

Trader Tax Status

Using Tax Law To



Disclaimer

The following presentation is for informational and educational purposes only. It does not represent specific tax advice on the part of Shrink My Taxes. Each individual has unique situations and should consult privately with a qualified tax professional.

“There is nothing wrong with a strategy to avoid the payment of taxes. The Internal Revenue Code doesn’t prevent that.”

William H. Rehnquist

Chief Justice of the United States

1986-2005

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

Judge Learned Hand
US District Court

Today's Agenda

- Trader or Investor
- Trader Status Benefits
- Entities for Traders
- 5 Most Common Tax Mistakes

Tax Update

- New tax form for reporting Capital gains and losses Form 8949 *Sales and Other Dispositions of Capital Assets*
- Emergency Stabilization Act in 2008
- Starting in 2011, cost basis info for stocks will be detailed on your 1099-B
 - 2012 Mutual Funds
 - 2013 All other investment products

Tax Update

- Schedule D now functions as a summary of all capital gains info
- Individual investment sales will be detailed on Form 8949
- 3 Categories (separate Form 8949 for each)
 - Sales of covered securities for which cost basis is provided
 - Sales of non-covered securities for which no cost basis is provided on the 1099-B
 - Sales of investments for which no 1099-B is received

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 2011
- Can go back and claim for 2008-2010
 - 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

Trader Tax Status Benefits



Possible Trader Tax Deductions



- Chat room subscriptions
- Data feeds (DTN IQ, DTN Market Access)
- Software subscriptions (Investor RT, Market Delta)
- Newsletters & newspapers (WSJ, IBD)
- Trading books & publications (Master Traders, etc)
- Telephone (separate business line)
- Internet
- Seminars (transportation & lodging cost)
- Wages paid to family members (data entry, etc)

Possible Trader Tax Deductions

- Rent (if leasing space)
- Home office deduction
- Cable fees (CNN, FNN, CNBC)
- Computer & office supplies
- Depreciation on all fixed assets used in Trading (Section 179)
- Margin interest (\$ For \$ on Schedule C)
- Legal fees
- Tax preparation & advice (Shrink My Taxes!)

Mark to Market Accounting

- IRC Section 475
- Converts capital gains/losses into ordinary gains/losses
- Not Subject To Wash Sale Rules
- 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 treated as capital gains
- Losses limited to trading gains plus \$3000 (capital loss)
- Cannot carry back loss
- Carry forward loss until used up

Trader Electing M2M

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

Mark to Market Accounting

Trader (cash method)

- \$20,000 trading loss
- \$100,000 taxable income
- \$97,000 AGI (\$100,000-\$3000)
- \$17,000 capital loss carry forward

Trader Electing M2M

- \$20,000 trading loss
- \$100,000 taxable income
- \$80,000 AGI (\$100,000-\$20,000)
- Entire \$20,000 loss taken in current year

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 2012, attach and send in with your 2011 tax return by 4/15/12
- 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, 2012.

Making The Election To M2M

- Form 3115 (Change of Accounting Method) needs to be filed with your 2013 tax return if you elect M2M for 2012
- 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

Trader Entities

Should You Incorporate Your Trading Business?



Trader Entities

- Why Form A Trading Entity?
- Types of Trading Entities
 - Sole Proprietors
 - LLCs
 - S-Corps
 - Partnerships
- Entity Cautions

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 2012 must be attached to your 2011 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 2011 personal return on Feb 15
 - March 1 forms an entity and makes the election for remainder of 2012
 - 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
- Not a business expense!
- Must not be eligible to participate in another health plan at another job or through spouse's work
- Deduction limited to actual amount up to business income
 - Excess amount taken on Schedule A (subject to 7.5% AGI limitation)
 - Ex. \$10,000 expense and \$5000 in revenue: take \$5000 deduction and over \$5000 goes on Schedule A

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

Entities For Traders



Bad Entity Choices

- Single Member LLCs
 - Disregarded entity
 - Taxed as a sole proprietor (Schedule C)
 - Must elect to be taxed as a corp (S-Corp)
- C-Corps
 - Double taxation (corporate & individual level)
 - Losses are trapped in entity (no pass thru)
 - No 60/40 tax treatment for futures

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

Husband / Wife Partnerships

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

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)

S Corporations

- Preferred entity for single owners
- 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**

Top 5 Trader Tax Mistakes



#1 Deducting Health Insurance

- Special personal deduction for health insurance – not a business expense
- Sole proprietors, partners in partnerships, LLC members, and S-Corp shareholders who own more than 2%
- Business Income Limitation
 - Deduct only as much as your business earns
 - S-Corp limited by amount of wages paid

Deducting Health Insurance

- Reported directly on the 1040 line 29
 - Does not go on schedule C for sole proprietors
 - Excess expense goes on Schedule A subject to the 7.5% limit
- Sole Proprietor traders can hire their spouse & provide them with health insurance (becomes a business expense)

