

Trader Entities

Should You Incorporate Your Trading Business?



A Little Accountant Humor

What is the difference between an introverted accountant and an extroverted accountant?

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What is the difference between an introverted accountant and an extroverted accountant?

An introverted accountant looks at his shoes when he's talking to you; the extroverted accountant looks at your shoes when he's talking to you.

Disclaimer

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"Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands."

Judge Learned Hand
Judge, U.S. Court of Appeals
1872-1961

Tonight's Agenda

- Qualifying for Trader Tax Status
- Mark to Market Accounting
- Why Form A Trading Entity?
- Types of Trading Entities
 - Sole Proprietors
 - LLCs
 - S-Corps
 - Partnerships
 - C Corps
- Entity Cautions

Trader or Investor?



Are You A Trader?

- IRS offers no clear definition
- Not defined in the Internal Revenue Code or in tax regulations
- Guidance comes from court cases
 - *Moeller vs. United States* (1983)
 - *Stephen A. Paoli* (1991)
 - *Frederick R. Mayer* (1994)
 - *Rudolph Steffler* (1995)

What The IRS Says

- <http://www.irs.gov/taxtopics/tc429.html>
- Topic 429: Traders In Securities
 - You must seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation.
 - Your activity must be substantial, **AND**
 - You must carry on the activity with continuity and regularity

What Does The IRS Look For?

- Typical holding periods for securities bought and sold
- The frequency and dollar amount of your trades during the year
- The extent to which you pursue the activity to produce income for a livelihood, **AND**
- The amount of time you devote to the activity

Miss One of Those Four...

- You will be taxed as an **INVESTOR**
 - Lose home office deductions
 - Lose investment seminar deductions
 - Margin interest cannot exceed investment income (excess carried forward)
 - Allowed expenses go on Schedule A and subject to 2% AGI
 - Subject to Wash Sale Rule
 - Cannot use Mark-to-Market Sect 475(f)

General Guidelines For Traders

- Substantial Portion of *Liquid* net worth trading the market
- Weekly buys/sells (daily even better)
- Substantial # of buys/sells spread throughout the year
 - North of 500 generally safe
 - 100–200 range tough to up hold trader status

General Guidelines For Traders

- Typical holding period under a month
 - Weekly or daily even better
- Spend substantial time watching and trading market (3 hours/day minimum)
 - Keep a time log
- Maintain a business-like operation
 - Keep good books & records
 - Trading journal

Electing Trader Tax Status

- **NO FORMAL ELECTION!**
- Can claim trader status for 2010
- Can go back and claim for 2007-2009
 - File amended tax returns
 - Include Schedule C (Profit/Loss from Business)

Not Sure If You Qualify?

www.shrinkmytaxes.com

Fill out Trader Analysis

Fax or E-mail back for
Free Trader Evaluation



Trader Tax Questionnaire / Analysis

- 1) What Types Of Securities Do You Trade? (check all that apply)
 Stocks Bonds Options Commodities Futures Forex
- 2) How Frequently Do You Trade? Daily Weekly Monthly
- 3) How Many Trades On Average (round trips) Do You Make During That Time Frame?
 1-2 3-5 5-10 11-15 16-20 21-25 26-50 51-100 100+
- 4) What Is Your Average Holding Period?
 Minutes Hours Days Weeks Months Years
- 5) How Many Hours Per Day Do You Spend Actively Trading During Market Hours?
 Less Than 1 1 to 2 3 to 4 5 to 6 6+
- 6) How Many Hours Per Day Do You Spend Reading Financial Publications, Analyzing Market or Stock Action, Analyzing Charts, etc?
 Less Than 1 1 to 2 3 to 4 5 to 6 6+
- 7) Do You Have Another Source of Income From Employment (W-2 or self employed)?
 Yes No
- 8) How Many Hours A Week Do You Spend at That Job or Business?
 Less Than 5 5 to 10 10 to 20 20 to 30 30 to 40 40+
- 9) What % of Your Total Investable Assets Are In Your Trading Account?
 Under 5% 5 to 10% 10 to 24% 25 to 50% 50 to 75% 75 to 100%
- 10) Do You Maintain a Separate Brokerage Account For Your Long Term Positions?
 Yes No Don't Have Long Term Positions
- 11) What is Your Security Selection Process?
 Technical Analysis Fundamental Analysis Automated Trading System Other
- 12) Do You Hire Outside Money Managers To Manage Your Trading Account?
 Yes No Only For My Long Term Account

Name: _____ Phone: _____

Email Address: _____

Fill Out and Fax Back To: 866-961-5668 or Scan & Email to info@shrinkmytaxes.com

Mark To Market Accounting



Mark to Market Accounting

- IRC Section 475
- Converts capital gains/losses into ordinary gains/losses
- At year end
 - All open positions priced as if sold on last trading day in December
 - “Buy Back” at same price on 1st trading day of January

