Green's 2013 Trader Tax Guide

The Savvy Trader's Guide to 2012 Tax Preparation & 2013 Tax Planning

by Robert A. Green, CPA

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The savvy trader's guide to 2012
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About the Author

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About GreenTraderTax & GreenTraderFunds

We are a full-service company dedicated to the needs of all types of clients, successfully helping traders and investment managers since 1983 (celebrating our 30-year anniversary). The GreenTraderTax division is dedicated to the needs of traders. Green NFH, LLC, our CPA firm, provides tax compliance services, accounting, consultations, entity formations, retirement-plan services and IRS/state tax exam representation services. The GreenTraderFunds division is dedicated to the needs of investment managers. Green NFH, LLC focuses on providing assurance (audit and other attest services) and tax compliance services to funds, managers and traders.

Green & Company, Inc. offers extensive free educational resources for traders and investment managers on its Web site, including a blog covering the latest tax and regulatory topics, trader tax guides, Webinars, podcasts, videos, calculators and other resources. For more information or to participate in free Webinars, visit www.greencompany.com or call (888) 558-5257 or (646) 224-6923.

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Executive summary and what's new in this year's guide

Many traders and investment managers don't take advantage of all available tax breaks and they fall into common pitfalls costing thousands. Unfortunately, far too many accountants still don't know these breaks or the many nuances and pitfalls that accompany them.

For example, many tax professionals are unaware that broker-issued securities Form 1099-Bs are unreliable for cost-basis reporting on individual tax return Form 8949 due to many known problems with wash sale loss deferral reporting. Other tax professionals don't sufficiently know about trader tax status and the many tax breaks it offers.

After reading this guide, you should claim as many tax benefits as possible for tax-year 2012, file your 2013 tax-treatment elections on time and consider an entity and retirement plan to receive more tax breaks for 2013 and subsequent years.

> If brokers didn't get wash sale loss deferrals right for 2011, how can they carry over the correct cost-basis to 2012?

BUSINESS TRADERS ARE FAR BETTER OFF THAN INVESTORS IN THE TAX CODE

Business traders who qualify for trader tax status (TTS) are entitled to several tax breaks, whereas investors are not. By default, the IRS lumps all traders into "investor tax status," and investors get penalized in the tax code with restricted investment interest and investment expenses, capital-loss limitations ($3,000 per year), wash-sale loss deferrals, no retirement plans and more.

Investment expenses exclude home-office deductions, most education expenses and Section 195 startup expenses. Investment expenses must exceed 2% of adjusted growth income (AGI), and they aren't permitted as a deduction for alternative minimum taxes (AMTs).

MORE TAX REFORM IS IN THE WORKS FOR 2013

In the 2012 fiscal cliff agreement to extend the Bush-era tax rates, Congress restricted itemized deductions (Pease limitations) and exemptions (PEP) for the upper income starting in 2013. For these tax hikes, the threshold is AGI over $300,000 (married) and $250,000 (single). We cover these tax changes in Chapter 9.

As of late January 2013, Congress and the President are discussing tax reform. While Republicans are focusing on spending cuts and entitlement reforms, Democrats are insisting that tax increases be part of a "fair and balanced" approach. Congress and President Obama are talking about closing tax loopholes, restricting tax expenditures (such as itemized deductions) further and ending corporate welfare like special tax breaks for oil companies and offshore business.

President Obama campaigned on repealing the "carried interest" tax break for hedge fund and private equity fund managers. This repeal would significantly affect the hedge fund industry. Upper-income taxpayers engage investment managers, paying them material investment expenses. With carried interest, hedge fund investors agree to allocate 20% of their trading gains to the manager. If they are long-term capital gains, the manager benefits from the lower long-term capital gains rate. Carried-interest is not available on separately managed accounts, where the 20% is considered an incentive fee.

If Republicans must concede to some tax hikes, carried-interest could be on that list. Will House Republicans defend carried-interest tax breaks for the perceived ultra-rich and Wall Street? The potential combination of repealing carried interest and restricting investment expense deductions could drastically raise investment advisory fees on an after tax basis. Some investors might then consider alternative investments to hedge funds.

Trader tax status (business treatment) could be a savior for hedge funds. TTS tax breaks are at the core of small-business tax breaks, and President Obama favors small business — although not small hedge funds making millions. A hedge fund qualifying for trader tax status can pass through business expenses in connection with its management and incentive fees to its investors, so all investors get a full deduction from gross income for their fees.

There are many new ideas floating around on how to replace carried-interest tax breaks with other similar structures that will hold muster going forward.

QUALIFYING FOR TRADER TAX STATUS REMAINS CONFUSING

To qualify for trader tax status, business traders must first learn these mostly unpublicized rules, navigate around the vague, yet strict business-qualification requirements, and execute the strategies properly on their tax return (which also is somewhat difficult and often botched by untrained accountants). The burden is on you to get what you're entitled to. That may be unfair, but rules are rules — take them or leave them!

Don't confuse trader tax status with the related tax-treatment election of Section 475 mark-to-market (MTM) accounting, which converts capital gains and losses into business ordinary gains and losses. Only qualified business traders or dealers may use Section 475 MTM; investors may not.

A business trader can assess and claim use of trader tax status after year-end, even going back three open tax years. But business traders may only use Section 475 MTM if they filed a timely election, either by April 15 of the current year (i.e., April 15, 2012 for 2012), or within 75 days of inception of a new taxpayer (i.e., a new entity).

CAN YOU DEDUCT YOUR TRADING LOSSES FOR 2012?

Many traders bought this guide hoping to find a way to deduct their 2012 trading losses. Maybe they qualify for trader tax status, but that only gives them the right to deduct their trading business expenses.

Securities trading receives capital gain/loss treatment by default, and there is a $3,000 capital loss limitation against ordinary income. Yes, Section 475 MTM would have made those losses business ordinary losses, but you had to file the Section 475 MTM election on time. If you did not do this, you are stuck with capital loss treatment and your next problem is how to use up a capital loss carryover in the next year(s).

If you traded Section 1256 contracts, you may be in luck if you have Section 1256 gains in the prior three tax years. On top of Form 6781 (for reporting Section 1256 contracts), you can file a Section 1256 loss carryback election, but only to apply them on Form 6781 in the prior three tax years. Business traders may elect Section 475 MTM on Section 1256 contracts, but most elect it on securities only so they can retain the lower 60/40 tax rates on Section 1256 gains.

If you traded forex, you are probably in luck. By default, Section 988 receives ordinary gain or loss treatment, which means the capital loss limitation doesn't apply. But without trader tax status, the loss isn't a business loss and if you have negative taxable income, the negative part is wasted — it's not a business net operating loss (NOL) or capital loss carryover. Forex traders can file a contemporaneous "capital gains and losses" election to opt out of Section 988.

ADD A SCHEDULE C FOR TRADER TAX STATUS

If you realize you qualified for trader tax status in 2012 and you have material trading business expenses, you can add a Schedule C to your 2012 tax return. Even though you can't take an ordinary business deduction for your trading capital losses, deducting your trading expenses can be helpful to your tax savings. Plus, claiming TTS for 2012 can help in deducting 2012 wash sale losses as ordinary business losses in 2013 — with a 2013 Section 475 MTM and Section 481(a) adjustment from year-end 2012.

Some business traders are satisfied to operate as sole proprietors (with a Schedule C) because it appears less complicated than using a separately filed entity return, they can claim trader tax status after year-end and it appears to cost less than forming an entity. But Schedule Cs are increasingly drawing more IRS attention especially for business traders, because they have trading gains and losses reported on other tax forms. Federal and state tax exams are on the rise, especially for small-business taxpayers (including traders) and upper-income taxpayers.

We suggest using a Schedule C for 2012 (if you didn't have an entity) and forming a trading entity for 2013. A Schedule C works well for 2012 business expense treatment, but an entity works better and it also unlocks additional tax breaks like AGI deductions for retirement plans and health insurance premiums.

THE IRS COST-BASIS REPORTING SAGA CONTINUES

Accounting for trading gains and losses is the responsibility of securities traders; they must report each securities trade on a trade-by-trade basis on IRS Form 8949. This new form came about after the IRS beefed up compliance for securities brokers starting in 2011, causing traders, tax professionals and brokers headaches, confusion and additional tax preparation cost.

Broker-issued securities Form 1099-Bs provide lots of cost-basis reporting information, but they're not reliable for inputting into a taxpayer's tax return. The 1099-B leaves out many items. They don't account for trader tax status and tax treatment elections. Also, the IRS permits brokers to report wash sales on a more limited "identical position" basis, which means between the same stock symbols. Conversely, the IRS requires taxpayers to use "substantially identical positions" which means wash sales between the same stock and stock option symbols, even at different option expiration dates.

See Chapter 4 for more about these changes.

IRS IS WATCHING *ALL* 1099 REPORTING

The IRS is beefing up 1099 reporting across the board, not just for brokers. If you claim business treatment with TTS, Schedule C asks if you issued Form 1099-Misc. to the people or pass-through entities that worked for you as independent contractors or service vendors. The IRS has large penalties for not issuing 1099s on time. See our website for an article on preparing 1099s, and consider using a good online filing service like www.filetaxes.com. The IRS rules require distribution of the 2012 Form 1099-Misc to your payee by the end of January 2013; you must file the forms with a Form 1096 cover with the IRS by the end of February 2013. If you paid someone by credit card, you can omit that amount from the 2012 Form 1099. That can lead to confusion for both payer and payee.

OPTION TRADERS

Option traders generally don't day trade; rather they execute multi-leg positions. While many option traders may execute trades only a few days per week, they have a position on almost every day of the week. In last year's guide, we showed how the "continuous business activity" (CBA) standard can help traders who fall a little short on the required frequency of trades standard. We explained how CBA works and how you may be able to benefit from it.

We haven't seen any developments with the IRS on this standard since last year, and unfortunately CBA remains untested in tax court. We fall back on the CBA standard when traders have over 300 round-trip trades, but under our golden rule number of 500 round-trip trades. While option traders often have less frequency of trades, they usually have solid CBA. While trading monthly options may be a challenge for claiming trader tax status, in the past year we've noticed more clients trading weekly options, which is better for TTS.

FUTURES AND FOREX TRADERS HAVE IT EASIER

Futures traders, other section 1256 contract traders and forex traders have it much easier. Futures brokers report Section 1256 contracts in summary fashion, with mark-to-market accounting for realized and unrealized gains and losses, on a one-page 1099 that is simple to understand and use for tax compliance. Taxpayers can rely on a futures 1099 to report net "aggregate profit and loss" in summary fashion on Form 6781, Part I. See Chapter 4 for more details.

KEY TAX DIFFERENCES FOR VARIOUS TRADING INSTRUMENTS

There are complexities in sorting through different tax-treatment rules and tax rates. Section 1256 contracts have lower 60/40 tax rates, with 60% being a lower long-term capital gain even on day trades, and 40% being the short-term rate, which is the ordinary tax rate. At the maximum tax brackets for 2012, the top Section 1256 contract tax rate is 23%. In 2013, the top 60/40 rate will rise to 28%.

Section 1256 contracts include U.S. futures, options on futures, foreign futures with a CFTC and IRS letter, broad-based indexes, options on broad-based indexes, forward forex with the opt out election into Section 1256g and options on commodities/futures ETFs taxed as publicly traded partnerships (PTPs).

Active traders generally have short-term capital gains treatment on securities trades or ordinary gain or loss treatment with Section 475 MTM. Securities include: equities, stock options, narrow-based indexes and options on narrow-based indexes, ETFs, options on

ETFs taxed as Registered Investment Corps (RICs), bonds, mutual funds and single-stock futures.

Precious metals, including precious metal backed ETFs (organized as grantor trusts) are taxed with short-term and long-term capital gains, but the long-term "collectibles rate" of 28% applies for 2012 and 2013.

If you get stuck with a bushel of wheat, actual commodities receive ordinary gain or loss treatment.

Spot and forex forwards fall into Section 988 ordinary gain or loss. Forex traders may file a Section 988 opt-out "capital gains election" into short- and long-term capital gains or loss treatment. Forex forwards are permitted into Section 1256g, and we make a case to treat spot forex in a similar fashion subject to limitations and opinion. Gains on personal currency holdings are capital and losses are non-deductible.

More traders are gaining access to trading swaps and derivatives overall. Tax treatment is different, so we tackled the subject with new content in Chapter 3.

It's often hard to tell which financial instrument falls into which category. Plus, sometimes you can make an election to change tax treatment; sometimes it's conditional on having trader tax status, and other times not.

UPDATES ON SECTION 475 MTM ELECTIONS, FORM 3115 AND SUSPENDED TREATMENT

Since Congress changed the 1997 tax law to allow business traders to elect Section 475 MTM, GreenTraderTax helped thousands of business traders save a fortune in taxes by simply making this free election on time. We refer to Section 475 as free "tax loss" insurance. If you suffer a trading loss of $100,000, you can receive a full business loss deduction against any kind of income in the current year, or with a NOL two-year carryback or 20-year carry forward. Section 475 also exempts traders from wash sale reporting; trades are reported on Form 4797, rather than Schedule D where the $3,000 capital loss limitation applies against ordinary income.

The biggest problem with Section 475 is that most traders don't make the required election on time. Business traders may elect Section 475 MTM on securities only, retaining lower 60/40 tax rates on Section 1256 contracts. Plus, they can segregate their securities investment positions, so they can enjoy tax deferral and lower long-term capital gains rates on investment positions.

Existing taxpayer individuals and partnerships that qualify for TTS must file a 2013 Section 475 election statement with their 2012 tax return or extension filing by April 15, 2013. The next step is to "perfect" the Section 475 election statement by filing a 2013 Form 3115 (Change of Accounting Method) with the 2013 tax return, also on time.

In the past, if a taxpayer botched any part of the election process, the IRS could deny ordinary loss treatment on technical grounds. We learned some good news in the past year from the IRS office in charge of Form 3115 for Section 475 elections: They told us the IRS generally provides relief for late-filed Form 3115s for Section 475 elections, provided the taxpayers can demonstrate they filed their Section 475 MTM election statement on time. The Form 3115 must contain a signed perjury statement from the taxpayer stating that as well.

During this past year, we have had discussions with the IRS regarding Section 475 MTM elections for traders who never qualified for TTS or those who exit TTS with a current Section 475 MTM election. Here's one example: A new trader is not yet sure if he will qualify for trader tax status in 2012, but he must file the Section 475 MTM election by April 15, 2012. It's like applying to graduate school (Section 475) before you graduate from undergraduate school (TTS). If he never ends up qualifying for TTS in 2012, he may not use Section 475 MTM in 2012. In that case, his Section 475 MTM election is "null and void" and there's no need to perfect it, so he should skip filing a 2012 Form 3115. If the individual wants Section 475 for 2013, he needs to file another Section 475 MTM election statement by April 15, 2013.

Here's another example: Suppose an existing sole proprietor business trader elected and used Section 475 MTM in 2011. She stopped trading at year-end 2011. What should she do for her 2012 taxes? An IRS agent may advise her to file a second Form 3115 to change back to the cash method and that costs several thousand dollars, plus the IRS does not automatically grant the change. We suggest skipping that second Form 3115 and treat your Section 475 MTM election as "suspended." If you qualify for TTS later, you must resume use of Section 475 MTM at that time.

For these and other reasons, we suggest a new entity for your trading business. If you close the entity, Section 475 MTM ends. There's also no need for a Form 3115 when you open the entity and elect Section

475 MTM internally by resolution, as you adopt MTM rather than change your accounting.

BUSINESS TRADERS SHOULD USE A PASS-THROUGH ENTITY

We strongly recommend a trading entity to claim and use trader tax status related tax breaks. Business deductions save traders around $8,000 or more per year. A trading entity unlocks AGI deductions for retirement plans and health insurance premiums, saving traders $2,000 to $17,000 more. A trading entity disconnects wash sale loss treatment with your individual return and in your IRA.

A new entity provides more flexibility for electing, using and exiting from Section 475 MTM. If you have a big capital loss carryover to work your way out of, the entity gives you the flexibility to use up those capital losses with capital gains passed through from the entity. If you have a big new loss in the entity, you can elect Section 475 MTM ordinary loss treatment instead. Next, simply form a "do-over" entity with the capital gains treatment until you use up your carryover capital losses.

If you've been on the fence about forming a new trading entity, consult with us about it this year. Our entity formation service is low cost, fast and just what you need. We continue to recommend simple pass-through tax entities like LLCs, S-corporations and general partnerships for a husband and wife. The trading entity files a separate tax return and the summary of income, gain, loss and expense is passed on to the owner's individual tax return, where taxes are due or refunded.

Our tax attorney prefers an LLC over a general partnership (GP) for a husband and wife, as the IRS may respect that structure more for business treatment. Our many existing husband-wife GPs are fine, but we may want to consider an LLC for new clients if it's not costly in your home state.

Our tax attorney continues to stress that a single-member LLC should elect S-corporation status to file a separate tax return or admit a spouse for a partnership return, as the IRS may reject an internal Section 475 MTM election from a disregarded entity. If you remain a SMLLC, you need to file an external Section 475 MTM election, just like an individual.

Our administration fee strategy works well and we haven't heard about any issues with it.

Those impacted by the Obama-era tax hikes may want to consider a defined-contribution plan where they can deduct $200,000 from gross income.

RETIREMENT PLAN UPDATES

Retirement plans provide significant tax savings for traders in several different ways. Annual tax-deductible contributions to retirement plans generally save traders more in income taxes than they cost in self-employment (SE) or payroll taxes. A married couple can save up to $17,000 by establishing defined-contribution Individual 401(k) plans for each of them. An SE or payroll tax is charged on the declared earned income component only. (One exception: Members of a futures exchange are subject to SE taxes on their trades made on those exchanges.) This guide provides the math (Chapter 8) so you can see exactly how this tax savings strategy works. It's a very powerful savings tool and a good idea overall.

