

# Trader Tax Status

## Using Tax Law To



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# **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.**

MARCH 1 IS \$20 TO \$1,000.  
(SEE INSTRUCTIONS ON PAGE 4.)

UNITED STATES INTERNAL REVENUE.

RETURN OF ANNUAL NET INCOME OF INDIVIDUALS.

(As provided by Act of Congress, approved October 3, 1913.)

RETURN OF NET INCOME RECEIVED OR ACCRUED DURING THE YEAR ENDED DECEMBER 31, 191 . . . .

(FOR THE YEAR 1913, FROM MARCH 1, TO DECEMBER 31.)

Filed by (or for) ..... of .....  
(Full name of individual.) (Street and No.)

in the City, Town, or Post Office of ..... State of .....  
(Fill in pages 2 and 3 before making entries below.)

1. GROSS INCOME (see page 2, line 12) . . . . .	\$				
2. GENERAL DEDUCTIONS (see page 3, line 7) . . . . .	\$				
3. NET INCOME . . . . .	\$				
Deductions and exemptions allowed in computing income subject to the normal tax of 1 per cent.					
4. Dividends and net earnings received or accrued, of corporations, etc., subject to like tax. (See page 2, line 11) . . . . .	\$				
5. Amount of income on which the normal tax has been deducted and withheld at the source. (See page 2, line 9, column A)					
6. Specific exemption of \$3,000 or \$4,000, as the case may be. (See Instructions 3 and 19) . . . . .					
Total deductions and exemptions. (Items 4, 5, and 6) . . . . .	\$				
7. TAXABLE INCOME on which the normal tax of 1 per cent is to be calculated. (See Instruction 3) . . . . .	\$				
8. When the net income shown above on line 3 exceeds \$20,000, the additional tax thereon must be calculated as per schedule below:					

**You must pay taxes.  
But there's no law that says  
you have to leave a tip!**

# Today's Agenda

- Trader or Investor
- Trader Status Benefits
- Entities for Traders
- Tax Impact of Obamacare
- Frequently Asked Questions

# Trader or Investor?



# Moeller vs United States (1983)

- Managed 4 portfolios worth about \$14M
- Spent about 40 hours a week on investments
- 1976: 83 transactions
  - Average holding period **3 years 4 months**
  - Total capital gain income **\$612**
- 1977: 76 transactions
  - Average holding period **8 years**
  - Total capital gain income **\$223**
- 98% of their gross income came from dividends

Needless to say, the Moellers lost their case. They were not looking to profit from short term price movements in the market (average holding periods and focus on income producing investments) so trader status was denied.



# Stephen A. Paoli (1991)

- 1982: 326 transactions
- 63% of his trades held less than 30 days
- 40% of trades made during 1 month
- 71% of trades made over 4 months
- Only 1 trade in October
- No trades in November and December

Stephen lost his case because his trading was not continuous through out the year. He maintained that he spent 4 to 5 hours every day to trading and studying the market even though he didn't trade. The court did not believe him because he could not provide documentation (this is why we recommend keeping a trading log or journal every day)

# Fredrick Mayer (1994)

- Stated objective: Preservation of Capital
- 1986: 1140 trades
  - Trading vol: \$16.6M
  - Average holding period 317 days
- 1987: 1569 trades
  - Trading vol: \$18.5M
  - Average holding period 439 days
- 1988: 1136 trades
  - Trading vol: \$14.5M
  - Average holding period 415 days

Mr. Mayer lost his trader status due to hiring outside money managers to manage his portfolio. The average holding periods also showed that he was interested in long term growth. The tax courts ruled in favor of the IRS and Mayer was taxed as an investor.

# Van Der Lee vs Commissioner (2011)

- 148 trades in 2002
- Claimed mark to market loss of \$1,388,327
- \$91,872 of trading expenses
- 30 trades were from exercising options
- Half of trades held longer than a year
- Didn't attach M2M election to return
- No Form 3115 filed

# Van Der Lee case

- IRS Ruling: **NOT A TRADER**
- Activity was sporadic
  - April, July, August between 4 – 8 trades
  - June: 29 trades but done on 5 days
- Never sold stock on same day of purchase
- Didn't make timely Mark to market election
- Disallowed M2M loss & trading expenses
- \$620,235 in taxes due + penalties & interest

# 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
- The frequency and dollar amount
- The extent to which you pursue the activity, **AND**
- The amount of time devoted

