CHAPTER 7

Tax Planning for Traders

Wise taxpayers do tax planning before year-end. Traders have special circumstances that make year-end tax planning even more paramount. Certain moves can save you a fortune for next April 15.

YEAR-END TAX PLANNING STRATEGIES FOR TRADERS

Investors and active traders have tax-savings opportunities at year-end. Many investors sell losing positions toward the end of the year to lower their capital gains income and capital gains taxes (known as "tax loss selling").

Business traders with mark-to-market (MTM) accounting (IRC § 475) report unrealized gains and losses at year-end, so it's not necessary for them to exit their losing positions to gain tax savings. Traders have plenty of things they can do just before year-end to improve their tax situation, but it all depends on a trader's tax status.

Investors and active traders use the default cash method of accounting, which means they report realized gains and losses, and not open positions (unrealized gains and losses), at year-end. Cash method accounting also includes the dreaded wash sale and straddle loss deferral rules; certain realized losses are not allowed to be deducted on your current year's tax return; instead, they are carried over (deferred) to the following tax year, potentially raising your tax bill for the current year.

The most dreaded part of cash method accounting is the onerous excess capital loss limitation rules. Congress allows taxpayers to deduct a maximum loss of $3,000 per year, and the balance may be carried forward to future tax years (commodities and futures section 1256 contracts losses may also be carried *back* three tax years, although they can only be applied against section 1256 contract gains).

Many business traders elected MTM for securities only (because MTM is not beneficial for commodities) and thereby get around the less desirable aspects of cash method accounting. MTM business traders are exempt from the onerous wash sale and straddle loss deferral rules, and all losses are deductible as ordinary losses without any capital loss limitations. Many traders use the cash method for the current year and want to elect MTM in the following year, which raises further complications and requires other strategies.

Find Your Tax Status and Act Accordingly

Your first order of business in late November or early December is to determine what your tax status is for the current tax year. Did you rise to the level of business status (trader tax status) for the entire year, or a portion of the year? Will that portion of the year include the year-end?

Did you elect MTM IRC § 475 on time in the current tax year, or carry over that election from the prior tax year? Existing taxpayers must elect MTM by April 15 of the current tax year by attaching an election statement to their prior year tax return or extension. New taxpayers don't have a prior tax return, so they can elect internally (in their own books and records), within seventy-five days of inception.

Some taxpayers miss the MTM election filing and later realize they qualify as a de facto husband-wife general partnership because they have joint trading accounts and both worked as traders. Perhaps their de facto partnership made the necessary new taxpayer internal election with a verbal resolution. If you think you may qualify for a de facto partnership and need to use MTM accounting to deduct large losses in the current year, consult with a proven trader tax expert. Our firm handles many husband/wife trading partnerships.

If you elected MTM but don't qualify for trader tax status at year-end, you must use the cash method at year-end (and for any other portion of the year you did not qualify for trader tax status). If you are a business trader without MTM, you must use the cash method like any other investor. You can still take advantage of many business tax breaks, some of which require action before year-end.

Cash Method Accounting Trading Strategies to Lower Your Taxes at Year-end

If you are an active trader but don't qualify for business treatment (trader tax status)—or you do qualify but did not elect MTM IRC § 475—you must use the default cash method of accounting. Here are some tips for lowering your taxes at year-end:

- Manage your portfolio at year-end to defer unrealized capital gains and realize capital losses, which lowers your capital gains taxes.
- Hold investment securities positions for twelve months to avoid short-term capital gains (which are taxed at ordinary tax rates up to 35 percent) in order to benefit from long-term capital gains (which are capped at a 15 percent tax rate). The 2003 Tax Act lowered both rates, but it also widened the difference, making this strategy more beneficial than in prior years.
- Avoid wash sale and straddle loss deferrals by reentering similar, rather than identical, positions within thirty days. Sometimes wash sales are good; see below.
- Avoid purchasing mutual funds just after dividend declaration dates, which usually occur around the end of the year. Price often drops after dividends.

