2013 GTT Guide: Accounting for trading gains and losses

Executive Summary:

Accounting for trading gains and loss can be confusing and active traders face more difficulty dealing with a larger volume of transactions. There are different tax treatments to consider, some financial instruments require mark-to-market accounting at year end, or wash sale loss deferrals, and there are other tax rules to consider, too.

Section 1256 traders have it the easiest at tax time because they can skip trade accounting and rely on a one-page Form 1099 from their broker showing "aggregate profit and loss" on a mark-to-market (MTM) basis with realized and unrealized gains and losses at year end. With MTM done a daily basis, this accounting is very reliable. Traders may want to double check their futures broker using the performance record formula or worksheet included in this guide.

Spot forex traders don't get a Form 1099, as spot forex is not a covered security, only forex forwards are reported on 1099s. Forex brokers provide fairly reliable annual tax summaries, which traders can use for tax reporting, since forex is reported in summary form. See the Accounting chapter 4 of Green's 2013 Trader Tax Guide included in this guide, too, for special accounting considerations with forex.

Securities traders need their own accounting solutions since brokerage-firm reporting is incomplete on 1099-Bs and brokerage firm profit and loss reports are generally unreliable, too. See our March 4, 2013 blog "Caution, downloading securities Form 1099-Bs into TurboTax often leads to incorrect tax filings." The IRS requires securities traders to do line-by-line or trade-by-trade reporting on Form 8949 for the cash method, or Form 4797 Part II for the Section 475 MTM method used by qualifying business traders, only (if timely-elected in the proper manner).

We suggest TradeLog software for securities traders to download their trading transactions (debits and credits) and TradeLog automates does line-by-line reporting, either with wash sales for the cash method, or MTM with Section 475. But, not every client can use TradeLog for various reasons like they don't have access to downloads, or details of trades in older years.

One of the main values of this accounting guide is to provide **last resort accounting solutions** for traders to either generate their trading gain or loss amounts, or to check up on the preferred solutions listed above.

We've provided these alternative accounting worksheets and formulas for many years. They have shortcomings in complying with IRS rules. For example, they don't do trade-by-trade accounting, they do a summary accounting for the year. They don't account for wash sales, either. But, they do summary reporting on a mark-to-market basis well. If you are totally lost on accounting, rather than counting the trees in the forest (each trade), it counts the entire forest in a summary form.

It's not acceptable to use these worksheets in lieu of TradeLog, just because you don't want to pay the TradeLog license fee. These worksheets have shortcomings for securities accounting.

What's Included in this Guide & Table of Contents

Guidance for GTT Worksheets

GTT Inventory Approach™:

The GTT Worksheets come in three different accounting scenarios:

- Cash Method of Accounting for current tax year
- Mark-To-Market Method of Accounting for current tax year
- Elect Mark-To-Market Method of Accounting for current tax year

General Guidance for GTT Inventory Approach Worksheets™

The inventory approach worksheets use the same logic that is used in inventory accounting used by retailers and manufacturers. “Revenue” minus “Cost of Goods Sold” equals “Gross Margin.” Cost of Goods sold = “Opening Inventory” plus “Purchases” minus “Ending Inventory.” For the trading business, Revenue equates to Proceeds, and Opening and Ending Inventory equates to Opening and Closing Positions Held.

Cash Method of Accounting for current tax year - Here’s the formula for calculating your profit or loss for the tax year.

Trading gain or loss = R – CGSC, where

CGSC (cost of goods sold) = OPC + P – EPC, where R

= revenue, or proceeds (from security sales)

P = purchases (security purchases)

OPC = opening positions held for tax period priced at original cost EPC =

ending positions held for tax period priced at original cost

Mark-To-Market Method of Accounting for current tax year - Here’s the formula for calculating your profit or loss for the tax year.

MTM Trading gain or loss = (R + EPM) – CGSM, where CGSM

(cost of goods sold) = OPM + P, where

R = revenue, or proceeds (from security sales) P

= purchases (security purchases)

OPM = opening positions held for tax period priced at market on January 1 EPM =

ending positions held for tax period priced at market on December 31

Elect Mark-To-Market Method of Accounting for current tax year

There are two components to this method.

You start with the above Mark-To-Market Method of Accounting for the current tax year and then you add your Section 481(a) adjustment.