# Miss One of Those Four...

- You will be taxed as an **INVESTOR**
  - Lose home office deductions
  - Lose investment seminar deductions
  - Limit Margin interest deduction
  - 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 2012
- Can go back and claim for 2009-2011
  - File amended tax returns
  - Include Schedule C (Profit/Loss from Business)

# **Not Sure If You Qualify?**

**[http://www.tradertaxcoach.net/Trader\\_Status.html](http://www.tradertaxcoach.net/Trader_Status.html)**

## **Free Trader Analysis**

# Trader Tax Status Benefits



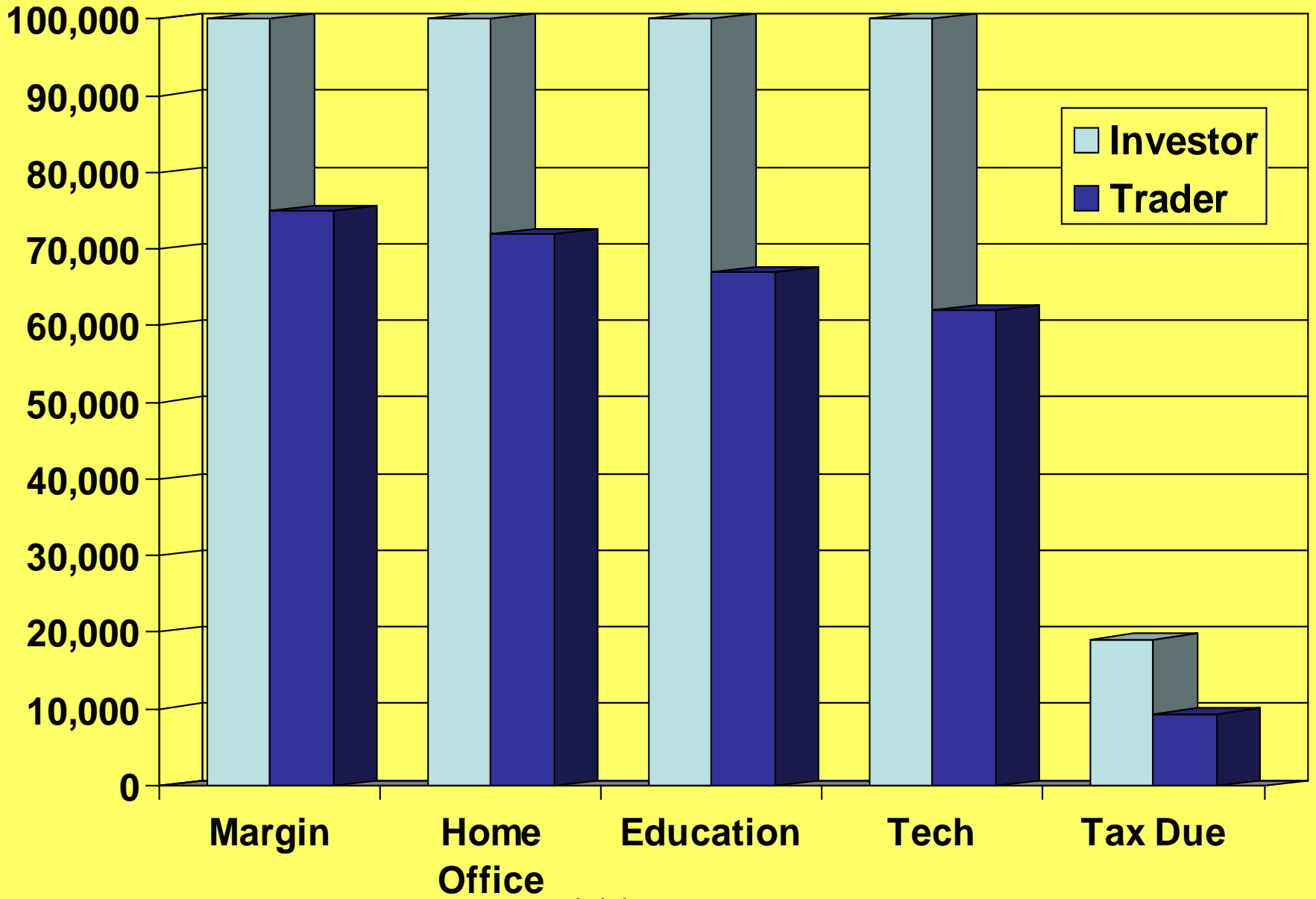
# Possible Trader Tax Deductions

- 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
- Educational Seminars / Webinars
- 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!)