- Avoid capital loss carryovers. Don't exceed the $3,000 capital loss carryover. This carryover creates "tax baggage" for business traders.
- When planning for capital loss limitations and estimated taxes, anticipate mutual fund capital gain distributions.
- Avoid investment interest carryovers and investment expense limitations.
- Find out whether your hedge fund or investment company Form K-1s will report trading gains and losses using the cash or MTM methods of accounting (trader tax status and this accounting election is on the entity level).
- Consider allocating some of your taxable portfolio to tax-free investments and tax-free retirement accounts (with tax deductible or nondeductible contributions).
- Consider shifting income to other family members. Children younger than 14 are subject to the "kiddie tax" rules, which allow lower tax rates on the first $1,600 (for 2004) of unearned income (the excess is taxed at the parents' tax rates). Children 14 or older are exempt from the kiddie tax rules. Consider paying children wages to help in your trading business; you both are exempt from payroll taxes, and can benefit from the child's lower tax bracket rates. You can also set up fringe benefit plans for family members.
- Contribute appreciated securities to charity. You get a tax deductible contribution at the higher fair market value (FMV). You are exempt from capital gains taxes on the increase of FMV over purchase price. This approach is wiser than paying capital gains taxes and then contributing cash to the charity.
- Commodities and futures traders (with or without trader tax status) are automatically subject to another type of mark-to-market accounting, IRC section 1256. They report "economic" gains and losses and can't manage their income with some of the preceding strategies. Commodities losses can be carried back three tax years against commodities gains, so plan accordingly.
- If you are in low tax brackets in the current year and expect higher income and to be in high tax brackets the following year, you may want to reverse some of these strategies.

- Lower 2003 Tax Act rates apply for qualifying dividends and long-term capital gains.
- Arrange your investments to take advantage of the new lower tax rates on qualifying dividends, paid by domestic and qualifying foreign corporations. Pay careful attention to the detailed rules; most traders won't get these benefits, except on their segregated investment accounts.
- Dividends from money market funds, life insurance policies, real estate investment trusts (REITS, 90 percent portion), and some mutual funds do not qualify. Many mutual funds invest in bonds, currencies and other instruments that do not have qualifying corporate earnings and profit taxes.
- The holding period for qualifying dividends is 60 of 120 days beginning 60 days before the ex-dividend date, which will ruin this benefit for many traders (those who don't hold positions that long).
- The "effective date" for lower long-term capital gains rates is May 5, 2003.
- Shift investment income to children (with annual gift limits) to take advantage of the two lowest tax brackets (5 percent) on long-term capital gains.
- MTM traders can't manage trading gains and losses, but they have many other tax-saving opportunities, including net operating losses (NOL). Unlike traders who use the default cash method of accounting, MTM business traders (and all commodities and futures traders) report both realized and unrealized gains and losses at year-end.
- MTM business traders may not defer capital gains on trading positions, but can on segregated investment positions; segregated investments are not subjected to MTM.
- MTM business traders are not penalized with the onerous wash sale and straddle loss deferral rules and capital loss limitations; all realized and unrealized trading losses are deductible in the current tax year in full as ordinary losses (not capital losses).
- MTM business traders can have negative taxable income and carry back net operating losses (NOLs—the business portion of

trading expenses and trading losses) two tax years (or five years for 2001 and 2002 only).

- Carefully plan your NOLs in advance in order to receive immediate tax refund relief for prior years in which you have taxable income taxed at higher marginal rates. For example, if you have significant taxable income in 2001 but losses in 2002, try to increase your 2003 NOL so you can carry the NOL back to 2001. You won't be able to carry back a 2004 NOL for any benefit in 2002 and 2003 because you have losses in those carryback years. Instead, you can carry forward your 2004 NOL to 2005 and beyond (up to twenty years).
- Traders without MTM can still generate a NOL with their trading business expenses.
- MTM traders don't need to worry about tax loss selling. They can take profits early and not worry about trying to defer capital gains. They also don't have to worry about rushing to sell a losing position to lock in the tax loss; it is already locked in with MTM.

Switching to MTM from Cash Method Accounting Is Difficult If You Have Tax Baggage

Business traders may face complex issues when they consider switching to MTM from the default cash method (capital gains and losses). The most important issue concerns capital loss carryovers if you have any.

- Capital loss carryovers are the main culprit for putting traders out of business. Not being able to deduct your trading losses because of capital loss limitation and wash sale rules denies you the opportunity to get tax refunds from the IRS and your state to replenish your trading capital. It can accelerate your exit from a trading business.
- It's unwise not to obtain exemption from the capital loss limitation rules on securities if you are a business trader. What is nec-

essary is a little free education about how and when to elect MTM IRC § 475. You can't tell the IRS later on to allow you to use MTM. The IRS is strict about no late MTM elections.