Here's the formula for calculating your Section 481(a) adjustment. Section

481(a) adjustment = OPM - OPC

OPM = opening positions held for tax period priced at market on January 1 OPC =

opening positions held for tax period priced at original cost

You will need to perform the below steps to gather the necessary tax information to enter into the worksheets.

- Step 1 - determine your opening inventory (your "Opening Positions Held" on January 1. You will find this information listed on your December 31 prior year monthly brokerage statement. "Opening Positions Held" are listed at market prices as of December 31 (or last trade day of the prior tax year). If you are using the cash method of accounting (versus the mark-to-market accounting method - see below), you will also need the original cost basis (or carryover cost basis with deferred wash sale losses) for the open positions. Note that monthly brokerage statements are based on "settlement date", whereas tax returns and Form 1099s are based on "trade date." Care needs to be taken to account for "unsettled trades" (trades clearing or settling in early January that were traded in the prior tax year).

- Step 2 - determine your total purchases of securities during the tax year. You can find purchases listed on most Form 1099 supplemental information. Some brokers report purchases in detail, but then don't total them up. You also may find purchases totaled each month on the monthly statements, but again take care about unsettled trades. Finding total purchases is usually the most difficult part of this exercise, if the broker doesn't total them up in the Form 1099 supplemental information.

- Step 3 - determine your total sales of securities during the tax year. Total sales of stocks, bonds and mutual funds are reported on the first part of your Form 1099. You can usually find total sales of options in the supplemental information section of your Form 1099. If not, look in the monthly brokerage statements.

- Step 4 - determine your ending inventory (open positions at year-end). As with opening inventory (above), you can find these amounts on the monthly statement at the end of the tax year.

GTT Performance Record Approach™

Money managers use the performance record approach to report their trading activity to their investors.

Basically, you determine performance using the following formula: Ending net assets (ENA) minus additions (funds added to your accounts during the tax year) plus withdrawals (funds or expenses paid out of your accounts during the tax year) minus beginning net assets (BNA) equals total performance. Total performance minus portfolio income plus margin interest expense equals trading gains and losses.

Trading gains and losses = TP – PI + MIE, where TP

= ENA – A + W - BNA, where

ENA = ending net assets BNA
= beginning net asset A =
additions
W = withdrawals

The performance approach has variations for cash or mark-to-market accounting methods. Most securities traders are better off using the inventory approach. The performance record approach is preferable when you have trouble determining total purchases or other information required for the inventory approach. It's also the preferred method for forex currency traders.

GTT Inventory Approach Method™ Worksheets - Templates

Cash Method of Accounting for Securities Traders

http://www.greencompany.com/Guides/Accounting/GTTInventoryApproachcashmethodanyyear.pdf

http://www.greencompany.com/Guides/Accounting/GTTInventoryApproachcashmethodanyyear.xls

Section 475 Mark-to-Market Method (MTM) of Accounting for Securities Traders, who elected Section 475 MTM in the prior tax year and used MTM for prior and current tax years

http://www.greencompany.com/Guides/Accounting/GTTInventoryApproachMTMMethodpriorandcurrentyear.pdf

http://www.greencompany.com/Guides/Accounting/GTTInventoryApproachMTMMethodpriorandcurrentyear.xls

Section 475 Mark-to-Market Method (MTM) of Accounting for Securities Traders, who elected Section 475 MTM in the current tax year.

http://www.greencompany.com/Guides/Accounting/GTTInventoryApproachMTMMethodelectcurrentyear.pdf

http://www.greencompany.com/Guides/Accounting/GTTInventoryApproachMTMMethodelectcurrentyear.xls

Section 481(a) Adjustment - required when you elect mark-to-market accounting

Section 481(a) Adjustment - tax law for traders

According to Rev. Proc. 99-17, 1999-7 IRB 1, IRC Sec(s). – Mark to market accounting method for dealers in securities – election for traders and dealers. Section 6. Change in Method of Accounting;
Clause.03 Section 481(a) Adjustment

"If a taxpayer changes its method of accounting under section 6.01 of this revenue procedure, the taxpayer must take into account the net amount of the section 481(a) adjustment in the manner provided in section 5.04 of Rev. Proc. 98- 60. Thus, the section 481(a) adjustment generally is taken into account ratably over four taxable years beginning with the year of change. For purposes of section 481, a change in method of accounting made under this revenue procedure is a change in method of accounting initiated by the taxpayer."

