

CHAPTER 6

Accounting

COMPLEX ACCOUNTING FOR TRADING GAINS AND LOSSES

Most traders who qualify for trader tax status have more than 1,000 trades per year; some have hundreds of thousands. Figuring out your trade-by-trade accounting for securities can be a nightmare and cost a trader too much valuable time.

GTT TradeLog software programs from GreenTraderTax and Armen Computing completely automates your stock, options and futures trades, and tax accounting. Save days of time and professional fees by using our programs to import all your trades (prior and current years). Our program generates your Schedule Ds (cash method) and Form 4797 (mark-to-market method) tax reports. *Barron's* and *Active Trader* magazine have rated it among the best tax accounting solutions for traders. Learn more, take a tour, and get a free download at <http://www.greencompany.com/Traders/Software.shtml>.

Insufficient Help from Brokers

IRS Form 1099s sent by your broker at tax time do not include securities trading gains and losses; rather they only include proceeds. Some brokerage firms provide traders with reports of trading gains and losses; but

most of these reports have unmatched trades or don't account for mark-to-market accounting or wash sales. Commodities and futures traders have it easy. Their Form 1099s do report "aggregate profit or loss."

Don't get lost trying to calculate each securities trade. Instead, use the inventory approach or performance record approach formulas with guidance to calculate an annual net gain or loss amount per brokerage account. The formulas and the annual gain or loss numbers generated are proven and acceptable to the IRS. You enter one line per brokerage account on your Schedule D or Form 4797. One drawback is these formulas cannot calculate wash sales, and you must determine them in another manner. If you use MTM IRC § 475, the formulas are 100 percent accurate.

Many traders use their own formulas or consumer finance software programs during the tax year, which is useful for knowing their profit and loss. Many of these traders have trouble generating accurate tax return numbers that reconcile to their Form 1099s, and they don't make correct adjustments for mark-to-market accounting, § 481(a) adjustments, or wash sales.

Inventory Approach

The formulas come in three different accounting scenarios:

1. Cash method of accounting
2. Mark-to-market method of accounting
3. Elect mark-to-market method of accounting

General Guidance for Inventory Approach

The inventory approach formulas use the same logic that is used in inventory accounting used by retailers and manufacturers. Revenue minus Cost of Goods Sold equals Gross Margin.

$$\begin{aligned}\text{Cost of Goods Sold} &= \text{Opening Inventory} \\ &+ \text{Purchases} - \text{Ending Inventory.}\end{aligned}$$

For the trading business, Revenue equates to Proceeds, and Opening and Ending Inventory equates to Opening and Closing Positions Held.

Cash Method of Accounting

Here's the formula for calculating your profit or loss for the tax year.

$$\text{Trading gain or loss} = R - \text{CGSC}$$

where

$$\text{CGSC} = \text{OPC} + P - \text{EPC}$$

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

Here's the formula for calculating your profit or loss for the tax year:

$$\text{MTM trading gain or loss} = (R + \text{EPM}) - \text{CGSM}$$

where

$$\text{CGSM (cost of goods sold)} = \text{OPM} + \text{P}$$

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

This method includes two components: (1) You start with the preceding mark-to-market method of accounting, and (2) then you add your § 481(a) adjustment. Here's the formula for calculating your § 481(a) adjustment.

$$\text{Section 481(a) adjustment} = \text{OPM} - \text{OPC}$$

where

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 following steps to gather the necessary tax information to enter into the formulas.

- *Step 1.* Determine your opening inventory (your Opening Positions Held on January 1). You will find this information listed on your prior December 31 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), 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 stock 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, you can find these amounts on the monthly statement at the end of the tax year.

Performance Record Approach

Money managers use the performance record approach to report their trading activity to their investors. This approach works well for Forex traders too. 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.

$$\text{Trading gains and losses} = \text{TP} - \text{PI} + \text{MIE}$$

where

$$\text{TP} = \text{ENA} - \text{A} + \text{W} - \text{BNA}$$

where

TP = Total performance

ENA = Ending net assets

BNA = Beginning net asset

A = Additions

W = Withdrawals

PI = Portfolio income

MIE = Margin interest expense

Section 481(a) Adjustments

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 always preferable for Forex traders.

The section 481(a) adjustment is required when you elect mark-to-market accounting. According to Rev. Proc. 99-17 (updated by Rev. Proc. 2002-19), 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 (modified by Rev. Proc. 2002-19 below). 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 (Change of Accounting Method), 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 four taxable years in computing taxable income. However, the taxpayer may elect to take the entire positive section 481 adjustment in the year of change, providing the section 481 adjustment is under \$25,000. Otherwise, the taxpayer is required to prorate this section 481 adjustment over four taxable years.

According to Rev. Proc. 2002-19, 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.

Section 481(a) Adjustment Calculation

On January 1, the taxpayer started the year with Security Trading Positions.

Market value on January 1 of security trading positions	\$903,221
Original cost basis of security trading positions	<u>875,105</u>
Section 481(a) adjustment	+\$28,116

This amount is reported on Form 4797 Part II.

Deferral Required

The section 481 adjustment is over \$25,000, so the taxpayer may not elect to report the entire amount in the current tax year; instead the taxpayer must prorate the adjustment over four years. The positive § 481(a) deferral is calculated as follows:

$$\text{Sec. 481(a) adjustment of } \$28,116 \div 4 \text{ years} \times 3 \text{ years} = \$21,087.$$

This deferral amount is also reported on Form 4797 Part II.

The taxpayer will report the balance of the positive deferral in the amount of \$7,029 per year on his or her Form 4797 Part II for the following three tax years. In the event that the taxpayer exits his or her trading business, the taxpayer will accelerate the balance of his or her § 481(a) adjustment to the exit year. The § 481(a) adjustment is reported on Form 4797 Part II of your tax return and in the year of change it is also reported on Form 3115 covered later in this book.

INDIVIDUAL EXAMPLES

If you traded securities as a business during the year, you should learn how to file a proper income tax return, taking advantage of trader tax status and mark-to-market accounting tax laws. We provide examples of federal and state tax returns for many types of traders. This “Individual Examples” section is excerpted from the “2004 GTT Guide: 2003 Tax Return Examples for Securities Traders (Individual and Entities)” available at GreenTraderTax.com. Each complete federal and state tax return example in that guide is 50 to 100 pages, too big to include in this book. Some buyers of this book may feel the need to also purchase these companion guides, but others will be fine with the book alone. At the time of this writing, only 2003 tax forms were available. Trader types included:

Part-time traders: These traders have other full-time jobs or other business activities. They are the traders the IRS attacks in exams. Our example tax returns show part-time traders how to avoid raising red flags with the IRS, and they include footnotes to explain your status and prevent IRS questions and exams. We show you many clever tax-filing strategies, and you should not file a part-time trader tax return without these examples and this guide. We also show you examples of how the IRS may want to change your tax returns and how your return would look without trader tax status.

Money-losing traders: These traders lost money in their trading businesses in the current year and prior years. They are the traders the IRS attacks in exams. Our example tax returns show money-losing traders how to avoid raising red flags with the IRS, and they include footnotes to explain your status and prevent IRS questions and exams. We show you many clever tax-filing strategies to maximize your tax benefits and increase your carryovers to future years or carrybacks to prior years for immediate tax relief. You should not file a money-losing trader tax return without these examples and

this guide. We also show you examples of how the IRS may want to change your tax returns and how your return would look without trader tax status.

Sole proprietor business traders: We have a few different example tax returns for profitable traders in a few different states. We show profitable traders how to maximize expense deductions, including home office, travel, meals, margin interest, and every conceivable trading business expense. We show you many clever tax-filing strategies to maximize your tax benefits.

For example, your trading business expenses are reported on Schedule C and your trading gains are reported on Schedule D (cash method) or Form 4797 (mark-to-market method). No gains or income is reported on Schedule C. If you file this way, you may invite IRS questions or an exam because of a large Schedule C business loss (for your expenses). Our many example tax returns show you how to transfer income from Schedule D or Form 4797 to Schedule C to do away with some or all of the loss.

This unlocks further tax benefits such as home office expenses and section 179 depreciation, which require Schedule C income. We also show you how to avoid self-employment taxes and to explain all these aspects to the IRS in customized footnotes. You should not file a profitable trader tax return without these examples and this guide.

Single-member LLC business traders: Both sole proprietor and single-member LLC (SMLLC) business traders can deduct all possible trading business expenses on Schedule C and elect mark-to-market (MTM) accounting for ordinary gain or loss treatment (tax loss insurance if you have losses). However, only a SMLLC trader can deduct health insurance premiums and contribute to a tax-deductible retirement plan.

Mark-to-market accounting traders: We cover examples of traders with or without MTM. A separate example also covers continuing MTM trader and those who first elected it for the current year (and have a Section 481 adjustment).

Part-year traders: We cover examples of traders who enter or exit their trading business during the tax year. We cover suspended MTM elections and whether a trader has to accelerate the remaining positive Section 481 adjustments (from electing MTM).

States: We will include examples for many states.

Form 3115 and more: The guide gives you everything you need at tax time including line-by-line guidance, Form 3115, footnotes, home office deductions, extensions, and more.

Tax reporting strategies and guidance: In our companion set of trader tax guides with complete example tax returns, at the end of each of the example tax returns (which are PDF files) and before the state return, are several pages titled “Supplemental Information.” The first few supplemental information pages are marked “TAX RETURN FOOTNOTES,” and just after them are “CLIENT NOTES—FOR INTERNAL USE ONLY.” We include as much of this information as possible in this book.

Tax return footnotes: These notes are included with your tax return and help explain your complex tax status to the IRS. Some accountants advocate no footnotes, but we strongly believe that trader tax status is quite complex. To prevent IRS questions and exams, we have had great success with our clients using footnotes. The footnotes explain trader tax laws, your status, and the trader tax treatment used on the return.

Client notes—For internal use only: Do not file this section with your tax return. These notes are for internal use only. The notes are intended to explain to you how we prepared these example tax returns. We include guidance, notes, warnings, strategies, tips, and form references.

Following is an example of a tax return footnote which you can customize depending on what type of trader you are.

TAX RETURN FOOTNOTES

The example footnote that follows is for a part-time business trader in securities who elected mark-to-market accounting (MTM IRC § 475) for the tax year being filed.

The first paragraph explains the trader's part-time business status. This paragraph is added to answer any IRS questions about part-time status upfront with the intention of preventing IRS questions or an exam later on. If you are full time, you can delete this paragraph.

Note the paragraphs about electing mark-to-market (MTM) accounting IRC § 475(f) for 2003 and the related IRC § 481 (a) adjustment on the tax return and Form 3115 (Change of Accounting Method). If you did not elect MTM for the tax year being filed, you can omit those paragraphs.

The rest of the footnote is standard and is intended to explain business trader tax status and how you reported various items on your tax return.

Customized footnotes together with full federal and state tax return examples for every type of business trader are included in our companion *GTT Trader Tax Examples Guides*, published every tax season at www.greentradertax.com.

Example Tax Return Footnote

Note to Schedules C, Form 4797-Part II & Form 3115 in connection with taxpayer's business activity: "trader in securities."

Taxpayer operated a trading business, in accordance with the definition below during the entire year of 2003. From January through October of 2003, the taxpayer carried on two careers at the same time. The taxpayer's former job allowed him access to his trading business during trading hours using his computer and Internet connection at work. Taxpayer also operated his trading business before, during, and after work and on weekends. Taxpayer left his job as an attorney at the end of October to focus on his trading business full time. Considerable time spent every trading day, consistent and frequent number of trades, and trading proceeds all support taxpayer's raising to the level of conducting this activity as a business.

Summary

Taxpayer qualifies as a trader in securities for 2003 and he duly elected mark-to-market accounting IRC § 475(f) on time for tax year 2003. Taxpayer's trading business expenses are reported on Schedule C, and his trading gains and losses are reported on Form 4797, Part II—Ordinary Gain or Loss. Taxpayer is not subject to self-employment taxes on this trading activity. Taxpayer is also not subject to wash sale loss deferral rules on this trading activity.

Taxpayer's investment positions (if any) are not subject to the above trading business tax treatment and instead are subject to normal rules for investing activities, which is Schedule D capital gains or losses, wash sales, and Schedule A for related investment expenses.

Special Notes

If taxpayer has net business trading gains, sufficient trading gains are transferred from Schedule D or Form 4797 to Schedule C to cover taxpayer's related trading business expenses. This is done since Schedule C business expenses relate to taxpayer's trading gains and income is not otherwise reported on Schedule C. There is no change to the tax liability as a result of this transfer.

See additional tax return explanations that follow.

Taxpayer's business activities are described in IRS Publication 550, Chapter 4—Special Rules for Traders. We excerpt these rules below (and add some notes in parenthesis).

Special Rules for Traders in Securities

Special rules apply if you are a trader in securities in the business of buying and selling securities for your own account. To be engaged in business as a trader in securities, you must meet all the following conditions. (Taxpayer met all the following conditions for tax year 2003.)

- 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.
- You must carry on the activity with continuity and regularity.

The following facts and circumstances should be considered in determining if your activity is a securities trading business.

- Typical holding periods for securities bought and sold. (Taxpayer had very short holding periods.)

- The frequency and dollar amount of your trades during the year. (Taxpayer traded frequently with lower dollar amounts—high turnover.)
- The extent to which you pursue the activity to produce income for a livelihood. (Taxpayer's intention is to earn a living from this trading business activity.)
- The amount of time you devote to the activity. (Taxpayer spends a good part of every day on this activity.)

Note: You may be a trader in some securities and have other securities you hold for investment. The special rules discussed here do not apply to the securities held for investment. You must keep detailed records to distinguish the securities. The securities held for investment must be identified as such in your records on the day you acquired them (for example, by holding them in a separate brokerage account). (If taxpayer has investment securities, they are clearly “segregated” from his or her trading securities in accordance with current IRS regulations.)

How to Report

Transactions from trading activities result in capital gains and losses and must be reported on Schedule D (Form 1040). Losses from these transactions are subject to the limit on capital losses explained earlier in this chapter.

Mark-to-Market Election Made

(Taxpayer elected mark-to-market accounting for securities only for 2003.)

If you made the mark-to-market election, you should report all gains and losses from trading as ordinary gains and losses in Part II of Form 4797, instead of as capital gains and

losses on Schedule D. In that case, securities held at the end of the year in your business as a trader are marked-to-market by treating them as if they were sold (and reacquired) for fair market value on the last business day of the year. But do not mark to market any securities you held for investment. Report sales from those securities on Schedule D, not Form 4797.

Expenses

Interest expense and other investment expenses that an investor would deduct on Schedule A (Form 1040) are deducted by a trader on Schedule C (Form 1040), Profit or Loss From Business, if the expenses are from the trading business. Commissions and other costs of acquiring or disposing of securities are not deductible (on Schedule C) but must be used to figure gain or loss on Schedule D (if cash basis) or Form 4797 (if mark-to-market). The limit on investment interest expense, which applies to investors, does not apply to interest paid or incurred in a trading business. (Taxpayer duly reported his or her trading business expenses on Schedule C: Trader in securities.)

Self-Employment Tax

Gains and losses from selling securities as part of a trading business are not subject to self-employment tax. This is true whether the election is made or not.

How to Make the Mark-to-Market Election

To make the mark-to-market election for 2004, you must file a statement by April 15, 2004. This statement should be attached to either your 2003 individual income tax return or a request for an

extension of time to file that return. (Taxpayer elected mark-to-market accounting for securities only for tax year 2003; by attaching that election to his 2002 tax return or extension filed by April 15, 2003. A copy of that election is included at the end of this footnote.) The statement must include the following information:

- That you are making an election under section 475(f) of the Internal Revenue Code.
- The first tax year for which the election is effective.
- The trade or business for which you are making the election.
- If you are not required to file a 2003 income tax return, you make the election by placing the above statement in your books and records no later than March 15, 2004. Attach a copy of the statement to your 2004 return.

After making the election to change to the mark-to-market method of accounting, you must change your method of accounting for securities under Revenue Procedure 2002-9 and 2002-19. Revenue Procedure 2002-9 requires you to file Form 3115, Application for Change in Accounting Method. Follow its instructions. Label the Form 3115 as filed under “Section 10A of the Appendix of Rev. Proc. 2002-9.” (Taxpayer is filing his or her Form 3115 together with the Section 481 adjustment [if any applies] with this tax return. Taxpayer is filing a duplicate copy with the IRS national office as is also required.)

Once you make the election, it will apply to 2004 and all later tax years, unless you get permission from IRS to revoke it. The effect of making the election is described under mark-to-market election made, earlier.

For more information on this election, see Revenue Procedure 99-17, 1999-1 CB 503.

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 four taxable years in computing taxable income. However, the taxpayer may elect to take the entire section 481 positive adjustment in the year of change, providing the Section 481 adjustment is under \$25,000. Otherwise, taxpayer is required to prorate this Section 481 adjustment over four 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 (Rev Proc 2002-19).

Section 481(a) Adjustment—Calculation

On January 1, 2003, taxpayer started the year with “Trading Positions.”

Market value on January 1, 2003	\$286,522
Original cost basis	<u>170,979</u>
Section 481 adjustment is the difference	+ 115,543

This amount is reported on Form 4797, Part II, and prorated over four years.

The Section 481 adjustment is greater than \$25,000. As indicated above, taxpayer must prorate the greater than \$25,000 positive adjustment over four tax years.

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

$$\begin{array}{l} \text{Sec 481(a) adjustment of \$115,543} \div \\ \text{by 4 years} \times 3 \text{ years} = \$ (86,658). \end{array}$$

This amount is also reported on the Form 4797, Part II.

Taxpayer will report the deferred prorated income on his or her Form 4797 Part II in the amount of \$28,886 per year for each of the following three tax years, 2004, 2005, and 2006. In the event that taxpayer exits the trading business before the final adjustment year, taxpayer shall be required to accelerate the remaining deferred income in that year of exit.

Copy of Taxpayer's Election for MTM Accounting

This election was attached to taxpayer's 2002 tax return or extension filed by April 15, 2003.

Pursuant to IRC 475(f), the taxpayer hereby elects to adopt the mark-to-market method of accounting for the tax year ended December 31, 2003, and subsequent tax years. The election applies to the following trade or business: Trader in Securities as a Sole Proprietor.

***Example 1: Money-Losing,
Full-Time Securities Business MTM Trader***

Trader elected mark-to-market accounting for tax year with a negative section 481 adjustment. Home office for rental apartment.

Client facts: This client is single and lives in California. He trades securities full-time and operates from his three-bedroom rental apartment. Even though he is full-time, he only had 1,000 round-trip trades, because he had a difficult year. He traded every day the market was open, except when he was sick or on vacation. His trading business is his only means of making a living. On average, his holding periods are less than a few days. On most days, he spends the entire day in his trading business, executing and researching trades, and doing management activities. The client's securities proceeds total over \$27 million.

Trader tax status determination: Based on the preceding facts, this trader has trader tax status for the entire year; therefore, his return was prepared as a sole proprietor (an unincorporated business). We reported all of the client's trading business expenses on Schedule C (Profit or Loss From Business) as shown in Figure 6.1. The client was trading full time, made a sufficient number of round-trip trades, had short holding periods, spent sufficient time in the business, and had large proceeds. Equally important, the client mentioned that his intention was to operate a trading business on a frequent, continuous, and regular basis, and his objective was to profit from quick swings in price, not long term price appreciation.