- Many traders skip the MTM election when they start their trading business because they don't know about it, get the wrong advice, or make the wrong decision about it. The latter is certainly the case if they get stuck with capital loss carryovers.
- You can carry back MTM losses for immediate tax refunds to replenish your trading accounts rather than having carried-over capital losses suspended to future years. Many traders never cash in on those capital loss carryovers after having to exit a trading business. They simply have no or little money left to invest for capital gains, and the tax deductions are wasted.
- These non-MTM traders fall into the following tax trap, because you can't have it both ways. If you have trading gains in the following year, you want to keep the cash method to offset new trading capital gains with capital loss carryovers. If you have trading losses, you want to have MTM for ordinary loss treatment, as it's adding fuel to your fire to add to your capital loss carryovers.
- If you have large trading losses by April 15, the election deadline, it's probably safer to elect MTM to insure ordinary loss treatment. Conversely, if you have large trading gains, it may be okay to skip the MTM election and gamble on having net trading gains for the year (and using your capital loss carryovers). If you have small gains or losses, your MTM election decision is a gamble.
- Consider electing MTM on securities only (not commodities) and utilizing other ways to generate capital gains to use up your capital loss carryovers.
- Use up capital loss carryovers by trading commodities such as the E-Minis, which may be similar to securities products you trade. E-Minis and other commodities will not be subject to MTM IRC § 475 treatment (unless you also elect MTM IRC § 475 on commodities) and will instead generate capital gains and losses.

- Your first set of commodities gains will be tax-free because you will offset them with your capital loss carryovers. Afterwards, you will benefit from the lower tax rates on commodities: 60 percent is long-term capital gains (capped at a 15 percent tax rates) and 40 percent is short-term capital gains (which are taxed at up to 35 percent). Those rates translate to a maximum blended rate of 23 percent on commodities versus a maximum rate of 35 percent on short-term securities trading. Instead of trading the QQQ, an exchange-traded fund taxed as a security, trade the E-Mini, a similar market risk instrument taxed as a commodity.
- Traders have a large variety of new financial products to trade: ETFs, E-Minis, single-stock futures, plenty of new indexes, and options and futures on almost everything. Learn how all these new products are taxed—as securities or commodities—and consider that commodities have lower tax rates. This is covered in an earlier section of this book.
- Another way to use up capital loss carryovers is to segregate some securities as investment positions, not subject to MTM. For starters, until you use up your capital loss carryovers. their capital gains are tax-free. Afterwards, if you hold them for twelve months, the capital gains are taxed at the lower long-term capital gains rates. If you believe the markets are trending higher, this strategy may be timely.
- Limit capital losses and then convert some into wash sales for ordinary loss treatment with MTM next year. The higher your capital loss carryovers, the harder it is for you to make the switch to MTM. First, try to limit the amount of your capital loss carryovers.
- If you already reached the capital loss limitation, sell profitable positions and keep open losing positions. Hedge accordingly. Don't sell any additional losing positions. More losses won't benefit your current year's taxes, and they will make your MTM election in the following year a tougher decision to make.

- If you do sell losing positions that generate a capital loss carryover, consider reentering the position within thirty days to create a beneficial wash sale condition (in all other cases, wash sales are not beneficial). If you elect MTM in the following year, wash sale loss deferrals are better than capital loss carryovers because wash sales can be converted into ordinary losses (with an MTM election the following year), whereas capital loss carryovers may never be converted into ordinary losses (and remain as your tax baggage).

Pay Your Bills Early for Additional Tax Savings, Providing You Don't Trigger AMT Taxes and AGI Limitations

- Most taxpayers should consider paying more bills early before year-end to maximize current year tax deductions.
- Taxpayers and most sole proprietor business traders use the cash method of accounting rather than the accrual method of accounting. This treatment is different from the cash versus MTM methods of accounting. Those methods apply to trading gains and losses. Cash accounting is when bills are paid; accrual accounting is when expenses are incurred. Credit card purchases are cash items on the date purchased, not when the credit card bill is paid.
- Normal taxpayers and investors may want to consider "bunching" their itemized deductions into the current year and then taking a standard deduction in the following year. The point is to avoid coming up short on the standard deduction every year and wasting some itemized deductions such as charitable contributions.
- Again, watch out for that dreaded alternative minimum tax (AMT), because many itemized deductions are not deductible for AMT (including investment interest, all taxes, and miscellaneous itemized deductions).
- Calculate whether your adjusted gross income (AGI) will be significantly lower in the following tax year. Many itemized deductions and other tax breaks are limited by AGI levels. Medical expenses

are deductible in excess of 7.5 percent of your AGI. Miscellaneous itemized deductions, including nonreimbursed employee business expenses, job-hunting expenses, education expenses (except business traders), and investment expenses are only deductible in excess of 2 percent of AGI. Also beware of casualty losses.

