JUNE 2022

CAN YOU DEDUCT THE COSTS OF A SELF-MANAGED PORTFOLIO?

Do you have significant investment-related expenses, including payment for financial service subscriptions, home office maintenance and clerical support? Under current tax law — specifically the 2017 Tax Cuts and Jobs Act — these expenses aren't deductible through 2025 if they're considered investment expenses to produce income. But they are deductible if they're considered trade or business expenses.

For years before 2018, production-of-income expenses were deductible, but they were included in miscellaneous itemized deductions, which were subject to a 2%-of-adjusted-gross-income floor. (Unless Congress acts to extend them, these rules are scheduled to return after 2025.) If you do a significant amount of trading, you should know which category your investment expenses fall into, because qualifying for trade or business expense treatment is more advantageous now.

To be able to deduct your investment-related expenses as business expenses, you must be engaged in a trade or business. The U.S. Supreme Court held many years ago that an individual taxpayer isn't engaged in a trade or business merely because the individual manages his or her own securities investments — regardless of the amount or the extent of the work required.

A TRADER VS. AN INVESTOR

However, if you can show that your investment activities rise to the level of carrying on a trade or business, you may be considered a trader, who is engaged in a trade or business, rather than an investor, who isn't. As a trader, you're entitled to deduct your investment-related expenses as business expenses. A trader is also entitled to deduct home office expenses if the home office is used exclusively on a regular basis as the trader's principal place of business. An investor, on the other hand, isn't entitled to home office deductions since the investment activities aren't a trade or business.

Since the Supreme Court decision, there has been extensive litigation on the issue of whether a taxpayer is a trader or investor. The U.S. Tax Court has developed a two-part test, both parts of which must be satisfied for a taxpayer to be considered a trader.

PROFIT IN THE SHORT TERM

A taxpayer's investment activities may be regular, extensive and continuous. But that itself isn't sufficient for determining that the taxpayer is a trader. To be considered a trader — and therefore entitled to deduct investment-related business expenses — you must show that you buy and sell securities with reasonable frequency with the goal of making a profit on a short-term basis.

In one U.S. Tax Court case, a taxpayer made more than 1,000 trades a year with trading activities averaging about $16 million annually. Even so, the individual was deemed to be an investor rather than a trader, because the holding periods for stocks sold averaged about one year.

1. The taxpayer's trading is substantial (in other words, sporadic trading isn't considered a trade or business), and

2. The taxpayer seeks to profit from short-term market swings, rather than from long-term holding of investments.

Again, to pass this test, a taxpayer's investment activities are considered a trade or business only if *both* parts one and two are satisfied.

Contact us if you have questions or would like to figure out whether you're an investor or a trader for tax purposes. ■

HOW START-UP COSTS OF A NEW BUSINESS AFFECT YOUR TAX RETURN

Despite the COVID-19 pandemic, government officials are seeing a large increase in the number of new businesses being launched. The latest data available from the U.S. Census Bureau shows that for the period of June 2020 through June 2021, business applications were up 18.6%. The Bureau measures this by the number of businesses applying for an employer identification number.

Entrepreneurs often don't know that many of the expenses incurred by start-ups can't be currently deducted. You should be aware that the way you handle some of your initial expenses can make a large difference in your federal tax bill.

HOW TO TREAT EXPENSES FOR TAX PURPOSES

If you're starting or planning to launch a new business, keep these three rules in mind:

1. Start-up costs include those incurred or paid while creating an active trade or business — or investigating the creation or acquisition of one.

2. Under the tax code, taxpayers can make a special election to deduct up to $5,000 of business start-up and $5,000 of organizational costs in the year the business begins. As you know, $5,000 doesn't go very far these days! And the $5,000 deduction is reduced dollar-for-dollar by the amount by which your total start-up or organizational costs exceed $50,000. Any remaining costs must be amortized over 180 months on a straight-line basis.

3. No deductions or amortization deductions are allowed until the year when "active conduct" of your new business begins. Generally, that means the year when the business has all the pieces in place to start earning revenue. To determine if a taxpayer meets this test, the IRS and courts generally ask questions such as: Did the taxpayer undertake the activity intending to earn a profit? Was the taxpayer regularly and actively involved? Did the activity commence?

Be sure to keep detailed records and receipts for these costs, so that nothing falls through the cracks.

ELIGIBLE EXPENSES

In general, start-up expenses are those you make to:

- Investigate the creation or acquisition of a business,
- Create a business, or
- Engage in a for-profit activity in anticipation of that activity becoming an active business.

To qualify for a special election, an expense also must be one that would be deductible if it were incurred after a business began. One example is money you spend analyzing potential markets for a new product or service.

To be eligible as an "organization expense," an expense must be related to establishing a corporation or partnership. Examples of organization expenses include legal and accounting fees for services related to organizing a new business and filing fees paid to the state of incorporation.

PLAN NOW

If you have start-up expenses that you'd like to deduct this year, you need to decide whether to take the election described above. Recordkeeping is critical. Contact us about your start-up plans. We can help with the tax and other aspects of your new business. ■

NONWORKING SPOUSES MAY STILL CONTRIBUTE TO AN IRA

Married couples may not be able to save as much as they need for retirement when one spouse doesn't work outside the home — perhaps so that spouse can take care of children or elderly parents. In general, an IRA contribution is allowed only if a taxpayer earns compensation. However, there's an exception involving a "spousal" IRA. It allows contributions to be made for nonworking spouses.

For 2022, the amount that an eligible married couple can contribute to an IRA for a nonworking spouse is $6,000, which is the same limit that applies for the working spouse.

IRA ADVANTAGES

As you may know, traditional IRAs offer two types of advantages for taxpayers who make contributions to them:

1. Contributions of up to $6,000 a year to an IRA may be tax deductible, and

2. The earnings on funds within the IRA aren't taxed until withdrawn. (Alternatively, you may make contributions to a Roth IRA. There's no deduction for Roth IRA contributions, but if certain requirements are met, distributions are tax-free.)

As long as the couple together has at least $12,000 of earned income, $6,000 can be contributed to an IRA for each, for a total of $12,000. (The contributions for both spouses can be made to either a regular IRA or a Roth IRA, or split between them, if the combined contributions don't exceed the $12,000 limit.)

BOOST CONTRIBUTIONS IF 50 OR OLDER

In addition, individuals who are age 50 or older can make "catch-up" contributions to an IRA or Roth IRA in the amount of $1,000. Therefore, for 2022, for a taxpayer and his or her spouse, both of whom will have reached age 50 by the end of the year, the combined limit of the deductible contributions to an IRA for each spouse is $7,000, for a combined deductible limit of $14,000.

There's one catch, however. Suppose in 2022, the working spouse is an active participant in one of several types of retirement plans. In that case, a deductible contribution of up to $6,000 (or $7,000 for a spouse who will be 50 by the end of the year) can be made to the IRA of the nonparticipant spouse, only if the couple's AGI doesn't exceed $129,000.

Contact us if you'd like more information about IRAs or you'd like to discuss retirement planning. ■