Upper-income traders and investment managers impacted by the Obama-era tax hikes may want to consider a defined-contribution plan where they can deduct $200,000 from gross income.

Traders can also actively trade a retirement plan, building up cumulative tax-free returns until retirement distributions are taken out. With a Roth IRA, those tax savings become permanently tax-free. Roth IRA conversions are a good idea. The income threshold rule was repealed starting with the 2010 tax year, opening the door to many other taxpayers. Now you don't need to wait until year-end to see if you qualify.

Avoid taking early withdrawals from regular retirement funds; this is often a mistake made by those looking to fund a trading business. Early withdrawals from retirement plans are subject to regular income taxes (at higher ordinary tax rates) plus a 10% excise tax. We show you how to tap these funds earlier than age 59½ in IRAs and age 55 in qualified plans by using loans from qualified plans. (You can't borrow funds from an IRA.)

Traders can use intermediary retirement firm administrators offering non-prototype retirement plans to facilitate alternative investments like hedge funds and rental real estate. Other traders may want to trade futures or forex in their retirement plans, but their brokers don't provide a retirement plan account for that type of trading. Some brokers allow an arrangement with an intermediary retirement administration firm to open a trust trading account owned by your retirement plan.

Several Web sites set up IRAs that own LLC trading accounts. We disagree with that practice and think there are grounds for it being a "prohibited transaction" subject to large penalties with the IRS. There are very limited ways for a retirement plan to own a trading business and it usually involves having employees. Consult with an expert on it before taking the plunge. (See Chapter 8 for more on retirement plans.)

FILING EXTENSIONS

This year's guide contains our tax strategies for traders filing extensions. Late-filing and late-payment penalties are confusing, so we lay out the rules and strategies to avoid those penalties as best you can. To avoid penalties, make sure you use "good faith" to estimate your tax liabilities. Run TradeLog well before the extension deadline. We also cover what to do if you can't afford to pay your taxes owed.

WILL TAX PLANNING BE EASIER IN 2013?

Planning your taxes well before year-end is important for traders. Whether it's pre-paying state income taxes for an additional tax deduction (without triggering AMT or the 2013 Pease limitation), accelerating other expenses and deferring income and therefore taxes, it's important to get a handle on trader tax status, your trade accounting and other tax matters.

We have new content about post-fiscal cliff tax planning for traders as a result of the tax agreement passed on Jan. 3, 2013. In The American Taxpayer Relief Act, Bush-era tax rates and breaks were permanently extended for taxpayers making under $300,000 (married) and $250,000 (single).

Starting in 2013, ordinary income tax rates were raised from 35% to 39.6% and qualifying dividend and long-term capital gains rates were raised from 15% to 20% on taxpayers with taxable income over $450,000 (married) and $400,000 (single). Itemized deductions were significantly limited (Pease limitations) and exemptions phased out (PEP limitations) on AGIs over $300,000 (married) and $250,000 (single). For large families in high-tax states, that's equivalent to raising the 33% rate to 38%.

To avoid these Obama-era income tax hikes on the upper income, we offer new ideas to shift income to c-corporations and family members.

> The ObamaCare 3.8% Medicare tax on unearned income starts in 2013 for AGIs over $250,000 (married) and $200,000 (single).

NEW MEDICARE TAX

The ObamaCare 3.8% Medicare tax on unearned income starts in 2013 for taxpayers with AGI over $250,000 (married) and $200,000 (single). We explain how these new rules work in detail, focusing on what affects traders and investment managers in particular. One key point is that the tax applies on net investment income, so traders can reduce it by deducting all their trading and investment expenses, including fees or salaries paid to them and their spouses for administration services.

While administration fees or salaries trigger 3.8% Medicare taxes on earned income, we offer strategies to avoid Medicare taxes on both earned and unearned income: Use an S-corporation to receive the administration fees first, then reduce the SE tax with reasonable compensation and pay a smaller fee to Schedule C for the AGI deductions (retirement plan and health insurance premiums). For more on the new Medicare tax, see Appendix C.

HOW TO DEDUCT LOSSES FROM BANKRUPT FUTURES BROKERS

We have several clients that got caught with losses in the sudden bankruptcies of futures brokers MF Global and PFG Best. Futures and forex brokers don't have government-backed FDIC and SIPIC insurance like banks and securities brokers, respectively. The Commodity Customer Coalition is helping traders with lost deposits and cited our content to its members. The IRS confirmed it, too. Business traders always fare better than investors when it comes to writing off lost deposits.

WORDS OF CAUTION

Many IRS agents still don't fully understand the nuances of their own complex and insufficiently defined rules for trading businesses. There is no bright line test. Don't let a tax exam (audit) spin out of control; seek to have it settled quickly, and get the IRS to accept your trader tax status before the exam gets too far along.

The IRS and state tax agents seem to be getting bolder and more aggressive, so it's wise to engage a trader tax expert CPA and/or tax attorney to help you from the first tax notice received. If you are a novice on taxes and don't have the right help, the IRS and your state may succeed in pushing you around.

Don't tell an agent trading is your hobby, as that will probably open the floodgates for a series of tough questions for denying hobby losses. It's important to let the agent know as soon as he or she broaches this topic that trading should not be considered a hobby loss under any circumstances.

The IRS and TTS: The IRS has been challenging trader tax status and Section 475 MTM ordinary loss treatment. A tax court case decided in August 2008 (*Holsinger vs. Commissioner*) raised issues related to qualifying for trader tax status based on the percentage of days traded, as well as other issues. See more on the Holsinger case in Chapter 11, including suggestions for improving trader tax status and IRS defenses.

A few trader tax court cases were decided in 2012, and we did not disagree with the court on most of these cases. The traders involved either tried to lie to the IRS or they were too aggressive when claiming trader tax status and related breaks. Trader tax status remains the lynchpin and you need to use good judgment in assessing it.

IRS notices and exams: Not taking care of your tax affairs can be costly. Filing a sloppy tax return with tax treatment or trade accounting errors, or reporting trades on Schedule C rather than the correct forms can initiate a painful tax exam.

We expect many 2012 Form 8949 preparation errors, sometimes attributable to error-prone 2012 Form 1099-Bs. This toxic combination may cause plenty of tax exams and IRS notices for 2012. We suggest that you first investigate 1099-B errors and differences and push your broker to correct its Form 1099-Bs. Make sure your broker files the corrections with the IRS because otherwise it doesn't do you much good. File an extension to leave yourself adequate time to receive corrections. We expect broker-corrected 1099-Bs to arrive throughout the summer months.

Once an exam starts, it can snowball into other issues. IRS agents often want to challenge TTS if the trader is not a full-time, extremely active trader. And the IRS agent can ask about TTS and other issues for the years before and after the tax year examined. Learn tips for dealing with the IRS in Chapter 10. Don't ignore tax reporting; the IRS will surely catch up with you.

Tax court: In the past, too many traders brought weak cases to tax court and have failed to defend themselves properly. Serving up easy wins in exams, appeals, private letter rulings and tax court encourages the IRS and states to further question business traders based on bad legal precedent. When trader tax status is too difficult to achieve, consider the alternative strategies discussed in Chapter 9. A recent report from the IRS Taxpayers Advocate indicated that taxpayers do far better in tax court with tax attorneys rather than alone. That's certainly been the case for traders, too.

If you are considering the last resort in tax court, we strongly recommend a consultation with our CPAs and tax attorney first. We can give you an honest and unemotional assessment of where you stand on TTS and your chances to win. Don't pay a tax attorney who is not very familiar with TTS. That can be an expensive mistake and loss of additional time and effort.

Watch out for bad tax advice: Over the years other service providers suggested traders could easily deduct pre-business education expenses. This advice is very wrong. We cover what's allowed and what's not in Chapter 5. Education is a material expense for traders and it's often incurred before a trader establishes trader tax status.

We provide a safer path to deductibility with Section 195 startup cost treatment for new business traders. Section 195 has a $5,000 first-year expense and straight-line amortization afterward over 15 years. You may be able to elect the accrual method of expense accounting to defer some education expense to your post-business-commencement period.

ALTERNATIVE STRATEGIES FOR CLOSE CALLS ON TTS

Trade actively in your retirement plan and deduct your Section 212 investment expenses and losses within the plan, rather than suffer investment expense restrictions on your taxable account. Usually an intermediary trust firm is required to allow direct payment or reimbursement of investment expenses on behalf of the retirement plan. Few brokerage firms allow this feature in their prototype plans, with the exception of their own brokerage firm advisory fees, which they do allow payment of inside the retirement plan. At least that shows you it's possible.

Trade Section 1256 contracts subject to lower Section 1256 60/40 tax rates, since that is not predicated on having TTS.

If you have AGI deductions through another business, job or through your spouse, then you don't need an entity or to push the envelope on TTS. Also, if your trading business expenses are not material, don't push the envelope on trader tax status. Keep in mind you can achieve business tax status as an investment manager, too. Trader tax status is not for everyone, but it's a pity to get stuck with a large wasted loss when you could otherwise have made the elections to have Section 475 MTM ordinary-loss treatment (with trader tax status as a prerequisite), generating full and often immediate federal and state income tax refunds.

PROPRIETARY TRADING

Proprietary trading vs. retail trading is covered in Chapter 12. The challenge for proprietary traders is deducting their business expenses, including home-office expenses. They're allowed to deduct these expenses even if they also trade from the firm's office.

LLC-member K-1 proprietary (prop) traders have difficulty with AGI deductions since their K-1s don't report any earned income, and it's hard to arrange that using a SMLLC S-corporation, as most firms only allow individual members. Independent contractor (IC) prop traders are issued a Form 1099-Misc for non-employee compensation. IC prop traders owe SE tax on their net income and AGI deductions are allowed since their compensation is earned income.

We also address how to handle education/prop trading firm hybrids and writing off education or deposits.

INVESTMENT MANAGEMENT

More traders are rising to the ranks of investment managers. Investment managers seek better tax treatment by using carried-interest tax breaks passed-through in their investment funds. They also reduce SE tax on management fees by using S-corporations. In recent years, Congress and the administration have threatened repeal of both of these breaks but so far, that hasn't happened. That may not last with tax reform and tax hikes in 2013. Learn more about investment management taxation in Chapter 13.

> Avoiding offshore compliance often leads to huge penalties.

TRADING IN FOREIGN MARKETS

Many traders living in the U.S. have offshore trading and bank accounts to trade on foreign exchanges. Some offshore brokers encourage traders to form foreign entities as a requirement to get access or to set up a foreign brokerage account. Look before you leap: Tax compliance for a foreign entity is significant and there are few to no tax advantages for traders.

Traders with foreign accounts need to learn about Foreign Bank Account Reporting (FBAR), Form 8938 (Statement of Specified Foreign Financial Assets), controlled foreign corporations (CFC), foreign disregarded entities, Passive Foreign Investment Companies (PFIC), tax treaties and more.

Chapter 14 touches upon these topics, along with the IRS's "come clean" program, the Foreign Account Tax Compliance Act and CFTC regulations.

FINANCIAL-TRANSACTION TAXES ARE A GROWING THREAT

Eleven countries in the EU including Germany, France, Italy and Spain passed a financial transaction tax (FTT) in their 11-country block. While Britain and Sweden lobbied against this FTT, they were unable to block it from proceeding toward implementation in 2014 or 2015. We call it the EU-11 FTT.

The EU-11 FTT may be like the recent French FTT, with controversial extra-territorial reach applied on global exchanges where foreigners execute trades with residents of the EU-11 zone (the "resident principal"). The new French FTT passed in late 2012 also applies on French ADRs trading on U.S. exchanges, no matter who makes the trades, a French resident or foreigner.

Some progressives in the U.S. like Rep. Peter DeFazio (D-OR), Rep. Keith Ellison (D-MN) and retiring Sen. Tom Harkin (D-IA) are calling for a FTT in the U.S. as well. To date, Democratic leaders President Barack Obama, Senate Leader Harry Reid and Minority Leader of the House Nancy Pelosi have not supported FTT proposals. Prior Treasury Secretary Timothy Geithner urged the EU not to pass FTT, and I hope President Obama's new Treasury Secretary (Jack Lew is nominated as of this writing) takes a similar position.

Stay abreast of important FTT updates on our www.TradersAdvocacy.org website.

CALL TO ACTION

Use *Green's 2013 Trader Tax Guide* to receive every trader tax break you're entitled to this tax season. Whether you self-prepare your tax returns using consumer tax preparation software, or engage a CPA firm or local tax storefront, this guide can help everyone through the process. Many of our tax preparation clients use this guide to take advantage of our offerings, as an educated consumer is the best customer. Others self-prepare and ask us to take a look at their tax returns.

Do whatever suits you best. If you have a complex Form 8949, large trading losses and really depend on TTS or use a trading entity, we suggest you consider our tax compliance (preparation) services.

Unfortunately, it may be too late for some tax breaks on your 2012 tax return if you wait until you're actually filing your taxes. If this is the case, then use this guide to execute these tax strategies — including forming an entity — and elections on time for tax-year 2013.

Throughout this guide we suggest consulting with a trader tax expert. That really means our CPA firm Green NFH LLC.

UPDATES

Several important tax changes are in various phases of development and negotiation in Congress and the administration. Check for updates in our guide login section at www.greencompany.com. Stay on our email list to receive guide announcements.

DESK REFERENCE

Some readers use our guides as a desk reference, to quickly find answers to specific questions in a given area. Others read this guide in its entirety. To accommodate desk-reference readers, we edit each chapter to stand alone, which inevitably means some chapters will have information covered in other chapters too.

LINKS

For your convenience, the blue areas are links to either a Web site or another section in the guide.

Chapter 1: Trader Tax Status

The first step to tax savings is qualifying for "trader tax status," which signifies business treatment of trading gains, losses and expenses as opposed to the default investment treatment.

Business treatment gives full ordinary-loss deductions, including home-office, education, start-up expenses, margin interest, and much more, whereas investment expenses are very limited, only allowed in excess of 2% of adjusted gross income (AGI), and not deductible against the nasty alternative minimum tax (AMT). Starting in 2013, investment expenses are further restricted with "Pease" itemized-deduction limitations for taxpayers with AGI over $300,000 (married) and $250,000 (single). Business expense treatment is much better.

The average trader saves more than $8,000 per tax year with trader tax status, and hedge funds also save taxes for their investors. You can claim trader tax status after year-end; it doesn't need to be elected in advance like Section 475 MTM (mark-to-market) and the forex election to opt out of Section 988. You can claim trader tax status for the tax year that just ended and even for the prior three tax years with amended returns by including a Schedule C as a sole proprietor. (Note: Filing amended tax returns may increase your odds of IRS questions or exam.)

Full-time active traders generally qualify for trader tax status quite easily. Part-time traders can also qualify, but it's more difficult. The bar is raised in the eyes of the IRS — especially if you have trading losses with business ordinary-loss treatment (Section 475) rather than capital-loss limitations.

QUALIFYING FOR TRADER TAX STATUS

Unfortunately, the IRS hasn't issued specific rules with objective criteria for how a trader qualifies for trader tax status (business treatment). This lack of guidance isn't unusual; the IRS doesn't provide objective tests for other types of businesses either. Business traders face more scrutiny from the IRS, similar to hobby-loss businesses. But hobby-loss rules can't be successfully applied against a trading business (more on this topic later). Arizona tried to apply hobby-loss rules to a trader and we blocked them from doing so.

Currently, there's no statutory law with objective tests for how to qualify for trader tax status. Subjective case law applies. Leading tax publishers have interpreted case law to show a two-part test to qualify for trader tax status:

- "Taxpayers' trading activity must be substantial, regular, frequent, and continuous.
- The taxpayer must seek to catch the swings in the daily market movements and profit from these short-term changes rather than profiting from long-term holding of investments."

IRS agents often refer to Chapter 4 in IRS publication 550, "Special Rules for Traders." Here's an excerpt: *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.*
- *The frequency and dollar amount of your trades during the year.*
- *The extent to which you pursue the activity to produce income for a livelihood*
- *The amount of time you devote to the activity.*

Case law is broad and subject to interpretation. Plus, a few recent tax court cases have set bad legal precedent (see Chapter 11). The words "substantial, regular, frequent, and continuous" are solid terms, yet case law doesn't give a bright-line test with exact numbers. The publication mentions holding period, frequency and dollar amount of trades, and time devoted. It also mentions intention to make a livelihood, an important element in defeating the hobby-loss rules. Trading is not personal or recreational in nature, which are the key terms used in hobby-loss case law.

We've made headway in establishing the importance of the "continuous business standard" vs. the frequency of trades. Plenty of traders meet the continuous business standard, but some fall short of the required frequency of trades. Over the past few years, more day traders have moved to swing trading and trading options, thereby reducing their frequency of trades and lengthening their holding period. There's new hope for these traders to retain or achieve trader tax status. Learn more about continuous business activity in Chapter 11.

GOLDEN RULES

Our golden rules for trader tax status qualification are based on years of experience. The trader:

Trades full time or part time, all day, every day. (Part-time and money-losing traders face more IRS scrutiny.)

Spends more than four hours per day, every market day working on his trading business. All time counts, including execution of trade orders, research, administration, accounting, education, travel, meetings, and more. Most active business traders spend more than 40 hours per week in their trading business. Part-time traders usually spend more than four hours per day. In one tax exam our firm handled, the IRS agent brought up "material participation" rules (Section 469), which require 500 hours of work per year. Most business traders easily surpass 500 hours of work. However Section 469 doesn't apply to trading businesses, under the "trading rule" exemption. Without this exception, taxpayers could generate passive-activity income by investing in hedge funds.

Has few to no sporadic lapses in the trading business during the year. The IRS has successfully denied trader tax status in several tax court cases by arguing the trader had too many sporadic lapses in trading, such as taking several months off during the year for no good reason. Traders can take vacations, sick time, and personal time off just like everyone else. Some traders take a break from active trading to recover from recent losses and learn new trading methods and markets. This should be carefully explained to the IRS in tax-return footnotes. We believe retooling and education during a sporadic lapse in trade executions still may count for the continuous business activity standard. Keep good records of your time spent.