- Business expenses are not added back for AMT tax calculations, so business traders should lower their AGI to unlock tax breaks. Business traders should accelerate expenses for two good reasons:

  (1) Additional business expenses lower your taxable income, which lowers your tax bill. If you have a net operating loss, additional expenses increase your NOL and related NOL tax refunds. The sooner the better when it comes to NOLs, because you can only go back two tax years.
  (2) A business trader should know about many special tax breaks that are based on lower AGI levels. These breaks are "phased out" at higher levels of AGI.

- A business trader's AGI can significantly fluctuate from year to year. One year their AGI may be high and most tax breaks are phased out. In other years, they have low AGI and their window opens to put in place many special tax breaks. For example, if your AGI is less than $100,000, you can convert a taxable retirement plan into a Roth IRA, which can convert "timing" tax-free buildup into "permanent" tax-free buildup (every trader's dream scenario). More details on this strategy follow.

Here are some other tax breaks limited to certain AGI levels: IRA contributions, Roth IRA conversions, education credits, Coverdell education savings accounts, interest on student loans, exemptions for children, earned income credit, real estate passive activity losses, and social security income exclusions, to name a few. Read about them and the phase-out amounts at www.irs.gov.

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Buy More Equipment Before Year-End

If you have trading gains in excess of your trading business expenses, accelerate fixed asset purchases before year-end to maximize IRC section 179 (100 percent) depreciation. IRC § 179 depreciation requires income; otherwise you must carry it over to the following year. Section 179 depreciation limits are $102,000 for 2004 (raised from $100,000 in 2003). If you don't have income, opt for accelerated bonus depreciation instead.

Deduct Health Insurance Premiums and Retirement Plans to Lower AGI

AGI deductions for sole proprietor businesses (Schedule C) include, but are not limited to, retirement plan deductions, health insurance premiums, and 50 percent of self-employment taxes. The problem for traders is that, unlike other sole proprietor businesses, they may not take these AGI deductions unless they create some earned income. Trading gains with or without MTM IRC § 475 are not earned income. Traders can form an entity for their trading business and have their entity pay them, as owner/manager, a fee.

This administration fee is reported on a Schedule C, which is earned income subject to self-employment taxes and which can drive a health insurance premium deduction and contribution to a tax-deductible retirement plan.

Alternatively, a trader can pay a spouse a fee for helping them administer the trading business, with the requirement that the spouse not be an owner of the trading business. A Schedule C owner may not pay himself or herself a fee or salary.

If the husband and wife are both owners, then they cannot file a Schedule C. Instead, they are a de facto general partnership and must file a partnership tax return. A guaranteed payment can then be declared in lieu of a fee to accomplish the same earned income result.

If you paid your spouse money during the year and he or she did help you in your trading business, you may be able to structure this arrangement all at year-end or early in the following year. Consult with a trader tax expert if you have further questions. It can be well worth it.

Paying fees to your children over age fourteen also lowers your AGI.

Establish Favorable Mini 401(k) Retirement Plans Before Year-End

Establish a Mini 401(k) retirement plan for you and/or your spouse before year-end with nominal funds. The balance of your tax deductible contribution can be calculated and paid after year-end.

All qualified retirement plans must be established before year-end, including 401(k) plans, Mini 401(k) plans, profit-sharing plans, and defined benefit plans. Qualified plans must be fully funded for annual contributions by the due date of your tax return, including extensions (up to October 15 of the following year).

IRA and Roth IRA plans must be established and contributions must be made by April 15 of the following year. SEP IRA plans, another type of profit-sharing plan for business owners, may be both established and funded up until the due date of your tax return, including extensions. If you miss the Mini 401(k) plan setup before year-end, use a SEP IRA instead.

Otherwise, Mini 401(k) plans are the most attractive for traders. You need fee income rather than trading income to fund a retirement plan. Therefore, owners/managers need a trading or investment entity such as a general partnership, LLC, or S-corporation to pay them a fee or salary before year-end.

Recent tax law changes increased the annual profit-sharing contribution limit from $40,000 for 2003 to $41,000 for 2004.