The mark-to-market accounting process: The client elected mark-to-market (MTM) accounting (IRC 475) for the tax year by the due date of April 15 of the same tax year (i.e., April 15, 2003, for tax year 2003). See page 147 for a copy of the election that should be

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SCHEDULE C (Form 1040) <small>Department of the Treasury Internal Revenue Service (99)</small>		Profit or Loss From Business (Sole Proprietorship) <small>Partnerships, joint ventures, etc., must file Form 1065 or 1065-B. Attach to Form 1040 or 1041. See Instructions for Schedule C (Form 1040).</small>		<small>OMB No. 1545-0074</small> <div style="font-size: 1.2em; font-weight: bold;">2003</div> <div style="font-size: 1.2em; font-weight: bold;">09</div>	
Name of proprietor EX13 Fed-CA fulltime MTM, loss, 481 loss			Social security number (SSN) 111-11-1111		
A Principal business or profession, including product or service (see instructions) Trader in Securities - Mark-to-Market accounting			B Enter code from instructions 523110		
C Business name. If no separate business name, leave blank.			D Employer ID number (EIN), if any		
E Business address (including suite or room no.) <small>City, town or post office, state, and ZIP code</small>					
F Accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input checked="" type="checkbox"/> Other (specify) Sec. 475(f) - Note					
G Did you 'materially participate' in the operation of this business during 2003? If 'No,' see instructions for limit on losses. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No					
H If you started or acquired this business during 2003, check here <input checked="" type="checkbox"/>					
Part I Income					
1 Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the 'statutory employee' box on that form was checked, see the instructions and check here. <input type="checkbox"/>			1		
2 Returns and allowances			2		
3 Subtract line 2 from line 1.			3		
4 Cost of goods sold (from line 42 on page 2).			4		
5 Gross profit. Subtract line 4 from line 3.			5		
6 Other income, including Federal and state gasoline or fuel tax credit or refund.			6		
7 Gross income. Add lines 5 and 6.			7		
Part II Expenses. Enter expenses for business use of your home only on line 30.					
8 Advertising			8		
9 Car and truck expenses (see instructions)			9		
10 Commissions and fees			10		
11 Contract labor (see instructions)			11		
12 Depletion			12		
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)			13 2,087.		
14 Employee benefit programs (other than on line 19)			14		
15 Insurance (other than health)			15		
16 Interest:			16		
a Mortgage (paid to banks, etc.)			16a		
b Other			16b 14,375.		
17 Legal & professional services			17		
18 Office expense			18		
19 Pension and profit-sharing plans			19		
20 Rent or lease (see instructions):			20		
a Vehicles, machinery, and equipment			20a		
b Other business property			20b		
21 Repairs and maintenance			21		
22 Supplies (not included in Part III)			22 893.		
23 Taxes and licenses			23		
24 Travel, meals, and entertainment:			24		
a Travel			24a 1,679.		
b Meals and entertainment			24b 2,345.		
c Enter nondeductible amount included on line 24b (see instrs.)			24c 1,173.		
d Subtract line 24c from line 24b			24d 1,172.		
25 Utilities			25		
26 Wages (less employment credits)			26		
27 Other expenses (from line 48 on page 2)			27 10,310.		
28 Total expenses before expenses for business use of home. Add lines 8 through 27 in columns.			28 30,516.		
29 Tentative profit (loss). Subtract line 28 from line 7.			29 -30,516.		
30 Expenses for business use of your home. Attach Form 8829 .			30		
31 Net profit or (loss). Subtract line 30 from line 29.			31 -30,516.		
<div style="display: flex; justify-content: space-between;"> <div> <ul style="list-style-type: none"> If a profit, enter on Form 1040, line 12, and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3. If a loss, you must go to line 32. </div> <div style="border-left: 1px solid black; height: 40px; width: 50px;"></div> </div>					
32 If you have a loss, check the box that describes your investment in this activity (see instructions).					
<div style="display: flex; justify-content: space-between;"> <div> <ul style="list-style-type: none"> If you checked 32a, enter the loss on Form 1040, line 12, and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3. If you checked 32b, you must attach Form 6198. </div> <div style="border-left: 1px solid black; height: 40px; width: 50px;"></div> </div>					
<div style="display: flex; justify-content: space-between;"> <div> 32a <input checked="" type="checkbox"/> All investment is at risk. </div> <div> 32b <input type="checkbox"/> Some investment is not at risk. </div> </div>					
BAA For Paperwork Reduction Act Notice, see Form 1040 instructions.					
FDI20112L 10/14/03			Schedule C (Form 1040) 2003		

Figure 6.1 Schedule C, Profit or Loss From Business

Schedule C (Form 1040) 2003 EX13 Fed-CA fulltime MTM, loss, 481 loss		111-11-1111	Page 2
Part III Cost of Goods Sold (see instructions)			
33 Method(s) used to value closing inventory: a <input type="checkbox"/> Cost b <input type="checkbox"/> Lower of cost or market c <input type="checkbox"/> Other (attach explanation)			
34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation. <input type="checkbox"/> Yes <input type="checkbox"/> No			
35 Inventory at beginning of year. If different from last year's closing inventory, attach explanation.	35		
36 Purchases less cost of items withdrawn for personal use.	36		
37 Cost of labor. Do not include any amounts paid to yourself.	37		
38 Materials and supplies.	38		
39 Other costs.	39		
40 Add lines 35 through 39.	40		
41 Inventory at end of year.	41		
42 Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on page 1, line 4.	42		
Part IV Information on Your Vehicle. Complete this part only if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 to find out if you must file Form 4562.			
43 When did you place your vehicle in service for business purposes? (month, day, year) ▶ _____			
44 Of the total number of miles you drove your vehicle during 2003, enter the number of miles you used your vehicle for: a Business _____ b Commuting _____ c Other _____			
45 Do you (or your spouse) have another vehicle available for personal use? <input type="checkbox"/> Yes <input type="checkbox"/> No			
46 Was your vehicle available for personal use during off-duty hours? <input type="checkbox"/> Yes <input type="checkbox"/> No			
47 a Do you have evidence to support your deduction? <input type="checkbox"/> Yes <input type="checkbox"/> No			
b If "Yes," is the evidence written? <input type="checkbox"/> Yes <input type="checkbox"/> No			
Part V Other Expenses. List below business expenses not included on lines 8-26 or line 30.			
Postage		195.	
Trader tax and accounting		755.	
Trading cable and internet service		652.	
Trading chat room		1,350.	
Trading newsletters and publications		1,145.	
Trading online information services		2,988.	
Trading seminars		3,225.	
48 Total other expenses. Enter here and on page 1, line 27.	48	10,310.	

Schedule C (Form 1040) 2003

FD/20112L 10/14/03

Figure 6.1 Schedule C, Profit or Loss From Business, *continued*

attached to this tax return. This election completes the first part of the MTM process.

Filing of Form 3115: For the second step of completing the MTM election process, we attach a Form 3115 (Change of Accounting Method) including any required IRC § 481 adjustment to his 2003 tax return, shown in Figure 6.2. We also file a duplicate copy of Form 3115 only to the IRS National Office. This filing needs to be done by the due date of this tax return, including extensions. Many traders and accountants err by filing Form 3115 in lieu of the MTM election statement. They reduced two steps to one and wind up without MTM. Filing either the MTM election statement or Form 3115 late will invalidate MTM—so be careful to do both properly and on time.

Applying MTM: For the third and final step of completing the MTM election process, we make sure to mark all open trading positions at year-end to market prices. We also report MTM gains and losses on Form 4797 Part II, ordinary gain and loss (see Figure 6.3).

Warning: If any of the preceding steps is done incorrectly or late (after the extended due date), the IRS can challenge this client's right to use MTM. This challenge can have serious consequences. Without MTM, the IRS will require all capital gains and losses to be reported on Schedule D, and this client will lose all the ordinary loss benefits of Form 4797. Capital losses are limited to \$3,000 per year, and the client will also be subject to wash sale loss and straddle loss deferral rules.

Section 481 adjustment: Because the client elected MTM for the tax year, the client had to calculate and report a section 481 adjustment. See the explanation of a section 481 adjustment and the related tax law in the Footnotes. Negative § 481 adjustments are taken 100 percent in the year of change.

Form 3115 (Rev. December 2003) Department of the Treasury Internal Revenue Service	Application for Change in Accounting Method	OMB No. 1545-0152				
Name of filer (name of parent corporation if a consolidated group) (see instructions) EX13Fed-NY full-time MTM, loss. 481 loss						
Identification number (see instructions) 111-11-1111		Principal business activity code number (see instructions) 523110				
Number, street, and room or suite no. If a P.O. box, see the instructions. Any Street		Tax year of change begins (MM/DD/YYYY) 01/01/2003				
City or town, state, and ZIP code New York, NY 10011		Tax year of change ends (MM/DD/YYYY) 12/31/2003				
Name of applicant(s) (if different than filer) and identification number(s) (see instructions)		Name of contact person (see instructions)				
Contact person's telephone number ()						
If the applicant is a member of a consolidated group, check this box <input type="checkbox"/>						
If Form 2848, Power of Attorney and Declaration of Representative, is attached, check this box <input type="checkbox"/>						
Check the box to indicate the applicant.						
<input checked="" type="checkbox"/> Individual <input type="checkbox"/> Corporation <input type="checkbox"/> Controlled foreign corporation (Sec. 957) <input type="checkbox"/> 10/50 corporation (Sec. 904(d)(2)(E)) <input type="checkbox"/> Qualified personal service corporation (Sec. 448(d)(2)) <input type="checkbox"/> Exempt organization. Enter Code section ▶	<input type="checkbox"/> Cooperative (Sec. 1381) <input type="checkbox"/> Partnership <input type="checkbox"/> S corporation <input type="checkbox"/> Insurance co. (Sec. 816(a)) <input type="checkbox"/> Insurance co. (Sec. 831) <input type="checkbox"/> Other (specify) ▶	Check the appropriate box to indicate the type of accounting method change being requested. (see instructions) <input type="checkbox"/> Depreciation or Amortization <input checked="" type="checkbox"/> Financial Products and/or Financial Activities of Financial Institutions <input type="checkbox"/> Other (specify) ▶				
Caution: The applicant must provide the requested information to be eligible for approval of the requested accounting method change. The applicant may be required to provide information specific to the accounting method change such as an attached statement. The applicant must provide all information relevant to the requested accounting method change, even if not specifically requested by the Form 3115.						
Part I Information For Automatic Change Request						
1 Enter the requested designated accounting method change number from the List of Automatic Accounting Method Changes (see instructions). Enter only one method change number, except as provided for in the instructions. If the requested change is not included in that list, check "Other," and provide a description. ▶ (a) Change No. 64 (b) Other <input type="checkbox"/> Description ▶		<table border="1" style="width: 100%;"> <tr> <th>Yes</th> <th>No</th> </tr> <tr> <td style="text-align: center;">x</td> <td></td> </tr> </table>	Yes	No	x	
Yes	No					
x						
2 Is the accounting method change being requested one for which the scope limitations of section 4.02 of Rev. Proc. 2002-9 (or its successor) do not apply? If "Yes," go to Part II.		<table border="1" style="width: 100%;"> <tr> <th>Yes</th> <th>No</th> </tr> <tr> <td></td> <td style="text-align: center;">x</td> </tr> </table>	Yes	No		x
Yes	No					
	x					
3 Is the tax year of change the final tax year of a trade or business for which the taxpayer would be required to take the entire amount of the section 481(a) adjustment into account in computing taxable income? If "Yes," the applicant is not eligible to make the change under automatic change request procedures.		<table border="1" style="width: 100%;"> <tr> <th>Yes</th> <th>No</th> </tr> <tr> <td></td> <td style="text-align: center;">x</td> </tr> </table>	Yes	No		x
Yes	No					
	x					
Note: Complete Part II below and then Part IV, and also Schedules A through E of this form (if applicable).						
Part II Information For All Requests						
4a Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any Federal income tax return(s) under examination (see instructions)? If you answered "No," go to line 5.		<table border="1" style="width: 100%;"> <tr> <th>Yes</th> <th>No</th> </tr> <tr> <td></td> <td style="text-align: center;">x</td> </tr> </table>	Yes	No		x
Yes	No					
	x					
b Is the method of accounting the applicant is requesting to change an issue (with respect to either the applicant or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) either (i) under consideration or (ii) placed in suspense (see instructions)?		<table border="1" style="width: 100%;"> <tr> <th>Yes</th> <th>No</th> </tr> <tr> <td></td> <td style="text-align: center;">x</td> </tr> </table>	Yes	No		x
Yes	No					
	x					
Signature (see instructions)						
Under penalties of perjury, I declare that I have examined this application, including accompanying schedules and statements, and to the best of my knowledge and belief, the application contains all the relevant facts relating to the application, and it is true, correct, and complete. Declaration of preparer (other than applicant) is based on all information of which preparer has any knowledge.						
Filer		Preparer (other than filer/applicant)				
Signature and date EX13Fed-NY full-time MTM, loss. 481 loss		Signature of individual preparing the application and date				
Name and title (print or type)		Name of individual preparing the application (print or type)				
Name of firm preparing the application						
For Privacy Act and Paperwork Reduction Act Notice, see the instructions.						
Cat. No. 19280E		Form 3115 (Rev. 12-2003)				

Figure 6.2

Accounting

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Form 3115 (Rev. 12-2003)		Page 2
Part II Information For All Requests (continued)		Yes No
4c	Is the method of accounting the applicant is requesting to change an issue pending (with respect to either the applicant or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) for any tax year under examination (see instructions)?	
d	Is the request to change the method of accounting being filed under the procedures requiring that the operating division director consent to the filing of the request (see instructions)? If "Yes," attach the consent statement from the director.	
e	Is the request to change the method of accounting being filed under the 90-day or 120-day window period? If "Yes," check the box for the applicable window period and attach the required statement (see instructions). <input type="checkbox"/> 90 day <input type="checkbox"/> 120 day	
f	If you answered "Yes" to line 4a, enter the name and telephone number of the examining agent and the tax year(s) under examination. Name <input type="text"/> Telephone number <input type="text"/> Tax year(s) <input type="text"/>	
g	Has a copy of this Form 3115 been provided to the examining agent identified on line 4f?	
5a	Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any Federal income tax return(s) before Appeals and/or a Federal court? If "Yes," enter the name of the (check the box) <input type="checkbox"/> Appeals officer and/or <input type="checkbox"/> counsel for the government, and the tax year(s) before Appeals and/or a Federal court. Name <input type="text"/> Telephone number <input type="text"/> Tax year(s) <input type="text"/>	X
b	Has a copy of this Form 3115 been provided to the Appeals officer and/or counsel for the government identified on line 5a?	n/a
c	Is the method of accounting the applicant is requesting to change an issue under consideration by Appeals and/or a Federal court (for either the applicant or any present or former consolidated group in which the applicant was a member for the tax year(s) the applicant was a member)? If "Yes," attach an explanation.	X
6	If the applicant answered "Yes" to line 4a and/or 5a with respect to any present or former consolidated group, provide each parent corporation's (a) name, (b) identification number, (c) address, and (d) tax year(s) during which the applicant was a member that is under examination, before an Appeals office, and/or before a Federal court.	
7	If the applicant is an entity (including a limited liability company) treated as a partnership or S corporation for Federal income tax purposes, is it requesting a change from a method of accounting that is an issue under consideration in an examination, before Appeals, or before a Federal court, with respect to a Federal income tax return of a partner, member, or shareholder of that entity? If "Yes," the applicant is not eligible to make the change.	n/a
8	Is the applicant making a change to which audit protection does not apply (see instructions)?	X
9a	Has the applicant, its predecessor, or a related party requested or made (under either an automatic change procedure or a procedure requiring advance consent) a change in accounting method within the past 5 years (including the year of the requested change)?	X
b	If "Yes," attach a description of each change and the year of change for each separate trade or business and whether consent was obtained.	
c	If any application was withdrawn, not perfected, or denied, or if a Consent Agreement was sent to the taxpayer but was not signed and returned to the IRS, or if the change was not made or not made in the requested year of change, include an explanation.	
10a	Does the applicant, its predecessor, or a related party currently have pending any request (including any concurrently filed request) for a private letter ruling, change in accounting method, or technical advice?	X
b	If "Yes," for each request attach a statement providing the name(s) of the taxpayer, identification number(s), the type of request (private letter ruling, change in accounting method, or technical advice), and the specific issue(s) in the request(s).	
11	Is the applicant requesting to change its overall method of accounting? If "Yes," check the appropriate boxes below to indicate the applicant's present and proposed methods of accounting. Also, complete Schedule A on page 4 of the form. Present method: <input type="checkbox"/> Cash <input type="checkbox"/> Accrual <input type="checkbox"/> Hybrid (attach description) Proposed method: <input type="checkbox"/> Cash <input type="checkbox"/> Accrual <input type="checkbox"/> Hybrid (attach description)	X
12	If the applicant is not changing its overall method of accounting, attach a detailed and complete description for each of the following: a The item(s) being changed. elected IRC 475(f) for trading securities b The applicant's present method for the item(s) being changed. Cash c The applicant's proposed method for the item(s) being changed. IRC Sec. 475(f)(1) mark to market d The applicant's present overall method of accounting (cash, accrual, or hybrid). **	

Form **3115** (Rev. 12-2003)

**** Keep using cash for business expenses**

Figure 6.2a

Form 3115 (Rev. 12-2003)				Page 3	
Part II Information For All Requests (continued)				Yes	No
13 Attach a detailed and complete description of the applicant's trade(s) or business(es), and the principal business activity code for each. If the applicant has more than one trade or business as defined in Regulations section 1.446-1(d), describe: whether each trade or business is accounted for separately; the goods and services provided by each trade or business and any other types of activities engaged in that generate gross income; the overall method of accounting for each trade or business; and which trade or business is requesting to change its accounting method as part of this application or a separate application.					
14 Will the proposed method of accounting be used for the applicant's books and records and financial statements? For insurance companies, see the instructions. If "No," attach an explanation.				X	
15a Has the applicant engaged, or will it engage, in a transaction to which section 381(a) applies (e.g., a reorganization, merger, or liquidation) during the proposed tax year of change determined without regard to any potential closing of the year under section 381(b)(1)?					X
b If "Yes," for the items of income and expense that are the subject of this application, attach a statement identifying the methods of accounting used by the parties to the section 381(a) transaction immediately before the date of distribution or transfer and the method(s) that would be required by section 381(c)(4) or (c)(5) absent consent to the change(s) requested in this application.					
16 Does the applicant request a conference of right with the IRS National Office if the IRS proposes an adverse response?				X	
17 If the applicant is changing to or from the cash method or changing its method of accounting under sections 263A, 448, 460, or 471, enter the gross receipts of the 3 tax years preceding the year of change.					
1st preceding year ended: mo. yr.	2nd preceding year ended: mo. yr.	3rd preceding year ended: mo. yr.			
\$	\$	n/a			
Part III Information For Advance Consent Request				Yes	No
18 Is the applicant's requested change described in any revenue procedure, revenue ruling, notice, regulation, or other published guidance as an automatic change request? If "Yes," attach an explanation describing why the applicant is submitting its request under advance consent request procedures.					
19 Attach a full explanation of the legal basis supporting the proposed method for the item being changed. Include a detailed and complete description of the facts that explains how the law specifically applies to the applicant's situation and that demonstrates that the applicant is authorized to use the proposed method. Include all authority (statutes, regulations, published rulings, court cases, etc.) supporting the proposed method. The applicant should include a discussion of any authorities that may be contrary to its use of the proposed method.					
20 Attach a copy of all documents related to the proposed change (see instructions).					
21 Attach a statement of the applicant's reasons for the proposed change.					
22 If the applicant is a member of a consolidated group for the year of change, do all other members of the consolidated group use the proposed method of accounting for the item being changed? If "No," attach an explanation.					
23a Enter the amount of user fee attached to this application (see instructions). ► \$ _____					
b If the applicant qualifies for a reduced user fee, attach the necessary information or certification required by Rev. Proc. 2003-1 (or its successor) (see instructions).					
Part IV Section 481(a) Adjustment				Yes	No
24 Do the procedures for the accounting method change being requested require the use of the cut-off method? If "Yes," do not complete lines 25, 26, and 27 below.					X
25 Enter the section 481(a) adjustment. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ► \$ <u>(32,188)</u> Attach a summary of the computation and an explanation of the methodology used to determine the section 481(a) adjustment. If it is based on more than one component, show the computation for each component. If more than one applicant is applying for the method change on the same application, attach a list of the name, identification number, principal business activity code (see instructions), and the amount of the section 481(a) adjustment attributable to each applicant.					
26 If the section 481(a) adjustment is an increase to income of less than \$25,000, does the applicant elect to take the entire amount of the adjustment into account in the year of change?					n/a
27 Is any part of the section 481(a) adjustment attributable to transactions between members of an affiliated group, a consolidated group, a controlled group, or other related parties? If "Yes," attach an explanation.				X	

Form **3115** (Rev. 12-2003)

Note ** - See Tax Return Footnotes Attached

Figure 6.2b

Accounting

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Schedule A—Change in Overall Method of Accounting (If Schedule A applies, Part I below must be completed.)

Part I Change in Overall Method (see instructions)

1 Enter the following amounts as of the close of the tax year preceding the year of change. If none, state "None." Also, attach a statement providing a breakdown of the amounts entered on lines 1a through 1g.

	Amount
a Income accrued but not received	\$ None
b Income received or reported before it was earned. Attach a description of the income and the legal basis for the proposed method	None
c Expenses accrued but not paid	None
d Prepaid expenses previously deducted	None
e Supplies on hand previously deducted and/or not previously reported	None
f Inventory on hand previously deducted and/or not previously reported. Complete Schedule D, Part II	None
g Other amounts (specify) ▶ See Tax Return Footnotes Attached	(32,188)
h Net section 481(a) adjustment (Combine lines 1a–1g.)	\$(32,188)

2 Is the applicant also requesting the recurring item exception under section 461(h)(3)? ☐ Yes ☒ No

3 Attach copies of the profit and loss statement (Schedule F (Form 1040) for farmers) and the balance sheet, if applicable, as of the close of the tax year preceding the year of change. On a separate sheet, state the accounting method used when preparing the balance sheet. If books of account are not kept, attach a copy of the business schedules submitted with the Federal income tax return or other return (e.g., tax-exempt organization returns) for that period. If the amounts in Part I, lines 1a through 1g, do not agree with those shown on both the profit and loss statement and the balance sheet, explain the differences on a separate sheet. n/a

Part II Change to the Cash Method For Advance Consent Request (see instructions) n/a

Applicants requesting a change to the cash method must attach the following information:

1 A description of inventory items (items whose production, purchase, or sale is an income-producing factor) and materials and supplies used in carrying out the business.

2 An explanation as to whether the applicant is required to use the accrual method under any section of the Code or regulations.

Schedule B—Change in Reporting Advance Payments (see instructions) n/a

1 If the applicant is requesting to defer advance payment for services under Rev. Proc. 71-21, 1971-2 C.B. 549, attach the following information:

- a Sample copies of all service agreements used by the applicant that are subject to the requested change in accounting method. Indicate the particular parts of the service agreement that require the taxpayer to perform services.
- b If any parts or materials are provided, explain whether the obligation to provide parts or materials is incidental (of minor or secondary importance) to an agreement providing for the performance of personal services.
- c If the change relates to contingent service contracts, explain how the contracts relate to merchandise that is sold, leased, installed, or constructed by the applicant and whether the applicant offers to sell, lease, install, or construct without the service agreement.
- d A description of the method the applicant will use to determine the amount of income earned each year on service contracts and why that method clearly reflects income earned and related expenses in each year.
- e An explanation of how the method the applicant will use to determine the amount of gross receipts each year will be no less than the amount included in gross receipts for purposes of its books and records. See section 3.11 of Rev. Proc. 71-21.

2 If the applicant is requesting a deferral of advance payments for goods under Regulations section 1.451-5, attach the following information:

- a Sample copies of all agreements for goods or items requiring advance payments used by the applicant that are subject to the requested change in accounting method. Indicate the particular parts of the agreement that require the applicant to provide goods or items.
- b A statement providing that the entire advance payment is for goods or items. If not entirely for goods or items, a statement that an amount equal to 95% of the total contract price is properly allocable to the obligation to provide activities described in Regulations section 1.451-5(a)(1)(i) or (ii) (including services as an integral part of those activities).
- c An explanation of how the method the applicant will use to determine the amount of gross receipts each year will be no less than the amount included in gross receipts for purposes of its books and records. See Regulations section 1.451-5(b)(1).