According to the rules for Form 3115, if the change results in a positive section 481 adjustment, the Taxpayer must, beginning with the year of change, take the section 481 adjustment into account ratably over 4 taxable years in computing taxable income. However, the Taxpayer may elect to take the entire positive section 481 adjustments in the year of change, providing the Section 481 adjustment is under $25,000. Otherwise, Taxpayer is required to pro-rate this Section 481 adjustment over 4 taxable years.

If the change results in a negative section 481 adjustment, the taxpayer must take the entire section 481(a) adjustment into account in the year of change.

This is good news. Negative adjustments are taken 100% in the year of change, thereby reducing your taxable income. Whereas, positive adjustments may be prorated over four years, giving you more time to report this income.

Section 481(a) Adjustment - Calculation

On January 1, Taxpayer started the year with "Security Trading Positions" (this does not include segregated "Investment Positions”).

Original Cost basis of security trading positions	$875,105	
Market value on January 1 of security trading positions	$903,221	

Section 481(a) adjustment	$ 28,116	positive adjustment

This amount is reported on Form 4797 Part II (but then notice the required pro-ration deferral below).

Deferral required

The Section 481 adjustment is over $25,000 (see tax law above), so taxpayer may not elect to report the entire amount in the current tax year; instead taxpayer must pro-rate the adjustment over 4 years as follows:

The positive Sec 481(a) deferral is calculated as follows:

Sec 481(a) adjustment of $28,116 divided by 4 years times 3 years = $(21,087). This amount is also reported on Form 4797 Part II.

Taxpayer will report the balance of the positive deferral in the amount of $7,029 on his or her Form 4797 Part II for each of the following three tax years. In the event that taxpayer exits his or her trading business, taxpayer will accelerate the balance of his or her Section 481(a) adjustment to the exit year.

Form 3115 - Change of Accounting Method

IRS Form 3115. Go to www.irs.gov and search for Form 3115. You will find blank forms and instructions.

Some traders will have “none” filled in for Section 481(a) adjustments and others will have positive or negative adjustments. You can fill in “see footnote attached” for adjustment details.

We have more guidance on Form 3115 including actual Form 3115 examples for traders in our “2013 GTT Guide: 2012 Tax Return Examples for Securities Traders (Individual and Entities).”

The Section 481(a) adjustment is reported on Form 4797 Part II of your tax return and in the year of change (per prior page) and it is also reported on Form 3115.

"Green's 2013 Trader Tax Guide" Chapter 4 Accounting

When it comes to a trading business, it's wise to do separate accounting for securities trading and business expenses. A consumer off-the-shelf accounting program is fine for keeping track of expenses, and even non-trading income, home office deductions and itemized deductions. But when it comes to trade accounting for securities, these programs are inadequate — you need a specialized program like TradeLog. Futures accounting is a snap, as you can rely on the tightly controlled one-page 1099-B with summary reporting, using MTM reporting. Although spot forex accounting could be a nightmare if you try to do it yourself, you can rely on the broker's annual tax reports and should use summary reporting. Spot forex is not a "covered security," so there are no Form 1099-Bs.

SECURITIES TRADERS

Accounting for trading gains and losses is the responsibility of securities traders; they must report each securities trade on a trade-by-trade basis on IRS Form 8949. This new form came about after the IRS beefed up compliance for securities brokers starting in 2011, causing traders, tax professionals and brokers headaches, confusion and additional tax preparation cost. (We covered this story in full on our blog and site, with interviews in the leading financial media. See our Cost-Basis Reporting Web page.) This problem hasn't improved and it may even be worse if unresolved problems from 2011 like wash sale reporting carry over into 2012 1099-B reporting. If you traded securities in 2012, you must read this guide and our continuing content on our blog covering this subject.