# Tax Tip: Paying Your Kids



# Paying Your Kids

- 13 year old child
- Pay them \$10,950 in fair market wages
- Child owes \$0 in taxes
  - \$5000 IRA contribution
  - \$5950 standard deduction
- \$4380 in TAX SAVINGS
- Child has \$5950 to spend on items you would have had to buy anyway
- College Time: withdraw \$ from IRA
  - No 10% penalty
  - No income tax due if below standard deduction

# Paying Your Kids

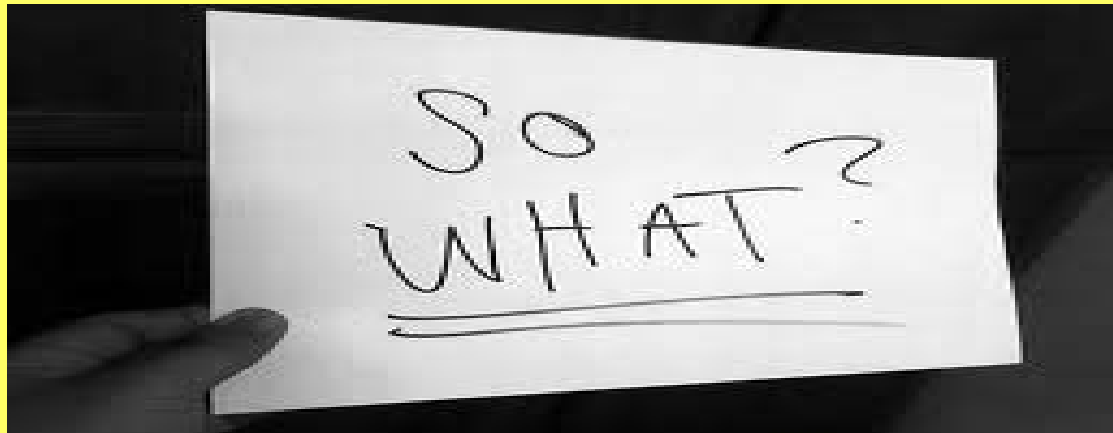
- To avoid payroll taxes, must be paid with a W-2 (NOT A 1099)
- **FAIR MARKET WAGES**
- **Keep good records**
- Works for sole proprietors, LLCs, & Partnerships
- S-Corps will owe payroll taxes

# The Golden Ticket for Traders



# Mark to Market Accounting

- IRC Section 475(f)
- Change of accounting method
- Cash Basis Trader = capital gains/losses
- M2M Trader = ordinary gains/losses



# Mark to Market Benefits

- 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
- NOLs can be carried forward up to 20 years
- Not subject to WASH SALE RULES



# Trader vs. Trader With M2M

## Trader (cash method)

- Gains treated as capital gains
- Short term gains taxed as ***ordinary income***
- Losses limited to trading 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

# Mark to Market Accounting

## Trader (cash method)

- \$20,000 trading loss
- \$100,000 taxable income from W-2
- \$97,000 AGI (\$100,000-\$3000)
- \$17,000 capital loss carry forward
- **\$18,258 tax due**

## Trader Electing M2M

- \$20,000 trading loss
- \$100,000 taxable income from W-2
- \$80,000 AGI (\$100,000-\$20,000)
- Entire \$20,000 loss taken in current year
- **\$13,258 tax due**

# Electing Mark to Market

- Make a mistake or file late...you will lose out on M2M tax benefits
- Penalties/Interest will be assessed by IRS



# Trader Entities

## Should You Incorporate Your Trading Business?



# Why Form A Trading Entity?

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

# 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

# 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
  - Passive vs. Earned
  - Trading gains are not considered earned income by the IRS
  - Pay yourself or a spouse



# 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
  - 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
- Deduct 100% of your premiums
- **Section 105 plans let you deduct 100% of your out of pocket medical expenses**

# Unreimbursed Medical Expenses

**SCHEDULE A  
(Form 1040)**

**Itemized Deductions**

OMB No. 1545-0074

**2011**

Department of the Treasury  
Internal Revenue Service (99)

▶ **Attach to Form 1040.**

▶ **See instructions for Schedule A (Form 1040).**

Attachment  
Sequence No. **07**

Name(s) shown on Form 1040

Your social security number

<b>Medical and Dental Expenses</b>	<b>Caution.</b> Do not include expenses reimbursed or paid by others.			
	1 Medical and dental expenses (see instructions) . . . . .	1		
	2 Enter amount from Form 1040, line 38 <b>2</b> . . . . .	2		
	3 Multiply line 2 by 7.5% (.075) . . . . .	3		
4 Subtract line 3 from line 1. If line 3 is more than line 1, enter -0- . . . . .			4	
<b>Taxes You Paid</b>	5 State and local <b>(check only one box):</b>	5		
	a <input type="checkbox"/> Income taxes, or	}		
	b <input type="checkbox"/> General sales taxes			
	6 Real estate taxes (see instructions) . . . . .	6		
	7 Personal property taxes . . . . .	7		
8 Other taxes. List type and amount ▶	8			
9 Add lines 5 through 8 . . . . .			9	
<b>Interest You Paid</b>	10 Home mortgage interest and points reported to you on Form 1098	10		
	11 Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address ▶			