Form **3115** (Rev. 12-2003)

Figure 6.2c

Form 4797		Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2)) ▶ Attach to your tax return. ▶ See separate instructions.		OMB No. 1545-0184 2003 27	
Department of the Treasury Internal Revenue Service (99)		Name(s) shown on return EX13 Fed-CA fulltime MTM, loss, 481 loss		Identifying number 111-11-1111	
1		Enter the gross proceeds from sales or exchanges reported to you for 2003 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions).		1 27,248,020.	
Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft — Most Property Held More Than 1 Year (See instructions.)					
2	(a) Description of property	(b) Date acquired (month, day, year)	(c) Date sold (month, day, year)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition
3 Gain, if any, from Form 4684, line 39..... 3					
4 Section 1231 gain from installment sales from Form 6252, line 26 or 37..... 4					
5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824..... 5					
6 Gain, if any, from line 32, from other than casualty or theft..... 6					
7 Combine lines 2 through 6 in columns (g) and (h). Enter the gain or (loss) here and on the appropriate line as follows..... 7					
<p>Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6, or Form 1120S, Schedule K, line 5. Skip lines 8, 9, 11, and 12 below.</p> <p>All others. If line 7, column (g) is zero or a loss, enter that amount on line 11 below and skip lines 8, 9, and 12. If line 7, column (g) is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain or (loss) in each column as a long-term capital gain or (loss) on Schedule D and skip lines 8, 9, 11, and 12 below.</p>					
8 Nonrecaptured net section 1231 losses from prior years (see instructions)..... 8					
9 Subtract line 8 from line 7. If line 9, column (g) is zero or less, enter -0- in column (g). If line 9, column (g) is more than zero, enter the amount from line 8, column (g) on line 12 below and include the gain or (loss) in each column of line 9 as a long-term capital gain or (loss) on Schedule D (see instructions)..... 9					
<p>*Corporations (other than S corporations) should not complete column (h). Partnerships and S corporations must complete column (h). All others must complete column (h) only if line 7, column (g), is a gain and the amount, if any, on line 8, column (g), does not equal or exceed the gain on line 7, column (g). Include in column (h) all gains and losses from column (g) from sales, exchanges, or conversions (including installment payments received) after May 5, 2003. However, do not include gain attributable to unrecaptured section 1250 gain.</p>					
Part II Ordinary Gains and Losses					
10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):					
See Statement 1				-213,504.	
11 Loss, if any, from line 7, column (g)..... 11					
12 Gain, if any, from line 7, column (g), or amount from line 8, column (g), if applicable..... 12					
13 Gain, if any, from line 31..... 13					
14 Net gain or (loss) from Form 4684, lines 31 and 38a..... 14					
15 Ordinary gain from installment sales from Form 6252, line 25 or 36..... 15					
16 Ordinary gain or (loss) from like-kind exchanges from Form 8824..... 16					
17 Recapture of section 179 expense deduction for partners and S corporation shareholders for property dispositions from 2002-2003 fiscal year partnerships and S corporations (see instructions)..... 17					
18 Combine lines 10 through 17. Enter the gain or (loss) here and on the appropriate line as follows..... 18 -213,504.					
<p>a For all except individual returns. Enter the gain or (loss) from line 18 on the return being filed.</p> <p>b For individual returns:</p> <p>(1) If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from Form 4797, line 18b(1). See instructions.....</p> <p>(2) Redetermine the gain or (loss) on line 18 excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14.....</p>					
18b (1)					
18b (2)				-213,504.	
BAA For Paperwork Reduction Act Notice, see instructions. FD/21001L 12/02/03 Form 4797 (2003)					

Figure 6.3

Home-office deduction: The client used one bedroom in his apartment exclusively for his trading business. Form 8829 is used to report his home office deduction. Note that the client does not benefit from the home office deduction for this tax return year because he does not have trading gains. These trading gains would be transferred to Schedule C to zero out Schedule C. This process is explained elsewhere in our guide. The client may benefit in future years with the Form 8829 home office expense carried over to the following tax years.

Depreciation: Because this client has losses, he is unable to benefit from IRC Section 179 (100 percent depreciation up to \$102,000 for 2004; \$100,000 for 2003); instead, we used regular and special depreciation on Form 4562.

Federal net operating loss (NOL) tax return: This client is entitled to significant tax relief using a Form 1045 NOL carryback claim. For more information on NOLs, see an earlier part in our book.

Example 2: Profitable, Full-Time Securities Business MTM Trader

Trader elected mark-to-market accounting for 2003 with a positive and deferred section 481 adjustment.

Client facts: This client is single and he lives in California. He trades securities full-time and operates from his three-bedroom rental apartment. Even though he is full-time, he only had 1,000 round-trip trades. He traded every day the market was open, except when he was sick or on vacation. His trading business is his only means of making a living. On average, his holding periods are less than a few days. On most days, he spends the entire day in his trading business, executing and researching trades, and doing management activities. The client's securities proceeds total more than \$27 million.

GTT trader tax status determination: Based on the preceding facts, GTT considers this trader to have trader tax status for the entire year; therefore, GTT prepared his return as a sole proprietor. We reported all this client's trading business expenses on Schedule C (Profit or Loss From Business), as shown in Figure 6.4. GTT reached this conclusion because the client was trading full time, made a sufficient number of round-trip trades, had short holding periods, spent sufficient time in the business, and had large proceeds. Equally important, the client mentioned to GTT that his intention was to operate a trading business on a frequent, continuous, and regular basis, and his objective was to profit from quick swings in price, not long term price appreciation.

Mark-to-market accounting process: Client elected mark-to-market (MTM) accounting (IRC § 475) for 2003 by the due date of April 15, 2003. See the Footnote (end) for a copy of the election that should be attached to this tax return. This election document completes the first part of the MTM process.

Filing of Form 3115: For the second step of completing the MTM election process, we attach a Form 3115 (Change of Accounting Method) to his 2003 tax return. We also file a duplicate copy of Form 3115 only to the IRS National Office. This filing needs to be done by the due date of this tax return, including extensions. We include the section 481 adjustment calculation on the Form 3115. See an example of Form 3115 in Figure 6.2.

Applying MTM: For the third and final step of completing the MTM election process, we make sure to mark all open trading positions at year-end to market prices. We also report MTM gains and losses on Form 4797 Part II, Ordinary Gain and Loss (see Figure 6.3).

Warning: If any of the preceding steps are done incorrectly or late (after the extended due date), the IRS can challenge this client's right to use MTM. This challenge can have serious consequences. Without

Accounting

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SCHEDULE C (Form 1040)		Profit or Loss From Business (Sole Proprietorship)		OMB No. 1545-0074	
Department of the Treasury Internal Revenue Service (99)		▶ Partnerships, joint ventures, etc., must file Form 1065 or 1065-B. ▶ Attach to Form 1040 or 1041. ▶ See instructions for Schedule C (Form 1040).		2003 09	
Name of proprietor EX14 Fed-CA fulltime MTM, gain, 481 gain				Social security number (SSN) 111-11-1111	
A Principal business or profession, including product or service (see instructions) Trader in Securities - Mark-to-Market accounting				B Enter code from instructions ▶ 523110	
C Business name. If no separate business name, leave blank.				D Employer ID number (EIN), if any	
E Business address (including suite or room no.) ▶ City, town or post office, state, and ZIP code					
F Accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input checked="" type="checkbox"/> Other (specify) ▶ Sec. 475(f)-Note					
G Did you 'materially participate' in the operation of this business during 2003? If 'No,' see instructions for limit on losses. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No					
H If you started or acquired this business during 2003, check here <input checked="" type="checkbox"/>					
Part I Income					
1 Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the 'statutory employee' box on that form was checked, see the instructions and check here. <input type="checkbox"/>				1	
2 Returns and allowances				2	
3 Subtract line 2 from line 1				3	
4 Cost of goods sold (from line 42 on page 2)				4	
5 Gross profit. Subtract line 4 from line 3				5	
6 Other income, including Federal and state gasoline or fuel tax credit or refund. See Statement 4				6 36,443.	
7 Gross income. Add lines 5 and 6				7 36,443.	
Part II Expenses. Enter expenses for business use of your home only on line 30.					
8 Advertising		8		19 Pension and profit-sharing plans	
9 Car and truck expenses (see instructions)		9		20 Rent or lease (see instructions):	
10 Commissions and fees		10		a Vehicles, machinery, and equipment	
11 Contract labor (see instructions)		11		b Other business property	
12 Depletion		12		21 Repairs and maintenance	
13 Depreciation and section 179 expense deduction (not included in Part II) (see instructions)		13 4,195.		22 Supplies (not included in Part II)	
14 Employee benefit programs (other than on line 19)		14		23 Taxes and licenses	
15 Insurance (other than health)		15		24 Travel, meals, and entertainment:	
16 Interest:				a Travel	
a Mortgage (paid to banks, etc.)		16a		b Meals and entertainment	
b Other		16b 14,375.		c Enter nondeductible amount included on line 24b (see instrs.)	
17 Legal & professional services		17		d Subtract line 24c from line 24b	
18 Office expense		18		25 Utilities	
28 Total expenses before expenses for business use of home. Add lines 8 through 27 in columns.		28 32,624.		26 Wages (less employment credits)	
29 Tentative profit (loss). Subtract line 28 from line 7		29 3,819.		27 Other expenses (from line 48 on page 2)	
30 Expenses for business use of your home. Attach Form 8829		30 3,819.		28 32,624.	
31 Net profit or (loss). Subtract line 30 from line 29.		31 0.			
• If a profit, enter on Form 1040, line 12 , and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3. • If a loss, you must go to line 32.					
32 If you have a loss, check the box that describes your investment in this activity (see instructions).					
• If you checked 32a, enter the loss on Form 1040, line 12 , and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3. • If you checked 32b, you must attach Form 6198 .				32a <input type="checkbox"/> All investment is at risk. 32b <input type="checkbox"/> Some investment is not at risk.	
BAA For Paperwork Reduction Act Notice, see Form 1040 instructions.					
Schedule C (Form 1040) 2003					

Figure 6.4

Schedule C (Form 1040) 2003 **EX14 Fed-CA fulltime MTM, gain, 481 gain** **111-11-1111** Page **2**

Part III Cost of Goods Sold (see instructions)

33 Method(s) used to value closing inventory: **a** ☐ Cost **b** ☐ Lower of cost or market **c** ☐ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If 'Yes,' attach explanation. ☐ Yes ☐ No

35 Inventory at beginning of year. If different from last year's closing inventory, attach explanation.	35	
36 Purchases less cost of items withdrawn for personal use.	36	
37 Cost of labor. Do not include any amounts paid to yourself.	37	
38 Materials and supplies.	38	
39 Other costs.	39	
40 Add lines 35 through 39.	40	
41 Inventory at end of year.	41	
42 Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on page 1, line 4.	42	

Part IV Information on Your Vehicle. Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 to find out if you must file Form 4562.

43 When did you place your vehicle in service for business purposes? (month, day, year) ▶ _____.

44 Of the total number of miles you drove your vehicle during 2003, enter the number of miles you used your vehicle for:
a Business _____ **b** Commuting _____ **c** Other _____

45 Do you (or your spouse) have another vehicle available for personal use? ☐ Yes ☐ No

46 Was your vehicle available for personal use during off-duty hours? ☐ Yes ☐ No

47 **a** Do you have evidence to support your deduction? ☐ Yes ☐ No
b If 'Yes,' is the evidence written? ☐ Yes ☐ No

Part V Other Expenses. List below business expenses not included on lines 8-26 or line 30.

Postage	195.
Trader tax and accounting	755.
Trading cable and internet service	652.
Trading chat room	1,350.
Trading newsletters and publications	1,145.
Trading online information services	2,988.
Trading seminars	3,225.
48 Total other expenses. Enter here and on page 1, line 27.	48 10,310.

Schedule C (Form 1040) 2003

FDIZ0112L 10/14/03

Figure 6.4a

2003		Federal Statements		Page 1		
Client EX14F-CA		EX14 Fed-CA fulltime MTM, gain, 481 gain		111-11-1111		
8/04/04				12:34PM		
Statement 1 Schedule A, Line 13 Investment Interest						
				\$ 796.		
Total				<u>\$ 796.</u>		
Statement 2 Schedule A, Line 15 Contributions by Cash or Check						
				\$ 976.		
Total				<u>\$ 976.</u>		
Statement 3 Schedule A, Line 16 Contributions Other than Cash						
				\$ 345.		
Total				<u>\$ 345.</u>		
Statement 4 - Trader in Securities - Mark-to-Market accounting Schedule C, Line 6 Other Income						
Tsfr part of trading gain fr F4797-Note				\$ 36,443.		
Total				<u>\$ 36,443.</u>		
Statement 5 Form 4797, Page 1, Part II Ordinary Gains and Losses						
Description of Property	Date Acquired	Date Sold	Sales Price	Depreciation Allowed	Cost or Basis	Gain or Loss
Cybertrader trading a/c (details avail) (Trader Transaction)						
	Various	Various	15,471,893.		15,339,352.	\$ 132,541.
TerraNova trading a/c (details avail) (Trader Transaction)						
	Various	Various	11,642,914.		11,467,516.	175,398.
Sec. 481(a) adjustment-See Note (Trader Transaction)						
	Various	Various	975,998.		936,346.	39,652.
Sec. 481(a) prorate 4 years - See Note (Trader Transaction)						
	Various	Various			29,739.	-29,739.
Tsfr part trading gain to Sch C-See Note (Trader Transaction)						
	Various	Various			36,443.	-36,443.
Total						<u>\$ 281,409.</u>

Figure 6.4b

MTM, the IRS will require all capital gains to be reported on Schedule D. The client will be subject to wash sale loss and straddle loss deferral rules, a problem even when a trader is profitable.

Section 481 adjustment: Because the client elected MTM for 2003, the client had to calculate and report a section 481 adjustment. See the explanation of a section 481 adjustment and the related tax law in the Footnotes. The section 481 adjustment calculation was made by GTT TradeLog accounting software, and the calculation recap is reported on Form 4797, the Footnotes, and on Form 3115.

Note: This client's section 481 adjustment is positive and more than \$25,000. According to the tax law, we prorated the adjustment over four years, deferring three-fourth's of the adjustment income to the following three tax years as shown in Figure 6.4b, statement 5.

Home office deduction: The client used one bedroom in his apartment exclusively for his trading business. Form 8829 is used to report his home office deduction. Note that the client does benefit from the home office deduction in 2003 because he has trading gains. Sufficient trading gains are transferred from Form 4797 to Schedule C to zero out Schedule C as shown in Figure 6.4. This process is explained elsewhere in this book.

Depreciation: Because this client has gains, he is able to benefit from section 179 (100 percent depreciation up to \$100,000 for 2003) in 2003. This depreciation is reported on Form 4562. All depreciation in excess of the section 179 cap is subject to regular depreciation.

Schedule C adjusted to zero: Notice the following key GTT tax filing strategy. All trading business expenses are reported on Schedule C. We used section 179 depreciation and home office expenses as well. It is important to note that section 179 depreciation expenses and home office expenses are only deductible on Schedule C in 2003

if sufficient net income is listed on Schedule C to cover these expenses. Otherwise, they must be carried over to 2004. Neither expense is permitted to generate a tax loss (except for the mortgage interest and real estate tax portion of home office expenses). The GTT filing strategy is to transfer sufficient trading gains (only) from Schedule D (cash method) or Form 4797 (mark-to-market method, which is the case here) to Schedule C to zero out Schedule C. Notice that we don't transfer too many trading gains to result in a Schedule C net income, which might invite the IRS to inquire about self-employment (SE) taxes. As indicated in the Footnotes, traders with or without MTM are exempt from SE taxes. This strategy is disclosed in the Footnotes.

Note: Not having a Schedule C loss helps reduce your chance of IRS questions. Having a Schedule C loss for trading business expenses, because you have trading losses, is fully acceptable and understandable. We advise you not to "short sell" yourself on your rightful trading business expenses. The Footnote explains this treatment and reduces the chance of IRS questions.

Alternative minimum tax (AMT): AMT is generated in this example because the client is over the AMT exemption threshold and his high-state income taxes paid are a preference item.

Note: Without trader tax status, the client would report all expenses as investment expenses. Besides being severely limited, these expenses are also preference items for AMT (meaning they are not AMT deductions). So, trader tax status saves this client a lot more money.

Estimated income taxes: For purposes of this example, assume the client had zero tax liability for 2002 and could therefore pay his entire federal 2003 tax liability by April 15, 2004. Otherwise, this client should have paid estimated taxes during 2003. For this example, the client paid his state tax liability on December 31, 2003, in

order to get a state tax deduction. Notice that this contributed to the AMT. To avoid AMT, this client should have paid a few dollars less and paid the balance of state taxes due on April 15, 2004, as he is doing for the federal return.

California State Notes: California is one of many states that is not respecting all the federal tax law changes from the 2003 Tax Act. Specifically, California does not accept “bonus depreciation” and the increased Section 179 deduction, as stated previously. There is an adjustment on the California return, adding back the difference between bonus depreciation and regular depreciation.

***Example 3: A Full-Time Securities Trader
Treated as an Investor (Close Call).***

This trader’s activity fell short of qualifying for trader tax status in 2003. Each year is assessed on its own. We reelected MTM for 2004 in case his trading activity picks up again. A continuing MTM business trader does not need to reelect each year.

Client facts: This client will be treated as an investor in 2003 and will reelect MTM for 2004.

History: An MTM election was made for 2002 by April 15, 2002. This was the first MTM election, and this client was treated as a business trader for 2002. No section 481 adjustment proration was needed, and therefore exiting the trading business as described presents no concern.

Trader tax status review: We reviewed the actual trades in his three trading accounts. They total 180 (90 round trips) for the year. This amount is much too low to qualify as a trader. He traded only

67 days out of a possible 250, and he went six months with only two or four trades. Although his proceeds might be sufficient (more than \$1 million) and trading is his sole occupation, problems arise when you look at number of trades and days on which trading activity took place. He does not rise to the level of trader. Actual trades and days traded are too sporadic, and he does not meet the regular, continuous, or frequency tests. We know the IRS is attacking traders who trade sporadically, because the IRS feels case law is strong on this point. This change in classification from trader to investor does not hurt the client. He receives the same refund either way but with a lot less risk of a potential IRS challenge to a person whose trader tax status is a close call. The client agrees with our conservative approach and advice.

Trade accounting: We prepared our GTT worksheets using the cash basis for investors. No positions were open at year-end, and our accounting agrees with the client's numbers. We confirmed the client had no wash sales, since our worksheets do not account for wash sales (only our GTT TradeLog software does). The client did not have enough expenses, even investor expenses, to itemize. Because the client is filing as an investor, a footnote is not required with this tax return.

GTT observations: Filing as an investor rather than a business trader did not cost this client any additional taxes. The investor status is correct, and it's less risky with the IRS.

Example 4: Part-Year Trader and Reentered Trading Business with MTM

Engineer for first part of year and then became a full-time securities business trader with mark-to-market accounting. He has MTM trading gains and an office in his Illinois home that he owns.

Client facts: Client made the 2003 mark-to-market IRC § 475(f) accounting election by April 15, 2003. We prepared Form 3115 (Change of Accounting Method) to go along with the tax return and sent a second copy directly to the IRS. Taxpayer does not have a section 481 adjustment on this Form 3115 and Form 4797.

Trader tax status analysis: Total round-trip stock and option trades are 866 from March to December, and total trading proceeds are more than \$11 million. The average daily time spent on trading is nine hours, and the average round-trip trades per day are more than six. We reviewed the days the client was available to trade compared to the days he actually traded and found no sporadic lapses in trading. He traded every day from March to December 2003. His total proceeds, number of trades, time spent on business, average number of trades per day and daily trading activity are all sufficient for qualifying for trader tax status. See Figure 6.5. The client is still trading in 2004 and making more than five round-trip trades per day. Plus, he is profitable. His intention is to continue this trading business for the future.

Trader accounting: We reviewed the client-prepared GTT Inventory Approach Worksheets using MTM accounting, and all appears to be correct, including open short sales and so on. Both realized and unrealized trading gains and losses are being reported, with the straddles marked to market at year-end. The client purchased GTT TradeLog after year-end and downloaded his 2003 trades. The GTT TradeLog Form 4797 gains and losses report agrees with his worksheets results.