The cost-basis saga continues. These new IRS cost-basis 1099-B reporting rules ushered in a major new tax form for securities traders to deal with on their 2011 and subsequent year tax returns. The IRS phased in the rules to allow brokers more time to add reportable items one year at a time, but the phase-in is making things even more complex and error-prone. For 2011, the IRS rules require cost-basis information — average cost basis and long- or short-term holding periods — for equity securities purchased on or after 2011. Mutual fund and dividend reinvestment plan shares are added in tax-year 2012. Debt securities, options and all other financial instruments will be added in 2014. (The IRS extended this date from the previously announced date of Jan. 1, 2013.)

Form 8949 replaced Schedule D-1 attachments, which used to feed into Schedule D. Starting in 2011, you may not enter disposition directly onto Schedule D; it must be inputted from tax form 8949. Form 8949 is constructed to mirror and receive the 1099-B with cost-basis reporting. Part A is for cost-basis reported; Part B is used when cost-basis is not reported and Part C is used when there is no 1099-B.

TradeLog software downloads trades directly from the broker, skips over 1099-B confusion and generates an accurate Form 8949. TradeLog only reconciles to the 1099-B in total and it lists an adjustment on Form 8949. We recommend a footnote attachment to explain it all (see Appendix A for an example).

Tax professionals who do not use TradeLog or another program find it very difficult to do the line-by-line reporting for securities, so they calculate and report those trades on a summary basis. They put one summary line for short-term and one line for long-term securities trades and write "details available on request" on Schedule D (prior to 2011) and Form 8949 (2011 and after). While this was permitted in the past, in 2005 the IRS forcefully warned tax professionals and taxpayers against this practice, reinforcing Schedule D instructions calling for line-by-line reporting with wash sales reported too. (Form 4797 for Section 475 MTM trade reporting also requires line-by-line reporting, and TradeLog can handle this as well. If you switch on Section 475 MTM, the TradeLog MTM version marks unrealized positions to market at year-end, and it also makes a Section 481(a) adjustment at the beginning of the year in the year Section 475 is elected.)

Summary reporting is an even bigger problem with Form 8949. The purpose of the new form is to allow IRS computers to match its details with Form 1099-B reporting by brokers. That's simply impossible with summary reporting. We strongly advise tax professionals and taxpayers to give up summary reporting, as it will probably lead to IRS notices and perhaps exams. TradeLog provides a good solution.

TradeLog doesn't account for corporate actions such as reinvested dividends and stock splits, though. Most brokers account for them in their cost-basis reporting on Form 1099-Bs. If you have corporate actions — which might be the case with longer-term investments rather than with active trading — it's important to adjust TradeLog accordingly. Otherwise, you could have unreconciled items for these situations between your Form 8949 and Form 1099-Bs, and in this case, the Form 1099-B will be correct.

Broker-issued securities Form 1099Bs provide lots of cost-basis reporting information, but they're not reliable for inputting into a taxpayer's tax return. The 1099-B leaves out many items like options, and IRS rules for brokers are very different than they are for taxpayers.

Although many groups (including our firm) asked the IRS not to computer match 2011 Form 8949s to the error-prone Form 1099-Bs, the IRS may still do just that and generate plenty of tax notices as a result.

Wash sales and 1099Bs. The biggest headache with the cash method is wash sales, as brokers follow different rules from taxpayers in reporting them on securities Form 1099-Bs. If your Form 1099-B states you have $50,000 of wash sales, don't panic! Instead, use TradeLog to see your actual wash sales, which are probably far less.

The 1099-Bs issued by brokers are prepared for the "everyman," meaning they are not customized for the tax compliance needs of individual taxpayers. They don't account for trader tax status and tax treatment elections. The IRS permits brokers to report wash sales on a more limited "identical position" basis, which means between the same stock symbols. Conversely, the IRS requires taxpayers to use "substantially identical positions" which means wash sales between the same stock and stock option symbols, even at different option expiration dates. Many traders use options to trade around stock positions and this is a very important distinction.

Another big wash sale issue with securities 1099-Bs is that the IRS seems to allow brokers to report "potential wash sales" rather than "actual wash sales." This is problematic because most potential wash sale conditions are resolved and they aren't actual wash sales as of year-end. The trader may make back the loss with a subsequent gain later in the year, or the trader may "break the chain" on the trade, not buying it back within 30 days before or after as of year-end. Allowing brokers to add up all potential wash sales throughout the year and report them on a 1099-B is a huge disservice to traders.