**Note.**  
Your mortgage interest

# Unreimbursed Medical Expenses

- \$15,000 in unreimbursed medical/dental expenses
- AGI of \$100,000
- Able to deduct \$5,000 of your actual expenses
  - $\$100,000 \times 10\% = \$10,000$  floor
  - $\$15,000 - \$10,000 = \$5,000$  deduction
- **Missing out on \$10,000 in deductions**

# **Medical Expense Reimbursement Plan**

Section 105 Plan

# “Employee” Benefit Plan

## Section 105 Employee Eligibility

Business Entity	How to Qualify
Proprietorship	Hire Spouse
Partnership	Hire Spouse (if <10% owner)
S-Corporation	Shareholders not eligible
C-Corporation	Hire Self

# Nondiscriminatory

- Must cover all eligible employees.
- However, you can exclude:
  - Under age 25
  - Those working less than 35 hours/week
  - Those working less than 9 months/year
  - Those who have worked less than 3 years

# The Benefit

- Reimburse medical expenses incurred for:
  - self
  - spouse
  - dependents
- Bypass 10% floor
- Avoid self-employment tax



# Eligible Expenses

- Major medical, LTC, Medicare, “Medigap”
- Co-pays, deductibles, prescriptions
- Dental, vision, and chiropractic
- Braces, LASIK, fertility, special schools
- Nonprescription medications and supplies

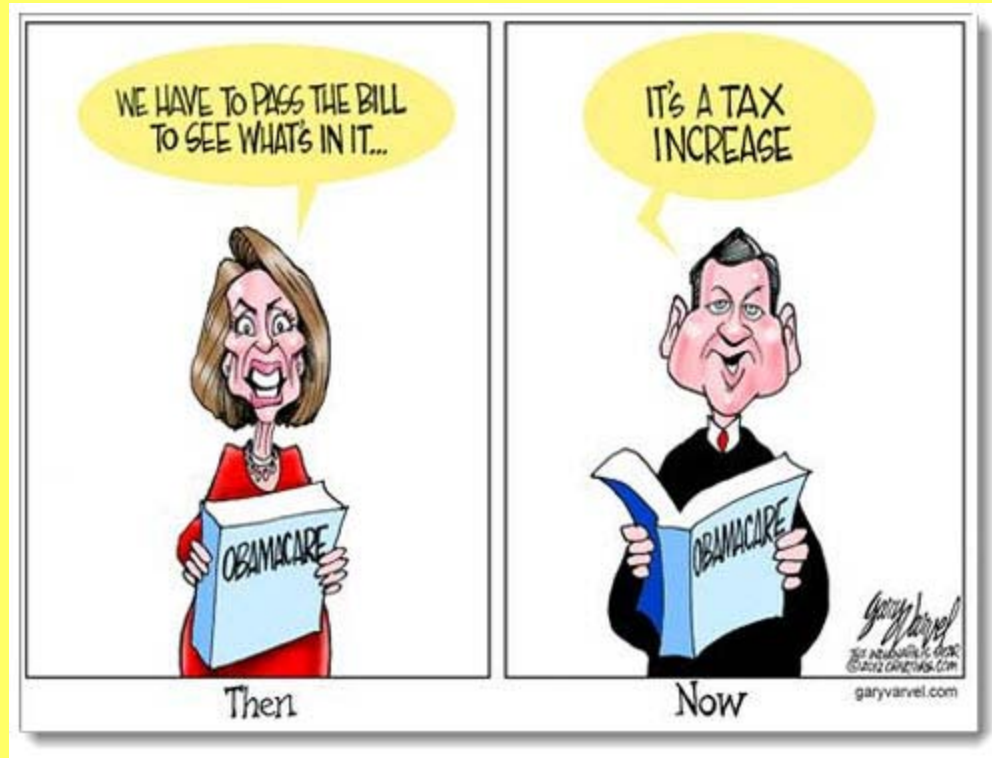
# Plan Requirements

- Written plan document
- Benefits are “reasonable compensation”
- Verify bona fide employment
- “Paper trail”