Home office: We apportioned taxpayer's expenses between two home office schedules: one for the consulting business earlier in the year and one for trading. We also apportioned depreciation as well between two Schedule Cs based on number of months (two months for consulting and ten months for trading). Expenses reported on

Accounting

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SCHEDULE C (Form 1040)	Profit or Loss From Business (Sole Proprietorship)	OMB No. 1545-0074 <div style="border: 1px solid black; padding: 2px; display: inline-block;"> 2003 09 </div>
Department of the Treasury Internal Revenue Service (99)		
▶ Partnerships, joint ventures, etc., must file Form 1065 or 1065-B. ▶ Attach to Form 1040 or 1041. ▶ See instructions for Schedule C (Form 1040).		
Name of proprietor EX17F-IL part year trader with MTM loss		Social security number (SSN) 999-99-9999
A Principal business or profession, including product or service (see instructions) Trader in Securities-Mark-to-Market (03/01/03 to 12/31/03)		B Enter code from instructions ▶ 523110
C Business name. If no separate business name, leave blank.		D Employer ID number (EIN), if any
E Business address (including suite or room no.) City, town or post office, state, and ZIP code		
F Accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input checked="" type="checkbox"/> Other (specify) ▶ Sec. 475(f) - Note		
G Did you 'materially participate' in the operation of this business during 2003? If 'No,' see instructions for limit on losses. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No		
H If you started or acquired this business during 2003, check here		
Part I Income		
1 Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the 'Statutory employee' box on that form was checked, see the instructions and check here. <input type="checkbox"/>		1
2 Returns and allowances		2
3 Subtract line 2 from line 1		3
4 Cost of goods sold (from line 42 on page 2)		4
5 Gross profit. Subtract line 4 from line 3		5
6 Other income, including Federal and state gasoline or fuel tax credit or refund. See Statement 3		6 13,767.
7 Gross income. Add lines 5 and 6		7 13,767.
Part II Expenses. Enter expenses for business use of your home only on line 30.		
8 Advertising	8	19 Pension and profit-sharing plans
9 Car and truck expenses (see instructions)	9	20 Rent or lease (see instructions):
10 Commissions and fees	10	a Vehicles, machinery, and equipment
11 Contract labor (see instructions)	11	b Other business property
12 Depletion	12	c Repairs and maintenance
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13 705.	d Supplies (not included in Part III)
14 Employee benefit programs (other than on line 19)	14	e Taxes and licenses
15 Insurance (other than health)	15	f Travel, meals, and entertainment:
16 Interest:	16	a Travel
a Mortgage (paid to banks, etc.)	16a	b Meals and entertainment
b Other	16b 1,566.	c Enter nondeductible amount included on line 24b (see instrs)
17 Legal & professional services	17	d Subtract line 24c from line 24b
18 Office expense	18	e Utilities
19 Pension and profit-sharing plans	19	f Wages (less employment credits)
20 Rent or lease (see instructions):	20	g Other expenses (from line 48 on page 2)
a Vehicles, machinery, and equipment	20a	28 11,818.
b Other business property	20b	29 1,949.
c Repairs and maintenance	21	30 1,949.
d Supplies (not included in Part III)	22 541.	31 0.
e Taxes and licenses	23	
f Travel, meals, and entertainment:	24	
a Travel	24a 664.	
b Meals and entertainment	24b 367.	
c Enter nondeductible amount included on line 24b (see instrs)	24c 184.	
d Subtract line 24c from line 24b	24d 183.	
e Utilities	25	
f Wages (less employment credits)	26	
g Other expenses (from line 48 on page 2)	27 8,159.	
28 Total expenses before expenses for business use of home. Add lines 8 through 27 in columns.	28	
29 Tentative profit (loss). Subtract line 28 from line 7	29	
30 Expenses for business use of your home. Attach Form 8829	30	
31 Net profit or (loss). Subtract line 30 from line 29.	31	
• If a profit, enter on Form 1040, line 12 , and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3. • If a loss, you must go to line 32.		
32 If you have a loss, check the box that describes your investment in this activity (see instructions).		
• If you checked 32a, enter the loss on Form 1040, line 12 , and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3.		32a <input type="checkbox"/> All investment is at risk.
• If you checked 32b, you must attach Form 6198 .		32b <input type="checkbox"/> Some investment is not at risk.
BAA For Paperwork Reduction Act Notice, see Form 1040 instructions.		

Figure 6.5

2003		Federal Statements		Page 1																																			
Client EX17F-IL		EX17F-IL part year trader with MTM loss		999-99-9999																																			
8/04/04				12:54PM																																			
<p>Statement 1 Schedule A, Line 10 Home Mortgage Interest Reported on Form 1098</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;">Home Office Nonbusiness Allocation.....</td> <td style="width: 10%; text-align: right;">\$</td> <td style="width: 10%; text-align: right;">15,173.</td> </tr> <tr> <td></td> <td style="text-align: right;">Total</td> <td style="text-align: right;">\$ 15,173.</td> </tr> </table>					Home Office Nonbusiness Allocation.....	\$	15,173.		Total	\$ 15,173.																													
Home Office Nonbusiness Allocation.....	\$	15,173.																																					
	Total	\$ 15,173.																																					
<p>Statement 2 Schedule A, Line 15 Contributions by Cash or Check</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;">Jersey Village Church of Christ.....</td> <td style="width: 10%; text-align: right;">\$</td> <td style="width: 10%; text-align: right;">855.</td> </tr> <tr> <td></td> <td style="text-align: right;">Total</td> <td style="text-align: right;">\$ 855.</td> </tr> </table>					Jersey Village Church of Christ.....	\$	855.		Total	\$ 855.																													
Jersey Village Church of Christ.....	\$	855.																																					
	Total	\$ 855.																																					
<p>Statement 3 - Trader in Securities-Mark-to-Market (03/01/03 to 12/31/03) Schedule C, Line 6 Other Income</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;">Tsfr part trading gains from F4797-Note.....</td> <td style="width: 10%; text-align: right;">\$</td> <td style="width: 10%; text-align: right;">13,767.</td> </tr> <tr> <td></td> <td style="text-align: right;">Total</td> <td style="text-align: right;">\$ 13,767.</td> </tr> </table>					Tsfr part trading gains from F4797-Note.....	\$	13,767.		Total	\$ 13,767.																													
Tsfr part trading gains from F4797-Note.....	\$	13,767.																																					
	Total	\$ 13,767.																																					
<p>Statement 4 - Trader in Securities-Mark-to-Market (03/01/03 to 12/31/03) Schedule C, Part V Other Expenses</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 80%;">Bank Charges.....</td> <td style="width: 10%; text-align: right;">\$</td> <td style="width: 10%; text-align: right;">108.</td> </tr> <tr> <td>Business accessories.....</td> <td></td> <td style="text-align: right;">591.</td> </tr> <tr> <td>Dues and Subscriptions.....</td> <td></td> <td style="text-align: right;">204.</td> </tr> <tr> <td>Trader tax and accounting.....</td> <td></td> <td style="text-align: right;">984.</td> </tr> <tr> <td>Trading backup services.....</td> <td></td> <td style="text-align: right;">221.</td> </tr> <tr> <td>Trading cable data and internet service.....</td> <td></td> <td style="text-align: right;">1,355.</td> </tr> <tr> <td>Trading communication.....</td> <td></td> <td style="text-align: right;">407.</td> </tr> <tr> <td>Trading data/chart services.....</td> <td></td> <td style="text-align: right;">2,577.</td> </tr> <tr> <td>Trading publications.....</td> <td></td> <td style="text-align: right;">657.</td> </tr> <tr> <td>Trading research.....</td> <td></td> <td style="text-align: right;">1,055.</td> </tr> <tr> <td></td> <td style="text-align: right;">Total</td> <td style="text-align: right;">\$ 8,159.</td> </tr> </table>					Bank Charges.....	\$	108.	Business accessories.....		591.	Dues and Subscriptions.....		204.	Trader tax and accounting.....		984.	Trading backup services.....		221.	Trading cable data and internet service.....		1,355.	Trading communication.....		407.	Trading data/chart services.....		2,577.	Trading publications.....		657.	Trading research.....		1,055.		Total	\$ 8,159.		
Bank Charges.....	\$	108.																																					
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Trading publications.....		657.																																					
Trading research.....		1,055.																																					
	Total	\$ 8,159.																																					
<p>Statement 5 Form 4797, Page 1, Part II Ordinary Gains and Losses</p> <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: left;">Description of Property</th> <th style="text-align: left;">Date Acquired</th> <th style="text-align: left;">Date Sold</th> <th style="text-align: left;">Sales Price</th> <th style="text-align: left;">Depreciation Allowed</th> <th style="text-align: left;">Cost or Basis</th> <th style="text-align: left;">Gain or Loss</th> </tr> </thead> <tbody> <tr> <td>CyberTrader trading ac (details availabl (Trader Transaction)</td> <td>Various</td> <td>Various</td> <td>3,455,877.</td> <td></td> <td>3,441,070.</td> <td>\$ 14,807.</td> </tr> <tr> <td>TerraNova trading ac (details available) (Trader Transaction)</td> <td>Various</td> <td>Various</td> <td>7,899,546.</td> <td></td> <td>7,881,892.</td> <td>17,654.</td> </tr> <tr> <td>Tsfr trading gains to Sch C - see note (Trader Transaction)</td> <td>Various</td> <td>Various</td> <td></td> <td></td> <td>13,767.</td> <td>-13,767.</td> </tr> <tr> <td></td> <td></td> <td></td> <td></td> <td></td> <td>Total</td> <td>\$ 18,694.</td> </tr> </tbody> </table>					Description of Property	Date Acquired	Date Sold	Sales Price	Depreciation Allowed	Cost or Basis	Gain or Loss	CyberTrader trading ac (details availabl (Trader Transaction)	Various	Various	3,455,877.		3,441,070.	\$ 14,807.	TerraNova trading ac (details available) (Trader Transaction)	Various	Various	7,899,546.		7,881,892.	17,654.	Tsfr trading gains to Sch C - see note (Trader Transaction)	Various	Various			13,767.	-13,767.						Total	\$ 18,694.
Description of Property	Date Acquired	Date Sold	Sales Price	Depreciation Allowed	Cost or Basis	Gain or Loss																																	
CyberTrader trading ac (details availabl (Trader Transaction)	Various	Various	3,455,877.		3,441,070.	\$ 14,807.																																	
TerraNova trading ac (details available) (Trader Transaction)	Various	Various	7,899,546.		7,881,892.	17,654.																																	
Tsfr trading gains to Sch C - see note (Trader Transaction)	Various	Various			13,767.	-13,767.																																	
					Total	\$ 18,694.																																	

Figure 6.5a

his engineering Schedule C reduce SE tax, whereas expenses on his trading business Schedule C do not reduce SE tax.

AGI Deductions: Client received earned income from engineering business Schedule C only. The trading business is not an earned income activity. The engineering business Schedule C is subject to the SE tax and serves as the basis of earned income used for retirement accounts as shown in Figure 6.6. With this earned income, the taxpayer also has an AGI deduction for health insurance premiums (100 percent in 2003). The client set up a Mini 401(k) plan before year-end and we made the maximum allowable contribution (\$12,000 elective deferral plus 20 percent after-tax profit-sharing plan).

Entry/Exit issues: Taxpayer was in the trading business in 2002 and he duly elected and used mark-to-market (MTM) accounting until he exited the trading business in May 2002. Exiting the trading business negates the opportunity to use MTM accounting and requires the acceleration of any deferred positive prorated section 481 adjustments. When taxpayer reentered the trading business in March 2003, he was required to reelect MTM accounting (duly done) and file another Form 3115 with section 481 adjustment. The date of adjustment is March 1, 2003. Taxpayer's trading activity before March 2003 is not subject to MTM accounting and is reported on Schedule D.

Example 5: Part-Time Trader and Full-time Other Job

Client has MTM trading gains and an office in his Georgia home that he owns.

Client facts: Client is a part-time trader and computer specialist at a bank. (The IRS could consider it a full-time job). Client made the

SCHEDULE C (Form 1040) <small>Department of the Treasury Internal Revenue Service (99)</small>		Profit or Loss From Business (Sole Proprietorship) <small>► Partnerships, joint ventures, etc., must file Form 1065 or 1065-B. ► Attach to Form 1040 or 1041. ► See instructions for Schedule C (Form 1040).</small>		<small>OMB No. 1545-0074</small> <div style="border: 1px solid black; padding: 2px; display: inline-block;"> 2003 09 </div>	
Name of proprietor EX17F-IL part year trader with MTM loss			Social security number (SSN) 999-99-9999		
A Principal business or profession, including product or service (see instructions) Engineering (01/01/03 to 02/28/03)			B Enter code from instructions ► 541330		
C Business name. If no separate business name, leave blank.			D Employer ID number (EIN), if any		
E Business address (including suite or room no.) City, town or post office, state, and ZIP code					
F Accounting method: (1) <input checked="" type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ►					
G Did you 'materially participate' in the operation of this business during 2003? If 'No,' see instructions for limit on losses. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No					
H If you started or acquired this business during 2003, check here <input type="checkbox"/> Yes <input type="checkbox"/> No					
Part I Income					
1 Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the 'Statutory employee' box on that form was checked, see the instructions and check here. <input type="checkbox"/>			1 42,555.		
2 Returns and allowances			2		
3 Subtract line 2 from line 1.			3 42,555.		
4 Cost of goods sold (from line 42 on page 2).			4		
5 Gross profit. Subtract line 4 from line 3.			5 42,555.		
6 Other income, including Federal and state gasoline or fuel tax credit or refund.			6		
7 Gross income. Add lines 5 and 6.			7 42,555.		
Part II Expenses. Enter expenses for business use of your home only on line 30.					
8 Advertising			8		
9 Car and truck expenses (see instructions)			9		
10 Commissions and fees			10		
11 Contract labor (see instructions)			11		
12 Depletion			12		
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)			13		
14 Employee benefit programs (other than on line 19)			14		
15 Insurance (other than health)			15		
16 Interest:			16		
a Mortgage (paid to banks, etc.)			16a		
b Other			16b		
17 Legal & professional services			17 488.		
18 Office expense			18		
19 Pension and profit-sharing plans			19		
20 Rent or lease (see instructions):			20		
a Vehicles, machinery, and equipment			20a		
b Other business property			20b		
21 Repairs and maintenance			21		
22 Supplies (not included in Part III)			22 244.		
23 Taxes and licenses			23		
24 Travel, meals, and entertainment:			24		
a Travel			24a 677.		
b Meals and entertainment			389.		
c Enter nondeductible amount included on line 24b (see instrs)			195.		
d Subtract line 24c from line 24b			24d 194.		
25 Utilities			25		
26 Wages (less employment credits)			26		
27 Other expenses (from line 48 on page 2)			27 1,219.		
28 Total expenses before expenses for business use of home. Add lines 8 through 27 in columns.			28 2,822.		
29 Tentative profit (loss). Subtract line 28 from line 7.			29 39,733.		
30 Expenses for business use of your home. Attach Form 8829 .			30 294.		
31 Net profit or (loss). Subtract line 30 from line 29.			31 39,439.		
32 If you have a loss, check the box that describes your investment in this activity (see instructions).			32		
• If a profit, enter on Form 1040, line 12 , and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3.			32a <input type="checkbox"/> All investment is at risk.		
• If a loss, you must go to line 32.			32b <input type="checkbox"/> Some investment is not at risk.		
• If you checked 32b, you must attach Form 6198 .			32b		
BAA For Paperwork Reduction Act Notice, see Form 1040 instructions.					

Figure 6.6

2003 mark-to-market accounting (MTM) election by April 15, 2003, the due date for a 2003 election. We prepared a Form 3115 (Change of Accounting Method). Client has a section 481 adjustment that is more than \$25,000, so we prorate it over four years.

Trader tax status analysis: Total trading proceeds are more than \$12 million, and his GTT TradeLog reports indicate he had more than 1,000 total round-trip trades. The client traded all day, every day. Although client is located on East Coast and could not trade in the mornings before work (as West Coast clients can), the client was able to trade throughout the day at his bank job. The client had no sporadic lapses in trading. Most of the client's trades are day trades, and rarely does he keep a position open overnight—and even then, usually only one day. The client's banking job involves computer support, and he is mostly on call to deal with infrequent problems. Hence, he has free time to trade at work during the day. The taxpayer spends more than six hours per day in the trading business, he makes trades at work, and spends plenty of time on research and management, before and after the bank hours and on weekends. The positive factors meet the requirements of IRS Publication 550; therefore, this part-time trader has trader tax status.

Trade accounting: We reviewed the client-prepared GTT TradeLog data files and reports showing MTM accounting and section 481 adjustment. We checked his stock proceeds totals and reconciled them to GTT TradeLog.

Example 6: Sole Proprietor Versus a Single-Member LLC Trader

Both sole proprietor and single-member LLC (SMLLC) business traders can deduct all possible trading business expenses on Schedule C (see Figures 6.7a,b,c and 6.8) and elect mark-to-market (MTM) accounting for

SCHEDULE C (Form 1040) <small>Department of the Treasury Internal Revenue Service (99)</small>		Profit or Loss From Business (Sole Proprietorship) <small>► Partnerships, joint ventures, etc., must file Form 1065 or 1065-B. Attach to Form 1040 or 1041. See instructions for Schedule C (Form 1040).</small>		<small>OMB No. 1545-0074</small> 2003 09	
Name of proprietor Joe Trader Single Member LLC			Social security number (SSN) 111-11-1111		
A Principal business or profession, including product or service (see instructions) Trader in Securities - Mark-to-Market Accounting			B Enter code from instructions ► 523110		
C Business name. If no separate business name, leave blank.			D Employer ID number (EIN), if any		
E Business address (including suite or room no.) <small>City, town or post office, state, and ZIP code</small>					
F Accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input checked="" type="checkbox"/> Other (specify) ► Sec. 475(f) - Note					
G Did you 'materially participate' in the operation of this business during 2003? If 'No,' see instructions for limit on losses. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No					
H If you started or acquired this business during 2003, check here <input checked="" type="checkbox"/>					
Part I Income					
1 Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the 'Statutory employee' box on that form was checked, see the instructions and check here. <input type="checkbox"/>			1		
2 Returns and allowances			2		
3 Subtract line 2 from line 1			3		
4 Cost of goods sold (from line 42 on page 2)			4		
5 Gross profit. Subtract line 4 from line 3			5		
6 Other income, including Federal and state gasoline or fuel tax credit or refund. See Statement 1			6 192,073.		
7 Gross income. Add lines 5 and 6			7 192,073.		
Part II Expenses. Enter expenses for business use of your home only on line 30.					
8 Advertising			8		
9 Car and truck expenses (see instructions)			9		
10 Commissions and fees			10		
11 Contract labor (see instructions)			11		
12 Depletion			12		
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)			13 7,866.		
14 Employee benefit programs (other than on line 19)			14		
15 Insurance (other than health)			15		
16 Interest:			16		
a Mortgage (paid to banks, etc.)			16a		
b Other			16b 15,752.		
17 Legal & professional services			17 147,366.		
18 Office expense			18		
19 Pension and profit-sharing plans			19		
20 Rent or lease (see instructions):			20		
a Vehicles, machinery, and equipment			20a		
b Other business property			20b		
21 Repairs and maintenance			21		
22 Supplies (not included in Part III)			22 943.		
23 Taxes and licenses			23		
24 Travel, meals, and entertainment:			24		
a Travel			24a 2,466.		
b Meals and entertainment			1,325.		
c Enter nondeductible amount included on line 24b (see instrs.)			663.		
d Subtract line 24c from line 24b			24d 662.		
25 Utilities			25		
26 Wages (less employment credits)			26		
27 Other expenses (from line 48 on page 2)			27 9,074.		
28 Total expenses before expenses for business use of home. Add lines 8 through 27 in columns.			28 184,129.		
29 Tentative profit (loss). Subtract line 28 from line 7			29 7,944.		
30 Expenses for business use of your home. Attach Form 8829			30 7,944.		
31 Net profit or (loss). Subtract line 30 from line 29.			31 0.		
• If a profit, enter on Form 1040, line 12, and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3. • If a loss, you must go to line 32.					
32 If you have a loss, check the box that describes your investment in this activity (see instructions).					
• If you checked 32a, enter the loss on Form 1040, line 12, and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3.					
• If you checked 32b, you must attach Form 6198.					
32a <input type="checkbox"/> All investment is at risk.					
32b <input type="checkbox"/> Some investment is not at risk.					
BAA For Paperwork Reduction Act Notice, see Form 1040 instructions.					

Figure 6.7a

Accounting

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Schedule C (Form 1040) 2003 Joe Trader Single Member LLC 111-11-1111 Page **2**

Part III Cost of Goods Sold (see instructions)

33 Method(s) used to value closing inventory: a ☐ Cost b ☐ Lower of cost or market c ☐ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory?
If "Yes," attach explanation. ☐ Yes ☐ No

35 Inventory at beginning of year. If different from last year's closing inventory,
attach explanation. 35

36 Purchases less cost of items withdrawn for personal use. 36

37 Cost of labor. Do not include any amounts paid to yourself. 37

38 Materials and supplies. 38

39 Other costs. 39

40 Add lines 35 through 39. 40

41 Inventory at end of year. 41

42 **Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on page 1, line 4. 42

Part IV Information on Your Vehicle. Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 to find out if you must file Form 4562.

43 When did you place your vehicle in service for business purposes? (month, day, year) ▶

44 Of the total number of miles you drove your vehicle during 2003, enter the number of miles you used your vehicle for:
a Business b Commuting c Other

45 Do you (or your spouse) have another vehicle available for personal use? ☐ Yes ☐ No

46 Was your vehicle available for personal use during off-duty hours? ☐ Yes ☐ No

47a Do you have evidence to support your deduction? ☐ Yes ☐ No

b If "Yes," is the evidence written? ☐ Yes ☐ No

Part V Other Expenses. List below business expenses not included on lines 8-26 or line 30.

Postage	199.
Seminars taken after trading started	2,685.
Telephone	660.
Trader tax & accounting services	750.
Trading chat rooms	1,349.
Trading internet service provider cable	540.
Trading online information services	1,852.
Trading publications and books	1,039.
48 Total other expenses. Enter here and on page 1, line 27.	48 9,074.

