

Trader Tax Status

Using Tax Law To



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“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

Today's Agenda

- Trader or Investor
- Trader Status Benefits
- Entities for Traders
- Frequently Asked Questions

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

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
- 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 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

Entities For Traders



Why Incorporate?

- Part time traders with W-2 income
- Late mark to market elections
- Deduct health insurance premiums
- Retirement plan contributions (earned income)
- Audit Paranoia

Audit Paranoia

- 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

Health Insurance Premiums

- Insurance premiums that are not deductible from AGI (no earned income), added to itemized deductions for medical expenses (schedule A).
- Amount over 7.5% of AGI is deductible
 - \$100,000 AGI (amount over \$7500 deductible)
 - \$12,000 expense (only \$4500 deductible)
- Creating “earned income” will make health insurance premiums deductible \$ for \$

Health Insurance Premiums

- Pay yourself a service fee (earned income from your corporation)
- \$12,000 expense 100% deductible
- Caution: cannot be eligible to participate in spouse's health plan

Retirement Plans

- No earned income = no retirement plans
- Have to have earned income to be able to contribute to Roth IRA and Traditional IRA
- Earned income can be from you or spouse
- Pay yourself a fee from your trading business to generate earned income

Best Entities for Traders

- Pass through entities
 - Gains/losses not taxed at the corporate level
 - Passed through to individual/joint tax return
- Examples
 - Partnerships
 - S-Corps
 - LLCs

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 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**

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

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
- Payroll services
- Tax preparation
 - S Corp, LLC, Partnership
 - Individual/Joint Return
- 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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