Some 1099-Bs we worked with for tax-year 2011 reported wash sales in the millions, when the actual wash sales were under $10,000. If brokers didn't get wash sale loss deferrals right for 2011, how can they carry over the correct cost-basis — the deferred wash sale — to 2012? Won't errors from 2011 compound into 2012? If your trade accounting is confusing or doesn't seem to add up, use TradeLog and consult with a trader tax accounting expert, like our CPAs at Green NFH, LLC.

Don't let your local tax professionals off the hook if they want to import a securities 1099-B into their tax software. The saying "garbage in, garbage out" applies here — if you import incorrect tax information, a tax preparation program will generate inaccurate results. Many traders have cost basis and proceeds in the millions, and simple errors can throw off the net trading gain or loss by tens of thousands of dollars.

Accounting for foreign securities can be confusing. Many traders have trading accounts in foreign countries and the reporting can be challenging (the new guidelines for foreign accounting are beyond the scope of this guide). The tax rules involve an election to keep your books in a foreign currency — a qualified business unit currency — which makes accounting easier than having to convert each trade into U.S. dollars on the day of the transaction. Instead, you can use an average currency conversion rate for the year.

Are brokerage firm accounting reports useful? Although each year online brokers make advances in their tax reporting on securities, in most cases, brokerage tax reports remain insufficient for tax return preparation. Wash sales must be reported on a consolidated basis across all accounts, including taxable and IRA accounts.

Brokers don't have the means of consolidating your accounts across several firms. TradeLog software can handle this consolidation.

FUTURES TRADERS

Futures traders, other section 1256 contract traders and forex traders have it much easier. Futures brokers report Section 1256 contracts in summary fashion, with mark-to-market accounting for realized and unrealized gains and losses, on a one-page 1099 that is simple to understand and use for tax compliance. Taxpayers can rely on a futures 1099 to report net "aggregate profit and loss" in summary fashion on Form 6781, Part I.

TradeLog is still useful in spotting what is a Section 1256 contract vs. what is a security, as sometimes the lines are murky (i.e., on ETF options) and brokers don't pick up all the Section 1256 contracts. Chapter 3 contains more information about futures tax treatment.

Spot forex brokers aren't supposed to issue a 1099, as spot forex isn't a covered instrument for 1099 issuance. (Forward forex is a covered instrument for 1099s, but few retail traders have access to forwards.) Spot forex brokers provide online tax reports for calendar year net trading gain or loss. Transaction costs, rollover interest and other items should be combined into the net trading gain or loss amount reported in summary fashion.

FOREX TRADERS

Spot forex brokers are not supposed to issue a 1099, as spot forex is not a covered instrument for 1099 issuance. (Forward forex is a covered instrument for 1099s, but few retail traders have access to forwards.) Spot forex brokers provide online tax reports for calendar year net trading gain or loss. Transaction costs, rollover interest and other items should be combined into the net trading gain or loss amount reported in summary fashion.

If a forex broker doesn't provide a trade accounting report on spot forex or a Form 1099 on forex forwards, a trader may have difficulties come tax time. In that case, we suggest annual performance record reporting.

Section 988 accounting. Most brokers use the cash method of reporting for realized Section 988 transactions. Few report gain or loss on unrealized positions at year-end. Section 988 doesn't require MTM, but Section 1256g does. If you opt out of Section 988 into Section 1256g lower 60/40 tax treatment, use MTM accounting, meaning you should report unrealized gains and losses at year-end. Learn more about the limited use of Section 1256(g) in Chapter 3.

Rollover transaction reporting is not always clear. Forex brokers often report rollover interest income or expense when generated. It's not really interest, but rather a trading gain or loss element in the transactions. However, most don't report the flip side of the rollover transaction: The appreciation or depreciation of the string of underlying rollover transactions until those rollover trades are closed out. We think brokers should report rollovers as closed trades with a replacement trade opened, rather than kick the can down the road on the appreciation or depreciation of the rollover transaction.

Foreign-based forex brokers. Don't even think about hiding a foreign-based forex broker account from the IRS. New CFTC rules require foreign forex brokers to be registered with the NFA if they want to handle U.S. retail off-exchange forex accounts. These new CFTC rules reduce allowable leverage to 50:1 on major currencies and the NFA requires "First In, First Out" (FIFO) only. Foreign bank accounts over $10,000 must be reported on TDF 90.22-1 (FBAR), and foreign assets over certain thresholds must be reported on the new tax form 8398. See Chapter 14 for further information.