Schedule C (Form 1040) 2003

FD-20112L 10/14/03

Figure 6.7b

SCHEDULE C (Form 1040)		Profit or Loss From Business (Sole Proprietorship)		<small>OMB No. 1545-0074</small> <div style="font-size: 1.2em; font-weight: bold;">2003</div> <div style="font-size: 0.8em;">09</div>	
<small>Department of the Treasury Internal Revenue Service (99)</small>		<small>► Partnerships, joint ventures, etc., must file Form 1065 or 1065-B. ► Attach to Form 1040 or 1041. ► See instructions for Schedule C (Form 1040).</small>			
Name of proprietor Joe Trader Single Member LLC		Social security number (SSN) 111-11-1111			
A Principal business or profession, including product or service (see instructions) Administration		B Enter code from instructions 561900			
C Business name. If no separate business name, leave blank.		D Employer ID number (EIN), if any			
E Business address (including suite or room no.) ► <small>City, town or post office, state, and ZIP code</small>					
F Accounting method: (1) <input checked="" type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ►					
G Did you "materially participate" in the operation of this business during 2003? If "No," see instructions for limit on losses. ... <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No					
H If you started or acquired this business during 2003, check here ... <input checked="" type="checkbox"/>					
Part I Income					
1 Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see the instructions and check here. ... <input type="checkbox"/>		1		147,366.	
2 Returns and allowances		2			
3 Subtract line 2 from line 1		3		147,366.	
4 Cost of goods sold (from line 42 on page 2)		4			
5 Gross profit. Subtract line 4 from line 3		5		147,366.	
6 Other income, including Federal and state gasoline or fuel tax credit or refund		6			
7 Gross income. Add lines 5 and 6		7		147,366.	
Part II Expenses. Enter expenses for business use of your home only on line 30.					
8 Advertising		8			
9 Car and truck expenses (see instructions)		9			
10 Commissions and fees		10			
11 Contract labor (see instructions)		11			
12 Depletion		12			
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)		13			
14 Employee benefit programs (other than on line 19)		14			
15 Insurance (other than health)		15			
16 Interest:					
a Mortgage (paid to banks, etc.)		16a			
b Other		16b			
17 Legal & professional services		17			
18 Office expense		18			
19 Pension and profit-sharing plans		19			
20 Rent or lease (see instructions):					
a Vehicles, machinery, and equipment		20a			
b Other business property		20b			
21 Repairs and maintenance		21			
22 Supplies (not included in Part III)		22			
23 Taxes and licenses		23			
24 Travel, meals, and entertainment:					
a Travel		24a			
b Meals and entertainment					
c Enter nondeductible amount included on line 24b (see instrs.)					
d Subtract line 24c from line 24b		24d			
25 Utilities		25			
26 Wages (less employment credits)		26			
27 Other expenses (from line 48 on page 2)		27			
28 Total expenses before expenses for business use of home. Add lines 8 through 27 in columns		28			
29 Tentative profit (loss). Subtract line 28 from line 7		29		147,366.	
30 Expenses for business use of your home. Attach Form 8829		30			
31 Net profit or (loss). Subtract line 30 from line 29.		31		147,366.	
• If a profit, enter on Form 1040, line 12 , and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3. • If a loss, you must go to line 32.					
32 If you have a loss, check the box that describes your investment in this activity (see instructions).					
• If you checked 32a, enter the loss on Form 1040, line 12 , and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3. • If you checked 32b, you must attach Form 6198 .					
32a <input type="checkbox"/> All investment is at risk.					
32b <input type="checkbox"/> Some investment is not at risk.					
BAA For Paperwork Reduction Act Notice, see Form 1040 instructions.					
<small>Schedule C (Form 1040) 2003</small>					

Figure 6.7c

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SCHEDULE C (Form 1040) <small>Department of the Treasury Internal Revenue Service (99)</small>		Profit or Loss From Business (Sole Proprietorship) <small>► Partnerships, joint ventures, etc., must file Form 1065 or 1065-B. Attach to Form 1040 or 1041. See instructions for Schedule C (Form 1040).</small>		<small>OMB No. 1545-0074</small> 2003 <small>09</small>
Name of proprietor Joe Trader Sole Proprietor		Social security number (SSN) 111-11-1111		
A Principal business or profession, including product or service (see instructions) Trader in Securities - Mark-to-Market Accounting		B Enter code from instructions ► 523110		
C Business name. If no separate business name, leave blank.		D Employer ID number (EIN), if any		
E Business address (including suite or room no.) City, town or post office, state, and ZIP code				
F Accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input checked="" type="checkbox"/> Other (specify) ► Sec. 475(f) - Note				
G Did you 'materially participate' in the operation of this business during 2003? If 'No,' see instructions for limit on losses. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No				
H If you started or acquired this business during 2003, check here <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No				
Part I Income				
1 Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the 'Statutory employee' box on that form was checked, see the instructions and check here. <input type="checkbox"/>		1		
2 Returns and allowances		2		
3 Subtract line 2 from line 1.		3		
4 Cost of goods sold (from line 42 on page 2).		4		
5 Gross profit. Subtract line 4 from line 3.		5		
6 Other income, including Federal and state gasoline or fuel tax credit or refund. See Statement 1.		6 44,707.		
7 Gross income. Add lines 5 and 6.		7 44,707.		
Part II Expenses. Enter expenses for business use of your home only on line 30.				
8 Advertising		8		
9 Car and truck expenses (see instructions)		9		
10 Commissions and fees		10		
11 Contract labor (see instructions)		11		
12 Depletion		12		
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)		13 7,866.		
14 Employee benefit programs (other than on line 19)		14		
15 Insurance (other than health)		15		
16 Interest:		16		
a Mortgage (paid to banks, etc.)		16a		
b Other		16b 15,752.		
17 Legal & professional services		17		
18 Office expense		18		
19 Pension and profit-sharing plans.		19		
20 Rent or lease (see instructions):		20		
a Vehicles, machinery, and equipment		20a		
b Other business property		20b		
21 Repairs and maintenance		21		
22 Supplies (not included in Part III)		22 943.		
23 Taxes and licenses		23		
24 Travel, meals, and entertainment:		24		
a Travel		24a 2,466.		
b Meals and entertainment		1,325.		
c Enter nondeductible amount included on line 24b (see instrs.)		663.		
d Subtract line 24c from line 24b.		24d 662.		
25 Utilities		25		
26 Wages (less employment credits)		26		
27 Other expenses (from line 48 on page 2)		27 9,074.		
28 Total expenses before expenses for business use of home. Add lines 8 through 27 in columns.		28 36,763.		
29 Tentative profit (loss). Subtract line 28 from line 7.		29 7,944.		
30 Expenses for business use of your home. Attach Form 8829.		30 7,944.		
31 Net profit or (loss). Subtract line 30 from line 29.		31 0.		
32 If you have a loss, check the box that describes your investment in this activity (see instructions).		32a <input type="checkbox"/> All investment is at risk.		
32b <input type="checkbox"/> Some investment is not at risk.		32b <input type="checkbox"/> Some investment is not at risk.		
BAA For Paperwork Reduction Act Notice, see Form 1040 instructions.				

Figure 6.8

ordinary gain or loss treatment (tax loss insurance if you have losses). However, only a SMLLC trader can deduct health insurance premiums and contribute to a tax-deductible retirement plan.

Filing of Form 3115: When you change your method of accounting for trading gains and losses from the default cash method to the MTM method (IRC § 475), you are required to file a Form 3115 (Change of Accounting Method). The one exception is if you are a new taxpayer (you never filed a tax return before as an individual, or if you are a new entity that has never filed a return before), then you can skip filing Form 3115. Electing MTM accounting is a three-step process. First, you elect MTM by April 15, 2003, for 2003. Next, you must properly report MTM on your 2003 tax return, and then you file your Form 3115 by the due date of your 2003 tax return, including extensions.

Line-by-Line Guidance

(Based on 2003 tax forms, the latest available as of this writing)

Form 1040, page 2

On the bottom of Form 1040, page 2, under Occupation, enter “Trader in Securities” if you qualify for trader tax status.

Trading gains and losses

- Use Form 4797 for mark-to-market (IRC § 475) trading gains and losses.
- Use Schedule D for cash method trading gains and losses.

Home office deductions

- See our separate section on Form 8829 Home Office deductions.

Footnotes

- See our separate section on footnotes; every trader tax return should have one.

Schedule C

For purposes of this guidance, we refer to Example 2. Profitable, full-time securities business trader who elected mark-to-market accounting for 2003 with a positive and deferred section 481 adjustment. Home office for rental apartment. Includes federal and state returns for California. If you qualify for trader tax status—meaning your trading activity for 2003 rose to the level of trading as a business—then you should report all your trading business expenses on Schedule C. Traders may deduct unlimited amounts of their trading business expenses on Schedule C, without restrictions. A qualifying trader may use Schedule C whether or not they elect mark-to-market accounting. Even if you did not learn about trader tax status until the following year (2004), you can still file this Schedule C for 2003 (after the fact).

Note: Mark-to-market accounting may not be elected after the fact; it must be elected by April 15th of the current tax year. Always attach a footnote to your Schedule C to explain your trader tax status and so on. See the Footnotes section.

Line A, Principle business

If you trade both securities and commodities, write “Trader in Securities and Commodities—See Note.” If you elect MTM for securities only, then put “Trader in Securities—Mark-to-Market Accounting.” To play it safe, just put “Trader—See Note.”

Line B, Enter code

Trader in securities or commodities without mark-to-market accounting:
523900 for “Other financial investment activities.”

Trader in securities with mark-to-market accounting: 523110 for “Investment bankers & securities dealers.”

Trader in securities with MTM and trader in commodities without MTM: 523110 for “Investment bankers & securities dealers.”

Trader in securities and commodities with mark-to-market accounting: 523130 for “Commodity contract dealers.”

Lines C, D, and E, Business name, tax ID number, and address

Nothing is required on these lines. Some traders use an assumed name or a d/b/a (doing business as) name for their business. If that’s the case, enter that name on line C. Some traders file an SS-4 to get a tax ID number for their d/b/a. In that case, enter this EIN on line D. You will need a business EIN if you have employees. If you have a separate address for your trading business—different from your home address—you can enter it here.

One Word of Caution: It might be better to omit your business address if you want to reduce the chances of the IRS questioning your home office expense (assuming you have one).

Line F, Accounting method

Schedule C businesses by default use the cash method of accounting, as opposed to the accrual method. Both methods are listed on Line F; “Other” is also listed. If you use mark-to-market accounting for securities, check Other and enter: IRC § 475(f)(1). 475(f)(1) is for securities and 475(f)(2) is for commodities. You can elect both or just one alone. If you do not use mark-to-market accounting for securities or commodities, check the cash method. If you want the accrual method for your business expenses, then check accrual method.

Line G, Material participation

Check the Yes box to indicate that you did materially participate in your trading business. If you check No, then you don’t qualify to use a trading business Schedule C.

Line H, Started business in 2003

Check the box if you started your trading business in 2003.

Part I, income

No entries are made on lines 1 to 5, because you do not have revenues, inventory, or cost of goods sold in this trading business.

Line 6, Other income

For line 6—Other income (loss)—If you receive commission rebates from your broker reported on Form 1099-Misc, those should be reported here. Then, report a negative amount to zero out your rebate, and transfer the amount to your trading gains and losses cost basis. This amount is not income, but rather a cost basis adjustment. (See Line 11.) Note that commissions are not business expenses (on Schedule C) but are part of your trading gains and losses reported on Schedule D (cash method) or Form 4797 (MTM method).

Transfer income from Form 4797 or Schedule D

Schedule C is adjusted to zero by an entry on line 6. Notice the following key GTT tax filing strategy. All trading business expenses are reported on Schedule C. We used section 179 depreciation and home office expenses as well. It is important to note that section 179 depreciation expenses and home office expenses are deductible on Schedule C in 2003 if sufficient net income is entered on Schedule C to cover these expenses. Otherwise, they must be carried over to 2004. Neither expense can generate a tax loss (except for the mortgage interest and real estate tax portion of home office expenses). The GTT filing strategy is to transfer sufficient trading gains (only), not gains on segregated investment positions, from Schedule D (cash method) or Form 4797 (mark-to-market method, which is the case here) to Schedule C to zero out Schedule C. Notice that we don't transfer too many trading gains to result in a Schedule C net income, which might invite the IRS to inquire about self-employment taxes. As indicated in the Footnotes, traders with or without MTM are exempt from SE taxes. This strategy is disclosed in the Footnotes.

Note: Not having a Schedule C loss helps reduce your chance of IRS questions. Having a Schedule C loss for trading business expenses, because you have trading losses, is fully acceptable and understandable. We advise you not to short sell yourself on your rightful trading business expenses. The Footnote explains this treatment and reduces the chance of IRS questions.

Part II, Expenses

Choose the cash or accrual method of accounting for business expenses. Don't confuse your expense method of accounting with your trading gains and loss method of accounting (cash or MTM). Here are some tax planning ideas that point out the advantage of accrual method accounting for expenses: Business traders accelerate expenses into 2003 for lower 2003 tax liabilities. The cardinal rule of year-end tax planning is to accelerate business deductions and losses into the current tax year and defer income and gains into the following tax year.

Deferring income taxes until the following tax years benefits the taxpayer by allowing the use of this tax money during the current and following tax year. These benefits are referred to as *timing* rather than *permanent* tax benefits. As a default method of accounting, business traders use the cash method of accounting for both business expenses and trading gains and losses, meaning business expenses are deductible when paid, as opposed to when incurred. For example, if a cash method business trader attends a seminar on December 28, 2003, but pays the bill on January 4, 2004, it is a 2004 business expense. A business trader may also elect to use the accrual method of accounting, which means that expenses are deductible when incurred (in 2003), not when paid (in 2004).

A business trader may also elect to use IRC § 475 mark-to-market accounting for trading gains and losses. This MTM election must be filed with the IRS by April 15 of the current tax year. Otherwise, the cash method of capital gains and losses applies for the entire tax year. (See the following chapter on tax planning moves related to trading gains and losses.)

Because trading gains and losses are treated separately from expenses and business traders don't have other forms of income, most business traders would be better served taxwise to use the accrual method of

accounting for business expenses. However, this approach may be more trouble accounting-wise. For cash method business traders, the easiest way to accelerate deductions is to pay all bills early, before the end of the year. Remember that a prepayment of 2004 expenses will not give rise to a 2003 tax deduction.

Credit card charges are treated like payments of cash or check. It does not matter when you pay the credit card bill. For example, if you charge your credit card for a new computer on December 31, 2003, it is a 2003 tax deduction under the cash method. It does not matter that the computer is listed on your January credit card statement. If you plan to upgrade your computers, equipment, or furniture and fixtures soon, it's better to do it before year-end than early the next year. Each tax year, a business taxpayer is allowed 100 percent (IRC § 179) depreciation up to the first \$100,000 of depreciable assets (\$102,000 for 2004). Excess amounts are subject to the normal rules of depreciation (over the useful life of the asset).

Line 8, Advertising

Most traders don't advertise because they don't have customers as dealers do.

Line 9, Bad debts

If you loaned money to another trader for business reasons, and he or she defaulted on paying it back, you may deduct the entire amount of the debt on Line 9. However, you need to first bring or otherwise threaten legal action against the debtor. Don't play around with this situation. Nonbusiness bad debts can be deducted as capital losses on Schedule D. Proprietary traders may write off lost deposits (with proprietary trading firms) as business bad debts.

Line 10, Car expenses

Most traders don't use a car for business. The nature of trading online involves trading from an office at home. If you trade at home and also trade in a trading office outside the home (and qualify for a home office deduction), then traveling from your home office to your other daytime trading office may qualify as travel expenses. Otherwise, if you don't have a home

office, travel to and from that office is nondeductible commuting expenses. Anyway, we don't suggest entering this type of expense here. Instead, enter it on line 24a, travel expense.

Line 11, Commissions and fees

Trading commissions are not recorded on Schedule C. Rather, all trading commissions are recorded as part of trading transactions on Schedule D and Form 4797. Commissions on purchases of securities are added to your cost basis and commissions on sales of securities are subtracted from proceeds. Your broker reports commissions in this manner on each confirmation and on your statements. Be careful in reading your broker's year-end reporting of net commissions on their website. Some brokerage firms separate commissions from profit and loss in their online reports, so be sure to ask your broker.

Some traders receive rebates on commissions. These amounts are usually not reflected on your confirmations, your statements, or Form 1099. Some traders do receive a Form 1099-Misc for commission rebates, but many traders don't realize that these amounts should be reported as a negative adjustment to cost basis reported on your Schedule D or Form 4797. Don't try to omit this income from your tax returns as it will lead to trouble.

Line 13, Depreciation

Traders use plenty of computers, equipment and furniture, and fixtures. Enter these costs on Form 4562 and choose the correct depreciation method. Form 4562 depreciation amounts are then transferred to this line.

Some notes about depreciation: These costs are depreciable whether you buy the item in 2003 or in a prior year and then convert it to business use in 2003. Don't short-change yourself here. Make a list of every item of technology, equipment, and furniture in your home office and in your trading business.

Fixed assets are depreciated, expenses are expensed. When you purchase an asset, you need to make a decision about whether that asset is going to help you earn income in future years. If the answer is Yes, then it

is called a *fixed asset* and you must depreciate it over its useful life. The IRS has schedules for different types of fixed assets and provides different methods for depreciating fixed assets over their designated useful lives. Computers and equipment are depreciated over five years and office furniture is seven years. Take note of bonus depreciation and accelerated methods allowed.

Section 179 Depreciation

Section 179 allows you to deduct 100 percent of your fixed asset cost up to \$100,000 for 2003 (\$102,000 for 2004) as a current expense for qualifying property purchased and placed in service during 2003. This property would otherwise have to be depreciated. You can only deduct section 179 depreciation if you have net income from wages and other business activities (let your tax software handle this calculation).

If trading is your only business or job activity, then this requires that you be a profitable trader and that you follow our suggested strategy of transferring sufficient trading gains to Schedule C, line 6 from Schedule D or Form 4797. If you have trading losses, and no income, then we suggest that you skip section 179 depreciation and take regular and bonus depreciation. This option would allow you to get some depreciation rather than none (carrying over your section 179 depreciation to the following tax year).

Form 4562 for your Schedule C

All depreciation is first entered on Form 4562. Section 179 depreciation is entered on the top of Part I, special bonus depreciation in Part II, and regular depreciation is entered in Part III. You should file a separate Form 4562 for each different business activity. You file one Form 4562 for your trading business Schedule C.

Software is an intangible asset, and it is amortized on Form 4562, page 2, Part VI. The depreciation method is three years straight-line. Starting in 2003, software may now be included with section 179 depreciable property or be included with bonus depreciation.

Line 14, Employee benefit programs

If you have employees, you enter the amounts of payroll taxes and other employee benefits here. If you have employees, you need to file payroll tax returns and issue all employees Form W-2s. You also have to withhold and remit payroll taxes. See the IRS Publications for Employers.

Sole proprietors, unlike single member LLCs, are not allowed to pay themselves a W-2 salary and then set up a retirement plan on that earned income. Trading income is not “earned income,” and sole proprietors are not entitled to contribute to retirement plans on this income. You need to form a separate business entity to pay yourself a fee or a salary in order to have a retirement plan.

Line 15, Insurance

Taxpayers without earned income, including business traders, may not deduct health insurance premiums from adjusted gross income. Other types of sole proprietors have earned income, and they can deduct health insurance premiums. This line 15 is for other types of insurance like business liability insurance, which few traders have. Home insurance is reported with other home office expenses on Form 8829.

Line 16b, Interest expense

If you have margin interest expense on your trading accounts, enter it here. Do not enter margin interest for investment positions or investment accounts. Investment interest expenses go on Form 4952 and deductions are limited to investment income. If you margin investment positions to purchase trading positions, that interest may be deemed business interest.

Line 17, Legal and professional fees

Legal fees for operations or business tax advice are deductible. Legal fees for asset acquisition are added to the cost basis of the asset. Legal fees for personal reasons are not deductible. Fees paid to your trader tax business preparer may be deducted here or on line 27, other expenses.

Line 18, Office expense

If you have an office in your home, don't use this line. Instead, use Form 8829 (Expenses for the business use of your home). **Note:** New IRS regulations further liberalize home office deductions by allowing taxpayers to protect more of their gain exclusion on sale of their principal residence, by not allocating the home office gain to the overall home gain (providing your office is in your home and not a separate structure). This rule is intended to help more taxpayers by not making them afraid to take this deduction and home depreciation in fear of losing their exclusion. The only recapture in many sales will be depreciation taken to date. That is not a lost benefit, but rather a timing difference (you pick up income later for what you deduct now). Note that depreciation is "allowed" or "allowable," which means you are treated by the IRS as taking this depreciation whether you did or not. So you may as well take it and receive the related tax benefits.

Line 19, Pension and profit-sharing plans

As previously stated, sole proprietor traders do not have earned income and they may not contribute to pension or profit-sharing retirement plans. Traders can contribute to tax-deductible retirement plans by creating an entity for their trading business and then paying themselves a salary or fee from that entity. If your Schedule C business has employees and you have a retirement plan for them, you would use this line.

Line 20a, Rent or lease

Enter operating lease payments on trading equipment here. Note that some leases should be capitalized and then depreciated on Form 4562.

Line 20b, Other business property

If you have a trading office outside your home, enter any rent you pay for that office on this line.

Line 21, Repairs and maintenance

If you have repairs or have done maintenance on either your trading busi-

ness equipment or your home office assets, enter those expenses on this line. General home repairs and maintenance are reported on Form 8829 (home office expenses).

Line 22, Supplies

Traders use a great deal of supplies. Enter supplies expenses on this line. Remember, the home office form is for indirect home costs, not specific trading business expenses such as supplies.

Line 23, Taxes and licenses

Some traders also get security industry licenses. The cost of those can be deducted here. Some states or cities (such as New York City) charge stealth taxes on unincorporated businesses. In most cases, these taxes won't apply to Schedule Cs, because Schedule Cs for traders always show either zero net income or a large loss (if you don't transfer any gains; see the line 6 explanation). Furthermore, trading gains are usually not subject to NYC unincorporated business tax (UBT). For a regular NYC business, they would deduct their NYC UBT tax here. State and local income taxes, real estate taxes, and personal property taxes are itemized deductions reported on Schedule A. Real estate taxes may instead be reported on Form 8829, for better tax results.

Line 24a, Travel expenses

Many traders working from a home office do not have large travel expenses. Traders don't usually visit the companies they trade in. Online traders don't usually visit their brokerage firms, professional advisors, or others. Traders don't have clients to visit either. (See line 10, Car expenses.)

Traders do travel for seminars, conferences, and meetings. The travel portion of these expenses can be taken as travel or combined with seminar costs. Some traders travel with other traders for trading seminars or conferences. Even if you all go on a ski trip/conference or seminar, these expenses can be deductible if you follow the rules on travel business expenses closely.

