS and even a MTMT, all expenses are reported on Schedule C for the sole proprietor and on page 1 of the entity tax return.

- **Are there any time deadlines for Traders?**

There are no specific dates with which a TIS should be concerned.

With that said, should a TIS desire to elect that his trading business utilize the MTM method of accounting, there are several critical dates to remember.

The MTM election is due with the filing of the unextended tax return – that is, filed on or before the original due date – or attached to a timely-filed extension and preferably mailed certified.

A new entity may elect MTM accounting by preparing the MTM election by the 15th day of the third month after the formation of the new entity and placing the election with its books and records – probably with the entity formation documents. Then, with the first-year tax return for the MTM entity, attach the MTM election to the tax return.

- **Are there any specific taxes to which Traders are subject?**

Actually, it is quite the opposite, Traders are subject to fewer taxes that regular sole proprietors.

An individual who files as a sole proprietor on Schedule C reports all income and expenses on that schedule. However, the TIS reports only expenses on Schedule C and all gains or losses on Schedule D and/or Form 6781 for those trading Sec 1256 contracts.

Therefore, the TIS is not subject to self-employment (SE) tax, which is the sold proprietor equivalent of social security and Medicare.

The same is true for the MTMT who files as a sole proprietor. All expenses are reported on Schedule C but all gains or losses are reported of Form 4797 Part II in addition to Form 6781 for all Sec 1256 contracts.

Further, for the MTMT, the income reported on Form 4797 is subject to the Qualified Business Income Deduction ("QBID") created by the Tax Cuts and Jobs Act in December 2017. The QBID creates up to a 20% deduction for income from flow-through entities depending on other items on the taxpayer's tax return.

Investor – Trader in Securities – Mark-to-Market Trader

Court Case Summaries

Summary of Court Cases

This summary is based upon the criteria used by most of the courts in the cases presented.

Case	Intent	Nature of Income	Frequency and Regularity	Result
Higgins (1941)	Long-term	Sought "permanent" holdings and did not replace securities when sold	Extensively "managed" those who managed his real estate and security investments Court concluded that real estate activities rose to the level of a trade or business but investments did not	Investor
Levin (1979)	No mention is actually made of the intent or nature of income except that he "traded"		Substantial research Spent whole day working on stock transactions Conducted 332 transactions representing 112,400 shares with value of $3.45 million Court said "sheer quantity of transactions" supports the conclusion of a trade or busines	Trader
Moller (1983)	Long-term	Invested for long-term growth and dividends	Spent 40-42 hours/week researching stocks 83 buys and 41 sells one year 76 buys and 30 sells in next year	Investor
King (1987)	Commodities futures	Short-term gains from spot market trades and investment interest expense	A trader can be engaged in a trade or business that produce capital rather than ordinary income	Trader
Yaeger (1988)	Sought undervalued companies and waited for their value to be reflected in their stock price	No interest or dividend income but longer-term appreciation	Pursued investment activity full-time and worked 7 days/week; Contacted company management and attempted mergers & acquisitions 1,176 buys and 86 sells one year 1,088 buys and 39 sells next year Court concluded that although extensive time involved, Yaeger managed securities rather than traded	Investor
Laureys (1989)	Short-term losses as ordinary instead of capital	Option trading and losses from straddle transactions	Substatial trading as a CBOE market-maker entitled petitioner to ordinary loss treatment as a trader	Trader but Capital
Paoli (1991)	Short-term profit 1 day holding period for some stocks	Stocks not held long enough to earn dividends	326 sales; $9.8 million in gross proceeds with $10.8 million in cost Sch D was 22 pages 40% of transactions during one-month period Also employed as engineer	Investor
Mayer (1994)	Gave investment managers three years to make profits	Weighted average holding period was 317, 439 & 415 days over three year period	Averaged over 1,000 trades/year over three year period	Investor

Summary of Court Cases

This summary is based upon the criteria used by most of the courts in the cases presented.