# How Can Shrink My Taxes Help?

- **Section 105 Plan Kit**
  - Section 105 Plan Document
  - Section 105 Plan Employee Enrollment Form
  - Employee Medical Expense Reimbursement Form
  - Employee Contract / Agreement
  - Consultation on Implementation of Plan

# Tax Impact of Obamacare



# Tax Impact of Obamacare

- Medical Expense Deduction
  - Floor rises to 10%
  - Ex. \$100,000 AGI—First \$10,000 not deductible
- 0.9% Surtax on Earned Income
  - Single filers over \$200,000
  - Married filers over \$250,000
  - Self employed too
- 3.8% Medicare Surtax on Unearned income

# Medicare Surtax

- Single filers over \$200,000
- Married filers over \$250,000
- Self employed
- Lesser of filer's net investment income **or**
- The excess of modified AGI over the above thresholds

# Medicare Surtax

- Single filer
- \$150,000 from W-2
- \$100,000 trading gains
- AGI \$250,000
- \$50,000 over the threshold
- $50,000 \times .038 = \mathbf{\$1900}$  extra tax due

# Medicare Surtax

- Married Couple
- \$140,000 from W-2
- \$120,000 trading gains
- AGI \$260,000
- \$10,000 over the threshold
- $10,000 \times .038 = \mathbf{\$380}$  extra tax due

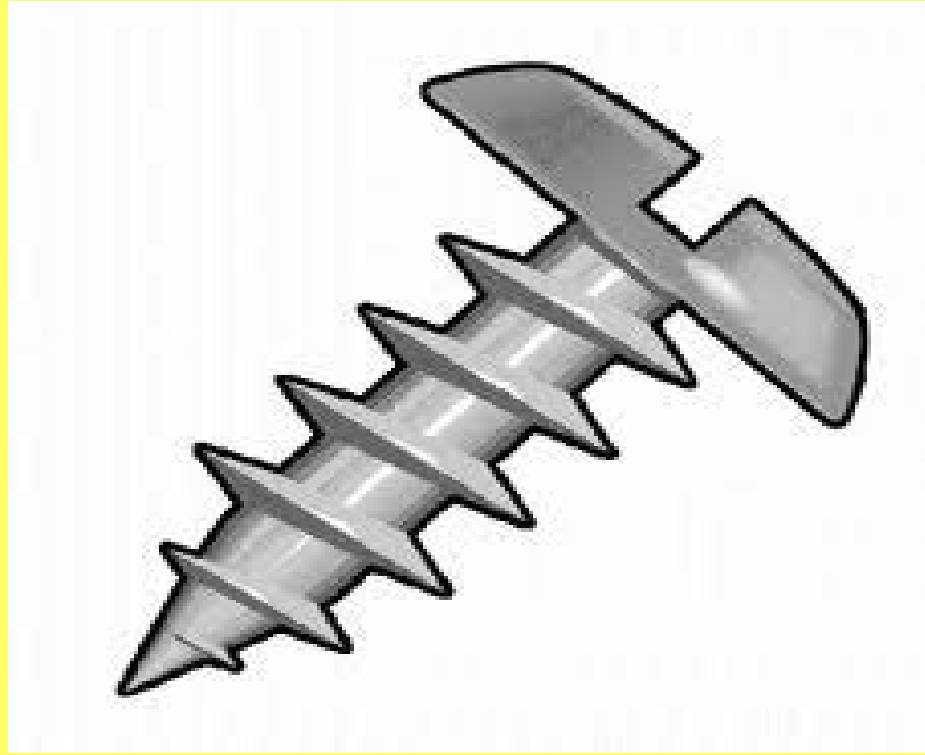


# Medicare Surtax

- Married Couple
- \$100,000 from W-2
- \$450,000 trading gains
- AGI \$550,000
- \$300,000 over the threshold
- $300,000 \times .038 = \mathbf{\$11,400}$  extra tax due

# Medicare Surtax

- Married Couple
- \$450,000 from W-2
- \$100,000 trading gains
- AGI \$550,000
- \$300,000 over the threshold
- $100,000 \times .038 = \mathbf{\$3800}$  extra tax due



**How is that for “affordable” care?**

# 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**

# 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

# 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 Trader Evaluation Form
- Not too late to claim Trader Tax Status
- Amend past returns
- Mark to Market Election?
- Questions: [info@shrinkmytaxes.com](mailto:info@shrinkmytaxes.com)

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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

# Thank You!



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## CONTACT INFO

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