- The actual costs of travel (e.g., plane fare, cab to airport, etc.) are deductible for out-of-town business trips. Additionally—and this aspect is significant—you are also allowed to deduct the cost of meals and lodging. Your meals are deductible even if they are “personal” (i.e., not directly connected with the out-of-town business) although, as with all deductible meals, only 50 percent of the cost is allowed. Also, no deduction will be allowed for meals or lodging to the extent the expense is “lavish or extravagant.” Although this term is not defined in the tax rules, it has been interpreted to mean “unreasonable.”
- Personal entertainment costs on the trip aren’t deductible, but business-related costs such as for dry-cleaning, phone calls, and computer rentals are.
- Some allocations may be required if the trip is a combined business/pleasure trip. For example, if you fly to a location for five days of business meetings and stay on for an additional period of vacation, only the cost of meals, lodging, and so on for the business days—not for the personal vacation days—are deductible.
- On the other hand, with respect to the cost of travel itself (plane fare, etc.), if the trip is “primarily” business, it can be deducted in its entirety and no allocation is required. Conversely, if the trip is primarily personal, none of the travel costs are deductible. An important factor in determining if the trip is primarily business or personal is the amount of time spent on each, although this factor isn’t the sole consideration.
- If the trip doesn’t involve the actual conduct of business but is for the purpose of attending a convention, seminar, or similar event, the IRS checks the nature of the meetings carefully to make sure they are not vacations in disguise. Be careful to save all material helpful in establishing the business or professional nature of this travel.
- The rules on deducting the costs for a spouse who accompanies you on a business trip are restrictive. No deduction is allowed unless the spouse is an employee of yours or your company and traveling for a business purpose.

Line 24b, Meals and entertainment

Many traders have meals with other traders to discuss their respective trading businesses. These traders seek ideas for improvement, research, trading ideas, and advice. In most cases, these meals qualify for this deduction.

Line 24c, Nondeductible amount

Fifty percent of meals and entertainment are not deductible, per IRS rules.

Line 25, Utilities

These expenses are usually included with indirect expenses allocated for the home office on Form 8829. If you have a separate meter for your business usage, then enter that amount on this line. Do not use this line for your phone and communications. Enter your communication costs on Part V where you list your Other Expenses.

Line 27, Other expenses, Schedule C, page 2, Part V

Here is where you list all your other actual trading business product and service expenses.

We include a partial list here:

- Internet access providers used for business exclusively. If combined with personal use, then report them as indirect expenses on Form 8829 for your home office.
- Trading market information online services.
- Trading research products and services.
- Trading print publications and subscriptions.
- Trading gifts to other traders, brokers, and other business related persons (limited to \$25 per person per year).
- Trading communication services (phone, fax, dial-up).
- Trading accessories not depreciated (small items less than \$100).
- Training and seminars for trading after getting started in the business. Education, training, and seminars before you commence business operations (trader tax status) are either start-up

costs (IRC § 195), investment expenses, or personal nondeductible expenses. See more guidance below.

- Trading chat room expenses.
- Trading tax and accounting fees. If you lack trader tax status, these expenses are reported as miscellaneous expenses on Schedule A (Itemized Deductions).
- Trading books.
- Trading miscellaneous expenses.
- Education expenses related to trading. Be careful with education expenses. If you incur education expenses to learn the trading business before you start trading, those expenses may not be deductible as education expenses. On the other hand, if you start your trading business and then take courses, training, and seminars, you may deduct these expenses on your Schedule C.

Here are the rules: A deduction is available if the education maintains or improves the skills related to your trade or business. Educational costs are also deductible if the education is required (e.g., by law or an employer) to keep your position or job. Conversely, educational costs are not deductible if the education is required to get a new field (as opposed to staying in a new field) or qualifies you for a new trade or business.

Observation: Most traders are not required to take trading seminars or other education courses. Some proprietary traders are required to take some training before being allowed to trade the firm's capital, so their education is deductible. A retail trader is his/her own employer (self-employed). Strictly speaking, a retail trader's educational costs do not meet the spirit of the tax law for not allowing a deduction. In most cases, a trader takes these courses to "improve trading skills," not to qualify to enter the business. Take note that in the future, the SEC may require day traders to qualify to enter the business, and they may require a minimum of educational courses. That requirement would change things here and perhaps disallow the current allowed deductions.

Line 28, Total expenses

Just total up all expenses. **Note:** this amount is before your home office deduction on line 30.

Line 29, Tentative profit (loss)

See our transfer income strategies in line 6.

Line 30, Business use of the home

Expenses are listed here if you have net income. Otherwise, all except mortgage interest and real estate taxes remain a carryover to 2004 listed on Form 8829, home office.

Line 31, Net profit (loss)

Just do the calculations on the form. In all cases, you should break even for profitable traders (because you transferred sufficient trading gains from Schedule D or Form 4797 to break even), or end up with a loss for your trading business expenses. You should never end up with a net income on Schedule C. Make sure to cover your entire home office deduction and section 179 depreciation deductions, if you have sufficient trading gains.

Line 32a

If you have a loss, check this box showing that “All your investment is at risk” in this trading business. Otherwise, leave blank.

Trading gains and losses

Use Form 4797 for mark-to-market IRC § 475 trading gains and losses.

Use Schedule D for cash method trading gains and losses (not needed in this book, since standard rules apply).

Form 4797, Part II (Ordinary gains and losses)

Traders with mark-to-market (MTM) accounting report their trading gains and losses on Form 4797, Part II—Ordinary Gains and Losses.

Form 4797 instruction excerpts:

Traders Who Made a Mark-to-Market Election A trader in securities or commodities may elect under section 475(f) to use the mark-to-market method to account for securities or commodities held in connection with a trading business. Under this method of accounting, any security or commodity held at the end of the tax year is treated as sold (and reacquired) at its FMV on the last business day of that year.

Unless you are a new taxpayer, the election must be made by the due date (not including extensions) of the tax return for the year prior to the year for which the election becomes effective.

If you are a trader in securities or commodities with a mark-to-market election under section 475(f) in effect for the tax year, the following special rules apply.

Gains and losses from all securities or commodities held in connection with your trading business (including those marked to market) are treated as ordinary income and losses, instead of capital gains and losses. As a result, the lower capital gain tax rates and the limitation on capital losses do not apply.

The gain or loss from each security or commodity held in connection with your trading business (including those marked to market) is reported on Form 4797, line 10 (see the instructions for line 10).

The wash sale rule does not apply to securities or commodities held in connection with your trading business.

For more details on the mark-to-market election and how to make it, see Pub. 550; Rev. Proc. 99-17, 1999-7 I.R.B. 52; and sections 475(e) and 475(f). Form 4797 Instructions for line 10 on page 4.

Part II

If a transaction is not reportable in Part I or Part III and the property is not a capital asset reportable on Schedule D, report the transaction in Part II.

Line 10

Report other ordinary gains and losses, including gains and losses from property held one year or less, on this line.

Securities or commodities held by a trader who made a mark-to-market election

On line 10, report all gains and losses from sales and dispositions of securities or commodities held in connection with your trading business, including gains and losses from marking to market securities and commodities held at the end of the tax year (see “Traders Who Made a Mark-to-Market Election” on page 2).

Attach a statement to your tax return using the same format as line 10 showing the details of each transaction. Separately show and identify securities or commodities held and marked to market at the end of the year. On line 10, enter “Trader—see attached” in column (a) and the totals from the statement in columns (d), (f), and (g). Also, see the instructions for line 1 on page 3.

Observation: For the past twenty years we have followed a widely accepted practice of reporting one line item per brokerage account. All our example tax returns use this strategy on Form 4797 or Schedule D.

Form 4797 Instructions for line 1

Enter on line 1 the total gross proceeds from:

- Sales or exchanges of real estate reported to you for 2003 on Form(s) 1099-S (or substitute statement) that you are including on line 2, 10, or 20 and
- Sales of securities reported to you for 2003 on Forms 1099-B (or substitute statements) that you are including on line 10 because you are a trader with a mark-to-market election under section 475(f) in effect for the tax year. See “Traders Who Made a Mark-to-Market Election” on page 2 and the instructions for line 10 on page 4.

Traders with mark-to-market (MTM) accounting report their trading gains and losses on Form 4797 Part II—Ordinary Gains and Losses.

Tax Return Footnotes

The following excerpts come from our 2004 GTT Guides.

In our companion guides, in each of the example tax returns, several pages are titled “Supplemental Information” at the end of the federal return (the PDF file) and before the state return. The first few supplemental information pages are marked “Tax Return Footnotes,” and just after them are “Client Notes—for Internal Use Only.”

Tax return footnotes: These footnotes are included with your tax return and help explain your complex tax status to the IRS. Some accountants advocate no footnotes, but we strongly believe that trader tax status is too complex. To prevent IRS questions and exams, we have had great success in using footnotes for our clients. The footnotes explain trader tax laws, your status, and the trader tax treatment used on the return.

Client notes—For internal use only: Do not file this section with your tax return. These notes are for internal use only. The notes are intended to explain to you how we prepared these example tax returns. We include guidance, notes, warnings, strategies, tips, and form references.

COMMODITY EXAMPLES

Comparing the Tax Return Examples

For examples 7 through 11, we used the same amounts for portfolio income, trading gains or losses, trading expenses, and itemized deductions,

except that examples 7 and 8 have the same numbers, including the same amount of commodities trading gains, but example 7 uses MTM IRC § 475 and example 8 does not. Examples 10 and 11 replace commodities trading gains with commodities trading losses.

Example 7

In example 7, Joe qualifies as a “trader in commodities” (i.e., he has trader tax status), so he reports all his trading business expenses on Schedule C (Business Profit and Loss) as in Figure 6.9. Notice that no limitation is placed on these ordinary trading expenses. In order to deduct home office expenses and section 179 depreciation expenses, Joe transferred trading gains from Form 6781 to Schedule C to have them result in zero net income or loss. Home office and section 179 depreciations are only deductible to the extent you have business income. This transfer is discussed in the tax return footnote. Without a transfer, Joe would carry over these expenses to the following tax year, or choose normal depreciation. Trader tax status alone (without MTM) saves Joe a significant amount of taxes, because of the Schedule C deductions.

Commodity trading gains and losses are reported on Form 6781. Because Joe elected mark-to-market accounting on his commodities trading, he reports his commodities trading gains first on Form 6781 and then transfers the net Form 6781 amount to Form 4797, Part II—Ordinary gains and losses.

Joe has commodity trading gains, so he pays a higher tax for electing MTM IRC § 475. See Example 8.

Example 8

In this example, Joe was wise; he was profitable trading commodities for the year as of April 15, 2003, and he decided to not elect mark-to-market accounting for 2003. If he had decided to, the election would have been

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SCHEDULE C (Form 1040) <small>Department of the Treasury Internal Revenue Service (99)</small>		Profit or Loss From Business (Sole Proprietorship) <small>Partnerships, joint ventures, etc. must file Form 1065 or 1065-B. Attach to Form 1040 or 1041. See Instructions for Schedule C (Form 1040).</small>		<small>OMB No. 1545-0074</small> 2003 <small>09</small>	
Name of proprietor Joe Trader MTM Comm Gains Ex 7		Social security number (SSN) 111-11-1111		B Enter code from instructions ▶ 523130	
A Principal business or profession, including product or service (see instructions) Trader in Commodities - Mark-to-Market accounting		C Business name. If no separate business name, leave blank.		D Employer ID number (EIN), if any	
E Business address (including suite or room no.) City, town or post office, state, and ZIP code					
F Accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input checked="" type="checkbox"/> Other (specify) ▶ <u>Sec 475(f)(2)-Note</u>					
G Did you 'materially participate' in the operation of this business during 2003? If 'No,' see instructions for limit on losses. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No					
H If you started or acquired this business during 2003, check here					
Part I Income					
1 Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the 'Statutory employee' box on that form was checked, see the instructions and check here. <input type="checkbox"/>		1		2	
2 Returns and allowances		2		3	
3 Subtract line 2 from line 1.		3		4	
4 Cost of goods sold (from line 42 on page 2).		4		5	
5 Gross profit. Subtract line 4 from line 3.		5		6	
6 Other income, including Federal and state gasoline or fuel tax credit or refund. See Statement.		6		46,147.	
7 Gross income. Add lines 5 and 6.		7		46,147.	
Part II Expenses. Enter expenses for business use of your home only on line 30.					
8 Advertising		8		19 Pension and profit-sharing plans	
9 Car and truck expenses (see instructions)		9		20 Rent or lease (see instructions):	
10 Commissions and fees		10		a Vehicles, machinery, and equipment	
11 Contract labor (see instructions)		11		b Other business property	
12 Depletion		12		21 Repairs and maintenance	
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)		13		22 Supplies (not included in Part III)	
14 Employee benefit programs (other than on line 19)		14		23 Taxes and licenses	
15 Insurance (other than health)		15		24 Travel, meals, and entertainment:	
16 Interest:		16		a Travel	
a Mortgage (paid to banks, etc.)		16a		b Meals and entertainment	
b Other		16b		c Enter nondeductible amount included on line 24b (see instrs).	
17 Legal & professional services		17		d Subtract line 24c from line 24b	
18 Office expense		18		24d	
28 Total expenses before expenses for business use of home. Add lines 8 through 27 in columns.		28		38,911.	
29 Tentative profit (loss). Subtract line 28 from line 7.		29		7,236.	
30 Expenses for business use of your home. Attach Form 8829.		30		7,236.	
31 Net profit or (loss). Subtract line 30 from line 29.		31		0.	
• If a profit, enter on Form 1040, line 12, and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3.		• If a loss, you must go to line 32.		32a <input type="checkbox"/> All investment is at risk.	
32 If you have a loss, check the box that describes your investment in this activity (see instructions).		• If you checked 32a, enter the loss on Form 1040, line 12, and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3.		• If you checked 32b, you must attach Form 6198.	
• If you checked 32b, you must attach Form 6198.		32b <input type="checkbox"/> Some investment is not at risk.		Schedule C (Form 1040) 2003	

Figure 6.9

due by April 15, 2003. Joe understood that electing MTM would convert his commodities capital gains and losses to ordinary gains and losses, and he did not want to forgo the 60 percent long-term capital gains rate benefit on commodities gains (see full discussion of this benefit on our Form 6781 earlier in this book). Without MTM IRC § 475, Joe saved a considerable amount of federal taxes versus Example 7.

Note: Had Joe ended the year with commodities trading losses, he would have been much better off having elected MTM IRC § 475. See discussion of this difference on the Loss Examples page.

One important note about transferring gains from Form 6781 to Schedule C to “zero out”: If a taxpayer does not elect IRC § 475 on commodities, then consider that transferring gains from Form 6781 to Schedule C (to zero it out) and unlocking section 179 depreciation and home office expenses (which require income on the tax return from any business or wage activity) may not be tax-beneficial in all cases. Be aware that this transfer will unlock those Schedule C benefits, but on the other hand it will also reduce a taxpayer’s 60 percent long-term capital gains rate tax benefit. For our clients, we run the numbers both ways to see which is preferable taxwise. Showing a Schedule C loss and gains on Form 6781 is fine, it’s more an issue of taking home office and 179 depreciation deductions.

Example 8(b) is the same as example 8, except no transfer of gains is made from Form 6781 to Schedule C. Notice in Figure 6.10 how Joe is better off taxwise with the transfer in that he wants to benefit from his home office expenses in 2003 and not carry them over to 2004. Keep in mind, if Joe exits the trading business in 2003, he may not be able to use carryover home office expenses. He prefers example 8 over example 8(b) without the transfer of trading gains from Form 6781.

Example 9

In example 9, Joe doesn’t qualify for trader tax status, so he is forced to report as a normal investor. Therefore, Joe may not report his trading business expenses on Schedule C. Instead, Joe must report these expenses as

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SCHEDULE C (Form 1040)		Profit or Loss From Business (Sole Proprietorship)		<small>OMB No. 1545-0074</small> <div style="font-size: 1.2em; font-weight: bold;">2003</div> <div style="font-size: 0.8em; font-weight: bold;">09</div>	
<small>Department of the Treasury Internal Revenue Service (99)</small>		▶ Partnerships, joint ventures, etc., must file Form 1065 or 1065-B. ▶ Attach to Form 1040 or 1041. ▶ See instructions for Schedule C (Form 1040).			
Name of proprietor Joe Trader no MTM CommGain Ex8B		Social security number (SSN) 111-11-1111			
A Principal business or profession, including product or service (see instructions) Trader in Commodities - See Note		B Enter code from instructions 523900			
C Business name. If no separate business name, leave blank.		D Employer ID number (EIN), if any			
E Business address (including suite or room no.) ▶ City, town or post office, state, and ZIP code					
F Accounting method: (1) <input checked="" type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ▶					
G Did you 'materially participate' in the operation of this business during 2003? If 'No,' see instructions for limit on losses. ... <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No					
H If you started or acquired this business during 2003, check here ▶					
Part I Income					
1 Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the 'Statutory employee' box on that form was checked, see the instructions and check here ▶ <input type="checkbox"/>		1			
2 Returns and allowances		2			
3 Subtract line 2 from line 1		3			
4 Cost of goods sold (from line 42 on page 2)		4			
5 Gross profit. Subtract line 4 from line 3		5			
6 Other income, including Federal and state gasoline or fuel tax credit or refund		6			
7 Gross income. Add lines 5 and 6		7			
Part II Expenses. Enter expenses for business use of your home only on line 30.					
8 Advertising		8			
9 Car and truck expenses (see instructions)		9			
10 Commissions and fees		10			
11 Contract labor (see instructions)		11			
12 Depletion		12			
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)		13		3,188.	
14 Employee benefit programs (other than on line 19)		14			
15 Insurance (other than health)		15			
16 Interest:					
a Mortgage (paid to banks, etc.)		16a			
b Other		16b		16,299.	
17 Legal & professional services		17			
18 Office expense		18			
19 Pension and profit-sharing plans		19			
20 Rent or lease (see instructions):					
a Vehicles, machinery, and equipment		20a			
b Other business property		20b			
21 Repairs and maintenance		21			
22 Supplies (not included in Part III)		22		953.	
23 Taxes and licenses		23			
24 Travel, meals, and entertainment:					
a Travel		24a		1,855.	
b Meals and entertainment				2,654.	
c Enter nondeductible amount included on line 24b (see instrs.)				1,327.	
d Subtract line 24c from line 24b		24d		1,327.	
25 Utilities		25			
26 Wages (less employment credits)		26			
27 Other expenses (from line 48 on page 2)		27		10,612.	
28 Total expenses before expenses for business use of home. Add lines 8 through 27 in columns		28		34,234.	
29 Tentative profit (loss). Subtract line 28 from line 7		29		-34,234.	
30 Expenses for business use of your home. Attach Form 8829		30			
31 Net profit or (loss). Subtract line 30 from line 29.					
• If a profit, enter on Form 1040, line 12 , and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3. • If a loss, you must go to line 32.				31	
32 If you have a loss, check the box that describes your investment in this activity (see instructions).					
• If you checked 32a, enter the loss on Form 1040, line 12 , and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3.					
• If you checked 32b, you must attach Form 6198 .					
32a <input checked="" type="checkbox"/> All investment is at risk.					
32b <input type="checkbox"/> Some investment is not at risk.					
BAA For Paperwork Reduction Act Notice, see Form 1040 instructions.					
<small>FDI20112L 10/14/03</small>					

Figure 6.10

itemized deductions on Schedule A. Investment interest expenses are limited on Form 4952 (not in this case, because Joe has investment income) and investment expenses are subject to “Miscellaneous Itemized Deduction” limitations.

Take note of the other nasty surprise for Joe: he triggered the nasty alternative minimum tax (AMT). When a taxpayer has a significant long-term capital gain (60 percent of Joe’s gains are taxed at the long-term capital gains rate) plus large miscellaneous itemized deductions and state taxes (both are not deductible for AMT tax), a taxpayer can oftentimes trigger the AMT tax.

The Bottom Line: Trader tax status always saves a trader a meaningful amount of taxes.

We don’t recommend MTM IRC § 475 for commodities traders because they forgo the 60 percent long-term capital gains rate benefit. However, if you have large commodities trading losses for 2003 as of April 15, 2003, and you might exit the commodities trading business, we suggest you do elect MTM IRC § 475 for 2003. This election will allow you to convert your commodities trading losses to ordinary loss treatment. Otherwise, you will be stuck with a capital loss limitation of \$3,000. Commodities traders are entitled to a three-year carryback of losses from section 1256 contracts, but only applied against commodities trading gains in those years.

Commodities Trader with Trading Losses

Joe Trader is single. He traded commodities as a business from his home office in Los Angeles for all of 2003. His tax matters are fairly simple. He has two brokerage accounts: a commodities trading account at Interactive Brokers, and a segregated securities account (i.e., he trades from the account but also has long-term investment positions) at Schwab. He elected MTM IRC § 475 accounting on commodities for tax year 2003 when he filed his 2002 federal tax return by April 15, 2003. Joe is not registered with an exchange as a commodities dealer, so he is exempt from self-employment taxation.

For examples 10 and 11, Joe qualifies as a trader in commodities (i.e., he has trader tax status), so he reports all his trading business expenses on Schedule C (Business Profit and Loss). Notice it places no limitation on these ordinary trading expenses. However, Joe's home office expenses are carried over to 2004, because Joe does not have trading gains from Form 6781 as he did in examples 7 and 8.

Joe does receive significant tax savings from reporting these large Schedule C expenses. Note that he used a regular depreciation method rather than section 179 depreciation, because he needs income to deduct section 179 depreciation (without income, section 179 depreciation is carried over to 2004).

Example 10

In example 10, because Joe elected MTM IRC § 475 accounting on his commodities trading, he reports his commodities losses first on Form 6781 and then he transfers the net Form 6781 amounts to Form 4797 Part II—Ordinary gains and losses.

Joe has commodities trading losses, so he benefits greatly from having elected MTM. Joe was wise: He was losing on his commodities trading as of April 15, 2003, for tax year 2003, so he decided to elect mark-to-market accounting for 2003. The 2003 MTM was due by April 15, 2003.

Joe understood that electing MTM would convert his capital gains and losses on commodities trading into ordinary gains and losses. Joe wisely exchanged the 60 percent long-term capital gains rate benefit on commodities trading gains in exchange for the important loss insurance of Form 4797 (ordinary gain or loss treatment). With MTM, Joe saved a considerable amount of federal and state taxes by utilizing his net operating loss for immediate tax refunds.