Case	Intent	Nature of Income	Frequency and Regularity	Result
	Focused on long-term appreciation		Court concluded he met the substantial trading requirement	
Steffler (1995)	Setup a business with name, cards, separate bank account Wrote software to analyze commodity markets	Sought to profit from short-term swings in commodity prices Positions were covered within two months of opening	Traded 16, 18 & 47 contracts in each of three years on 7, 8 & 12 days of those years, respectively	Investor
Chen (2004)	Short-term profit	Trading profits from short-term trades and covering short positions	323 trades in one year with 303 occuring in three months, 20 in another three months and none in six month period Employed full-time as engineer Court concluded that Chen met criteria for three months but not entire year	Investor
Knish (2006)	Trader in Securities	Short-term trades Substanital losses (> $5M over two years)	Trading within an S Corp that had not made a proper MTM Election Filed Form 3115 but without the Sec 475 election, the Change in Accounting Method was moot	not MTM
Vines (2006)	Short-term day trader	Short-term swings in market	Although this case pertained to a late mark-to-market election, one must be a "trader" to make the election Court concluded that "volume and frequency" of trading substantiated trader status Vines was also allowed a late MTM election utilizing 9100 relief	Trader
Arberg (2007)	Value/position trader Traded as a mark-to-market trader	Attempted to profit from undervalued securities; holding period based on value recovery	Traded from Feb to Sep and Feb to Oct next year; Trading 17 securities with gross proceeds of $32.4 million Traded spouse's account in a non-community property state Spouse's account constituted all short-term trades	Investor
Cameron (2007)	Court recognized short-term profit motive	Short-term profits - holding periods of less than 61 days	Did not trade 5 days/week and only traded 10 days/month two times during two year period 2002 - 46 buys, 14 sells 2003 - 109 buys, 103 sells	Investor
Jamie (2007)	Short-term day trader	Short-term swings in market No attempt to earn dividends or interest from securities traded	This case pertained to reflecting MTM tax treatment without making a MTM election IRS (and Court) apparently concluded that dlollar volume of trading activity rose to the level of a trader	Trader

Summary of Court Cases

This summary is based upon the criteria used by most of the courts in the cases presented.

Case	Intent	Nature of Income	Frequency and Regularity	Result
			Maximum trades in one year during 3 year period was 118 but dollar amount was $14.8 million	
Perkins (2007)	Day trader and Mark-to-market trader without election	Short-term losses without MTM election exceeded $3000 capital loss limit	Number of trades not stated but "day trader" losses at issue	Investor
Holsinger (2008)	To capture short-term market swings	Rarely held stocks LESS than 31 days and hardly bought and sold on the same day	Setup "trading" business but continued to use his name and social security number on brokerage accounts 289 trades one year 372 trades the next year Traded on 40% and 45% of trading days respectively	Investor
Kay (2011)	Short-term Made mark-to-market election	No day-trading activity but securities held short-term	313 transactions one year, followed by 72 the next year and 84 the next Traded on 73 days, 18 days and 21 days over three years	Investor
Van der Lee (2011)	Price appreciation	Capital appreciation from longer-term holdings No day trading	148 transactions in one brokerage account and 11 in another during year Traded on 7 of 252 trading days	Investor
	Note: Taxpayer's recordkeeping consisted primarily of credit card statements with expenses circled. This was found not to satisfy the substantiation threshold required by IRS.			
Endicott (2013)	Option premium hedged with stock + dividends	Short-term gains from option premium, some long-term gains plus dividends Significant margin interest	204 trades, 303 trades and 1,543 trades in subsequent years Trading not regular and continuous	Investor
Nelson (2013)	Short-term	Short-term gains	535 trades in 121 days; 235 trades in 66 days; Trade volume exceeded $32.5M and $24.2M	Investor
Poppe (2015)	Short-term Trader in Securities	Short-term gains 38.4% of Total Income from Trading Securities	Roughly 60 trades/month Traded 4-5 hours each trading day 10-12 hours per day when off "Sec 475 identifies being a trader in securities as a prerequisite to filing the mark-to-market election." Failed to file Form 3115	Trader nott MTM
Spicko (2016)	MTM Trader	Interest Dividends	Did not submit MTM Election to IRS but provided to brokerage	not MTM