Make Use of Roth IRAs

Roth IRAs are especially attractive for traders. Their main tax features are permanent tax-free savings on portfolio income, and traders know how to maximize portfolio savings. Roth IRA contributions (limited to $3,000 per year) are not tax deductible, but the corresponding good news is that distributions in retirement are not taxable.

Traditional IRA contributions (limited to $3,000 per year) are tax deductible (up to certain AGI levels), but the corresponding bad news is that distributions in retirement are taxable at the higher ordinary income tax rates (up to 35 percent).

Roth IRAs provide for permanent tax savings on the portfolio income buildup, whereas traditional IRAs (and qualified retirement plans) only provide temporary tax savings. Traditional IRAs may not be attractive for traders.

It might be a better idea to buy and hold securities in taxable accounts for the long term—no tax is due until sale of the securities and lower long-term capital gains tax rates (up to 15 percent) apply.

A Note of Caution: If you operate a business (trading or otherwise) in a retirement account, the IRS may classify it as a prohibited transaction which makes you subject to penalties. See our earlier section on Trading Your Retirement Funds.

Note: All retirement plan contributions require earned income.

Get More from a Roth IRA Conversion

Roth IRAs are ideal for traders, but many traders can't accumulate a sizeable account with a small $3,000 nondeductible contribution per year, which you can make even if you have other retirement plans. As a better solution, you may convert an existing retirement plan into a Roth IRA. The one caveat is that you must pay all income taxes on the ordinary income portion of the conversion in the year of conversion. The requirement is that your modified AGI is less than $100,000 in the year of conversion, before the converted income is added in. The conversion rules are complex, so visit www.irs.gov to learn more. You may only convert from an IRA to a Roth IRA, so if you have a qualified retirement plan, do a rollover IRA direct transfer first. The IRS treats the Roth-converted amount as ordinary income (an early withdrawal), but you are exempt from the additional normal early withdrawal excise tax penalties of 10 percent. Not included in ordinary income are nondeductible contributions (and certain employer matched contributions in 401(k) plans).

If your existing retirement plans have been battered by the markets, it's an ideal time to consider this conversion. You will have lower conversion income taxed at ordinary rates and the recovery of these assets will be tax-free. So if you had a low income year in 2004, it can be worth your while to make this conversion. Rather than carry back a NOL, which can lead to questions from the IRS (which you don't want if you are a close call on trader tax status), do a Roth conversion to use up your losses. Don't just stop at zero taxable income, consider taking advantage of the lower tax brackets with some positive taxable income. You can stop wherever you like by only converting a portion of your retirement plans to the Roth IRA.

Use Fringe Benefits Plans and Flexible Spending Accounts

If you are interested in opportunities to convert more of your nondeductible family expenses into deductible business expenses, you should learn about fringe benefit plans. Most small businesses, including trading businesses, overlook fringe benefit plans; many larger companies rely on fringe benefit plans to attract and retain employees.

Fringe benefits, commonly known as "perks," include retirement plans; health, life, and disability insurance; education, dependent care, and adoption assistance; meals, lodging, and parking; and many other types of plans. Self-employed individuals (and pass-through entity owner/employees) who want to benefit from fringe benefit plans can do so if their spouses work for the business. By covering employees and spouses, they become entitled to benefits by virtue of being the spouse of an employee. Learn more in an earlier section on Fringe Benefit Plans.

Choose the Right Entity Early

You still may have time before year-end to choose the right entity for your trading business to provide the tax benefits you need (retirement plans, health insurance premiums, and fringe benefit plans among them) for the current tax year. If you want to use your entity for the following year, it's beneficial to form the entity just before year-end and to commence its operations on January 1 of the following year.

If you commence your business operations after the start of the tax year, you will have a more complex tax filing for the following year; with sole proprietor operations for the first part of the year and the entity operations for the balance of the tax year.

Traders prefer pass-through entities to avoid double taxation in a C-corporation; on both the entity level (up to a 35 percent tax rate) and again on the individual level (up to 15 percent, if there are qualifying dividends). Pass-through entities have single taxation on only the individual level (rates up to 35 percent).

Traders also prefer pass-through entities to utilize ordinary losses on their individual tax returns, which allows them to offset other types of income and to get NOL carryback tax refunds. Losses are often trapped in C-corporations for many years to come.