Net Operating Losses: Joe has an NOL in connection with trader tax status. His NOL is comprised of his Schedule C trading business expenses plus his large Form 4797 trading losses, shown in Figure 6.11.

SCHEDULE C (Form 1040) <small>Department of the Treasury Internal Revenue Service (99)</small>		Profit or Loss From Business (Sole Proprietorship) <small>Partnerships, joint ventures, etc. must file Form 1065 or 1065-B. Attach to Form 1040 or 1041. See Instructions for Schedule C (Form 1040).</small>		<small>OMB No. 1545-0074</small> 2003 09
Name of proprietor Joe Trader MTM Comm Loss Ex 10		Social security number (SSN) 111-11-1111		
A Principal business or profession, including product or service (see instructions) Trader in Commodities - Mark-to-Market accounting		B Enter code from instructions 523130		
C Business name. If no separate business name, leave blank.		D Employer ID number (EIN), if any		
E Business address (including suite or room no.) City, town or post office, state, and ZIP code				
F Accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input checked="" type="checkbox"/> Other (specify) <u>Sec 475(f)(2)-Note</u>				
G Did you 'materially participate' in the operation of this business during 2003? If 'No,' see instructions for limit on losses. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No				
H If you started or acquired this business during 2003, check here				
Part I Income				
1 Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the 'Statutory employee' box on that form was checked, see the instructions and check here <input type="checkbox"/>		1		
2 Returns and allowances		2		
3 Subtract line 2 from line 1		3		
4 Cost of goods sold (from line 42 on page 2)		4		
5 Gross profit. Subtract line 4 from line 3		5		
6 Other income, including Federal and state gasoline or fuel tax credit or refund		6		
7 Gross income. Add lines 5 and 6		7		
Part II Expenses. Enter expenses for business use of your home only on line 30.				
8 Advertising		8		
9 Car and truck expenses (see instructions)		9		
10 Commissions and fees		10		
11 Contract labor (see instructions)		11		
12 Depletion		12		
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)		13 3,983.		
14 Employee benefit programs (other than on line 19)		14		
15 Insurance (other than health)		15		
16 Interest:		16		
a Mortgage (paid to banks, etc.)		16a		
b Other		16b		
17 Legal & professional services		17		
18 Office expense		18		
19 Pension and profit-sharing plans		19		
20 Rent or lease (see instructions):		20		
a Vehicles, machinery, and equipment		20a		
b Other business property		20b		
21 Repairs and maintenance		21		
22 Supplies (not included in Part III)		22 953.		
23 Taxes and licenses		23		
24 Travel, meals, and entertainment:		24		
a Travel		24a 1,855.		
b Meals and entertainment		2,654.		
c Enter nondeductible amount included on line 24b (see instrs.)		1,327.		
d Subtract line 24c from line 24b		24d 1,327.		
25 Utilities		25		
26 Wages (less employment credits)		26		
27 Other expenses (from line 48 on page 2)		27 10,612.		
28 Total expenses before expenses for business use of home. Add lines 8 through 27 in columns.		28 18,730.		
29 Tentative profit (loss). Subtract line 28 from line 7.		29 -18,730.		
30 Expenses for business use of your home. Attach Form 8829 .		30		
31 Net profit or (loss). Subtract line 30 from line 29.		31 -18,730.		
• If a profit, enter on Form 1040, line 12 , and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3.				
• If a loss, you must go to line 32.				
32 If you have a loss, check the box that describes your investment in this activity (see instructions).				
• If you checked 32a, enter the loss on Form 1040, line 12 , and also on Schedule SE, line 2 (statutory employees, see instructions). Estates and trusts, enter on Form 1041, line 3.				
• If you checked 32b, you must attach Form 6198 .				
32a <input checked="" type="checkbox"/> All investment is at risk.		32b <input type="checkbox"/> Some investment is not at risk.		
BAA For Paperwork Reduction Act Notice, see Form 1040 instructions.				
<small>FD/20112L 10/14/03</small>		<small>Schedule C (Form 1040) 2003</small>		

Figure 6.11a



Form 4797	Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2)) ▶ Attach to your tax return. ▶ See separate instructions.	OMB No. 1545-0184 <div style="border: 1px solid black; padding: 5px; display: inline-block;"> 2003 27 </div>						
Department of the Treasury Internal Revenue Service (99)								
Name(s) shown on return Joe Trader MTM Comm Loss Ex 10		Identifying number 111-11-1111						
1 Enter the gross proceeds from sales or exchanges reported to you for 2003 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) 1								
Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft — Most Property Held More Than 1 Year (See instructions.)								
2	(a) Description of property	(b) Date acquired (month, day, year)	(c) Date sold (month, day, year)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) for entire year. Subtract (f) from the sum of (c) and (e)	(h) Post-May 5, 2003, gain or (loss)* (see below)
3	Gain, if any, from Form 4684, line 39						3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37						4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824						5	
6	Gain, if any, from line 32, from other than casualty or theft						6	
7	Combine lines 2 through 6 in columns (g) and (h). Enter the gain or (loss) here and on the appropriate line as follows						7	
Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6, or Form 1120S, Schedule K, line 5. Skip lines 8, 9, 11, and 12 below.								
All others. If line 7, column (g) is zero or a loss, enter that amount on line 11 below and skip lines 8, 9, and 12. If line 7, column (g) is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain or (loss) in each column as a long-term capital gain or (loss) on Schedule D and skip lines 8, 9, 11, and 12 below.								
8	Nonrecaptured net section 1231 losses from prior years (see instructions)						8	
9	Subtract line 8 from line 7. If line 9, column (g) is zero or less, enter -0- in column (g). If line 9, column (g) is zero, enter the gain from line 7, column (g) on line 12 below. If line 9, column (g), is more than zero, enter the amount from line 8, column (g) on line 12 below and include the gain or (loss) in each column of line 9 as a long-term capital gain or (loss) on Schedule D (see instructions)						9	
<small>*Corporations (other than S corporations) should not complete column (h). Partnerships and S corporations must complete column (h). All others must complete column (h) only if line 7, column (g), is a gain and the amount, if any, on line 8, column (g), does not equal or exceed the gain on line 7, column (g). Include in column (h) all gains and losses from column (g) from sales, exchanges, or conversions (including installment payments received) after May 5, 2003. However, do not include gain attributable to unrecaptured section 1250 gain.</small>								
Part II Ordinary Gains and Losses								
10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):								
Transfer Form 6781 loss fr		Form 4797-Note (Trader Transaction)						
Various	Various			79,186.	-79,186.			
11	Loss, if any, from line 7, column (g)						11	
12	Gain, if any, from line 7, column (g), or amount from line 8, column (g), if applicable						12	
13	Gain, if any, from line 31						13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a						14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36						15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824						16	
17	Recapture of section 179 expense deduction for partners and S corporation shareholders for property dispositions from 2002-2003 fiscal year partnerships and S corporations (see instructions)						17	
18	Combine lines 10 through 17. Enter the gain or (loss) here and on the appropriate line as follows						18	-79,186.
a For all except individual returns. Enter the gain or (loss) from line 18 on the return being filed.								
b For individual returns:								
(1) If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from Form 4797, line 18b(1). See instructions.								
						18b(1)		
(2) Redetermine the gain or (loss) on line 18 excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14.								
						18b(2)	-79,186.	

BAA Form Paperwork Reduction Act Notice, see instructions.

F0121001L 12/02/03

Form 4797 (2003)

Figure 6.11 b



Form 1045: Joe is ready to consult with GTT about filing a Form 1045 NOL refund claim. We will show him exactly how to get a quick NOL refund without problems (and avoid the many pitfalls here). If you have a large NOL and a large refund coming, we suggest you engage a professional to prepare your tax return with Form 1045 carrybacks. We have done many of these returns with great success. We also have heard horror stories about people who tried this on their own or with another firm that was less than expert. (E-mail info@greencompany.com.)

Joe may elect to carry back his 2003 NOL two years, or he may elect to carry forward the NOL instead to future tax years up to twenty years.

Note: It does not matter whether Joe was a trader in any of the prior or future carryback or forward years. Starting in 2003, the NOL carryback period reverts to only two years (the law was temporarily changed to allow two or five year carry backs for 2001 and 2002 only).

Example 11

In example 11, without MTM IRC § 475, Joe is really hurt. He is stuck with a capital loss limitation of \$3,000 and a large capital loss carryover to 2004. Joe does benefit from having an NOL from his Schedule C business expenses, shown in Figure 6.11.

Note About Form 6781 Carrybacks: Joe may carry back his Form 6781 (Section 1256 contract) losses three tax years but only to be applied to Form 6781 gains in those prior three years. This topic is included in this tax guide. Our firm generally does not recommend IRC § 475 MTM accounting for commodity traders because they lose the 60/40 tax benefit and also they have a built-in carryback rule (only on Form 6781) any way. This Form 6781 carryback rule applies to business traders and investors (who don't have trader tax status), so it helps Joe in Example 12 as well.

Example 12

When Joe doesn't qualify for trader tax status, he is forced to file as a normal investor. Therefore, Joe may not report his trading business expenses on Schedule C. Instead, he must report these expenses as itemized deductions on Schedule A. Investment interest expenses are limited on Form 4952 and investment expenses are subject to "Miscellaneous Itemized Deduction" limitations.

Joe has negative taxable income, so his trading business expenses are entirely wasted for this year or any other year. Joe does have a carryover of his investment interest expense. See note in Example 11 about Form 6781 carrybacks. This rule applies to investors as well.

The Bottom Line: Trader tax status always saves a trader a meaningful amount of money. We don't recommend MTM IRC § 475 for successful commodities traders because they forgo the 60 percent long-term capital gains rate benefit (and if you have losses you can carry them back three years against Form 6781 gains only). However, if you have large commodities trading losses for 2004 as of April 15, 2004, and you might exit the commodities trading business, we suggest you do elect MTM for 2004. This election will allow you to convert your commodities trading losses to ordinary loss treatment. Otherwise, you will be stuck with a capital loss limitation of \$3,000.

Line-by-Line Guidance**Form 1040, page 2**

Where it says "Occupation," enter "Trader in Commodities" if you qualify for trader tax status.

Trading expenses

If you qualify for trader tax status, you should report all your trading expenses on Schedule C (Profit or Loss From Business).

Trading gains and losses

Commodity trading gains and losses are reported on Form 6781 (Gains and Losses from Section 1256 Contracts and Straddles).

If you elected IRC § 475(f)(2)—the MTM commonly used by securities traders—for commodities (or use it from the prior year), transfer your Form 6781 commodities trading gains and losses to Form 4797 (Sale of Business Property—Part II, Ordinary Gains and Losses).

Change of Accounting Method

If you elected IRC § 475(f)(2) mark-to-market accounting for 2003 by April 15, 2003, file a Form 3115 with your 2003 tax return. Notice a copy of your election is included in the following footnote.

Home office deductions

If you have an office in your home, file a Form 8829 (Expenses for Business Use of Your Home).

Footnotes

All trader tax returns should include a footnote to explain trader tax status and how you reported your trading business activity.

Schedule C

For purposes of this guidance, we refer to Joe Trader example 7.

If you qualify for trader tax status—meaning your trading activity for 2003 rose to the level of a business—then you should report all your trading business expenses on Schedule C.

Traders may deduct unlimited amounts of their trading business expenses on Schedule C; there are no restrictions. A qualifying trader may use Schedule C whether or not they elect mark-to-market accounting IRC § 475. Even if you did not learn about trader tax status until 2004, you can still file this Schedule C for 2003.

Always attach a footnote to your Schedule C to explain your trader tax status. (See our Footnotes section.)

Line A, Principle business

If you trade commodities with MTM IRC § 475, write “Trader in Commodities—Mark-to-Market accounting—See Note.” in line A.

Line B, Enter code

Trader in commodities without mark-to-market accounting: 523900 for “Other financial investment activities.”

Trader in commodities with mark-to-market accounting: 523130 for “Commodity contract dealers.”

Trader in commodities and securities with mark-to-market accounting: 523130 for “Commodity contract dealers.”

Lines C, D, and E, Business name, tax ID number, and address

Nothing is required on these lines. Some traders use an assumed name or a d/b/a (doing business as) name for their business. If that is the case, you can enter that name on line C.

Some traders file an SS-4 to get a tax ID number for their d/b/a. If that is the case, you can enter the EIN on line D. You will need a business EIN if you have employees.

If you have a separate address for your trading business, different from your home address, you can enter it here. **One note of caution:** It might be better to omit this address if you want to reduce chances of the IRS questioning your home office expense (if you have one).

Line F, Accounting method

Schedule C businesses by default use the cash method of accounting as opposed to the accrual method. Both methods are listed on line F, but “Other” is also listed.

If you use mark-to-market accounting for commodities, check “Other” and enter: IRC Sec 475(f)(2). 475(f)(1) is for securities and 475(f)(2) is for commodities. You can elect both or just one alone.

If you do not use mark-to-market accounting for commodities, check the cash method. If you want the accrual method for your business expenses, then check accrual method.

Line G, Material participation

Check the Yes box indicating that you did materially participate in your trading business. If you check No, then you don't qualify to use a trading business Schedule C.

Line H, Started business in 2003

Check the box if you started your trading business in 2003.

Part I, Income

No entries are made on lines 1 to 5, because you do not have revenues, inventory, or cost of goods sold in this trading business.

Line 6, Other income (loss)

Transfer income from Form 6781. See the Joe Trader example 7 Footnote section titled "SPECIAL NOTES." If the taxpayer has net trading gains, sufficient trading gains can be transferred from Form 6781 to Schedule C to cover taxpayer's related trading business expenses. This transfer is made because Schedule C business expenses relate to taxpayer's trading gains.

See the Joe Trader example 8 section discussion on the tax consequences or benefits caused by transferring income on Form 6781 to Schedule C. You stand to lose some lower long-term capital gain rate benefits, as a trade-off to unlocking home office and 179 depreciation benefits. Also, see this same section of the securities examples area of this book.

Part II, Expenses

Choose the cash or accrual method of accounting for business expenses. Don't confuse your expense method of accounting with your trading gains and loss method of accounting (cash or MTM). Here are some tax planning ideas that point out the advantage of accrual method accounting for expenses: Business traders accelerate expenses into 2003 for lower 2003 tax

liabilities. The cardinal rule of year-end tax planning is to accelerate business deductions and losses into the current tax year and defer income and gains into the following tax year.

Deferring income taxes until the following tax years benefits the taxpayer by allowing the use of this tax money during the current and following tax year. These benefits are referred to as *timing* rather than *permanent* tax benefits. As a default method of accounting, business traders use the cash method of accounting for both business expenses and trading gains and losses, making business expenses deductible when paid, as opposed to when incurred. For example, if a cash method business trader attends a seminar on December 28, 2003, but pays the bill on January 4, 2004, it is a 2004 business expense. A business trader may also elect to use the accrual method of accounting, which means that expenses are deductible when incurred (in 2003), not when paid (in 2004).

A business trader may also elect to use IRC § 475 mark-to-market accounting for trading gains and losses. This MTM election must be filed with the IRS by April 15 of the current tax year. Otherwise, the cash method of capital gains and losses applies for the entire tax year. (See the following chapter on tax planning moves related to trading gains and losses.)

Because trading gains and losses are treated separately from expenses and business traders don't have other forms of income, most business traders would be better served taxwise to use the accrual method of accounting for business expenses. However, this approach may be more trouble accounting-wise. For cash method business traders, the easiest way to accelerate deductions is to pay all bills early, before the end of the year. Remember that a prepayment of 2004 expenses will not give rise to a 2003 tax deduction.

Credit card charges are treated like payments of cash or check. It does not matter when you pay the credit card bill. For example, if you charge your credit card for a new computer on December 31, 2003, it is a 2003 tax deduction under the cash method. It does not matter that the computer is listed on your January credit card statement. If you plan to upgrade your computers, equipment, or furniture and fixtures soon, it's better to do it before year-end than early the next year. Each tax year, a business taxpayer

is allowed 100 percent (IRC § 179) depreciation up to the first \$100,000 of depreciable assets (\$102,000 for 2004). Excess amounts are subject to the normal rules of depreciation (over the useful life of the asset).

Line 8, Advertising

Most traders don't advertise because they don't have customers as dealers do.

Line 9, Bad debts

If you loaned money to another trader for business reasons, and he or she defaulted on paying it back, then you may deduct the entire business bad debt on line 9. However, you first need to bring legal action or threaten legal-type action against the debtor. Don't play around with this situation. Nonbusiness bad debts are deducted as capital losses on Schedule D. Proprietary traders may write off lost deposits (with proprietary trading loss) as business bad debts.

Line 10, Car expenses

Most traders don't use a car for business. The nature of trading online involves trading from an office at home. If you trade at home and also trade in a trading office outside the home (and qualify for a home office deduction), then traveling from your main home office to your other daytime trading office may qualify as a travel expense. Otherwise, if you don't have a home office, travel to and from that office is a nondeductible commuting expense. Anyway, we don't suggest entering this type of travel here (under Car), but rather we suggest entering it on line 24a, Travel expense.

Line 11, Commissions and fees

Trading commissions are not recorded here on Schedule C. Rather, all trading commissions are recorded as part of trading transactions on Form 6781. Commissions on purchases are added to your cost basis and commissions on sales are subtracted from proceeds. Your broker reports commissions in this manner on each confirmation and on your statements. Be careful in reading your year-end brokerage website reporting of net commissions. Some brokerage firms separate commissions from profit and loss

in their online reports. It is important that you ask your broker.

Caution: A few brokers report commissions separately from trading gains and losses on Form 1099. This practice is wrong, but needless to say you should not omit reporting both amounts. If you leave out commissions, then you will overstate your tax liability.

Some traders receive rebates of commissions. These amounts are usually not reflected on your confirmations, your statements, or Form 1099. Some traders do receive a Form 1099-Misc for commission rebates. Many traders don't realize that these amounts should be reported as additional commodity trading income on Form 6781. If the Form 1099 is a Form 1099-Misc, we suggest you first report it on Schedule C line 6 in Other Income and then transfer it to Form 6781. This way, the IRS has a trail. It is unusual for commodities traders to receive rebates, although stock traders do receive such rebates.

Line 13, Depreciation

Traders use plenty of computers, equipment and furniture, and fixtures. Enter these costs on Form 4562 and choose the correct depreciation method. Form 4562 depreciation amounts are then transferred to this line.

Some notes about depreciation: These costs are depreciable whether you buy the item in 2003 or in a prior year and then convert it to business use in 2003. Don't short-change yourself here. Make a list of every item of technology, equipment, and furniture in your home office and in your trading business.

Fixed assets are depreciated, expenses are expensed. When you purchase an asset, you need to make a decision about whether that asset is going to help you earn income in future years. If the answer is Yes, then it is called a "fixed asset" and you must depreciate it over its useful life. The IRS has schedules for different types of fixed assets and provides different methods for depreciating fixed assets over their designated useful lives. Computers and equipment are depreciated over five years and office furniture is seven years. Take note of bonus depreciation and accelerated methods allowed.

Section 179 Depreciation

Section 179 allows you to deduct 100 percent of your fixed asset cost up to \$100,000 for 2003 (\$102,000 for 2004) as a current expense for qualifying property purchased and placed in service during 2003. This property would otherwise have to be depreciated. You can only deduct section 179 depreciation if you have net income from wages and other business activities (let your tax software handle this calculation). If trading is your only business or job activity, then this requires that you be a profitable trader and that you follow our suggested strategy of transferring sufficient trading gains to Schedule C line 6 from Form 6781. If you have trading losses, and no income, then we suggest that you skip section 179 depreciation and take regular and bonus depreciation. This option would allow you to get some depreciation rather than none (carrying over your section 179 depreciation to the following tax year).

Form 4562 for your Schedule C

All depreciation is first entered on Form 4562. Section 179 depreciation is entered on the top of Part I, special bonus depreciation in Part II, and regular depreciation is entered in Part III. You should file a separate Form 4562 for each different business activity. You file one Form 4562 for your trading business Schedule C.

Software is an intangible asset and it is amortized on Form 4562, page 2, Part VI. The depreciation method is three years straight-line. Starting in 2003, software may now be included with section 179 depreciable property or be included with bonus depreciation.

Line 14, Employee benefit programs

If you have employees, you enter the amounts of payroll taxes and other employee benefits here. If you have employees, you need to file payroll tax returns and issue all employees Form W-2s. You also have to withhold and remit payroll taxes. See the IRS Publications for Employers.

Sole proprietors, unlike single member LLCs, are not allowed to pay themselves a W-2 salary and then set up a retirement plan on that earned income. Trading income is not “earned income,” and sole proprietors are

not entitled to contribute to retirement plans on this income. You need to form a separate business entity to pay yourself a fee or a salary in order to have a retirement plan.

Line 15, Insurance

Taxpayers without earned income, including business traders, may not deduct health insurance premiums from adjusted gross income. Other types of sole proprietors have earned income, and they can deduct health insurance premiums. This line 15 is for other types of insurance like business liability insurance, which few traders have. Home insurance is reported with other home office expenses on Form 8829.

Line 16b, Interest expense

If you have margin interest expense on your trading accounts, enter that amount here. Do not enter margin interest for investment positions or investment accounts; investment interest expenses go on Form 4952 and deductions are limited to investment income.

Line 17, Legal and professional fees

Legal fees for operations or business tax advice are deductible. Legal fees for asset acquisition are added to the cost basis of the asset. Legal fees for personal reasons are not deductible. Fees paid to your trader tax business preparer may be deducted here or on line 27, other expenses.

Line 18, Office expense

If you have an office in your home, don't use this line. Instead, use Form 8829 (Expenses for the business use of your home). **Note:** New IRS regulations further liberalize home office deductions by allowing taxpayers to protect more of their gain exclusion on sale of their principal residence, by not allocating the home office gain to the overall home gain (providing your office is in your home and not a separate structure). This rule is intended to help more taxpayers by not making them afraid to take this deduction and home depreciation in fear of losing their exclusion. The only recapture in many sales will be depreciation taken to date. That is not

a lost benefit, but rather a timing difference (you pick up income later for what you deduct now). Note that depreciation is “allowed” or “allowable,” which means you are treated by the IRS as taking this depreciation whether you did or not. So you may as well take it and receive the related tax benefits.