2 Home Office Expense

- Square Footage Method
 - Sq footage of office divided by sq footage of home
 - Allowed to subtract sq footage of common areas of home like hallways, entries, stairs, landings, garages
 - Ex. 200 sq ft office / 1600 sq ft home = 12.5%
- Room Method
 - Number of rooms used for business divided by number of rooms in house
 - Can exclude bathrooms, closets, garage
 - Ex. 1 room used / 5 room house = 20%
- Can use either method

Home Office Expense

- IRS Reporting
 - Sole Proprietors use Form 8829
 - LLCs and Partnerships use Schedule E part 2
 - S Corp Owners use Schedule A
- Can be reimbursed directly through an accountable plan
 - Business deduction
 - No income tax consequence to you

Home Office Expense

- Direct Expenses
 - Exclusively for the home office
- Indirect Expenses
 - Benefits the entire home
 - Mortgage interest & property taxes
 - Depreciation
 - Utilities, Insurance, Security System, Home maintenance, Condo Assoc. Fees
 - Pest control, snow removal, etc
 - Cannot deduct lawn care

3 Accountable Plans

- Way to pay for work related expenses
 - Home office expense
 - Business expenses paid for with cash/personal credit card
- Must have written plan document
 - Shrink My Taxes can help!
- Must document the expense
 - Within 60 days

4 Mark to Market

- If you do not trade Sect 1256 contracts, you **SHOULD** always elect mark to market
 - No tax difference with gains
 - Big benefit on losses
 - Not subject to wash sale rules
- Don't get stuck with **HUGE** capital loss carry forwards

How are futures contracts taxed?

- IRC Section 1256 contracts (commodities & futures contracts)
- Trading Gains are taxed 60% long term & 40% short term automatically (no special election)
 - Current max 60/40 tax rate is 23%
 - Current ordinary tax rate is 35%
- Can carry back trading losses up to 3 years but only against Section 1256 gains
- **Profitable futures traders usually skip electing mark to market accounting**

Section 1256 Contracts

- Regulated Futures Contracts
- Foreign Currency Futures Contracts
 - 6E, 6A, etc.
- Non Equity Options
 - Debt Options
 - Commodity Futures Options
 - Currency Options
 - Broad Based Stock Index Options

Broad Based Stock Index Options

- NQ – Nasdaq 100 Mini
- ES – S&P 500 Mini
- YM – Dow Jones Mini
- SPX – S&P 500 Index
- NDX – Nasdaq 100 Index
- RUT – Russell 2000 Index
- TF – Russell 2000 Mini

5 Hiring Your Kids

- Must be a real employee
 - Use a time sheet to document
 - Kids as young as 7 can qualify (upheld in tax court)
- Compensation must be reasonable
- Comply with legal requirements
 - Form 941 quarterly/Form 940 annually
- No FICA tax if under 18
- No Income tax if paid under \$5800!

What To Do Next?

- Fill out and submit the Trader Evaluation Form
- Not too late to claim Trader Tax Status for 2011 (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 filing
- Entity consultation & formation
- Payroll services
- Tax preparation
 - S Corp, LLC, Partnership
 - Individual/Joint Return
 - State Tax Returns
- Tax planning & consultation
- Unlimited access included

“I’m proud of paying taxes. The only thing is...I could be just as proud for half the money!”

Arthur Godfrey

Thank You!



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Frequently Asked Questions



Capital Loss Carryovers

- I have a lot of capital loss carryovers. If I elect mark to market accounting, can I use them against future trading gains?
 - No. Capital loss carryovers can only be used to offset capital gains. Electing mark to market accounting creates ordinary gains and ONLY ordinary losses can be used to offset them.

Am I Responsible For Self Employment Tax?

- Only on earned income. Traders are exempt from self employment and payroll taxes because the IRS views trading gains as unearned income, regardless of trader status or mark to market election.
 - Prop traders who get a 1099-MISC
 - Futures traders who are members/dealer of an option or futures exchange

How Is Forex Taxed?

- Default taxation under IRC Section 988 taxes Forex as ordinary income and loss
 - Ordinary losses offset income of any kind
 - Report gain on line 21 (other income) of 1040
- Futures on currencies are taxed under IRC Section 1256 (60/40 capital gains)
- Traders can opt out of Section 988 if they want the 60/40 tax treatment of Section 1256 (not available if you take physical delivery)

What if I trade stocks and futures contracts?

- You can elect mark to market for “securities only”
- Enables you to keep the 60/40 tax treatment for futures gains

Can I Still Hold Long Term Investments?

- Yes. You can segregate your long term positions from your trading business (separate brokerage account)
- Separate account should **NOT** be titled in your business name (if you incorporated)

How Should I Title My Accounts?

- Sole proprietors should be in individual name
- Incorporated trading businesses should be in the name of the business
 - Not in your individual or joint names
- If you are trading as a sole proprietor and have joint accounts, you could have a default (husband/wife) partnership
 - Form 1065 partnership tax return