Executes trades on more than 75% of available trading days. After the Holsinger tax-court case (see Chapter 11), it's wise to prevent an IRS challenge by trading close to 80% of available trading days (four of five available trading days per week for securities and futures) — even if you need to make smaller trades with reduced risk on otherwise non-trading days. It's generally not a good idea to have the tax tail wag the dog. Holsinger only traded on 45% of available trading days with less than 160 round-turn trades for the year. The IRS should also count working days during which no trades are executed, but now it doesn't.

Makes close to 500 round-turn trades per year. With our establishment of the continuous business activity standard, we think some traders can qualify even if their frequency of round-turn trades is in the 300 to 500 range, but check with us to be sure.

In Holsinger, the IRS cited a case where trader tax status was granted for 550 round-turn trades. Some cases have allowed trader tax status with a lower number of round-turn trades most likely because the other factors assessed were positive for trader tax status. Forex and futures trades aren't listed line by line on your tax return (unlike securities trades), so the IRS doesn't see those numbers. Report strong number of trades in your tax return footnotes about trader tax status.

If you are an options or futures trader, count the expiration as the round-turn part of a trade.

Has proceeds in the millions of dollars per year. We originally wrote this rule well before the 2008 market meltdown, when share prices were much higher, so adjust this rule accordingly. More traders are using options and futures, which have lower proceed values. Explain this well in footnotes since proceeds for futures, options, and forex are not reported on 1099s.

Makes mostly day trades or swing trades. Few positions are held for more than a few weeks. Properly segregated investment positions aren't included in the average holding period calculations. Segregated investment positions are also not subjected to MTM in Section 475 (if elected), which then allows for deferral at year-end and perhaps lower long-term capital gains tax rates if held 12 months. Options traders may have average holding periods of one month if they trade expiration dates. Note: Holsinger was an options trader and his holding periods averaged between one to two months. Options trading is growing in popularity and traders should use the continuous business activity arguments to buttress their frequency of trading numbers.

Some option-trading strategies call for bunching trade executions around monthly option expirations, often using spreads and multiple-legged positions. The IRS may view this type of strategy as too infrequent on the number of executed trading days vs. available trading days and reject trader tax status. Many people trade weekly rather than monthly options and weekly options are less of a concern. Count each leg of an option credit spread as a separate trade. Consult a trader tax expert.

Has the full intention to run a business and make a living. It's not a good idea to try to achieve trader tax status within a business entity already principally conducting a different type of business activity. Whenever you combine a business trading activity within another business entity, or on a complex individual tax return (with wages and other business income), the IRS tends to think trading is a secondary activity, and they may deny trader tax status. It's best to form a new, separate entity dedicated to trading only. (Entities are covered in Chapter 7.) Entities look better on trader tax status than a Schedule C sole proprietor trader.

Has significant business tools, education, business expenses and a home office. Most business traders have multiple monitors, computers, trading services, education expenses, high-speed broadband, wireless, many trading services and subscriptions and a home office and/or outside office. The IRS needs to see that you have a serious trading business. How can you run a business without an office? Casual investors rarely have as elaborate an office set up as business traders do. Why would a long-term investor need three monitors? If you use the office exclusively for business rather than personal use, don't skip a valid home-office deduction.

Has a material account size. Securities traders need to have $25,000 on deposit with their broker to achieve "pattern day trader" (PDT) status. With this status, they can day trade using up to 4:1 margin rather than 2:1. Without PDT status, traders will have a very hard time qualifying for trader tax status. A small $5,000 account size, which can be typical for forex and futures trading, won't impress the IRS — you probably need more capital to qualify. We like to see over $10,000 for futures or forex accounts. Adequate account size also depends on your overall net worth and cash flow. Millionaires may need larger account sizes, whereas some unemployed traders without much cash flow may get by with lower account sizes. Factor in equipment and start up costs too.

There are several questions open to debate as well. For example, how does the IRS treat automated trading, expert advisor programs, or trading forex very late at night?

> **What Doesn't Qualify?**
>
> There are three factors that automatically don't qualify for trader tax status:
>
> 1. Automated trading without much involvement by the trader.
> 2. Engaging a money manager.
> 3. Trading retirement funds.

WHAT DOESN'T QUALIFY?

Three factors don't qualify:

1. Automated trading without much involvement by the trader. These programs and services are becoming more popular. A fully canned automated trading service — sometimes referred to as an "expert adviser" program in the forex area — with little to no involvement by the trader doesn't help trader tax status; in fact, it can undermine it. The IRS may view this type of automated trading service as they view a trader who uses a stock broker to make most buy and sell decisions and executions. On the other hand, if the trader can show he's very involved with the automated trading program or service — perhaps by writing the code or algorithms, setting the entry and exit signals, and turning over only execution to the program — the IRS may not count the automated trading activity against the trader. The IRS may even give the trader credit for the higher volumes of trades (which the IRS will still discount somewhat). The automated trader needs to show he spends more than four hours per day working his trading business. If you spend less time, consider capitalizing your program development time and amortizing it on a daily basis to help meet the requirement. We have not yet seen the IRS challenge automated trading for trader tax status, but we feel it may react this way when this comes up.

When I consult traders and they mention hundreds of trades per day or week, and they also have a demanding full-time job, I ask if they use automated trading systems. If they only spend 30 minutes per day, I figure they don't qualify for trader tax status and fully rely on an outside-vendor automated system. This is a growing trend now that more expert adviser systems are available and brokers use them with investors — they are not business traders. Some try active trading and if it doesn't work out, they turn to these automated trading systems. Investors often rely on investment advice from these providers, but many times the broker and automated trading system provider each claim exemption from that responsibility — they are not registered investment advisers. Plus, their websites may show off incredible trading results that are not audited or put through proper vetting by regulators and accountants. Proceed with caution.

2. Engaging a money manager. Hiring a registered investment adviser or CTA to trade your account doesn't count toward qualification. However, hiring an employee to help you trade your own funds should qualify. This is a similar concept to the previous point. In this case, decades-old tax court cases show using outside brokers and investment advisers to make trading decisions clearly undermines trader tax status.

Proprietary trading firms engage independent contractor or LLC-member proprietary traders to trade the firm's capital. In this case, trader tax status is achieved on the firm level, not on the individual trader level. In most cases, prop traders can deduct their business expenses on their individual returns Schedule C for independent contractors and Schedule E for LLC K-1 members. (See Chapter 12 on proprietary trading.)

When you set up your own small LLC, there are nuances between engaging an outside manager vs. an inside trader. If the engaged trader is a registered investment adviser, he's clearly an outside manager, and trader tax status is not achievable. Conversely, if the engaged trader is not in the business of trading for others, and only trades inside your LLC under your active direction, you may be able to achieve trader tax status. Consult with a trader tax expert about this point.

3. Trading retirement funds. Trader tax status is achieved through trading taxable accounts. Trading activity in retirement accounts doesn't qualify, although it may demonstrate seriousness in trading to the IRS. Trading in retirement plans can be a good way to build tax-free compounded returns, especially if you don't qualify for trader tax status in your taxable accounts. In some cases, you can arrange to pay your Section 212 investment expenses from retirement funds (usually with an intermediary trust firm; more on this scenario in Chapter 8). Trading losses in a traditional retirement plan are fully deductible in the sense that when you take ordinary income withdrawals in retirement, there will be fewer funds to withdraw and generate income.

FALLING SHORT

If your trading activity falls short of these golden rules, the IRS may scrutinize your return and challenge your trader tax status. The IRS may examine you anyway — especially with Schedule C tax exams on the rise — but if you meet our golden rules, you have a good chance to win trader tax status with our help. It's wise to consult a trader tax expert to review your particular facts and circumstances. Again, filing an entity tax return is safer than filing a Schedule C as a sole proprietor, because an entity currently attracts less IRS attention. Contrary to what some promoters promise, an entity must qualify for trader tax status. Plus, on an entity return, trading income, losses and expenses are displayed, so a profitable trading business looks profitable. Conversely on an individual return, Schedule C always looks like a losing business since trading gains are reported on other tax forms like Schedule D. The IRS often does not make a connection between Schedule C expenses and Schedule D business-related capital gains and losses. This is a structural problem for sole proprietor traders and we have some solutions in Chapter 6. Our "transfer trading gain" solution is more challenging with the IRS form 8949, which handles the cost-basis reporting rules.

Part-time traders with full-time jobs (with wages reported on a W-2) should file a separate entity tax return to safely claim and use trader tax status. A stand-alone trading business looks better on the entity and on your individual tax return, too.

DON'T BE AFRAID TO CLAIM TRADER TAX STATUS

If you have significant trading gains, the IRS may not be inclined to challenge a reasonable level of business-expense deductions. Even if you have small trading losses, if business-trading expenses aren't very high, it's probably not worth it for the IRS to audit your tax return. On the other hand, if you file a large net operating loss (NOL) carryback tax return with large Section 475 MTM ordinary trading losses, the IRS or your state may ask questions before or after paying you a huge tax refund, often including interest. Be prepared to defend your trader tax status, as it's a requirement for Section 475 MTM ordinary loss treatment. Instead of filing a NOL carryback that may draw IRS attention, consider NOL carryforwards and/or soaking up ordinary trading losses with a Roth IRA conversion. A Roth conversion can utilize unused itemized deductions and the NOL, so you have no net tax bill or refund. Consider it a way to convert your IRA at very low cost. (There's more on Roth IRAs in Chapter 8.)

After filing approximately ten thousand tax returns for business traders since the online revolution in 1997, only a small number of our clients have been audited by the IRS, and we received excellent results on those cases. Our audit percentages are considerably less than the national averages. We attribute this successful record to proper analysis of trader tax status, our good tax reporting techniques, our accuracy and including detailed footnotes with trader tax returns. (Read about footnotes in Chapter 6.) This answers most IRS questions before they are raised.

However, the IRS has been challenging business traders more recently, so traders must be more careful with trader tax status determinations on their tax returns.

QUALIFYING CAN BE TRICKY

No single factor from our golden rules determines the outcome. However, the IRS focuses on the objective factors such as frequency of trades, including the number of round-turn trades, the number of actual trading days vs. available trading days, and the average holding periods on a consistent basis throughout the year. It's hard to prove hours per day and business intention, although you should do your best to document those factors, too. Some brokers save login sessions and traders should keep contemporaneous diaries. The biggest challenge is explaining how trader tax status fits in with your other jobs, businesses, and lifestyle on a daily basis. It's better if your trading hours don't conflict with your other business activity or job hours.

Golden Rules

To qualify for trader tax status, the trader must:

Trade full time or part time, all day, every day.

Spend more than four hours per day, almost every market day working on his trading business.

Have few to no sporadic lapses in the trading business during the year.

Execute trades on more than 75% of available trading days.

Make close to 500 round-turn trades per year.

Have proceeds in the millions of dollars per year.

Make mostly day trades or swing trades.

Have the full intention to run a business and make a living.

Have significant business tools, education, business expenses, and a home office.

Have a material account size.

CLOSE CALLS

Because the law remains unclear and open to interpretation, it's sometimes difficult to assess how the IRS might come down in terms of trader tax status. We expect more difficulties in the coming years, especially as government remains under financial distress with

IRS and state tax agents hungry to raise revenue in tax exams. Congress wants the IRS to close the tax gap in compliance.

Here are some profiles of business traders whose trader tax determination would be considered close calls. If you recognize yourself here, proceed carefully:

West Coast trader trades early in the morning and monitors positions at his regular day job. Many West Coast traders operate a trading business early in the morning before commuting to their day jobs. East Coast securities markets open at 6:30 a.m. PT, providing them with several hours of trading time during peak market activity. Many traders have browser-based trading platforms which they can easily access at their jobs, with or without employer approval, or they bring a laptop to work. These traders often spend considerable amounts of time at lunch, on breaks, in the evenings, and on weekends. Again, the IRS can challenge claims made about time and effort spent and business intention, so make sure your number of trades, trading days, and holding periods are strong and verifiable. Document your intention with a well-crafted business plan.

East Coast trader has a day job and trades forex at night. The forex interbank markets operate around many different time zones, so U.S.-based traders can trade for significant time periods outside of their weekday job hours. The IRS can question the number and purpose of late-night hours, so again, keep your verifiable numbers strong and maintain a serious account size.

Flex-time employees and individuals transitioning into a full-time trading business. Many professionals work flexible hours and are able to structure their day jobs around market hours. Some West Coast traders don't begin their day jobs until after the East Coast markets close. Many plan to leave their current jobs to become full-time traders. Our firm handles several physicians who transition out of medicine into full-time trading and they trade between patient appointments, surgeries, etc. We also handle several pilot/traders who trade on non-flying days, and have more trading days than flying days. Many business owners have reliable employees running their businesses and are able to focus most of their time on trading as a business.

Homemaker/parent wants to fit a home-based business into his or her multi-tasking activities. Many stay-at-home parents turn to trading to pursue their entrepreneurial dreams while taking care of the children and home. The IRS can be doubtful of the trader's sincerity here, so avoid sporadic lapses in executing trades and keep your trading business open for several years. Profitability helps, too.

Early retiree wants to enhance insufficient retirement assets, pursue a business dream, and stay mentally active. Many people are offered early retirement or are laid off due to downsizing before they want or need to retire. Some of these people decide to pursue a trading business. Holsinger was challenged as a retiree with just 160 round-turn trades. It's important that these traders meet our golden rules as the IRS can be more skeptical here.

An unemployed person's last resort or first dream may be a trading business. While waiting for the economy to turn around before finding another job, many out-of-work individuals are attracted to the ease and opportunity of a trading business. Most people already have the key necessities — a computer and broadband — in place. There's no need to obtain an office lease, hire employees, get a professional license, and attract customers. But you can also lose money very fast. It's best to attain a trading education first.

Trader tax status does not conflict with state unemployment benefits, as states consider trading an investment activity rather than a job. A trader can continue to collect extended unemployment benefits while operating a trading activity. In most states, traders can also form a trading entity without jeopardizing those benefits, either. However, we advised against taking an administration fee from the trading entity. A fee seems like a conflict. In that case, the unemployed trader could trade in an entity all year long and wait for unemployment benefits to expire before year-end. He or she could take the fee just before year-end, which still allows the AGI deduction for the entire year. It's a good idea to check with your state or unemployment benefits/disability benefits provider. Unemployment-benefit rules could change at any time, so stay in touch with our content.

The job markets are recovering and some traders are finding new jobs and giving up trading, after experiencing losses or low profitability. A short time period in a trading business can negate trader tax status in the eyes of the IRS. In *Chen vs. Commissioner* — another landmark tax court case denying trader tax status — Chen only traded for three months before losing his trading money, thereby exiting his trading activity. Chen kept his job during his three months of trading, so his case is different from the unemployed trader. But this case indicates the IRS wants to see a longer time period in order to establish trader tax status. Some IRS agents like to intimidate taxpayers with a full year requirement, but that's not required by law. Hundreds of thousands of businesses start and fail within three months and they aren't challenged on business status. The IRS is rightfully more skeptical of traders vs. investors. The longer you can continue your business trading activity, the better your chances are with the IRS. We often ask clients about their trading activities in the subsequent year as we prepare their tax returns for the year that just ended. Strong subsequent-year trading activities and trading gains add creditability to the tax return being filed. We mention these points in footnotes, too. So, you can start your trading business in Q4 and continue it into the subsequent year.

BOTTOM LINE

Trader tax status drives many key business tax breaks like business expenses, business ordinary trading losses with the Section 475 election and AGI deductions for retirement plans and health-insurance premiums. These items are deducted from gross income without restriction, whereas investment expenses are subject to itemized deductions and AMT preferences, and there are capital-loss limitations and wash-sale loss deferrals to contend with as investors. Unfortunately, only a small fraction of active traders qualify for trader tax status, and the rules are vague and difficult to understand. If you're not sure, consult a trader tax expert.

Chapter 2: Section 475 MTM Accounting

Deducting Trading Losses with Section 475, Section 1256 or Section 988

The biggest problem for investors and traders occurs when they are unable to deduct trading losses on tax returns, significantly increasing tax bills or missing opportunities for tax refunds. Investors are stuck with this problem, but business traders can avoid it by filing timely elections for ordinary tax-loss treatment: Section 475 mark-to-market (MTM) for securities and Section 1256 contracts if elected. Section 1256 contracts include futures, broad-based indexes, options on futures, options on broad-based indexes and several other instruments (covered in Chapter 3).

Forex receives ordinary (non-business) loss treatment by default with Section 988; these traders can elect capital-gains treatment for forex on a contemporaneous basis.

By default, securities and Section 1256 investors are stuck with capital-loss treatment, meaning they're limited to a $3,000 net capital loss against ordinary income. Capital losses first offset capital gains in full without restriction. After the $3,000 loss limitation against other income of any kind is applied, the rest is carried over to the following tax years. Many traders wind up with little money to trade and unused capital losses. It can take a lifetime to use up their capital loss carryovers. What an unfortunate waste! Why not get a tax refund right away?

Business traders have the option to elect Section 475 MTM accounting with ordinary gain or business loss treatment in a timely fashion. When traders have negative taxable income generated from business losses, Section 475 accounting turns the losses into unrestricted and unlimited ordinary business losses and net operating losses (NOLs). Caution: Individual business traders who miss the Section 475 MTM election date (April 15, 2013 for 2013) can't claim business ordinary-loss treatment for 2013. They will be stuck with capital-loss carryovers and wash sale loss deferral rules will apply at year-end. A new entity set up after April 15, 2013 can deliver Section 475 MTM for the rest of 2013 if the entity files an internal Section 475 MTM election within 75 days of entity inception. That breaks the chain and stops wash sales in the individual trading account. (See Chapter 9.)

Ordinary trading losses can offset all types of income (wages, portfolio income, capital gains, passive income, etc.) for you and your spouse on a joint filing, whereas capital losses may only offset capital gains. Plus, business expenses and business ordinary trading losses comprise a NOL. Taxpayers can carry back NOLs two tax years and/or forward 20 tax years. It doesn't matter if you are a trader or not in a carryback or carryforward year. Business ordinary trading loss treatment is the biggest contributor to tax refunds.