Plan Your Business Start-up, Suspension, and Exit Well

Many important tax-planning issues need to be considered when you start up your trading business, when you suspend it, and when you exit it. The key in all cases is to maximize your business expenses and to use MTM accounting during the period of business activity (not before or after it). Expenses paid outside the period of business activity may be start-up expenses, investment expenses (restricted and limited), or nondeductible expenses.

Trading losses outside the period of business activity may not utilize MTM accounting, meaning those capital losses will be subject to the capital loss limitation.

If the business activity stops before year-end, the trader must deal with the onerous wash sale and straddle loss deferral rules at year-end. Before year-end, if you believe you are falling short of qualification, try to increase your trading activity by trading tiny amounts or taking small risks. Commissions are low enough these days to make this strategy worthwhile.

If you know you are exiting your trading business, make sure to pay all your business expenses before you close your trading accounts (or slow the activity to a point you no longer qualify). If you use MTM, you can mark all open positions to market on the date of exit and start with that market value for cash accounting going forward. Play it safer and sell all open positions before you exit the trading business. However, most traders don't know they exited until after the fact.

If you exit your trading business and have an open section 481 adjustment, you will have to report the remaining deferred income in the year of exit (and it may trigger estimated taxes in the quarter you exit). It may pay to try to continue to qualify through year-end to defer a section 481 adjustment one more year.

If you stop trading for awhile but plan to resume soon, you are in a complex situation without much guidance from the IRS. It's wise to reelect MTM in the following year in case the IRS considers you to have exited and then reentered a trading business. You should consult with a proven trader tax expert.

Consider Start-up Expenses

In general, your costs for acquiring a capital asset, including the start of a business, are added to the cost basis of your asset and not deducted until the business is sold or closed.

With a special rule for start-up expenses (IRC § 195), you may amortize these expenses over not less than sixty months on a straight-line basis. Start-up expenses must meet three requirements: (1) expenses must be paid in connection with investigating the creation of your trading business (easy for traders); (2) they must be a normal expense of the business (also easy for traders); and (3) they must not be interest, taxes, or research and development, each of which has its own tax treatment.

Many traders spend considerable funds before entering a trading business. They attend seminars, educational programs, buy computers, and start using trading tools for mock trading. Later, when they see success from simulated trading, they open a brokerage account and start their actual trading activity. It's wise to open your trading account early and trade small sums with small risk before you pay for many business expenses. That avoids start-up expense complications and deferred deductions.

Pay Education Expenses After You Start Trading

Education expenses are only deductible as business expenses after you start your trading business. If you are already in a trading-related profession or business, such as a stock broker, then it's deductible for "maintaining and improving your job or business skills."

Education expenses may not be lumped in with start-up expenses. Investors can not deduct education expenses, even after trading (because they don't have business status). Education expenses for qualifying institutions (undergraduate or post-graduate school) can be utilized for education credits.

Trading schools are not qualifying institutions, but room for interpretation may allow you to aggressively consider trading schools as a way to investigate a trading business and then include these expenses as amortizable start-up expenses.

Make Timely Tax Payments to Avoid Penalties and Interest

Trading and investment income is subject to the estimated tax payment rules. This income is not part of an employee W-2; therefore no employer withheld your taxes. If you are late with estimated tax payments, consider asking your employer (if you have one) to withhold additional amounts from your paycheck at year-end. A tax loophole treats all W-2 tax withholding as being ratably done throughout the tax year.

Estimated tax payment rules call for paying your tax obligations on a quarterly basis. Read about these rules at www.irs.gov. Read about the "safe harbor" rules, which provide for paying a lower amount based on your prior year's taxes. In general, these rules work as follows: You may owe an underestimated tax penalty for the current year if the total of your withholding and estimated tax payments did not equal at least the smaller of 90 percent of your current year tax liability, or 100 percent of your prior year tax liability (the "safe harbor rule"). If your adjusted gross income (AGI) for the prior year was more than $150,000 ($75,000 if your filing status is married filing a separate return), substitute 110 percent for 100 percent.

Estimated tax payment rules are not a good match for trading businesses and provide headaches for many traders who face the following problem: They may have large trading gains in the first quarter only to lose some or all of it in the later quarters. If they pay Q1 estimated taxes, then they must wait until the following tax year to file their tax returns and get these refunds back. One could argue that if you lost money in the later quarters, it was safer to leave some capital with the IRS rather than in your trading account.