Mark to Market Accounting

- Reported on Form 4797 (Sale of Business Property)
- Ordinary losses may be deducted **IN FULL** against **ANY** type of tax return income
- Net Operating Loss (NOLs) can be carried back up to 2 years for immediate tax refunds (form 1045 or 1040X)
- NOLs can be carried forward up to 20 years

Trader vs. Trader With M2M

Trader (cash method)

- Gains taxed as ordinary income
- Losses limited to capital gains plus \$3000 (capital loss)
- Cannot carry back loss
- Carry forward loss until used up

Trader Electing M2M

- Gains taxed as ordinary income
- Losses taken in full (ordinary loss)
- Carry back loss up to 2 years
- Carry forward loss up to 20 years

Electing Mark to Market

- Make a mistake or file late...you will lose out on M2M tax benefits
- 3 Important Steps
 - Attach an election to prior year tax return or extension
 - File Form 3115 (Change of Accounting Method) with filing of current year's tax return
 - Section 481(a) adjustment on the Form 3115 and on tax return Form 4797

Making The Election To M2M

- Attach election statement to prior year tax return
- To elect M2M for 2011, attach and send in with your 2010 tax return by 4/15/11
- Example statement
 - I hereby elect to use the mark-to-market method of accounting under section 475(f) of the Internal Revenue Code for my trade or business of trading securities. The first year for which the election is effective is the taxable year beginning January 1, 2011.

Making The Election To M2M

- Form 3115 (Change of Accounting Method) needs to be filed with your 2011 tax return if you elect M2M for 2010
- Any open positions on January 1?
 - Calculate and report Section 481(a) adjustment on Form 3115 and tax return Form 4797 (Sale of Business Property)
 - Unrealized gains prorated over 4 years
 - Unrealized losses are 100% deductible

Why Form A Trading Entity?



Why Form A Trading Entity?

- Audit “Protection”
- Retroactive Mark to Market Election Filing
- Part Time Trader or W-2 Income
- More Tax **DEDUCTIONS!**
 - Retirement Plans
 - Health Insurance

Audit “Protection”

- 1 out of 100 tax returns audited in 2008
- Schedule C (under \$100,000)
 - 400% more likely to get audited
- Schedule C (over \$100,000)
 - 1400% more likely to get audited

Audit “Protection”

- Majority of trader status cases that go to Tax Court are filed as a sole proprietorship on a schedule C
- Very few cases go to Tax Court for an entity that files a separate tax return

Retroactive Mark to Market Filing

- Mark to Market (IRC section 475) election for 2011 must be attached to your 2010 tax return and filed by due date
- If you missed making the election this year (already filed your personal return)
 - Forming an entity enables you to make the election for the rest of the year
 - Otherwise you'd have to wait until next year to make the election!

Retroactive Mark to Market Filing

- Example: Trader filed his 2010 personal return on Feb 15
 - March 1 forms an entity and makes the election for remainder of 2011
 - Taxed as a sole proprietor Cash Basis from January 1 to February 28 (schedule D)
 - Taxed as an entity with Mark to Market from March 1 to December 31 (Form 4797)

Revocation of Mark to Market

- Must request permission from IRS to do so
 - Unlikely to allow you to do so
- Stop using or close down entity
 - Back to being a sole proprietor on cash basis
- Can always form another entity down the road and elect mark to market again

Part Time Trader or W-2 Income

- Income from full time /part time W-2 job
- Having other self employment earnings
- Being supported in any way other than active trading (spouse's income, etc)

**A trading entity should be established!
The entity will be considered the trader
since 100% of its activities & 100% of its
capital are employed in an active business
of trading**

More TAX Deductions!

- Retirement Plans
 - Have to have “earned” income to be able to fund a retirement plan (IRA, Solo 401k, SEP)
 - Trading gains are not considered earned income
 - Having an entity means you can “pay” yourself an administration fee
 - Generates earned income to fund a retirement plan

Health Insurance Deduction

- Can deduct 100% of health insurance premiums
 - Partners, LLC members, & single owner S Corps
- **Not a business expense!**
 - Taken on form 1040
- Must not be eligible to participate in another health plan at another job or through spouse's work
- Deduction cannot be greater than income of business!
- Medical expenses not covered by insurance go on Schedule A (7.5% AGI floor)

Health Insurance Deduction

- Sole Proprietor Traders have no earned income
- Entities can pay out an “administration” fee
- Claimed on Schedule C
 - Pay Self Employment Tax
- Opens up Health Insurance & Retirement Plan benefits

Self Employment Taxes

- Traders are exempt from self employment taxes
 - **Doesn't matter if you elected M2M or not**
- IRS Pub 550: "Gains and losses from selling securities as part of a trading business are not subject to self employment tax"
- Proprietary traders who get a 1099-MISC ARE subject to self employment tax
- Dealers/Members of Options or Futures Exchange are subject to self employment tax