You need to qualify for trader tax status in order to use this Section 475 election. There are many nuances and misconceptions about Section 475 MTM, and it's important to learn the rules. For example, you're entitled to segregate investment positions that aren't subject to MTM treatment at year-end, meaning you can defer unrealized gains. You can have the best of both worlds — ordinary tax-losses on business trading and deferral with lower long-term capital gains tax rates on segregated investment positions. The IRS doesn't permit Section 475 MTM ordinary loss treatment on investment positions, whether they are segregated or not. Far too many accountants and traders confuse trader tax status and Section 475; they are two different things, yet very connected. Confusion leads to missed elections, overpayment of taxes and missed opportunities for significant refunds. Consult with a trader tax expert.

RESTRICTED CAPITAL LOSSES VS. UNRESTRICTED ORDINARY BUSINESS LOSSES

Securities business traders may elect Section 475 MTM on time to convert current year restricted capital losses into unrestricted ordinary losses. Past year capital losses and carryovers can not be redetermined with this current-year election. Section 1256 contract traders are usually better off retaining the default lower 60/40 tax rates. Learn more later in this chapter. There are many nuances to these tax code sections, and you need to adhere to the deadlines to get these breaks.

SECTION 475 MTM ACCOUNTING IS TAX-LOSS INSURANCE

Section 475 MTM allows current-year (otherwise restricted) capital losses ($3,000 cumulative net limit per year) to be treated as unlimited ordinary business losses, which generates significant tax breaks immediately, rather than being stuck with large capital-loss carryovers to subsequent tax years. Section 475 MTM also reports year-end unrealized gains and losses. You must impute sales for all open trading business positions at year-end using year-end prices. This is where the term "mark-to-market" comes from. Many traders have no open business positions at year-end, anyway. You're reporting realized and unrealized gains and losses, similar to Section 1256 which has MTM built in by default.

> Using up capital-loss carryovers is a challenge for many traders. Proper Section 475 MTM election planning and entities are the answer.

CAPITAL-LOSS CARRYOVER MISCONCEPTIONS

Many traders mistakenly think they can only utilize $3,000 of capital loss carryovers each year going forward, so they worry it can take a lifetime to use up these losses. They don't realize they can also offset capital losses without limitation against subsequent year capital gains, which means if they make money trading — remaining in capital gains treatment rather than electing Section 475 MTM treatment — they can use these losses. The $3,000 limitation is against non-capital gains income, not capital gains. Unfortunately, for traders who have run out of capital to trade, it can take a long time to use up capital-loss carryovers.

Here's an example. If your capital loss carryover is $50,000, and your subsequent year capital gains are $60,000, you can apply the $50,000 capital-loss carryover in full; your net capital gain would be $10,000. Conversely, if the subsequent year capital gain is $35,000, the net capital loss before limitation would be $15,000. Up to $3,000 is allowed against other income and the remaining capital-loss carryover to the following year would be $12,000.

Some traders mistakenly think individually generated capital loss carryovers incurred before trading in new pass-through trading entities are going to be lost. This isn't the case; capital gains are passed through from the entity to individual tax returns (Schedule D), where they are offset by individual capital-loss carryovers.

Using up capital-loss carryovers is a challenge for many traders. Proper Section 475 MTM election planning and entities are the answer.

SECTION 475 MTM IS GOOD FOR SECURITIES TRADERS ...

Securities business traders should usually elect Section 475 MTM, unless they already have significant capital-loss carryovers. You can't offset MTM ordinary trading gains with capital-loss carryovers; only non-MTM capital gains (such as gains from segregated investment positions or Section 1256 contracts) can be used in such a manner. On the other hand, if a trader generates large new trading losses before April 15, 2013, he or she might prefer to elect Section 475 MTM for 2013 to have business ordinary-loss treatment rather than adding to unused capital-loss carryovers. That trader can form a new entity afterward to use capital gains treatment, so he can get back on track with using up capital loss carryovers. Short-term capital gains are taxed like ordinary income. But short-term capital losses are limited, whereas Section 475 MTM ordinary trading losses are unlimited. Hence, Section 475 MTM is free tax-loss insurance for securities traders.

... BUT IT'S NOT ALWAYS GOOD FOR HEDGE FUNDS ...

Many hedge-fund managers find it too restrictive to deal with the segregation of investment rules within Section 475 and skip the MTM election entirely. These managers have trouble determining business positions vs. segregated investment positions on the day they purchase a security, which is required for segregating investments. Many seek to defer capital gains at year-end to save their investors a tax bill, to avoid investor redemption requests to pay related taxes and to seek lower long-term capital gains tax rates. Running afoul of the segregation rules can drag long-term positions into Section 475 MTM ordinary gains treatment at year-end and thereby forgo both deferral and lower long-term capital gains tax rates. Many hedge funds are used to generating trading gains; they aren't focused on needing tax-loss insurance with Section 475 MTM.

… AND SECTION 475 MTM IS OFTEN NOT ADVISED FOR SECTION 1256 CONTRACTS

Section 1256 contract traders should generally not elect Section 475 in order to retain the lower 60/40 tax rates. Section 475 would override Section 1256 and subject trading gains to the short-term ordinary tax rate. With Section 1256, 60% of trading gains are considered long-term capital gains — even on day trades — taxed at lower tax rates (up to 15% in 2012 and 20% in 2013), and 40% are short-term capital gains taxed at ordinary tax rates (up to 35% in 2012 and 39.6% in 2013). The maximum 2012 tax rate on Section 1256 is 23% vs. 35% for securities, a meaningful 12% difference. For 2013, it's 28% vs. 39.6% — a difference of 12%. Investors and business traders may elect to carry back Form 6781 trading losses three tax years, but it's only applied against Section 1256 contract trading gains on Form 6781, not other types of income. Section 1256 contracts are also marked-to-market on a daily basis, but it's a different type of MTM than Section 475.

If you trade Section 1256 contracts and lose a bundle before the April 15, 2013 election deadline or within 75 days of inception for a new taxpayer entity formation, you may want to elect Section 475, especially if you don't have the opportunity to carry back Section 1256 contract trading losses against gains in the prior three tax years. Why not take the opportunity to lock in a large ordinary business loss? You can form a new entity right after that election to get back into lower 60/40 tax treatment on Section 1256 contracts. (For more on "do over" elections using entities, see Chapter 7 on entities.)

DIGGING OUT OF A CAPITAL-LOSS CARRYOVER HOLE

We design our trader tax strategies to prevent traders from falling into a hole of having used tax losses. But many traders miss the boat on our advice and inevitably fall into that hole. In this section, we focus on how best to climb out of the hole using capital gains to soak up capital loss carryovers, and how not to dig a bigger hole with a Section 475 MTM election. The problem is you can't have it both ways; you need to choose one tax treatment or the other. At least, you have some hindsight in this decision making. That's April 15 for existing individuals or partnerships, March 15 for existing S-corporations and 75 days from inception in a new entity. At every decision-making juncture possible, choose the tax treatment that's best for the hindsight period — i.e., Jan. 1 to April 15. Next, form a new trading entity for a "do over" on the tax treatment election choice. You can't do this multiple times, as that would be too aggressive.

Here are some examples. If you have a $50,000 capital-loss carryover going into 2013 and your Q1 2013 trading gains are $50,000, consider skipping the 2013 Section 475 MTM election as a sole proprietor, since you want to offset your carryover against current-year capital gains. If you're at breakeven on using up your capital loss carryovers before the April 15, 2013 MTM election deadline, it's wise to form a new entity to trade with Section 475 MTM for the rest of 2013 so you have ordinary tax loss insurance going forward. It's best to elect Section 475 when you have a "clean slate" — meaning, no remaining capital loss carryovers or unrealized capital losses. Large trading losses incurred in Q3 or Q4 it will be an ordinary business loss.

Conversely, if you lose $50,000 in Q1 2013, it's probably wise to elect Section 475 MTM as a sole proprietor for business ordinary loss treatment — and related tax relief — rather than digging a bigger hole of unutilized capital losses. Again, you can form a new entity for a "do over" to get back to capital gains treatment, so you can use up your capital loss carryovers. You have 75 days of additional hindsight once the entity commences business to file an internal Section 475 MTM election resolution. You're hoping to generate capital gains in the entity to use up your remaining capital-loss carryovers and put off the Section 475 MTM election to the following entity year.

There are many variations on these examples, so it's best to consult with a trader tax expert. We see countless cases of traders who botch these decisions. Why pay taxes on gains that otherwise could be offset with capital-loss carryovers? Why waste further tax losses without getting immediate refunds? Making the wrong decision can cost you thousands!

ONCE ELECTED, INDIVIDUALS MUST USE SECTION 475 MTM AS LONG AS THEY QUALIFY

Once you elect Section 475 MTM and file Form 3115 to perfect it, you're stuck with it until you file a second Form 3115 to change back to the cash accounting method. Sole-proprietor traders who exit a trading business during the year or at year-end must suspend Section 475 MTM accounting as of that date and resume it when they qualify for trader tax status again. Alternatively, there's a filing fee to withdraw Section 475 MTM, and it's not automatic, unlike the first filing.

Here's how to handle an exit from business trading. Apply Section 475 MTM to open positions — even mid-year — and then begin the cash accounting method for the rest of the year. You might generate unutilized capital losses after exiting trader tax status. If you have trading gains the following year, you may seek to apply them against the capital-loss carryover, but you may have requalified for trader tax status. In that case, those trading gains are Section 475 MTM ordinary gains and you can't offset them with capital-loss carryovers. There can be many nuances in these cases, so it's best to consult a trader tax expert. This is one of the reasons we prefer entities. You can simply open and close an entity and don't need to worry about the added nuances of suspended Section 475 MTM status on an individual tax return.

See the Executive Summary for updates on exiting trader tax status with Section 475.

SECTION 475 ELECTION PROCEDURES

The first step in the Section 475 MTM election process is filing an election statement on time. Existing individuals and LLC/partnerships elect Section 475 MTM for the current tax year by attaching an election statement to last year's tax return or extension due by April 15. Existing S-Corps file in the same manner by March 15. New taxpayers (i.e., new entities) elect MTM internally within the first 75 days of business-entity inception. Internal elections occur in your own books and records — an email will suffice. External elections are filed with the IRS, and you must sign a perjury statement attesting to that as well on Form 3115 (the second step).

MTM extensions don't work. If you miss the March 15 or April 15 deadline, you can file a private letter ruling (PLR) for a six-month extension, but the IRS has denied almost all PLR MTM extension requests in the past. The Vines vs. Commissioner case is the only one where the taxpayer prevailed in tax court. Vines, an attorney/trader, had several million dollars of trading losses before the Section 475 MTM election deadline. He did not know about MTM, he did not trade after the MTM election deadline, and he did not use hindsight to prejudice the IRS. Vines had a perfect set of factors which other taxpayers will be unlikely to duplicate. Plus the PLR is an expensive process. To win a PLR on a MTM extension procedure, a trader needs to prove he or she did not use "hindsight." Examples of hindsight are: having a capital-loss carryover to start the year, having commingling investment positions or having capital gains at the beginning of the year turn into trading losses after the MTM election date. A taxpayer also needs to show "unusual and compelling" facts and circumstances, which is difficult to do.

A better solution is to form a new entity and file the MTM election statement internally within 75 days of inception. But this won't help with Q1 losses if you miss the MTM election on April 15. Many new traders don't begin trading until after April 15; an entity is wise if they want Section 475 MTM.

Election statement. The MTM election statement is one simple paragraph; unfortunately the IRS hasn't created a tax form for it. The IRS is working on a new tax form for this election, but they wanted it earlier than April 15. We pointed out that this is not practical. It's a version of the following: "Pursuant to Section 475(f), the Taxpayer hereby elects to adopt the mark-to-market method of accounting for the tax year ended Dec. 31, 2013 and subsequent tax years. The election applies to the following trade or business: Trader in Securities as a sole proprietor (for securities only and not Section 1256 contracts)." If you expect to have a loss in trading Section 1256 contracts, you can modify the parenthetical reference to say "for securities and Section 1256 contracts." But remember, you'll give up the lower 60/40 tax rates on Section 1256 contracts. Consider a new entity for a do over on Section 475 MTM in that case.

Existing taxpayers complete the Section 475 MTM election process by filing a Form 3115 (change of accounting method) with their current-year tax return. A 2012 MTM election filed by April 15, 2012 is reported on a 2012 Form 3115 filed in 2013 with your 2012 tax returns. New taxpayers adopt Section 475 from the outset; they aren't changing their accounting method so they don't have to file a Form 3115. Many accountants and taxpayers confuse this two-step procedure and they file the Form 3115 as step one on the election statement date. The IRS usually sends back the Form 3115, which can ruin ordinary-loss treatment. Perhaps you can treat this filing as tantamount to the election statement, but you need to refile a Form 3115 correctly and on time.

Form 3115 is filed in duplicate — one is filed with Form 1040 and a second copy goes to the IRS national office. There's no fee required for this, and the election is automatic. That means the IRS won't confirm this election statement or the Form 3115 filing. Many accountants and taxpayers make an error here — they think a fee is required and that the IRS needs to confirm these filings.

This Form 3115 filing should also include a perjury statement saying you filed your Section 475 MTM election on time. The IRS system for recording those elections indeed needs improvement. Several traders missed the Form 3115 filing deadline. The IRS provided relief to these late filers, providing they filed the Section 475 MTM election on time, as that is the more key element in the process.

Some traders change their mind after they file their Section 475 election statement, and they want to skip the Form 3115 filing. That's wrong and it's incumbent on them to perfect the election. One allowable way to skip a Section 475 MTM election is to take the posture that you fall short of trader tax status, but that must be based on accurate facts and circumstances and not on a whim. It's important to be consistent and credible with the IRS.

See "Updates on Section 475 MTM elections, Form 3115 and suspended treatment" in the Executive Summary for discussion of "null and void" Section 475 MTM elections. One example is a trader who files the Section 475 MTM election but falls short of trader tax status at year-end. His election is null and void and he doesn't need to file a Form 3115. Don't let an IRS agent try to tell you different. Consult with us as needed.

Election Procedures

To elect Section 475 MTM, follow this two-step procedure:

1. File an election statement on time. The MTM election statement is one simple paragraph; unfortunately the IRS hasn't created a tax form for it. It's external for existing taxpayers and internal for new taxpayers.

2. Existing taxpayers finish their MTM election by filing a Form 3115 (change of accounting method) with their current-year tax return. A 2012 MTM election filed by April 15, 2012 is reported on a 2012 Form 3115 filed in 2013 with your 2012 tax returns. (New taxpayers adopt Section 475 from the outset; they aren't changing their accounting method so they don't have to file a Form 3115.)

SECTION 481(A) ADJUSTMENT

Form 3115 includes a section for reporting a Section 481(a) adjustment, which is required when a change of accounting is made. The rest of the multi-page Form 3115 relates to tax law and code sections, etc. In the case of changing to Section 475 MTM, a trader's section 481(a) adjustment is his unrealized business trading gain or loss as of Dec. 31 of the prior tax year. A section 481(a) loss is deductible in full, whereas a gain of more than $25,000 must be prorated over four tax years. This is favorable to taxpayers for income deferral reasons — but don't forget to report these deferred items in later tax years. Section 1256 contract traders don't have to worry about a 481(a) adjustment, since MTM is already built into Section 1256. The 481(a) adjustment is also reportable as a Jan. 1 transaction on Form 4797 Part II, along with MTM trading gains and losses for that tax year (which start the year at market values for cost basis). Proper trade accounting software makes this adjustment. We offer a filled-in Form 3115 in our companion 2013 GreenTraderTax Guide: 2012 Tax Return Examples for Securities Traders (individual and entities).

Wash sale loss deferrals on trading business positions (this excludes investments) are also part of a Section 481a adjustment. For example, if you have a $2,000 capital loss for 2012 and $15,000 of wash sale loss deferrals, the latter becomes part of your Section 481a ordinary loss on Jan. 1, 2013 if you elect Section 475 by April 15, 2013. For this reason, wash sale losses can be much better than capital loss carryovers. We cover this more in Chapter 9.

TradeLog® — our recommended software (see Chapter 4) — also calculates your Section 481a adjustment, whereas other programs have known problems with wash sales or don't offer this calculation.

THE IRS CAN DENY ORDINARY-LOSS TREATMENT

If you don't follow both Section 475 MTM election steps properly and by the deadline, the IRS may audit you and seek to deny your ordinary-loss treatment, thereby taking away your MTM tax-loss insurance.

Be careful to apply Section 475 MTM properly on your tax return using Form 4797. In several tax court cases, the IRS has debated trader tax status, but it will act forcefully to deny ordinary trading loss treatment if the taxpayer elected Section 475 MTM too late. Consult a trader tax expert if you have questions about Section 475 MTM.

In *Holsinger vs. Commissioner*, Holsinger properly elected Section 475 MTM for his newly formed LLC (internally). But he never converted his trading accounts to the name of the LLC with the LLC tax identification number. He continued trading in his individual account. He tried to use Section 475 MTM on his individual tax returns, but the IRS denied it on simple technical grounds. The trading account must be titled with the same entity or individual that duly elected Section 475 MTM and qualifies for trader tax status. The IRS denied Holsinger trader tax status too. Had Holsinger defended Section 475 MTM loss treatment first, he may not have conceded trader tax status so quickly. See more in Chapter 11. This can also be a problem when one family member is the trader and the account is in the name of another family member, and it's not a partnership account. In the past, taxpayers would seek to share accounts and that is far more difficult with Form 8949 feeding Schedule D.