Some traders consider the underestimated nondeductible tax penalty of 5 percent per annum an attractive "margin loan" rate. The IRS changes the rate often, and the current rate is fairly low. Five percent is the published rate for April 16, 2004 through June 30, 2004. Even if you want to borrow from the IRS as long as possible (until April 15, the tax return due date) when you have to pay 90 percent of your taxes or be subject to additional penalties and interest), it's a good idea to pay some or all of your state taxes before year-end to maximize your itemized deductions for additional tax savings.

Note: State taxes are not deductible for alternative minimum tax (AMT), so you gain nothing from paying early if you don't get a tax benefit. Learn more about AMT taxes at www.irs.gov.

Get an Extension of Time to File, But Not to Pay

Trader tax law is complex, so if you aren't finished with your tax preparation on time (by April 15), don't panic, you are entitled to a six-month extension of time to file your actual tax return. This extension only applies to filing your actual tax return; it does not apply to paying what you owe in taxes.

The IRS and states want full payment of your taxes, based upon your best estimate, by the original due date of April 15. When you file after April 15, if you don't pay 90 percent or more of your actual tax liability with your timely extension, the IRS and most states treat the extension as invalid, rendering your returns late and subject to late filing and late payment penalties (5 percent per month up to five months for 25 percent total penalties). You are also subject to interest expense on all tax payments made after April 15, whether your extension is valid or not.

Example of Year-End Tax Planning for a Trader

Joe Trader converts unutilized unrealized capital losses from the current year into fully deductible ordinary losses in the following year. Joe Trader is a cash method (non-MTM) securities trader. On December 1 of the current tax year, Joe calculates current year-to-date net capital losses in the amount of $25,000. On the same day, Joe also calculates net unrealized trading losses on his open trading positions in the amount of $50,000. As a cash method trader, he is limited to a net capital loss deduction of $3,000 for the current tax year.

Joe plans to elect MTM for the following year, by April 15, so his following year securities trading gains and losses will be ordinary and not capital. Joe is happy to avoid the prospect of increasing his already unutilized capital loss carryovers.

Joe does not have a quality trade accounting program, and he is not certain of his wash sales and straddles. He figures he can skip this headache because he can't imagine that his deductible capital loss would end up being less than his capital loss limitation of $3,000.

Joe should know that a wash sale or straddle loss deferral may be better taxwise than a capital loss carryover, because he is electing MTM for the following year. In most cases, wash sale and straddle loss deferrals become part of a section 481(a) ordinary loss adjustment the following year. However, a capital loss carryover can never be recovered as an ordinary loss. Joe should calculate his proper wash sale and straddle loss deferrals to take advantage of this tax benefit. Our GTT TradeLog software program calcullates wash sales and 481(a) adjustments.

When thinking about his open positions in December, Joe figures his current year-to-date capital losses already far surpass the $3,000 capital loss limitation, so why take more capital losses before year-end? They won't help lower his current year tax liability.

Joe further figures that capital loss carryovers are harder to utilize in the following year because he will be generating ordinary rather than capital gains from trading with MTM, and he will have few segregated investment positions to generate capital gains.

The smart move for Joe in December is to not sell his open losing positions and instead try to hold them through year-end. If the market risk is too great, Joe can hedge the open positions with indexes. In this way, Joe will convert unutilized current year unrealized capital loss carryovers into a negative section 481(a) adjustment that is an ordinary loss in the following year.

Joe solved two prolems with one move. He lowered his capital loss carryover, and he also increased his ordinary tax loss in the following year.

Joe can be even more clever by selling open unrealized gain positions before year-end. That action will reduce his capital-loss carryover and increase his section 481(a) adjustments, respectively.

Note: If Joe had the reverse fact pattern and had net unrealized capital gains instead of unrealized capital losses, it would be imperative for Joe to sell all those unrealized capital gains before year-end to offset his $25,000 of realized capital losses to date.

The Bottom Line: The tax code is complex for all taxpayers. For traders it's even more complex, with the myriad of investment rules and complexities of trader tax status. To make things even more difficult, the tax code has different breaks for different income levels, and traders move quickly between these levels. How can a trader keep one eye on the markets and another on mastering the tax code? The answer is they can't, so they need a trader tax expert to help. A general checkup is most effective just before the end of the year.

CHAPTER SUMMARY

Taxes are never an easy thing, but the more you can do before the tax year is over, the more time and money you will save when April 15 rolls around. Divide your tax planning into pre- and post-April 15 responsibilities, and it will make your life easier.