Using a foreign currency to purchase foreign stocks. Traders are stuck with ordinary gain or loss treatment for physical currencies used for investing and trading purposes. Sometimes, taxpayers purchase foreign currencies to use to buy and sell foreign equities where those transactions are conducted on a foreign exchange. Traders may purchase foreign stocks in a foreign brokerage account, or even in U.S.-based accounts offering global access. If a trader buys Euros, holds them in his account and converts them back to U.S. dollars the following year, the gain or loss is ordinary. The trader can't claim short- or long-term capital gain or loss or the Section 1256g lower 60/40 capital gains rates.

It's more complicated when the trader buys and sells foreign stocks. The currency appreciation or deprecation during the foreign stock holding period is embedded in the capital gain or loss accounting (in this case, the appreciation or depreciation is capital gain or loss). When you have a foreign account in this manner, it's important to be extra careful not to count the overall currency appreciation income twice. First, calculate capital gains and loss treatment on the foreign securities. After converting all foreign currency back to U.S. dollars, see how many dollars you gained or lost, and back out the capital gain and loss on the foreign security trading. The rest is an ordinary gain or loss on holding the physical currency. Software may not handle this, so it's best to consult a trader tax expert in these situations. Trading on foreign exchanges is becoming more popular now too, so this is an important matter to focus on. Brokers and banks often may botch this type of reporting. Foreign brokers don't file 1099-Bs.

Performance record reporting. TradeLog does not work with most forex brokers. If broker reports aren't available, we often turn to the performance record approach, which is generally used by administrators to generate performance records for investment managers. The performance record formula is ending net assets (ENA) minus beginning net assets (BNA), minus additions, plus withdrawals, equaling total performance. Subtract non-trading performance such as interest income and the result is net trading gain or loss. There's no forex interest expense, and generally no interest income either, even though it may seem that way on some statements.

As covered in Chapter 3's forex area, forex rollover interest or expense is part of trading gain or loss; it's not separate interest. That means total performance equals forex trading gain or loss. The only problem with this approach is whether ENA and BNA are based on MTM (Section 1256g) or the cash method (Section 988). The performance record approach is easier to use for futures since Section 1256 contracts are MTM by default. Forex traders who opt into Section 1256g must also use MTM.

GENERAL LEDGER ACCOUNTING

Our CPAs want more of our business trader clients to operate a full general ledger accounting program such as QuickBooks. There are some great accounting solution choices online now, with smartphone and tablet apps, too.

For annual tax compliance services, far too many clients provide us with their tax information on a piecemeal basis. They omit deductions they could otherwise take. Why give us 80% of your items, when you could show us 100% of your accounting in a reconciled manner? Many of our trader clients are now using trading entities and it's much better to present the full accounting records in a proper accounting solution. We need the balance sheet in addition to the statement of operations. On an entity tax return, we must fill in balance sheet items and track your cost basis, capital account, contributions, distributions and accumulated earnings. We also look for fixed assets to capitalize and depreciate, and intangible assets to capitalize and amortize.

There are complex accounting issues when you start a new trading business. You can capitalize Section 195 startup costs (like education expenses), Section 248 organization costs and items to use Section 179 depreciation on.

Come year-end, you need to issue 1099-Misc. to vendors and contractors, including yourself for the administration fee. If you set up QuickBooks correctly, the 1099 issuance can be much easier to accomplish.

Use QuickBooks or another program for your individual finances, too. In your chart of accounts, separate home office deductions, itemized deductions, investments, taxes and personal non-deductible items. That helps with tax compliance on your individual tax returns.

BOTTOM LINE

Trade accounting can be challenging and prone to errors. Many active traders deal in the millions of dollars, and one little error can throw off their net gain or loss by thousands of dollars. Errors can cause significant tax overpayments or underpayments. Trade accounting is just too important an area to get wrong. Start off tax season by focusing on this area and get it right. Don't even think about hiring a CPA to do trade-by-trade accounting — it's laborious, expensive and will most likely lead to errors. Use the solutions we mention here.