Chapter 3: Tax Treatment

Securities, Options, ETFs, Indexes, Futures, Forex, Precious Metals & More

There are complexities in sorting through different tax-treatment rules and tax rates. Section 1256 contracts have lower 60/40 tax rates, with 60% being a lower long-term capital gain even on day trades, and 40% being the short-term rate, which is the ordinary tax rate. At the maximum tax brackets for 2012, the top Section 1256 contract tax rate is 23%. In 2013, the top 60/40 rate will rise to 28%.

In this chapter, we cover many different trading instruments and how they're treated come tax time. In addition to these trading vehicles, more traders are gaining access to swaps and derivatives. Tax treatment for these instruments is complex, but we recently covered this topic in detail on our blog: "Tax treatment for swaps."

TAX TREATMENT ON FINANCIAL INSTRUMENTS IS CONFUSING

Is it ordinary or capital gain or loss treatment? Can you benefit from lower long-term capital gains rates on securities held over 12 months or on Section 1256 contracts with the 60/40 blended MTM rate? Do wash sale loss deferral rules apply? Do you report realized transactions only, or also unrealized transactions with mark-to-market accounting?

The following sections list the instruments included in each group, and the important details you need to know.

SECURITIES

Securities include equities (stocks), equity (stock) options, narrow-based indexes (which is an index made up of nine or fewer securities) and options on narrow-based indexes, exchange-traded funds (ETFs), options on ETFs taxed as Registered Investment Corps, bonds, mutual funds and single-stock futures. Because a single-stock future is based on one underlying stock, it's treated like a stock. Securities are reported on Form 8949, which feeds into Schedule D where short- and long-term capital gains rates apply. Short-term rates are the ordinary tax rates. (See "The cost-basis saga continues" in Chapter 4 for more on Form 8949.)

With the default cash method, only realized gains and losses on securities are reported for the tax year. Securities traders using the cash method may defer unrealized gains (or losses) on open positions until realizing a gain (or loss) on a sale. Long-term capital gains rates apply to securities held for 12 months or longer.

Because taxpayers can play games with offsetting positions, the IRS has passed rules for wash sales, straddles, constructive receipts and shorting against the box.

Qualifying business traders often elect Section 475 marked-to-market (MTM) on securities, which eliminates these tax-loss deferral rules. With Section 475 MTM economic reporting, the trader reports both realized and unrealized gains and losses on Form 4797 Part II, as nothing is deferred.

Schedule D capital losses are limited to $3,000 per year against ordinary income, whereas Section 475 MTM losses are unlimited as business losses (see Chapter 2).

SECTION 1256 CONTRACTS

Section 1256 contracts include U.S. futures (regulated futures contracts), options on futures, foreign futures with Commodity Futures Trading Commission (CFTC) and IRS approval (otherwise, the contract is treated as a security), broad-based indexes (a broad-based index is one that is made up of 10 or more securities and most indexes are broad-based), options on broad-based indexes, forward forex with the opt out election into Section 1256g, and options on commodities/futures ETFs taxed as publicly traded partnerships and other non-equity options. Our firm and many other tax attorneys believe the fairly new Nadex binary options are non-equity options under Section 1256.

U.S. commodities and futures exchanges offer "regulated futures contracts" based on commodities, energies, currencies, interest rates, stock indexes and much more. Foreign futures don't automatically qualify as Section 1256 contracts, but they may if the foreign exchange has received special approval letters from the CFTC and IRS.

MTM applies to Section 1256 contracts by default. Even if you hold a Section 1256 contract over a year, you receive that 60/40 blended tax rate, and all unrealized gains and losses are treated as if realized at year-end.

Mixed straddle election and hedging rule. Section 1256 contract trading professionals should also learn about the "mixed straddle election" and "hedging rules" in Section 1256(d) and (e), and as discussed on Form 6781. Offsetting positions between Section 1256 contracts and securities can generate some tax complications under certain circumstances involving the hedging rule. The IRS is concerned about some traders reporting Section 1256 MTM unrealized losses and deferring unrealized gains on offsetting securities positions, so there are rules in place intended to prevent that from happening. Consult a tax professional on this matter, as it's beyond the scope of this guide.

EXCHANGE TRADED FUNDS (ETFS)

ETFs cover the gamut of instruments. Many different structures are used and tax treatment can be very confusing to some — but not us.

Securities ETFs are usually Registered Investment Companies (RICs). Like mutual fund RICs, securities ETFs pass through their underlying ordinary and qualifying dividends to investors. When you sell a securities ETF, it's deemed a sale of a security, calling for short-term and long-term capital gains tax treatment.

Commodities/futures ETFs: Commodities/futures ETFs may not use the RIC structure, so they are usually publicly traded partnerships (PTPs). Commodities/futures ETFs issue annual Schedule K-1s passing through their underlying Section 1256 tax treatment on Section 1256 transactions to investors, as well as other taxable items.

When you sell a commodities/futures ETF, it's still deemed a sale of a security, calling for short- and long-term capital gains tax treatment. That may be counter-intuitive, since it's a commodities/futures ETF and the ETF itself is still considered a security for tax purposes.

Warning: Taxpayers invested in commodities/futures ETFs need to make some cost-basis adjustments on Form 8949 to capital gains and losses, ensuring they don't double count some the Schedule K-1 pass-through items. For example, if the K-1 passes through income, you need to add that income to your cost basis on Form 8949, otherwise you will double count it and over pay your taxes.

Mutual fund companies provide "average cost basis" capital gain or loss reports. But ETFs don't provide this documentation, so you're on your own. Annual K-1s for commodity/futures ETF PTPs can be big tax information packages and can cause confusion for many on tax compliance. Consult a trader tax expert as needed.

Precious metals ETFs: Physically backed precious metals ETFs may not use the RIC structure either. Although they could use the PTP structure, they usually choose the publicly traded trust (PTT) structure (also known as a grantor trust). A PTT also issues an annual Schedule K-1 passing through tax treatment to the investor, which in this case is the "collectibles" long-term capital gains tax rate on sales of physically backed precious metals (such as gold bullion).

The sale of a precious metal ETF is treated like the sale of a security for short-term holding and should be reported on Form 8949. The "collectibles" long-term capital gains tax rate applies for long-term (over 12 months) holdings. The collectibles rate is 28% for 2012 and 2013; notice the rate is higher than the top long-term capital gains rate of 15% for 2012 and 20% for 2013. Unlike other tax rates, the collectibles rate did not rise in 2013.

Options on ETFs: The IRS hasn't clearly stated tax treatment on sales of options based on ETFs. Some tax attorneys make the case that sales of exchange-listed options on broad-based securities ETFs as well as on commodities or futures ETFs should be treated as Section 1256(g)(3) non-equity options, with lower 60/40 tax rates. Sales of options based on narrow-based securities ETFs are treated like securities.

Although we tended to agree with this tax treatment in the past, starting in mid-2012 we adopted a more conservative view of ETF options. All options on securities ETFs that are organized as RICs are treated as securities. That means options on both broad-based and narrow-based securities ETF organized as RICs are treated as securities. This leaves only options on commodities and futures ETFs organized as PTPs as qualifying for Section 1256 treatment.

If you have any questions on ETF tax treatment, consider a consultation with our firm.

FOREX

"Forex" is a trading-industry term which refers to trading spot, forwards or over-the-counter (OTC) option contracts on foreign exchange in the off-exchange "Interbank" market. Forex differs from trading currency regulated futures contracts (RFCs) on exchanges like the CME. Like other RFCs, currency RFCs are Section 1256 contracts reported on Form 6781 with lower 60/40 capital gains tax rate treatment.

Forex has unique tax treatment. By default, all off-exchange forex transactions start off receiving ordinary gain or loss treatment, as dictated by Section 988 (foreign currency transactions). The good news is that Section 988 forex ordinary losses offset ordinary income in full and ordinary losses are not subject to the dreaded $3,000 capital loss limitation against ordinary income. That's a welcome relief for many new forex traders who have losses.

There's further good news with flexible forex tax treatment elections. Section 988 allows investors and business traders to file a contemporaneous "capital gains election" to opt-out of Section 988 into capital gain or loss treatment reported on Schedule D. One reason to file this election is to generate capital gains in order to use up capital loss carryovers, which otherwise may go wasted for years.

With the capital gains election, it's also possible to navigate your way into lower 60/40 tax rates of Section 1256(g) (labeled "foreign currency contracts") on forex forwards. In 1986, Congress and the IRS modified Section 1256 by adding section (g) to accommodate "forex forwards," provided the trader filed the Section 988 opt-out capital gains election on a contemporaneous basis. There are two further requirements for 1256(g): the forex forwards must be in major currencies for which currency RFCs also trade on exchanges, and the trader "does not take or make delivery of the underlying physical foreign currency." (Note: A Section 988 opt-out capital gains election may never be filed on actual holding of physical foreign currency. Gains on personal currency holdings are capital and losses are non-deductible.)

The big tax question for most retail off-exchange forex traders is how to handle spot forex. Guidance from the IRS is uncertain on spot forex. We've done extensive work on forex taxation, and spot forex in particular. We believe that in many cases, spot forex can be treated like forex forwards, qualifying for lower 60/40 tax rates in Section 1256(g).

We've learned from direct discussions with the IRS Chief Counsel's office on forex taxation that the tax attorney authors of Section 988 never contemplated retail trading in spot forex transactions. IRS attorneys figured the spot forex marketplace was for corporations to exchange currency in the ordinary course of their trade or business, and of course those transactions would be ordinary gain or loss per Section 988. Manufacturers and other global businesses transact in the Interbank market (to hedge and exchange currency). Why would they want to file a capital gains election to opt-out of Section 988? Only traders can file that election per Section 988.

IRS attorneys understood that professional forex traders were trading forex forwards and there was a clear pathway into Section 1256(g). We learned from the author of Section 1256(g) and from doing our own extensive IRS research that spot forex isn't specifically mentioned in Section 1256(g); only forex forwards are. That makes sense since retail spot forex trading began around the year 2000, whereas Section 1256(g) was added around 1986.

Our position is that most small retail off-exchange forex traders now trade spot, which has become a large marketplace. Spot forex settles in one or two days and retail spot forex brokers offer their clients rollover transactions to extend their economic holding periods resembling forex forwards, which settle in over two days. Clearly, this type of trading in the retail spot forex marketplace has nothing to do with hedging transactions in a normal trade or business like manufacturing. Smaller retail spot forex traders don't have access to forwards which require much greater credit and net worth.

There is clear IRS guidance on forex OTC options. First the IRS allowed forex OTC options into

Section 1256(g), but in a second revenue ruling in 2007, the IRS barred them from Section 1256(g) tax treatment. For the same reasons IRS attorneys argued that forex OTC options shouldn't be allowed into Section 1256(g), our tax attorneys argue spot forex *should* be allowed into Section 1256(g). Forex OTC options lost their case because they don't settle in cash, unlike spot forex transactions.

To gain entry into Section 1256(g), the IRS also requires that spot forex be traded in the Interbank marketplace, but it's debatable what constitutes this marketplace. While most retail spot forex brokers net their books out with trades directly in the Interbank marketplace and reference prices from it, some don't offer direct Interbank trading. They allow retail spot forex trading clients to trade against their house account. It's not clear if the IRS will accept that for entry into Section 1256(g).

See our blog (Jan. 29, 2011 and Nov. 11, 2010) for in-depth articles on forex taxation and our Webinar on forex tax treatment dated Feb. 23, 2012.

What should you do on spot forex tax treatment? If you have significant trading gains on spot forex contracts, the lower Section 1256(g) tax rates (foreign currency forwards) may be very desirable. We lay out a case for Section 1256(g) treatment on spot forex transactions, with certain conditions and restrictions. It's important to use proper tax return footnote disclosure, and consult with our firm about it. Our tax attorneys provide opinion letters when appropriate.

We'll keep working closely with the IRS tax attorneys who authored Section 988 and Section 1256(g) to iron out questions in these tax code sections. Stay tuned to our blog for further developments.

The Section 988 opt-out election. The election to opt out of Section 988 must be filed internally (meaning you don't have to file an election statement with the IRS) on a contemporaneous basis. Section 988 talks about the election on every trade, but you can also make a "good to cancel" election which is more practical. The election can be made and withdrawn throughout the year.

A word of caution: If you don't have trader tax status and you don't elect out of Section 988, your forex trading losses can become wasted in the event you have negative taxable income. If you do qualify for trader tax status, those forex losses become a part of your NOL; but again, investors don't have NOL treatment. Investors with no other source of income may be better off electing out of Section 988 so their forex trading losses can be classified as capital-loss carryovers and not wasted forever.

If you don't have trader tax status and you don't elect out of Section 988, your forex trading losses can become wasted in the event you have negative taxable income.

Physically held currency for investment or business trading purposes. Tax treatment varies when holding physical foreign currency. For investors and business traders, Section 988 rules apply, and you can't file a capital gains opt-out election. That means its ordinary gain or loss treatment in Section 988.

Physically held currency for personal use. For personal use of currency such as on a vacation, losses are not deductible, while gains are considered capital gains. Some traders look for answers on currency taxation in IRS publications and they find this answer, but it only applies to currency held for personal use. Traders and investors use Section 988 by default.

Chapter 4: Accounting

Accounting for Trading Gains and Losses and Business Expenses

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

It's wise to do separate accounting for securities trading and business expenses.

SECURITIES TRADERS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Are brokerage firm accounting reports useful? Although each year online brokers make advances in their tax reporting on securities, in most cases, brokerage tax reports remain insufficient for tax return preparation. Wash sales must be reported on a consolidated basis across all accounts, including taxable and IRA accounts. Brokers don't have the means of consolidating your accounts across several firms. TradeLog software can handle this consolidation.

FUTURES TRADERS

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

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

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

FOREX TRADERS

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

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

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

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

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

Using a foreign currency to purchase foreign stocks. Traders are stuck with ordinary gain or loss treatment for physical currencies used for investing and trading purposes. Sometimes, taxpayers purchase foreign currencies to use to buy and sell foreign equities where those transactions are conducted on a foreign exchange.

Traders may purchase foreign stocks in a foreign brokerage account, or even in U.S.-based accounts offering global access. If a trader buys Euros, holds them in his account and converts them back to U.S. dollars the following year, the gain or loss is ordinary. The trader can't claim short- or long-term capital gain or loss or the Section 1256g lower 60/40 capital gains rates.

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

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

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

GENERAL LEDGER ACCOUNTING

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

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

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

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

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

BOTTOM LINE

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

Chapter 5: Trading Business Expenses

Business traders can deduct all reasonable business expenses, whether they have trading gains or losses, saving around $8,000 per year on average. Business-expense deductions hinge on qualifying for trader tax status, of course. Investors, on the other hand, are very limited.

The good news is you can still claim trader tax status for 2012, and even other open tax years (usually up to three years prior). Unlike Section 475 MTM (mark-to-market) accounting, which must be elected by the April 15 deadline, trader tax status can simply be claimed by a taxpayer after the fact, based on facts and circumstances. If you're just learning about trader tax status, you might still be in luck for tax-year 2012.

INVESTORS VS. BUSINESS TRADERS

Unlike business traders, investors are stuck with restricted itemized deductions. Investors can't deduct pre-business education including most seminars and travel costs, home-office expenses, start-up costs and many other types of trader expenses.

Investment expenses are only allowed as part of "miscellaneous itemized deductions" in excess of 2% of adjusted gross income (AGI), and they aren't deducted against the alternative minimum tax (AMT). Most itemized deductions are subject to a phase-out for the upper-income bracket starting in 2013 (known as the Pease limitation); some taxpayers are better off using the standard deduction than the itemized deduction. Bottom line: Many investment expenses wind up on the cutting room floor.

If Congress flattens the tax code as proposed by the Bowles Simpson Deficit Commissions and others, it will do away with more itemized deductions, but business deductions will be safeguarded.

Investment-interest expenses are limited to investment income (on Form 4952), with the excess carried over to the following tax years. With trader tax status, investment (margin) interest is treated as a business-interest expense, which is fully deductible on Schedule C or the separate entity business tax return. Passive spouses/partners in an LLC filing a partnership tax return are required to use investment-interest expense treatment, but the active spouse/partner is entitled to business-interest treatment. Spouses/partners are considered "active" if they trade or perform administrative duties. If your spouse is passive and if margin interest is material, you may want to give your spouse 1 to 10% interest rather than 50% interest to avoid investment-interest expense treatment.

Let's presume you easily qualify for trader tax status, either individually or in an entity. Which business expenses are deductible, and which ones are not?

BUSINESS EXPENSES

Business deductions include:

- Section 179 (100%) and/or regular depreciation on computers, equipment, furniture and fixtures.
- Amortization on start-up costs (Section 195), organization costs (Section 248) and software.
- Post-business education.
- Internet and cable, books and publications, market data, online and professional services, chat rooms, mentors, coaches, gifts, supplies, telephone, travel and entertainment, seminars, conferences, assistants, consultants and more.
- Home-office expenses.

Business deductions don't include:

- ***Cars.*** Vehicles aren't usually deductible for at-home traders, because traders don't need a car to visit clients or companies.
- ***Commissions.*** These are part of trading gains and losses; they aren't a separately stated business expense. If you exceed the net capital loss limitation of $3,000 per year, commissions are deferred as part of your capital-loss carryover. With Section 475 MTM, the trading loss is unlimited.

CASH VS. ACCRUAL

A trading business may elect either cash or accrual accounting methods for business expenses only. Trading gains and losses are dictated by other rules, including

Section 475 MTM, Section 1256 and Section 988.

Most business traders choose the cash method for expenses, meaning expenses are deductible when paid, not when they are incurred. The accrual method deducts expenses when incurred. Under the cash method, a credit card charge by Dec. 31 or a check dated Dec. 31 is considered a year-end tax cash deduction.

Here's one case where the accrual method may be better: Say a new trader purchases $10,000 of trading training (not classic education) on Dec. 1, 2012. The trader starts classes in December and continues them through March 2013. The trader commences his trading business halfway through the training in early 2013. The cash method classifies the $10,000 as a start-up cost, with $5,000 deducted in 2013 as amortization and the balance amortized over 15 years. With the accrual method, the trader will have the same amortization amount ($5,000) on his 2013 tax return, and he can deduct the other $5,000 in full as a post-business-commencement education expense in 2013. Pre-business education is a nuanced area that's widely misunderstood. Consult a trader tax expert on choosing cash vs. accrual accounting.

