CHAPTER 11

Tax Law Changes for Traders

Congress and the White House are always tinkering or suggesting drastic change to the income tax code. Business traders benefit from having most of their benefits occur "above the line" as part of gross income. We address new tax legislation passed and on the agenda.

HOW THE 2003 TAX ACT AFFECTS BUSINESS TRADERS

Section 179 depreciation (which allows for 100 percent first-year depreciation) now includes off-the-shelf computer software. Before, software was not an eligible deduction.

The 50 percent bonus depreciation has many special dates for phase-in and phase-out. This classification means that taxpayers should not do their returns manually, instead, they should rely on tax software for these items.

Dividends

Brokers will be required to have their 1099s report qualifying dividends versus nonqualifying (or, 15 percent rate dividends versus ordinary dividends).

So, this change should reduce some complexity for taxpayers and their tax preparers. However, notice some complexities are all dependent on the taxpayer and will not be sought out on the Form 1099.

The holding period for qualifying dividends is changed to 60 of 120 days before the ex-dividend date (raised from 45 of 90). This change essentially ruins things for business traders, and they won't have qualifying dividends on their trading positions.

If you owe dividends on short positions, the owe part is ordinary. Therefore, the offsetting dividends on the long side of positions are nonqualifying.

The theory of the new tax act is clear. It makes sure that if you have offsetting ordinary (higher tax rate) tax deductions, you convert an otherwise qualifying dividend into a nonqualifying dividend. So, it eliminates arbitrage opportunities to deduct short dividends or other items at ordinary rates and get 15 percent rates on gains.

You can borrow money to buy dividend stocks as investment positions and deduct ordinary interest as an offset to 15 percent rate qualifying dividends. However, notice the next rule on investment income, which may limit some of this strategy.

Investment Income

This rule appears to mean that if you use qualifying dividends as part of your investment income for purposes of deducting investment interest expenses at ordinary rates (investment interest expenses are limited to investment income), your qualifying dividends become nonqualifying. It's not possible for a broker to report this investment income on a Form 1099, because every taxpayer's return is different. Tax software should handle this issue.

Many provisions distinguish between what is and what is not a qualifying dividend (REITs, foreign corps, regulated investment companies, etc.). On the other hand, most of the act is straightforward on rate acceleration, bigger and better depreciation, the child credit increase, and the complex rules on dividends.

The Bottom Line: Business traders and investors will benefit greatly from reduced tax rates. Ordinary rate reduction helps everyone. Business securities traders don't have many long-term capital gains, so this rate reduction won't help them much. Business and investor commodities traders will benefit from the long-term capital gains rate reduction, because they have 60/40 treatment and the 60 is the long-term part. All traders should consider segregating some investments to generate long-term capital gains and qualifying dividends. Buy-and-hold at low market values may be a good strategy now (if you think the market is trending higher).

Business traders and investors will benefit from increased depreciation; it is a subsidy to buy more computers and other equipment. This strategy is no giveaway, though, because it allows you to deduct what you spend a little faster. Big deal!

Business traders will rarely have qualifying dividends, because few will meet the 60-of-120-day holding period rule.

The dreaded alternative minimum tax (AMT) is reduced with higher exemptions. This change helps most middle and upper income taxpayers, especially those in higher-taxing states (state taxes are not deductible for AMT). Most business treatment with trader tax status is beyond the tangles of AMT.

All in all, the 2003 Tax Act is a helpful tax act. It's too bad all the dividend hoopla doesn't help business traders.

MISCELLANEOUS RULES FOR TRADERS

Short-Sale Expenses and Substitute Payments in Lieu of Dividends

If you short stocks as part of your trading program (certainly a profitable activity the past few years), you need to know how short-sale expenses and substitute payments in lieu of dividends are handled on your tax returns.

Short-Sale Expenses

While you are short a security, you might be responsible for paying a dividend to the true owner of the stock (the person or entity you borrowed it from). Your payment of this dividend is considered a short-sale expense.

According to IRS Publication 550, if your short sale is open for forty-six days or more, the short-sale expense is considered interest expense. Qualified traders deduct interest expenses on Schedule C (individuals) or as ordinary deductions on entities. Investors deduct investment interest expense as an itemized deduction on Schedule A.

According to IRS Publication 550, if your short sale is open for less than forty-six days, then the short-sale expense should be added to the cost basis of the securities purchased to close the short sale.

For this reason, all short sellers should elect and use mark-to-market accounting, which will ensure that your trading losses are ordinary in nature. You don't want to convert short-sale expenses into unutilized capital losses.

With MTM, you are in the best position to be a short seller. An investor ends up with limitation on capital losses or investment interest expenses. A business trader without MTM ends up with capital losses and ordinary trading business expenses. An MTM business trader ends up with ordinary losses and ordinary trading business expenses. If that's the case, you don't need to bother with the forty-six-day rule.

Most traders close short sales in less than forty-six days, so they will end up with their short-sale expenses reducing their trading gains and losses.

Substitute Payments in Lieu of Dividends

The flip side of short-sale expenses is substitute payments in lieu of dividends. Consider the case of person A, who lends a security to person B, who then sells it short to person C.

Person C receives the true dividend and has simple tax matters. In fact, he or she doesn't even know a short sale occurred. Person C receives a Form 1099-Dividend at the end of the year and reports their dividend on Schedule B (Interest and Dividend Income). Person B is the short seller and has short-sale expenses.

Person A is the one who has substitute payments in lieu of dividends. In a sense, person A is receiving a dividend. For tax purposes, though, only person C is allowed dividend tax treatment (because corporations get special advantages and the IRS does not want double dipping on these benefits).

Person A receives a Form 1099-Misc. A business trader should report this amount on Schedule C on the Other income line. This income is not subject to self-employment taxation. An investor should report this income on Form 1040, line 21, Other income, which is also not subject to self-employment taxation.

Tax treatment for a business trader versus an investor does not differ here. The only difference is using Schedule C versus page 1 of Form 1040. One benefit is the trader has more income, which comes in handy when using section 179 depreciation and home office expenses. Person A does not get qualified dividends treatment.