Line 19, Pension and profit-sharing plans

Traders do not have earned income, and as a result they may not contribute to pension or profit-sharing retirement plans. Traders can set up retirement plans by creating an entity for their trading and then paying themselves a salary or fee from that entity.

If your Schedule C business has employees and you have a retirement plan for them, you would use this line.

Exception: If a trader in commodities is registered with an exchange as a dealer, then their trading gains and losses (with or without IRC § 475(f)(2)) are subject to self-employment taxation. In that case, the trader can have a retirement plan contribution, but it would be reported in the adjusted gross income area, not on this line.

Line 20a, Rent or lease

Enter operating lease payments on trading equipment here.

Note: Some leases should be capitalized and then depreciated on Form 4562.

Line 20b, Other business property

If you have a trading office outside your home, enter any rent you pay for that office here.

Line 21, Repairs and maintenance

If you have repairs or maintenance on trading business equipment, or your trading home office assets, enter those expenses here. General home repairs and maintenance are reported on Form 8829.

Line 22, Supplies

Traders use a great deal of supplies. Enter those supplies expenses here. Remember, the home office form is for indirect home costs, not specific trading business expenses such as supplies.

Line 23, Taxes and licenses

Some traders also get security industry licenses. The cost of those can be deducted here. Some states or cities (such as New York City) charge stealth taxes on unincorporated businesses. In most cases, these taxes won't apply to Schedule Cs, because Schedule Cs for traders always show either zero net income or a large loss (if you don't transfer any gains; see the line 6 explanation). Furthermore, trading gains are usually not subject to NYC unincorporated business tax (UBT). For a regular NYC business, they would deduct their NYC UBT tax here. State and local income taxes, real estate taxes, and personal property taxes are itemized deductions reported on Schedule A. Real estate taxes may instead be reported on Form 8829, for better tax results.

Line 24a, Travel expenses

Many traders working from a home office do not have large travel expenses. Traders don't usually visit the companies they trade in. Online traders don't usually visit their brokerage firms, professional advisors, or others. Traders don't have clients to visit either. (See line 10, Car expenses, for deductions that can be taken here.)

Traders do travel for seminars, conferences, and meetings. The travel portion of these expenses can be taken as a travel expense or combined with seminar costs. Some traders travel with other traders for trading seminars or conferences. Even if you all go to a conference or seminar that winds up doubling as a ski trip, these expenses can be deductible if you follow the rules on travel business expenses closely:

- The actual costs of travel (e.g., plane fare, cab to airport, etc.) are deductible for out-of-town business trips. More significant than that, however, is the fact that you are also allowed to deduct the cost

of meals and lodging. Your meals are deductible even if they are personal (i.e., not connected with business), although as with all deductible meals, only 50 percent of the cost is deductible (55 percent for long-haul truckers, certain airline, train, and bus employees, and certain merchant mariners). Additionally, no deduction will be allowed for meals or lodging to the extent the expense is “lavish or extravagant.” Although this term is not defined in the tax rules, it has been interpreted to mean “unreasonable.”

- Personal entertainment costs on the trip aren’t deductible, but business-related costs such as dry cleaning, phone calls, and computer rentals are.
- Some allocations may be required if the trip is a combined business/pleasure trip. For example, if you fly to a location for five days of business meetings and stay on for an additional period of vacation, only the cost of meals, lodging, and so on, for the business days are deductible. Any expenses accrued on the personal vacation days are not deductible.
- On the other hand, if the trip is “primarily” business, the cost of the trip itself (i.e., plane or bus fare, etc.) can be deducted in its entirety. No allocation is required. Conversely, if the trip is primarily personal, none of the travel costs are deductible. An important factor in determining whether the trip is primarily business or personal is the amount of time spent on each, although this factor isn’t the sole consideration.
- If the trip doesn’t involve the actual conduct of business but is for the purpose of attending a convention, seminar, or similar event, you might be able to deduct it. The IRS checks the nature of these meetings carefully to make sure they are not vacations in disguise. Be careful to save all material that will be helpful in establishing the business or professional nature of this travel.
- The rules on deducting the costs for a spouse who accompanies you on a business trip are restrictive. No deduction is allowed unless the spouse is an employee of yours or your company and is also traveling for a business purpose.

Line 24b, Meals and entertainment

Many traders have meals with other traders to discuss their respective trading businesses. These traders seek advice and ideas for improvement, research, and strategies. In most cases, these meals qualify for a deduction.

Line 24c, Nondeductible amount

Fifty percent of meals and entertainment are not deductible, per IRS rules.

Line 25, Utilities

These expenses are usually included with indirect expenses allocated for the home office Form 8829. If you have a separate meter for your business usage, enter that amount here. Do not use this line for your phone and communications. Enter your communication costs on Part V where you list your Other Expenses.

Line 27, Other expenses, schedule C, page 2, Part V

Here is where you list all your other actual trading business product and service expenses. A partial list of these would include:

- Internet access providers used for business exclusively. If combined with personal use, then report them as indirect expenses on Form 8829 for your home office.
- Trading market information online services.
- Trading research products and services.
- Trading print publications and subscriptions.
- Trading gifts to other traders, brokers, and other business related persons (limited to \$25 per person per year).
- Trading communication services (phone, fax, dial-up).
- Trading accessories not depreciated (small items less than \$100).
- Training and seminars for trading after getting started in the business. Education, training, and seminars before you commence business operations (trader tax status) are either start-up costs (IRC § 195), investment expenses, or personal nondeductible expenses. See more guidance below.

- Trading chat room expenses.
- Trading tax and accounting fees. If you lack trader tax status, these expenses are reported as miscellaneous expenses on Schedule A (Itemized Deductions).
- Trading books.
- Trading miscellaneous expenses.
- Education expenses related to trading.

Education expenses is a tricky area as far as deductions go. If you incur education expenses to learn the trading business before you start trading, those expenses may not be deductible as education expenses. On the other hand, if you start your trading business and then take courses and seminars, you may deduct these expenses on your Schedule C. Here are the rules: A deduction is available if the education maintains or improves the skills related to your trade or business. Educational costs are also deductible if the education is required (e.g., by law or an employer) to keep your position or job.

Conversely, educational costs are not deductible if the education is required to get into a new field (as opposed to staying in the field) or qualifies you for a new trade or business.

Observation: Most traders are not required by anyone to take trading seminars or other education courses. A trader is his/her own employer (i.e., he or she is self-employed). Strictly speaking, a trader's educational costs (even those incurred before a trader actually begins trading) do not meet the spirit of the tax law for not allowing a deduction. In most cases, a trader takes these courses to "improve trading skills," not to qualify to enter the business. Take note that in the future, the SEC or CFTC may require day traders to qualify to enter the business, and they may require a minimum of educational courses. That requirement would change things here and perhaps disallow the current allowed deductions.

Line 28, Total expenses

Just total up all expenses.

Note: This amount is before your home office deduction on line 30.

Line 29, Tentative profit (loss)

See our transfer income strategies in line 6.

Line 30, Business use of the home

Form 8829 home office expenses are listed here to the extent you have net income; otherwise all except mortgage interest and real estate taxes remain a carryover to 2004 and are listed on Form 8829.

Line 31, Net profit (loss)

Just do the calculations on the form. In all cases, profitable traders should break even (because sufficient trading gains have been transferred from Form 6781 or Form 4797), and other traders should end up with a loss. You should never end up with a net income on Schedule C.

Line 32a

If you have a loss, check this box if “All your investment is at risk” in your trading business. Otherwise, leave blank.

Form 6781

Form 6781 is for entering commodity transactions or section 1256 contracts (also see IRS Publication 550 Glossary). The new section 1256 laws effectively applied mark-to-market accounting to all section 1256 contracts. It closed the loophole, because taxpayers had to mark all open gain positions to market at year-end, thereby doing away with deferring the gain side of the straddle transaction.

Section 1256 mark-to-market laws should not be confused with the mark-to-market (MTM) accounting tax law section 475(f): (1) for securities and (2) for commodities.

Congress and the IRS take away the concept of unrealized gains and losses (MTM makes them realized) and instead allowed gains and losses on section 1256 contracts to be treated as 60 percent long-term capital gains and losses (a lower tax rate) and 40 percent short-term capital gains

and losses. This treatment gives commodities traders a significant tax benefit versus securities traders.

Congress also realized that many commodities traders were operating businesses trading, so they require options. Congress also passed a special rule to treat their commodities trading gains as earned income for purposes of self-employment taxation and contributions for retirement plans (only for dealers registered on an exchange).

Trading Gains and Losses

If you elected IRC § 475(f)(2) MTM accounting for commodities (or use it from the prior year), transfer your Form 6781 commodities trading gains and losses to Form 4797 (Sale of Business Property—Part II Ordinary Gains and Losses).

Form 4797, Part II (Ordinary gains and losses)

Traders with MTM accounting (IRC 475(f)) report their trading gains and losses on Form 4797 Part II—Ordinary Gains and Losses. Form 4797 instruction excerpts:

Traders Who Made a Mark-to-Market Election

A trader in securities or commodities may elect under section 475(f) to use the mark-to-market method to account for securities or commodities held in connection with a trading business. Under this method of accounting, any security or commodity held at the end of the tax year is treated as sold (and reacquired) at its FMV on the last business day of that year.

Observation: Commodity trading is already subject to mark-to-market provisions in accordance with IRC § 1256 contract rules. For com-

modities traders, when you transfer your Form 6781 gains and losses to Form 4797, you are not changing any amounts, because the amounts are already marked to market; you are only changing the character of the income or loss. Form 6781 amounts are capital gain or loss (when they are transferred by the default method) on Schedule D (Capital Gains and Losses). By transferring Form 6781 to Form 4797, you convert your commodity trading gains and losses from capital gain or loss treatment to ordinary gain or loss treatment.

Unless you are a new taxpayer, the IRC § 475(f) election must be made by the due date (not including extensions) of the tax return for the year prior to the year for which the election becomes effective.

If you are a trader in securities or commodities with a mark-to-market election under section 475(f) in effect for the tax year, the following special rules apply:

- Gains and losses from all securities or commodities held in connection with your trading business (including those marked to market) are treated as ordinary income and losses, instead of capital gains and losses. As a result, the lower capital gain tax rates and the limitation on capital losses do not apply.
- The gain or loss from each security or commodity held in connection with your trading business (including those marked to market) is reported on Form 4797, line 10 (see the instructions for line 10 on page 4).
- The wash sale rule does not apply to securities or commodities held in connection with your trading business. (Wash sales don't apply to commodities anyway, because all unrealized gains and losses are treated as realized at year-end.)

For more details on the mark-to-market election and how to make it, see Pub. 550; Rev. Proc. 99-17, 1999-7 I.R.B. 52; and sections 475(e) and 475(f).

Form 4797 Instructions for line 10 on page 4.

Part II

If a transaction is not reportable in Part I or Part III and the property is not a capital asset reportable on Schedule D, report the transaction in Part II.

Line 10

Report other ordinary gains and losses, including gains and losses from property held one year or less, on this line.

Securities or commodities held by a trader who made a mark-to-market election

Report on line 10 all gains and losses from sales and dispositions of securities or commodities held in connection with your trading business, including gains and losses from marking to market securities and commodities held at the end of the tax year (see Traders Who Made a Mark-to-Market Election on page 2).

Attach to your tax return a statement, using the same format as line 10, showing the details of each transaction. Separately show and identify securities or commodities held and marked to market at the end of the year. On line 10, enter “Trader—see attached” in column (a) and the totals from the statement in columns (d), (f) and (g). Also, see the instructions for line 1 on page 3.

Observation: For the past twenty years we have followed a widely accepted practice of reporting one line item per brokerage account. All our example tax returns use this strategy on Form 4797 or Schedule D. In this case, it is only one line as follows: “Transfer commodity trading gains and losses from Form 6781—see Note.”

Form 4797 Instructions for line 1.

Line 1

Enter on line 1 the total gross proceeds from:

- Sales or exchanges of real estate reported to you for 2003 on Form(s) 1099-S (or substitute statement) that you are including on lines 2, 10, or 20.
- Sales of securities or commodities reported to you for 2003 on Forms 1099-B (or substitute statements) that you are including on line 10 because you are a trader with a mark-to-market election under section 475(f) in effect for the tax year. See *Traders Who Made a Mark-to-Market Election* on page 2 and the instructions for line 10 on page 4.

Form 3115 (Change of Accounting Method)

If you elected IRC § 475(f)(2) mark-to-market accounting for 2003 by April 15, 2003, file a Form 3115 with your 2003 tax return.

Unlike the Form 3115 for securities traders, the Form 3115 for commodities traders does not need a section 481 adjustment. Commodities are already marked to market in accordance with section 1256 contract law. Therefore, no amount is generated from this change of accounting method, which is what a section 481 adjustment is for. The Form 3115 already filled out by GTT in our companion guides can be used for all commodities traders, whether you have gains or losses. Simply add your name and address to page 1, top and bottom.

HOME OFFICE DEDUCTIONS FOR TRADERS

If you qualify as a trader and have a home office (most do), you can save lots of extra taxes each year by deducting a home office. Be careful, because the rules are complex.

Many traders work out of an office in their home, and they should know about the strict rules that govern whether they can deduct their home office expenses. In our firm's experience, the average trader saves more than \$6,000 per year from deducting their home office expenses.

Many active traders qualify as being in the trading business. For purposes of this discussion, when we mention "trader(s)," we refer to active

traders who qualify as being in the business of trading. Nonactive traders and investors are not allowed to take a home office tax deduction.

A home office tax deduction is especially valuable because you are not spending extra money to generate a deduction. Instead, you are converting personal expenses into tax deductions. The IRS liberalized the home office deduction rules for tax years 1999 and afterwards. It is easier to qualify, but you still must make sure you meet the specific requirements as set forth. You may deduct your home office expenses if you meet any of the following three tests:

1. *Separate Structure Test*: You are allowed a deduction for the costs of a separate, unattached structure on your property. To qualify, the separate structure must be used exclusively and on a regular basis in connection with your trading business.
2. *Office Used for Meeting Patients, Clients, or Customers Test*: This test is not applicable to most traders, because traders don't have clients or customers.
3. *Principal Place of Business Test*: This third test is the one that many online traders have the best chance of satisfying. If you use your home office, exclusively and on a regular basis, as your principal place of business, you meet this third test. Two subtests are used to determine whether your home office is your principal place of business: the management or administrative activities test, and the relative importance/time test. If your home office satisfies either of these two subtests, it will be treated as your principal place of business.

- *Management or administrative activities test*: Many traders use their home office to conduct administrative or management activities. These traders also must not have another fixed location where they conduct substantial administrative or management activities for their trading business. The IRS has been quoted as requiring the home office to be used exclusively and on a regular basis for a tax-

payer's business administration or management. If your trading home office is your only home office, then meeting this principal place of business test is easily satisfied. If you use two trading offices, one at a day trading firm and the second in your home, some questions arise. Consider this example. Most traders in a day trading office come to work just before the markets open for trading and they leave soon after the markets close. Many of these traders also regularly use a home office for managing and administering their trading businesses. They use their day trading office for trading during market hours, and they use their home office (early in the morning, at night, and on weekends) for managing and administering their trading business. A trading business requires several hours per day of management and administration including accounting for trading buy/sell transactions and trading business expenses; trading risk assessment; trading market research; trader tax and financial planning and preparation; and computer hardware/software set up and maintenance. A trader meeting the facts and circumstances of this example (two offices) qualifies to use the home office deduction because the trader meets the management and administration subtest (assuming the trader also uses his or her home office exclusively and regularly for the trading business).

- *Relative importance/time test:* Two factors determine a trader's principal place of business using this test. First is the relative importance of the trading activities performed at each of a trader's offices. Second is the amount of time a trader spends at each office. Notice that this test assumes a trader has an office outside home in addition to his or her home office. The IRS says that it will first apply the relative importance test by comparing the activities performed at home with those carried on in another office outside the home. For the example of a trader using a day trading firm

office during the day and a home office at night, we believe most traders will not meet this test. We believe that the relative importance of trading (buys and sells) is more important than management and administration. In the example of a trader with two offices, the trader met the management and administration test, so they do not need to meet the relative importance/time test. If a trader passes this relative importance test (they usually will not), then the time test is not necessary. If the trader is not sure about the relative importance test, then the time test is necessary.

Exclusive and Regular Use Requirements

A trader's home office must be used exclusively and on a regular basis in connection with their trading business. Exclusive means that traders must use their trading home office area only for their trading business. Traders cannot use their trading home office area for family living purposes, as a guest room, a TV room, a playroom for children, or for other nonbusiness purposes. A trader's home office area can simply consist of desks, chairs, TV(s) (for market information), computer(s), office equipment, file cabinet(s), a couch, and so on. This setting sounds like a home office library or family room, but it is not. If you do not meet the exclusive test, try to remove your personal usage from your trading home office area so you can meet this subtest. This requirement is not easy for traders living in expensive, big city apartments, like in New York City, where space is limited.

Regular use means that a trader must use a home office for his or her trading business on a continuous, ongoing, or recurring basis. Traders usually easily meet this test because they must spend many hours per day and every day in their trading business (to qualify for trader tax status in the first place). Most traders that use a day trading firm office also still spend several hours per day on management and administration activities in their home office.

Other tax benefits are connected to the home office deduction.

- *Travel expenses:* A trader with a home office may deduct travel expenses to (and from) a day trading firm office and other trading business destinations. Without a qualified home office, those travel expenses are treated as nondeductible commuting expenses.

Your home office expenses include the following:

- Direct expenses specifically traced to your trading home office, including painting, trading office build-ins, and repairs for your home office.
- Indirect expenses not specifically traced to your trading home office, including your general electric, oil and gas, water, sewer, lawn care, cleaning, insurance, and other home expenses including depreciation.

The home office tax form (Form 8829) prorate these general home expenses based on square footage of your home office versus your total home. Your mortgage interest expenses and real estate taxes are included in these allocated indirect expenses. The amount of mortgage interest and real estate taxes not allocated to your home office is then deducted as itemized deductions on Schedule A.

Limitations on Home Office Deductions

You may deduct your home office expenses up to the amount of your net trading business income. Therefore, if you have a net trading loss for the tax year, you will not be allowed a home office deduction. Instead, you will be allowed to carry forward your home office expense to the following tax year. If you have sufficient trading business income the following year, you will be able to utilize your entire carry forward amount.

Home office expenses are reported on IRS Form 8829 (Expenses for Business Use of Your Home). Form 8829 calculates the allocated indirect expenses plus the direct expenses. Your net home office expenses are then transferred to your trading business Schedule C. If you don't have sufficient Schedule C net income, then the excess home office expense amount is reported on Form 8829 in the carry forward section. **Important:** For Schedule C and home office expense tax reporting strategy, see the Line-by-Line Guidance of Schedule C about the transfer of income strategy to drive the home office deduction.

Transfer income from Form 4797, Schedule D or Form 6781

If taxpayer has net trading gains, sufficient trading gains are transferred from Form 4797 Part II (or from Schedule D if not MTM or from Form 6781 for commodities traders) to Schedule C to cover the taxpayer's related trading expenses. This approach is used because Schedule C business expenses relate to trading gains. No change to the tax liability occurs as a result of this transfer for securities traders. Commodities traders can lose some 60/40 tax benefits as a trade-off to unlocking home office deductions.

For securities traders, we recommend this transfer to reduce the chance of the IRS questioning your Schedule C losses. If you have trading losses, obviously you can't do this transfer. If your trading gains are less than your trading expenses, transfer all your trading gains.

Note: Transfer enough gains to cover your Schedule C expenses including home office and section 179 depreciation. These amounts are only deductible to the extent you have income.

Effect of Home Office Deductions on Later Sales of Your Principal Residence

New IRS regulations further liberalize home office deductions by allowing taxpayers to protect more of their gain exclusion on sale of their residence

by not allocating the home office gain to the overall home gain (providing your office is in your home and not a separate structure). This rule is intended to help more taxpayers by not making them afraid to take this deduction and home depreciation in fear of losing their exclusion. The only recapture in many sales will be depreciation taken to date. That is not a lost benefit, but rather a timing difference (you pick up income later for what you deduct now).

The Bottom Line: Most traders can qualify for a home office deduction by meeting the principal place of business test (subtests: management or administrative activities test, exclusive use test, and regular use test).

Under a 1997 law, homeowners who sell their homes can exclude as much as \$250,000 (or \$500,000 if you are married and filing jointly) of the gain from their federal taxable income.

To qualify for this full exclusion, you must have owned your home and lived in it as your primary residence for at least two of the five years before the sale. But if you used part of your home for business during the two-year ownership-and-use periods, the exclusion generally applied only to the gain attributable to the nonbusiness portion of your home. The new rule says homeowners don't have to allocate the gain between business and personal use, as long as the office was within their residence. However, as in the past, they still "must pay tax on the gain equal to the total depreciation they took after May 6, 1997," the IRS says.

Example: Suppose a lawyer bought a home in 1999 and sells it this year for a \$13,000 profit. The lawyer used part of the house as his law office. He claimed depreciation deductions of \$2,000 during those years. Under the new rules, the IRS says \$11,000 of the gain would be tax-free. Only the \$2,000 of the gain equal to the depreciation deductions would be taxable (at a maximum rate of 25 percent). Note that depreciation is "allowed" or "allowable," which means you are treated by the IRS as taking this depreciation whether you did or not. So you may as well take it and receive the related tax benefits.

This rule represents a big change from the old rules. The new regulations "can be applied retroactively," meaning that "taxpayers can go back and amend returns for any open years—typically within three years from

the time the return was filed,” and take advantage of the new rules. Some taxpayers still may decide not to claim the deduction because of fears it will trigger an IRS audit. Those fears probably are overblown, as long as you follow the rules carefully. Business traders, more than most taxpayers, really have a legitimate home office, and they should use this excellent tax deduction.