DEPRECIATION ON HARD ASSETS

Some expenses or costs must be capitalized and depreciated (on hard assets) or amortized (on soft or intangible assets) over their "useful life," according to the IRS. Certain assets (such as computers, equipment, furniture and fixtures) qualify for Section 179 depreciation, which allows an immediate 100% write off per specific IRS rules. Computers and equipment are depreciated over five years, with various accelerated methods or the straight-line depreciation method. The same rules apply to furniture and fixtures, but their useful life is seven years. Residential property, including a home office, has a 39-year useful life and only straight-line depreciation is allowed. For more information on depreciable assets and depreciation methods, visit www.irs.gov.

The Section 179 100% depreciation limits are currently much higher than what most small business traders spend on fixed assets. It's highly unlikely traders would ever go beyond these limits.

Section 179 depreciation requires business income or wages to offset it; otherwise it's a carryover item. In that case, regular depreciation may be preferable. You can't take Section 179 or bonus depreciation on used assets you owned prior to forming your business, so use regular depreciation in that instance.

Starting in 2011, the IRS now requires capitalization of all fixed assets over $100. (Previously, you could expense smaller amounts, and there was no exact cut-off amount requiring capitalization.)

START-UP EXPENSES & ORGANIZATION COSTS

Start-up expenses can be capitalized and amortized over 15 years (Section 195). The first year expense allowance is $5,000, whether you start your business toward the beginning or end of the year. Start-up expenses are limited to "investigating and inquiring" about a new business. Otherwise, they may be capitalized to the cost of an investment in a new business and not amortized at all. Organization expenses (Section 248) are similar to Section 195, and they also have a $5,000 first-year expense allowance with the balance amortized on a straight-line basis over 15 years. Organization costs include attorney fees for forming your trading entity.

EDUCATION

Educational expenses incurred after a trading business commences are tax deductible, provided the education maintains or improves your business. Pre-start-up education expenses, however, are a problem for tax-deduction purposes. They're not business expenses and most do not qualify as "investment expenses" (Sections 212 and 274(h)(7)).We advise some traders to squeeze a reasonable amount of pre-business education expenses into Section 195 start-up expenses, which may be appropriate under certain circumstances. Trading education isn't classic secondary school education and this approach can work in some cases. The education has to be in the recent past (figure around six months before) and you can only capitalize a reasonable amount. It's best to consult a trader tax expert about pre-business education expenses. For more information on deducting education expenses, see our three-part blog series "Dangerous entity scams targeting traders":

- Part 1: Dual-entity schemes don't deliver business treatment without qualification for trader tax status
- Part 2: Are trading education, seminars and travel expenses tax deductible?
- Part 3: Education expenses are a problem in dual-entity schemes

TRAVEL, MEALS AND ENTERTAINMENT

Like the seminar itself, travel to seminars is not deductible as investment expenses per Section 274(h)(7).

Many traders travel to seminars and workshops taught by industry pros to further their trading education. Many trading seminars are hosted in resorts or fun cities such as Las Vegas and New York City. Traders often take their spouses, who may or may not be included in their trading activities. Travel to an education location is a business expense provided the education qualifies as a business expense, too, as their tax treatment is connected. Travel for education, seminars,and conferences looks to the underlying tax treatment of that item itself as either non-deductible investment expense (Section 274(h)(7)), Section 195 start-up cost or allowable business expense after business commencement. Deducting a trading seminar trip hinges on previously qualifying for trader tax status, too. The precedent here is a 2008 IRS revenue ruling that said an investor couldn't deduct travel expenses to and from an investment seminar because the taxpayer didn't qualify for trader tax status before the trip.

Meals and entertainment with trader colleagues may be tax deductible, but the expenses have to be reasonable. Visit www.irs.gov to learn the many IRS rules on travel, meals and entertainment-related expenses.

HOME-OFFICE EXPENSES

Since 1999, the home-office deduction is no longer a red flag — millions of Americans benefit from this deduction each year. With the advent of computers and the Internet, countless Americans run businesses from home, and the IRS understands this. The income-requirement rule also limits the use of this deduction to profitable businesses, which appeases IRS concerns about abuse and hobby-loss businesses. Before the IRS liberalized home-office deduction rules in 1999, a more stringent requirement was that taxpayers needed to meet clients in their home office. Now, only administration work is required in a home office and another principal office outside the home doesn't negate the deduction.

Most traders operate their trading business from a home office, which is their main or sole office. Some traders also trade from job locations using browser-based trading platforms accessible on work computers, laptops, tablets, and even smartphones. They can qualify for the home-office expense deduction as well.

> To calculate the home-office deduction, take the square footage of your home office and divide by the total square footage of your home.

Home-office deductions are one of the biggest and most important deductions for profitable business traders. Unlike other types of business expenses, which require new cash outlays, deducting home-office expenses is especially rewarding because you can convert fixed personal expenses into tax-deductible business expenses. This same concept applies to many other business expenses such as telephone, Internet connections, furniture, fixtures and more. You need to have trading gains to unlock home-office deductions (exception: the mortgage-interest expense and real-estate tax portion don't require income). If you don't have sufficient business trading gains, home-office deductions are carried over to the following tax years. (In this situation, hopefully the trader remains in the business and has trading gains in those later years to use the carryovers.)

There are several special requirements and rules for the home-office deduction. A home office must be exclusively and regularly used for business, meaning children and guests can't use this room. Report "indirect expenses" on Form 8829 and include every expense and cost related to your home. For example, include depreciation or rent, utilities, insurance, repairs and maintenance, security, cleaning, lawn care and more. Mortgage interest and real-estate taxes are included, too, and this portion doesn't require income. The non-business portion of mortgage interest and real-estate taxes are considered itemized deductions on Schedule A. Real-estate taxes on Schedule A aren't deductible for AMT, but they are on Schedules C (sole proprietor) and E (entity), so taking the home-office deduction is a wise move.

To calculate the home-office deduction, take the square footage of your home office (and all related business areas such as storage, hallways and bathrooms) and divide by the total square footage of your home.

Ten to 15% is customary. Alternatively, you can do the apportionment based on the room's method. Form 8829 multiplies the home-office percentage by the indirect expenses. If you file a partnership or S-corporation return, home-office expenses are reported as unreimbursed partnership expenses (UPE) on Schedule E for pass-through entities. You still need offsetting income to unlock the home-office deduction, but it looks better than Form 8829 and Schedule C.

Income exclusion on the sale of your home office: Taking the home-office deduction with depreciation doesn't reduce the exclusion on the sale of your principal residence. You have to recapture depreciation. Depreciation is "allowed or allowable" (an IRS phrase), meaning traders should depreciate their home offices because the IRS will treat it that way, anyway. If you have a gain on the sale of a residence containing a home-office, the recapture of home-office depreciation means you only had a temporary tax break for the depreciation portion. That is still very helpful.

If you sell your personal residence at a loss, the net loss is not deductible. But the recapture of depreciation income may not surpass the loss amount, meaning you have no taxable income from depreciation recapture to report on your tax return.

A HYBRID CASE

Some traders have both business trading expenses and segregated investment expenses. If you have an outside-managed account or an expert adviser system in forex, those fees are investment expenses, as they aren't part of your trading business. You may have investment interest expense on core investment positions and business margin interest on business trading. Be careful to apportion your expenses properly.

BOTTOM LINE

Traders can still claim trader tax status on their 2012 tax returns. Taking the proper business deductions can save a lot of money come tax time. Start-up expenses including some education should not to be overlooked. If you're unsure how to proceed, check with a trader tax expert.

For more ideas on what business traders can deduct, see our companion tax return examples guides.

Chapter 6: Trader Tax Return Reporting Strategies

Forms, forms, and more forms. Which form should you use if you're a forex trader? Which form is best for securities traders using the Section 475 MTM method? The different reporting strategies for the various types of traders make tax time not so cut-and-dried.

Tax Form 8949 will be a big challenge again this year for many securities traders and their accountants to deal with — it has to do with the new IRS cost-basis reporting rules on 1099-Bs. See Chapter 4: "The cost-basis saga continues" and "Wash sales and 1099-Bs." Getting Form 8949 right is the first job of any securities trader when it comes to tax preparation. The IRS hasn't created specialized tax forms for trading businesses as it has done for just about every other type of business. For example, other sole-proprietorship businesses report revenue, cost of goods sold and expenses on Schedule C. Business traders report only expenses reported on Schedule C. Trading gains and losses are reported on various forms, depending on the situation. In an entity, all trading gains, losses and expenses are consolidated.

Securities must be first reported on Form 8949, which then feeds into Schedule D (cash method) with capital losses limited to $3,000 per year against ordinary income (the rest is a capital loss carryover).

Business traders who elect Section 475 MTM on securities report their trades (line by line) on Form 4797 Part II, rather than Form 8949. Form 4797 Part II has unlimited business ordinary loss treatment and avoids capital loss limitations, which is the case with Schedule D.

Futures traders should use Form 6781, unless the futures trader elected Section 475 (in that case, use Form 4797). Futures traders don't use Form 8949. It's easier for futures traders with a one-page Form 1099-B showing their net trading gain or loss ("aggregate profit or loss"). Simply enter that amount in summary form on Form 6781 Part I and you are done! (We use the term futures in this paragraph to refer to all Section 1256 contracts.)

Securities must be first reported on tax Form 8949, which feeds into Schedule D with capital losses limited to $3,000 per year.

In the forex arena, if the trader doesn't qualify for trader tax status, by default without an opt-out (capital gains) election he should use line 21 (other gross income or loss) of Form 1040; qualifying business traders report on Form 4797. What's the difference? Form 4797 Part II losses contribute to net operating loss (NOL) carrybacks against any type of income, whereas line 21 "other losses" do not. The latter can be wasted losses if the taxpayer has negative income. This forex other income or loss isn't subject to SE taxes.

It can be confusing because the Section 475 MTM and Section 988 elections don't have tax forms; traders must figure it out on their own. New taxpayers file Section 475 MTM elections internally, but existing taxpayers file a statement by a due date with the IRS and perfect it later with a Form 3115 filing by the deadline (see Chapter 2). Section 988 capital gains elections are only filed internally on a contemporaneous basis — before not after you make a trade.

Sole-proprietor business traders report business expenses on Schedule C and trading income/loss and portfolio-related income on other tax forms, which may confuse the IRS. It may automatically view a trading business Schedule C as unprofitable even if it has large net trading gains on other forms. The IRS is increasing its audits on sole-proprietorship trading-business tax returns. This is one reason why we recommend an entity for trading.

TRANSFER TRADING GAINS TO SCHEDULE C

The most important tax strategy for sole proprietorship business traders is to transfer some business trading gains, if possible, to Schedule C to zero the income out, but not show a net profit. Showing a profit could cause the IRS to inquire about a self-employment (SE) tax, which is otherwise not due for traders who aren't full members of a futures or options exchange.

This special income-transfer strategy also unlocks the home-office deduction and Section 179 (100%) depreciation deduction, both of which require income. While Section 179 depreciation can also look to wage income outside the business, the bulk of home-office deductions can only look to business income. This transfer strategy isn't included on tax forms or form instructions. It's our suggested industry-accepted practice to date designed to deal with insufficient tax forms for sole-proprietorship trading businesses, and it must be carefully explained in footnotes — another important strategy for business traders. In the past, we transferred business-trading gains from Schedule D if it was for a cash method securities trader. Now we must do that same transfer from Form 8949 and that will draw more attention since we will have to explain it in the more noticeable Part C of Form 8949. This problem doesn't exist with a trading entity.

INCLUDE FOOTNOTES

Always include well-written tax-return footnotes, explaining trader tax law and benefits, why and how you qualify for trader tax status (business treatment), whether you elected Section 475 MTM or opted out of Section 988, and other tax treatment, such as the income-transfer strategy. Part-time traders explain how they allocate their time between other activities and trading. Money-losing traders explain how hobby-loss rules don't apply since there's no personal or recreational intent. We offer many different example footnotes in our companion examples guides, which we also publish each year.

SEPARATE ENTITIES CAN DEFLECT IRS QUESTIONS

The IRS has been challenging trader tax status more frequently lately, so it's wise to consider establishing a separate entity — such as an LLC, general partnership or S-corporation — for your trading business. Sole-proprietor business returns (Schedule C) are very useful after the fact (meaning after year-end), but forming a separate legal entity during the year will make your case stronger. Entities have several benefits over sole-proprietor schedule Cs, including the "red-flag" factor. A partnership tax return Form 1065 shows trading gains, losses, and expenses on one set of forms, plus the IRS won't see the taxpayer's other activities.

Form 1065 is filed for a general partnership or multi-member LLC choosing to be taxed as a partnership. Form 1120S is filed for an S-corporation and a single-member LLC electing to be taxed as an S-Corp. Forms 1065 and 1120S issue Schedule K-1s to the owners, so taxes are paid at the owner level rather than at entity level, thereby avoiding double taxation. Ordinary income or loss (mostly business expenses) is summarized on Form 1040 Schedule E rather than in detail on Schedule C (hence less IRS attention). Section 179 is broken out separately on Schedule E, along with unreimbursed partnership expenses (UPE) including home-office expenses. As with sole-proprietors, the entity needs trading gains to unlock most of the home-office deduction.

Under the "trading rule," these are considered "active" rather than "passive-loss" activities, so losses are allowed in full without restriction. Portfolio income is passed through to Schedule B. Capital gains and losses are passed through to Schedule D in summary form, bypassing Form 8949, whereas sole proprietorships must list portfolio income line by line on the individual tax return Form 8949. Pass-through entities draw less IRS attention than a detailed Schedule C filing. Net taxes don't change; they're still paid on the individual level.

Entities provide additional tax breaks including AGI deductions for retirement plans and health-insurance premiums, two tax breaks that sole-proprietor traders can't do unless they have another source of earned income. Wages are not earned income.

There are several other tax advantages with a trading entity like avoiding wash sales, and more flexibility on tax elections like Section 475. See Chapter 7.

CLAIMING TRADER TAX STATUS

If you qualify for trader tax status and haven't formed a separate legal entity, you're classified as a "sole proprietor" or "unincorporated business." Report your trading business expenses on Form 1040 Schedule C (Profit or Loss from Business). Home-office deductions are reported on Form 8829. Depreciation and amortization are reported on Form 4562. Both forms require transferring deductions to Schedule C; income is required for home-office deductions and Section 179 depreciation. You can use the transfer strategy mentioned earlier.

REPORTING LARGE TRADING LOSSES ON FORM 8886

If you have a large trading loss, you may have to file a Form 8886 (Reportable Transaction Disclosure Statement). The instructions mention losses of $2 million in any single tax year ($50,000 if the losses are from certain foreign currency transactions) or $4 million in any combination of tax years. If your forex loss is ordinary under Section 988, the $50,000 rule applies; however, if your forex transactions have capital gains and loss treatment, the $2 million limitation may apply.

Form 8886 is a red flag to the IRS as it was initially intended to catch tax-shelter users. While filing form 8886 significantly raises your chances of IRS questions, or even an IRS exam, skipping it is a bigger problem. If the IRS catches you, it will assess large tax penalties. File 8886 when due and include a simple explanation. These are not tax shelters and if the IRS sends you a tax notice, it should be very simple to reply to and close out. Although you don't need to attach a forex statement from your broker since forex is not covered on 1099-Bs, if you file Form 8886, you may want to attach that annual statement so the IRS sees the forex trading loss is real.

REPORT FOREIGN ACCOUNTS, INCOME AND ASSETS

Foreign bank, brokerage, investment and other types of accounts — including retirement and insurance in some cases — must be reported on TDF 90.22-1 by June 30 of the following year. The filing threshold is $10,000 for all foreign accounts combined. Starting with tax year 2011, the IRS expanded its international compliance with tax form w8938 (Statement of Specified Foreign Financial Assets). For more on this topic, see Chapter 14 and "Trading in foreign markets" in the Executive Summary.

TAX-PREPARATION PROGRAMS

I recommend using good trading software to download, match and properly account for your active trading in securities. (See Chapter 3 for details on TradeLog software.) Our CPAs consider TradeLog the best solution available for dealing with Form 8949, as it generates Parts A, B and C for you. Some consumer tax-preparation programs offer trade-import capability, but many aren't robust enough for hyperactive traders and some have glitches with short sales and other trade complications. Shop carefully for a software program that will meet your needs as an active trader. The best trade-accounting programs don't handle tax preparation; they only handle the Schedule D, Form 8949 or Form 4797 tax schedules. It's best to use two different software programs — one for trade accounting and one for tax preparation.

It's also wise to have a trader tax expert review the results and help reconcile tax matters with 1099-Bs and more. Our GreenTraderTax guides are meant to complement TradeLog and tax-preparation software.

If you use TradeLog, we recommend using our footnote in Appendix A.

Chapter 7: Entities for Traders

If you're thinking about creating an entity for your trading business, you have options — LLCs, general partnerships or S-Corps. Before we take a closer look, it's critical to note that entities don't guarantee trader tax status. Your trading must rise to the qualification level of a business trader before you should consider forming an entity.

Some securities traders who fall a little short of trader tax status also may want to form an entity, principally to consolidate their trading activity on an entity tax-return filing. Some plan to qualify for trader tax status soon, so having the entity in place gives them more flexibility for tax breaks later on.

Keep in mind that most hedge funds don't qualify for trader tax status, as they are investment companies and not very active in day and swing trading. See "Pass-through entities" later in this chapter.

ENTITIES FOR UPPER-INCOME INDIVIDUALS

We suggest a middleman S-corporation to receive a larger administration fee from the trading business entity to reduce the ObamaCare 3.8% Medicare tax on unearned income. Then pay a smaller administration fee to the owner's Schedule C — the original amount planned — to unlock the adjusted gross income (AGI) deductions for health insurance and retirement plans. (For a more detailed explanation, see "Example: 2013 tax savings using entities" later in this chapter.)