Entities For Traders



Sole Proprietor

- Least expensive to set up and maintain!
- Default method for traders
- Expenses go on Schedule C
- Income on Schedule D or Form 4797 (mark to market)
- Problem—no earned income!
 - Home office deduction
 - Section 179 expenses
 - Retirement plans & health insurance

Sole Proprietor

- Solution: pay your spouse an “administration” fee to open up retirement plan options
 - Cannot pay yourself a management fee as a sole proprietor
 - Spouse must perform service to the business

Sole Proprietor Example

- \$75,000 in net trading gains for year
- Do nothing: owe \$11,125 in taxes
- Pay \$13,000 to spouse
 - Owe \$1976 in SE taxes
 - Take the \$12,000 IRA deduction (catch up)
 - Owe \$8466 in federal taxes
 - Total tax: \$10,442 (save \$683)
 - \$12,000 IRA grows tax deferred!

Husband / Wife Partnerships

- Inexpensive to form and maintain
 - Should get an EIN
- Happen automatically whenever 2 or more people go into business together
- File Form 1065 informational return (due April 15)
- Profits & Losses flow through to individual tax return (Schedule E)

Husband / Wife Partnerships

- Pay yourself an “administration” fee to generate earned income
 - Goes on Schedule C
 - Pay SE tax
- Spouse can be active or passive
 - If passive: should be 10% owner due to passive loss limitations

Limited Liability Corps (LLCs)

- More expensive to set up and maintain than a Husband / Wife Partnership
 - State Registration Fees
 - **Minimum State Taxes (CA \$800!)**
 - Annual State Filing Fees
- File Form 1065 if taxed as a partnership (4/15)
- File Form 1120S if taxed as an S Corp (3/15)
- Profits & Losses pass through to individual tax return (Schedule E)

Limited Liability Corps (LLCs)

- Much less administrative paperwork and record keeping vs S Corps & C Corps
 - No requirement for annual general shareholder meeting in most states!
- Earned income generated with “administration fee” paid out and reported on a schedule C

Single Member LLCs

- Disregarded entity by the IRS
- Taxed as a sole proprietor on schedule C
- Single traders can use SMLLCs
 - Elect to be taxed as an S corp
 - File Form 8832 Entity Classification Election
 - File Form 2553 (to be taxed as an S corp)

S Corporations

- More expensive to set up and maintain vs LLCs
- Annual registration fees
- State taxes
 - **CA 1.5% of profits AND \$800 min franchise tax!**
- Profits & Losses pass through to individual tax return (schedule E)
- File Form 1120S informational return (due March 15)
- Use payroll to generate earned income
 - **Payroll taxes due**

C Corporations

- Not a good choice for trading businesses
 - Double taxation of earnings
 - Losses are trapped in the entity and not passed thru
 - No 60/40 tax treatment for futures trades
- Good: Fringe Benefit Plans
 - Medical Reimbursement Plans
 - Pays for (and deducts) medical costs not covered by insurance!
 - Better than taking the expenses on Schedule A (amount over 7.5% of AGI)

Entity Cautions

- Just because you formed an entity do not neglect the 4 things IRS looks for in traders
 - Frequency
 - Dollar amount
 - Time
 - Intent

Entity Cautions

- Open a business checking account
 - Use it for trading expenses
- Put your trading accounts into the name of your business!
 - 2008 LLC lost trader status because trading accounts were listed as individual ownership

Home Office Deduction

- Deduction cannot be more than your business Net Income
- Calculate deduction on Form 8829 and take deduction on Schedule C
- Can still take the deduction even if you rent!
- Direct: take 100% deduction for anything spent just for the home office
 - Decorating, repairs, floors, built-ins, etc.
- Indirect: take a pro rata share of expenses
 - Utilities, repairs, maintenance, insurance, taxes, etc.

Home Office Deduction

- LLCs, Partnerships, & S Corps
 - Employees so cannot file schedule C
- Unreimbursed Employee Expenses
 - Deduction is claimed on Schedule A (2% Floor)
- Accountable Plan
 - Written Corporate Resolution
 - Reimburse yourself for business use of home
 - Deductible to the business and not taxable to the owner (not counted as income)
 - Use Form 8829 to calculate the deduction amount
 - Works even if the home is rented

What To Do Next?

- Fill out and submit the Trader Evaluation Form
- Not too late to claim Trader Tax Status for 2010 (submitted on Schedule C)
- Can also go back up to 3 years and file amended returns to claim Trader Tax Status
- Don't need special forms or elections to do this (Schedule C-Profit & Loss From Business)
- Prepare to make the election for 2011 (M2M)
- **Questions: info@shrinkmytaxes.com**

How Can Shrink My Taxes Help?

- Free trader evaluation
- Review previous 3 years of tax returns **FREE**
- Mark to Market election
- Entity consultation & formation
- Tax preparation
 - S Corp, LLC, Partnership
 - Individual/Joint Return
- Tax planning & consultation
- Unlimited access included

“In America there are two tax systems: one for the informed and one for the uninformed. Both systems are legal.”

Judge Learned Hand

Thank You!



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