For high-income business traders, we suggest a C-corporation to own your trading business intellectual property. Your trading business entity pays the corporation a royalty, shifting income from your individual tax return to a corporation tax return. This strategy avoids some of the Obama-era tax hikes on the top individual income tax brackets.

AN ENTITY CAN HELP AVOID WASH SALES

A new entity for Jan. 1 is your ticket out of wash sale losses and related problems on your individual trading accounts from the prior year-end. If you stop trading on your individual taxable accounts at year-end and continue trading in a new entity account on Jan. 1, you successfully break the chain on wash sales. You will be free to buy back the securities in your entity account without waiting 30 days, and it doesn't matter if you elect Section 475 MTM in 2013 or not. This works because the entity and the individual are considered different taxpayers. This also means you don›t have to worry about triggering wash sales in your individual IRA accounts. Individuals trading both taxable and IRA accounts often don't realize they trigger permanent wash sale loss deferrals when they buy back a wash sale position from their taxable account in their IRA account. An entity account isn›t related to an individual IRA, so the entity skips this wash sale loss concern.

> Entities provide more flexibility for tax treatment elections.

WHY ENTITY?

Although entities aren't absolutely necessary for business traders, they're very helpful in reducing IRS scrutiny. This is because the entity tax return is filed separately, so the IRS won't see W-2 (wages) from another full-time job, or retirement income.

Additionally, entities help traders elect Section 475 MTM (ordinary-loss treatment) later in the tax year if they missed the individual MTM election deadline on April 15. "New taxpayers" such as a new separate legal entity or an individual who never filed before may elect Section 475 within the first 75 days of inception. (Only new trades within the entity qualify for MTM treatment; current-year individual capital losses and capital-loss carryovers aren't included in Section 475 MTM ordinary-loss treatment elected in the entity.) Traders must qualify for trader tax status in order to elect and use Section 475 MTM. It's easier for an entity to exit trader tax status and Section 475 MTM than it is for a sole proprietor. See "Updates on Section 475 MTM elections, Form 3115 and suspended treatment" in the Executive Summary.

Don't worry, prior capital loss carryovers on the individual level are not lost; they still carry over on your individual Schedule D. The new entity can pass through capital gains if you skip the Section 475 MTM election to use up those capital loss carryovers. After using up capital loss carryovers, your entity can elect Section 475 MTM in a subsequent tax year.

Entities provide more flexibility for tax treatment elections. You can form a new entity for a do over on those elections. (See Chapter 2's "Digging out of a capital loss carryover hole.") Entities also unlock AGI tax deductions, including retirement plans and health-insurance premiums (at 100%). Business traders often use entities to contribute to a retirement plan, which otherwise isn't possible unless a trader has other sources of earned income or is a dealer member of a futures or options exchange.

Trading in an entity can help constitute a performance record for traders looking to launch an investment-management business. Finally, many types of entities are useful for asset protection and business continuity. A separate legal entity gives the presumption of business purpose, but a trader still must achieve trader tax status.

Trading entities can create earned income if needed to save income taxes in excess of self-employment (SE) tax costs with AGI deductions.

If a trader doesn't have earned income, he may want to consider the following tax strategy, which isn't clear in the tax law. If you want to contribute to a tax-deductible retirement plan (or even a tax-free retirement plan such as a Roth IRA or Roth 401k), form a separate legal entity. The entity is used to turn a portion of non-earned income trading gains into earned income. Caution: IRS regulations do not allow investment partnerships to issue guaranteed payments (which are earned income) to owners. This could cause the IRS to challenge this strategy. However, various court cases (including *Armstrong v. Phinney*) state that the IRS regulation is incorrect. As a result, we continue to advocate this strategy, but only in entities that achieve trader tax status, which seems to overcome the concerns raised in the IRS audit manual. We don't think it's possible to do this strategy with an investment company (without trader tax status) and even if you could, it probably wouldn't generate net tax savings.

We suggest paying an "administration fee" rather than a "guaranteed payment" to the owner/manager; therefore, you won't technically trigger the IRS audit manual clause. The earned income (administration fee) is subject to SE tax, but the retirement plan AGI deduction usually saves more in income taxes. If it doesn't, a trader can choose to skip this strategy in any given year. For example, the retirement plan deduction might save income taxes at a combined federal and state tax rate of 40%, which is offset with SE tax costs at 15.3%. Plus, the SE tax rate is 2% less for 2012 under the payroll tax cut temporary legislation in Washington. The trader saves the difference in the tax rates.

Partnerships report administration fees on the annual Form 1099-Misc. due in February of the following year. This is an attractive option because you don't have to file payroll tax forms or pay workers' compensation and unemployment insurance on the fees, which is high in some states.

HOW DOES THE TAX SAVINGS WORK?

With trader tax status, it's a full offset in gross income: The administration fee gross income on Schedule C is offset with business expense for that fee passing through the entity return reported on Schedule E. The AGI deductions for retirement plan contributions and health insurance premiums generally save income taxes at a materially higher income tax rate than offsetting SE taxes due on that administration fee income. Most traders save several thousand dollars net on this strategy and married couples can save over $17,000 by each contributing to an Individual 401(k) plan.

Conversely, in an investment partnership (without trader tax status), the Schedule C administration fee income is not fully offset because of restricted miscellaneous itemized deductions for investment expenses, which are also not deductible for the alternative minimum tax, either. Investors don't report the fee on Schedule E (from gross income) — they report it on Schedule A where the itemized-deduction limitations apply.

WHERE SHOULD I FORM MY ENTITY?

Form your trading entity in your home state, unless you plan to move to a new state soon. General partnerships are portable from state to state because they aren't incorporated or organized in any given state. Pass-through entities pass income to your home state, so setting up out of state doesn't save on taxes and can cause extra expenses and trouble with your home state. Your home state may catch up with you later on and charge you for state registration fees, minimum taxes and large penalties and interest. It can add up over many years.

It's different for hedge funds; most are formed in Delaware as LLCs or Limited Partnerships with the related management company LLC formed in your home state. See Chapter 13 on investment management businesses.

ASSET PROTECTION

Tax-free states market entities for asset protection and tax-avoidance reasons, but both often fail in practice. If you live and work in your home state, you need to register a foreign entity in that state anyway. Registering is a must: Asset protection won't work in your home state if you have not registered your company there. If you are sued by another party, it's generally in your home state, too.

In our view, trading your own money in an entity doesn't need legal protection since you don't have any customers or investors. Conversely, investment managers trading other peoples' money absolutely need legal liability protection.

If you want asset protection, consider a trust in your home state. If you have a husband and wife general partnership, you can convey interests in the entity to your trust. As in an LLC which offers protection with customers — what we call front-door risk — a trust offers back-door risk, too. If someone gets hurt in your house or car and sues you beyond the limits of your insurance, the trust offers you protection, whereas the LLC would not. Proper insurance is important, too. Consult with an attorney and insurance broker about liability protection.

PASS-THROUGH ENTITIES

A separate pass-through entity passes all items of income, loss and expense directly to the trader's individual tax return in summary form, so taxes are paid on the owner level only. Summary reporting on the individual return without using a Schedule C means fewer IRS questions. Reporting methods for pass-through entities include:

- Dividend and interest income are reported on individual Form 1040 Schedule B.
- Section 475 MTM gains and losses are consolidated into ordinary income or loss on the entity tax return and Schedule K-1 given to the owner. Form 4797 is filed on the entity level.
- Business expenses are reported in summary manner on individual Form 1040 Schedule E, with expense details reported on the entity return. Form 4797 gain or loss is consolidated with business expenses on the entity level, so profitable business traders report net income on Schedule E, which looks much better than Schedule C for a sole proprietor trader.

Some traders with investor tax status may want to consider an entity, even if they can't efficiently use the AGI deduction strategies, to consolidate their trading activities in one tax place. This avoids wash sales on their individual taxable and IRA trading accounts. If they benefit from investment expense treatment (i.e., they don't trigger the alternative minimum tax and they're well over the 2% AGI limitation), it's beneficial to consolidate those expenses on an entity return and pass them through in summary form to the individual return; it resembles a hedge-fund investment and looks quite normal to the IRS. Otherwise, the IRS might nit-pick at investment expense details on Schedule A.

An incubator fund plan allows family and close friends to pool trading assets into one fund (LLC or LP) to share expenses. It's an attractive idea for some, even without trader tax status. Learn more on the GreenTraderTax website in the Investment Management area.

GENERAL PARTNERSHIPS

General partnerships between spouses are a good choice in many states because they're the most inexpensive to form and maintain. Partnership tax returns should use administration fees (not guaranteed payments) to financially engineer earned income.

IRS law now treats husbands and wives in non-community property the same as those in community property states. This means they can file a joint Schedule C rather than a Form 1065 partnership tax return, provided they elect to do so in advance. However, we advise using Form 1065, since the goal here is a separate tax filing to reduce IRS attention on Schedule C trading business returns. Plus, a joint Schedule C can't pay the owners an administration fee for AGI deductions, but the Form 1065 can.

General partnerships vs. LLCs and S-Corps. Usually there's no charge at the state level for formation or maintenance of a general partnership. LLCs and S-Corps are subject to fees of this nature. General partnerships may also have a prior de facto (or verbal) period like sole proprietorships, whereas LLCs and S-Corps may not. (De facto means a partnership in facts and circumstances that was not previously formalized.) De facto and verbal general partnerships are complicated with the new IRS rules for allowing joint Schedule Cs. We very rarely like to use a defacto or verbal general partnership solution and it's even more of a problem with new IRS form 8949. Tax treatment elections — like Section 475 MTM — may not be verbal or defacto. They must be filed internally or externally as required, on a timely basis. These issues are beyond the scope of this article, so be sure to consult with us.

Our tax attorney now prefers a husband and wife LLC over a general partnership in states where the LLC is not costly. He thinks the IRS respects an LLC more. (See "Business traders should use a pass-through entity" in our Executive Summary.)

LIMITED LIABILITY COMPANIES (LLC)

Limited liability companies commence operations on the date they're filed with the state or even later. Multi-member LLCs usually file partnership tax returns in the same manner as general partnerships, so tax matters are basically the same. LLCs can also elect to be taxed as S-Corps or C-Corps.

LLCs have liability protection, but most traders don't have customers and therefore don't need it. An LLC is a good choice for high-risk individuals who prefer some level of asset protection.

Investment managers have customers (i.e., investors) so liability protection is a must; they should never consider a general partnership. Many investment-management companies operate as an LLC, with some also filing an S-Corp election in order to reduce SE tax on advisory fees (see Chapter 13).

SINGLE-MEMBER LLC (SMLLC)

SMLLCs are "disregarded entities," a "tax nothing" in the eyes of the IRS. An individual owner reports SMLLC business activity just like a sole proprietorship on a Schedule C, so this option isn't helpful for executing the trader-tax benefit strategies. The point of forming an entity is to file a separate business tax return — not a Schedule C included with an individual tax return.
In a disregarded SMLLC, the IRS may not allow creating earned income with an administration fee, as sole proprietorships aren't allowed to pay fees or salaries to owners. The IRS may also challenge a valid SMLLC "new taxpayer" internal election for Section 475 MTM accounting, so file your external MTM election as an individual would by the April 15, 2013 deadline. Adding a second member (a spouse) to your SMLLC in order to file a partnership tax return is safer and solves these issues.

Alternatively, if you don't have a partner and wish to remain the sole owner, consider electing S-Corp status on your SMLLC. The S-Corp election can be filed late (after the 75 days required) with IRS relief. Consult a professional for assistance. Many states require an S-Corp election too, so if you are filing late under IRS relief, make sure your state grants late relief too.

Single traders in jurisdictions with high costs (such as California and New York City) for LLCs and/or S-Corps may want to form a general partnership as a second entity. The SMLLC with S-Corp election can only hold a 1% interest in the general partnership, with the trader individually owning the other 99%. You can't be partners with yourself, but you can be partners with your own SMLLC/S-Corp.

S-CORP

Corporations start out as C-corporations and may elect S-corporation pass-through tax treatment within 75 days of inception or the start of the following calendar tax year by March 15. As discussed earlier, LLCs may elect S-Corp status. (We prefer this method of achieving S-Corp status in most states, but not all.) You can remain a disregarded entity until you achieve trader tax status, if that's a concern. Also, corporations have rules for annual meetings whereas LLCs do not. The IRS allows late S-Corp elections with generous relief. See if your state provides similar relief too.

As required by the IRS, most accountants use "salaries" with S-Corps to compensate owner/managers. The payroll method requires compliance with W-2s, quarterly 941s, annual 940s and state filings including unemployment insurance. If this payroll tax is high in your state, consult an expert about using an administration fee instead. The underlying income isn't earned income, so the IRS and state tax law may be amenable. On the other hand, you may be able to claim unemployment benefits in connection with salaries if you close your trading business, so consider that as well.

Using a new computer matching program, the IRS has recently been on the lookout for "Officers Compensation," which is salary reported on a W-2 to the owner/manager on S-Corp tax returns. Businesses that generate earned income often seek to reduce payroll taxation using an S-Corp structure (see Chapter 13). Traders using an S-Corp do not have earned income, so they don't need to report officers' compensation. Explain this factor in footnotes.

If you chose salary over an administration fee, you can achieve the maximum contribution to a Mini 401(k) plan on slightly lower salary with payroll in an S-Corp vs. an administration fee in a partnership. Administration fees are reduced by 50% of SE tax in determining the tax-deductible retirement-plan basis amount. Payroll saves the trader about $300 in SE tax, which offsets some of the added payroll tax and compliance costs. With salary, the retirement plan should be on the entity level, whereas with administration fees, the retirement plan is in your individual name.

S-Corps may not have special allocations or two classes of stock, but partnerships and LLCs may have both. That means you can't arrange carried interest with an S-Corp structure.

C-CORPS

Unlike S-corporations, C-corporations don't pass through trading losses and expenses to the owner's individual tax return, where they could otherwise generate immediate tax refunds. C-Corps aren't preferred to operate a trading business, for several reasons:

- Lower 60/40 rates tax on Section 1256 contracts aren't allowed in C-Corps.
- Improperly marketed dual-entity schemes for traders with an LLC and C-Corp are often expensive and can have many tax pitfalls. One out of a thousand clients may benefit from a C-Corp in the mix, and unfortunately one of our competitors recommends a dual-entity structure with a C-Corp. They promise the C-Corp can fix the non-qualification for trader tax status problem and it does not. We wind up having to clean up this mess often when their clients turn to us in frustration.
- Paying out salaries or administration fees to avoid double taxation (triggered with C-Corps) causes payroll or SE tax that otherwise might not be due, since retirement plan deduction strategies usually only require a small portion of trading gains to be converted into earned income.
- The $3,000 capital loss isn't allowed in a C-Corp. Losses are trapped in C-Corps until the entity is closed, so traders can't immediately benefit from losses. Final closure leads to capital loss treatment too. You can't sell tax losses in an entity to another party.

We suggest using a C-Corp — not as a trading entity but to hold intellectual property — to avoid Obama-era income tax hikes on upper-income taxpayers starting in 2013. For a specific scenario of how this works, see "Example: 2013 tax savings using entities" later in this chapter.

New strategy: Shift 2013 income with a corporation. Consider that the corporate tax rates for small businesses are 15% (first $50,000), 25% (next $25,000) and 34% (thereafter). Large companies are paying up to 38% or 39%. President Obama is discussing lowering corporate tax rates as part of tax reform. He wants to capture more offshore income as part of that grand bargain, and that doesn't really affect traders using a corporation in the U.S.

A C-corporation is otherwise called a "corporation" and it has entity-level taxes. Public companies are corporations. Certain small businesses may elect S-corporation tax status, which makes the corporation a pass-through entity. S-corps have no entity-level taxes with the income, expense, gain or loss passed through to the owner's tax returns.

Business traders can pay a royalty to their own corporation for the use of intellectual property created in connection with their trading strategies, systems and algorithms. For example, a trader can set up a corporation in the U.S. to own and lease out his trading intellectual property (IP). His trading business pass-through entity — husband and wife general partnership/LLC or single-member LLC with S-Corp election — can pay a royalty to this new corporation.

Managing double taxation in a corporation. One big concern with shifting income from individuals to corporations is double taxation — Corporations pay entity-level taxes and taxes on dividends. There are plenty of ways to limit or avoid double taxation. Traditionally, owners of small corporations pay out compensation and interest to owners to reduce entity-level net income, as both are tax deductible in the entity. But dividends are not tax deductible. Tax reform may consider a change on that disparity of dividends vs. interest, as current tax policy is faulted for encouraging debt and leverage over equity.

If you live in a state that doesn't have a corporate state income tax, then you don't need to worry about state double taxation using up any of the federal tax savings. But if you live and work in a high corporate tax state like New York or California, then this strategy may not be cost beneficial. The next section provides more details on state costs.

STATE COSTS VARY

Several states subject S-Corps to low levels of franchise tax. Most are very nominal, but some can be material. For example, California has a 1.5% franchise tax that applies to trading gains, too. Don't worry about this California tax unless you expect net income over $53,000 ($800 minimum tax divided by 1.5%). If you go over, we can form a general partnership for the S-Corp to own 1%. Illinois has a 1.5% replacement tax, but pure trading entities are exempt. New York City taxes S-Corps the same as C-Corps, which taxes trading gains, so S-Corps are not wise there. Again, use that S-Corp to own 1% of a general partnership,

Example: 2013 tax savings using entities

Suppose you make $500,000 as a joint filer in 2013, which breaks down as follows: Your spouse's W-2 income of $260,000, your trading business K-1 income of $200,000, and $40,000 of other "unearned income." These amounts are over the thresholds for the Obama-era tax hikes.

First, the $500,000 of income exceeds the threshold of $450,000, triggering the new top tax rate of 41% (after PEP and Pease eliminations) on $50,000. The prior Bush-era top tax rate was 35%, so the Obama-era income tax hike is $3,000 ($50,000 x 6%).

Second, the $240,000 of unearned income is entirely above the $250,000 threshold, so all the unearned income is subject to ObamaCare's 3.8% Medicare tax. That's a new Medicare tax hike of $9,120 on unearned income.

Consider using an S-corporation. Instead of paying an administration fee of $30,000 from your trading business partnership to your Schedule C to unlock the AGI deductions — which we usually recommend — use a new S-corporation to first pay an administration fee of four times that amount ($120,000). If you work hard all year in your trading business, that level of an administration fee seems reasonable.

The trading business partnership tax return's unearned income will be reduced to $80,000 from 200,000. That reduces the ObamaCare Medicare unearned taxable income by $120,000. This equals a Medicare tax savings of $4,560.

The S-corporation then pays a $30,000 administration fee or salary to the individual owner. $30,000 is the amount required for the corresponding AGI deductions for an Individual 401k retirement plan contribution — elective deferral of $22,500 for over age 50 — and health insurance premiums.

This takes advantage of the S-corp self-employment (SE) tax reduction loophole (see "Here's how the SE loophole works" in Appendix C).

Mr. Neuschwander points out that the IRS requires "reasonable compensation." He and many CPAs suggest that 25% to 50% of net income is reasonable compensation, so potentially up to 75% may avoid SE or payroll taxes. The other $90,000 of S-corporation profits — $120,000 revenue minus the $30,000 compensation to owner — isn't subject to SE taxes on earned income or ObamaCare Medicare taxes on unearned income. It goes into the blank box.

In Appendix C, I argued that an S-corporation trading company doesn't reduce the ObamaCare 3.8% Medicare tax on unearned income, because unearned income passes through on the K-1. While that statement is still true, our new idea is different, carving out fee income into an earned-income related S-corporation. The ObamaCare 3.8% Medicare tax applies to "net" unearned income and this administration fee reduces the net trading income in the trading business partnership or S-corporation tax return.

This idea and tax strategy is new and we are still vetting it further. You have time to add these entities to the mix later in the year, so wait for our updates on this strategy.

Pay royalties to your own C-corporation. Another strategy is to have your trading business partnership pay a royalty (up to $75,000) on intellectual property (IP) to your own C-corporation. The first $50,000 of corporation net income is taxed on the corporate federal tax return at 15%, and the next $25,000 of net income is taxed at a 25% rate. After $75,000, the tax rate rises to 34%. That's a nice savings compared to the top individual tax rate of 39.6% (effectively 41% with PEP and Pease). The initial tax savings on the C-corporation strategy is $13,000: $50,000 taxed at 15% vs. 41%.

Your corporation can defer paying a qualifying dividend to you for several years. When you pay the dividend, you will owe an additional $7,500 ($50,000 dividend times the 15% dividend rate). That reduces your net tax overall federal tax savings to $5,500. Try to pay the dividend in years your income is under the 20% dividend tax threshold of $450,000/$400,000.

Investment managers and other businesses can consider the corporation housing IP tax strategy, too. Coupled with a Web-based ecommerce strategy, you may be able to land the corporation in Delaware.

Be aware of the corporate "Accumulated Earnings Tax." This 20% tax incentivizes corporations to pay out dividends when their accumulated earnings exceed their working capital needs. Don't wait for an IRS auditor to assess this tax with interest owed over the years, too. Consult with an expert about it.

Mr. Neuschwander says we need to also consider "professional services corporation" (PSC) rules, which disallow the lower corporate tax rates of 15% and 25%, with all PSC income taxed at 34%. The IRS has the PSC rules to prevent professionals from easily shifting individual income to a corporation. But the corporation we suggest is for housing intellectual property and receiving royalties, not revenues from professional services. Many technology companies utilize IP companies in tax free states and tax haven countries too. A trading company is not a professional services company in the first place.

Even with double taxation factored in, there is net tax savings. The fiscal cliff deal is good news since it makes the qualifying dividend's tax rate permanent. We've avoided the C-corporation strategy in the past since the differential in individual vs. corporate tax rates was inconsequential, and we worried about the Bush-era rates expiring and the dividend rate jumping back to 39.6%. That's no longer a concern and the difference in rates is significant. C-corporations are clearly not for every high-income trader, but some many want to consider using one.

which is free of tax in New York City.

In New York, LLCs must publish a notice in two general-circulation newspapers within 120 days of formation. The notice has to run once a week for six weeks, which can be costly depending on the newspaper. New York is one of three states left in the nation with this archaic publishing stipulation, along with Arizona and Nebraska.

California has the most expensive minimum tax ($800 assessed) on LLCs and S-Corps, but there's no tax on general partnerships. Massachusetts and Illinois have high formation and annual costs. Texas subjects LLCs and S-Corps with trading gains of $300,000 or more to a 1% margins tax. A general partnership in Texas owned by natural persons is exempt from this tax. The Washington state's B&O tax doesn't apply on trading gains, but it does apply on investment management fees or profit allocations.

As a general rule, LLCs and S-Corps trading gains are exempt from state pass-through entity-level taxation. For example, entities in New York City and Illinois that have trading gains with no earned income are exempt from the NYC unincorporated business tax (UBT) of 4% and Illinois replacement tax of 1.5%, respectively.

The exception to the general rule is in California, where the S-Corp franchise tax applies to all income including trading gains. Also, Washington DC imposes an entity tax on all income including trading gains. General partnerships are free of all state minimum taxes and annual maintenance costs, so they are the most inexpensive entity choice. Next in line are LLCs, which may have small annual report or minimum taxes, and those costs are generally capped. Look closely at the S-Corp franchise tax rules, as they can have higher tax costs in some states.

Listing all states is beyond the scope of this guide, so check with a trader tax expert with a national practice like Green NFH, LLC.

DUAL-ENTITY SCHEMES AREN'T A GOOD IDEA FOR TRADERS

(Note: This is very different from our C-Corp strategy mentioned earlier to avoid Obama-era tax hikes in 2013.) Some accountants and tax attorneys recommend C-Corps to traders who don't qualify for trader tax status, especially, the ones that target new traders on the seminar circuit. They're interested in selling expensive cookie-cutter schemes to make money, not in advising traders on the right strategies that work over time. We're the opposite; we want to support a trader with strategies that work for the long-term.

C-Corps don't have the same concept of business vs. investment expenses. But this strategy still fails when a second trading entity such as an LLC pays fees to the C-Corp to zero out income after using the C-Corp to pay expenses. The LLC partnership return has a restricted investment expense deduction in this case, so tax benefits aren't achieved in the end anyway.

Some suggest another ill-advised angle: Paying a small amount of fees while letting the C-Corp build up a higher amount of expenses (which become losses), trying to achieve business ordinary-loss write-offs in closing the C-Corp in a later year based on Section 1244 ordinary-loss tax treatment. A trading C-Corp alone doesn't qualify for Section 1244 stock-loss treatment, as it fails the necessary business revenues qualification. A dual entity paying fees only to the C-Corp (by the trading LLC) might qualify for Section 1244 stock treatment. However, we expect the IRS to treat this scenario as a sham transaction, because the C-Corp never achieved business purpose — with the plan of having more expenses than revenues (net losses). Alternatively, the IRS may argue the fees paid to the C-Corp were below market rate and need to be restated upwards — after all, in an arm's length transaction, an independent company would charge a customer more than the cost of its expenses. Consult a trader tax expert. It's better to address whether or not you qualify for trader tax status and plan accordingly around that determination in a more honest approach. Paying thousands of dollars for dual entity schemes up front and having costly tax problems later isn't worth it.

If you don't qualify for trader tax status, stay clear of promoters who promise an entity can still deliver business deductions, including pre-business education and Section 475 MTM ordinary loss treatment. Without trader tax status, an entity is an investment company, with Section 212 investment expense treatment.

DATA-FEED FEES

Nasdaq, NYSE and some other market-data vendors offer multiple-tier pricing for their market data, arranged through brokerage firm platforms. They offer higher professional rates and lower non-professional rates. Unfortunately, their policies often require higher professional rates for all entities, including a family trading entity without outside investors.

Years ago, a Nasdaq official told us they would informally permit a family trading entity without any outside investors to use the lower non-professional rates. I asked a Nasdaq representative about this at the New York City Traders Expo in February 2012 and he restated their policy to charge higher professional rates on all entities without exception. When I mentioned that I would pass on this conversation in our content, he pointed out that the brokerage firm was Nasdaq's customer, and if the broker allowed non-professional rates to the entity, Nasdaq could not go after the entity to pay the higher fees.

Most brokers allow a husband and wife entity to continue paying non-professional data feed fees even though the vendors' data provider agreements call for higher professional data-feed fees on entity accounts. But this can change so check with your brokerage firm. Some brokers may require an individual account connected to your entity account to avoid the higher rates. In general, costs should not go up on entity accounts, so the tax savings hit your bottom line. It's best to inquire about these issues with your broker before forming your entity. We recently heard that data vendors may be more accommodating by treating a family trading entity like an investment club, which seems to qualify for non-professional rates. The definition permits individual subscribers associated with other organizations to access non-professional rates if the organization is established exclusively to manage accounts of the individual or the individual's immediate family. In addition, non-commercial organizations solely owned by an individual and members of their immediate family (also non-professionals) utilizing the market data for their own personal investing may access data at non-professional rates.

UNEMPLOYMENT AND OTHER POTENTIAL CONFLICTS

Trader tax status doesn't conflict with social security or unemployment benefits. I don't think it conflicts with most disability providers, either, but it's best to double check. Forming a trading entity doesn't conflict with these benefits, either.

But having your entity pay you an administration fee or a salary conflicts with some of these social-welfare benefits. So, hold off until the benefits end. For example, you can form an entity early in the year, and if your unemployment ends by November, you can pay yourself a fee in December to unlock the AGI deductions for the entire year.

Tell the benefit providers you want to form an investment company. Trader tax status is more of a quirky IRS rule and it's not a factor on these social-welfare benefits.

BOTTOM LINE

Retail traders form entities to reduce the red-flag factor with the IRS over trader tax status and mostly to unlock valuable AGI deductions to save thousands of dollars. Entities are useful for late-year MTM elections and avoiding wash sales as well. Proprietary traders and investment managers form entities for legal-liability protection, too. Starting in 2013, entities can help avoid Obama-era tax hikes on the upper income, including the new 3.8% Medicare tax.

Chapter 8: Retirement Plans For Traders

Business traders can save additional income taxes by contributing to a tax-deductible retirement plan. The taxpayer pays a self-employment (SE) tax on administration fees from a partnership, or payroll taxes on salaries in an S-Corp on the earned income component, but usually winds up saving significantly more than that in income taxes. A married couple can save over $17,000 more with Individual 401(k) plan contributions and health-insurance deductions (see the example later in this chapter).

It's wise to save for retirement for many reasons. You can invest or actively trade those retirement assets tax-free until you take normal withdrawals as early as age 59½ and as late as age 70½. Avoid early withdrawals before age 59½ in an IRA — they're subject to a 10% excise tax penalty in addition to ordinary income tax rates. (A few exceptions apply.)

Small business traders can rollover a 401(k) plan from their previous job or an IRA into an Individual 401(k) plan and then take withdrawals starting at age 55, without triggering a 10% excise tax penalty. A qualified plan allows withdrawals at age 55, whereas IRA holders have to wait until age 59½. Many traders can benefit from that difference.

Retirement-plan contributions can only be made if that taxpayer has earned income, which is subject to the SE tax. Trading gains aren't earned income and are exempt from SE tax in a partnership or payroll taxes in an S-Corp. The exception to this is futures traders who are full-fledged dealer/members of options or futures exchanges; their futures gains are considered earned income subject to SE tax (Section 1402i). Business traders use entities to create earned income if they don't have another source (see Chapter 7).

There's one caveat with all retirement plans: You need to cover all employees in your company and other "affiliated service groups" such as a related entity you own. Some traders own the majority of equity in another business that hires many employees. They can't set up a high-deductible retirement plan for themselves in a trading entity without also offering a similar employee benefit to their employees in that other business, too. You can limit this problem by using employee vesting schedules. Consult an employee benefits attorney.

> Avoid early IRA withdrawals (before age 59 and a half) — they're subject to a 10% excise tax penalty in addition to ordinary income tax rates.

INDIVIDUAL 401(K) RETIREMENT PLANS ARE BETTER THAN SEP IRAS

Individual 401(k) plans — also called Mini 401k plans — often generate the most tax savings for traders. An Individual 401(k) plan minimizes the SE tax while maximizing income tax savings. (The SE tax consists of the FICA and Medicare tax for a self-employed person.) The net differential in tax savings is far greater than with a SEP IRA. The main reason is because a trader can determine what amount of his trading gains will be earned income, starting with none. Conversely, with other types of small business, the entire income is considered earned income, and it's often over the maximum needed anyway.

Profit-sharing plans such as a SEP IRA limit "defined contributions" to 20% of net earned income. They require a materially higher fee subject to the SE tax to drive a lower allowed contribution. SEP IRAs can be established up until the due date of your tax return, including extensions.

An Individual 401(k) plan, on the other hand, adds a 100% deductible 401(k) "elective deferral" to a profit-sharing plan, and that's where most of the tax savings come from. Individual 401(k)s are only available to small businesses and the plan needs to be established before year-end, but funding can wait until the extended due date. In an Individual 401(k), taxpayers can contribute the elective deferral maximum ($17,000 for 2012 and $17,500 for 2013), plus a 20% net profit-sharing plan. Individual 401(k)s have a "catch-up" provision for taxpayers 50 years of age or older ($5,500 for 2012 and 2013). SEP IRAs do not have this.

Individual 401k plans require an annual 5500 or 5500-EZ filing, whereas IRAs and SEP IRAs do not. Most brokers provide this form and they are usually not too complex. Don't miss that separate tax filing due date of July 31 for calendar year taxpayers.

THE MATH ON INDIVIDUAL 401(K) TAX SAVINGS

A married couple filing as business traders can save an additional $17,000 with adjusted gross income (AGI) tax deductions for Individual 401(k) retirement plans and family health insurance premiums. Let's say a husband and wife each have a $17,000 Individual 401(k) elective deferral for 2012, plus the $5,500 "catch up" provision for those over the age of 50, plus family health insurance premiums of $13,000 per year. Their total AGI deduction is $58,000 times the federal and state tax rates of 40% (35% federal plus state), so the income tax savings is $23,200.

Their SE taxes are 13.3% (15.3% less the 2% payroll tax cut for 2012) times $59,000 (which is just a little over the AGI deduction amount) equaling $7,847. Income tax savings exceed SE tax costs by $15,353. Additional income tax savings of $1,569 are achieved from deducting 50% of the SE tax cost; the total savings is approximately $17,000.

A single person under age 50 trading futures at lower 60/40 tax rates in a tax-free state is eligible for several thousand dollars of net tax savings as well. For both the married couple and the single person, the 20% profit sharing plan element can add even more tax savings when maxing out the contribution (up to $50,000 for 2012 and $51,000 for 2013), plus the $5,500 more for those over age 50.

Trader tax status saves the average business trader around $8,000 with business expense deductions. Adding the entity and retirement plan element can save thousands more. That's real money in your pocket! Plus, it's better to replace income taxes with SE taxes, as the latter generate benefits for you in retirement.

LOANS FROM QUALIFIED RETIREMENT PLANS

While taxpayers can't borrow money from an IRA or SEP IRA — non-qualified retirement plans — they can borrow money from a qualified plan like an Individual 401(k). You can borrow the money from your qualified plan for any reason you like. Many traders borrow money and use it to capitalize their trading business entity.

Limitations and special rules. You can borrow up to a maximum amount of $50,000, limited to 50% of retirement plan assets. For example, if your Individual 401(k) has $80,000, you can borrow up to $40,000. If it has $120,000, you can borrow up to $50,000.

You also must pay back the loan on no later than a quarterly fixed-amortization schedule over no longer than five years. You need a market rate of interest — which is very low now — and that interest is not tax deductible. If you can't pay back the loan, it's treated as a withdrawal, which is ordinary income. If it's an early withdrawal (under age 55), you will also owe a 10% excise tax penalty on Form 5329, included with your Form 1040 filing. Distributions are taxable in your home state, too.

A few brokers offer good cookie-cutter Individual 401(k) plans, and TD Ameritrade offers the plan loan feature as well. TDA offers both options, a regular 401(k) tax-deductible contribution that is temporarily tax-free until retirement, or a Roth 401(k) non-deductible contribution that is tax-free for life. You can choose each year which one is best for you.

DEFINED BENEFIT RETIREMENT PLANS

Highly profitable traders with excess cash flow should consider a "defined benefit" (DB) retirement plan. With a DB plan, you can contribute a much higher amount than the limit on defined contribution or profit-sharing plans, including the mini 401(k). An actuary is required to define your retirement benefits, and the annual contributions vary (up to $200,000 for 2012 and $205,000 for 2013). DB plans are more costly. You can find annual limits on contributions for different types of retirement plans on the Internet; search "maximum retirement plan contributions." One example is located here: http://tinyurl.com/6mzq53m.

ROTH IRAS AND ROTH 401(K)S

Roth IRAs and Roth Individual 401(k) plans are attractive to traders too. Annual contributions to Roth retirement plans aren't tax-deductible, but they aren't taxable either when distributions are taken in retirement. Traders can generate permanently deferred income in these plans with active trading and enjoy permanent tax-free income in retirement (and even in early retirement).

If you're unlikely to qualify for trader tax status and don't need immediate cash flow from a trading account, consider trading a Roth retirement plan instead of pushing the envelope on trader tax status. In general, active traders can trade frequently in their Roth IRA and traditional retirement plan accounts with few restrictions or higher costs. (There may be some restrictions on shorting stocks, and some brokers may charge higher commissions on retirement plans.)

Roth IRA conversions. Starting in 2010, the IRS income threshold was waived for Roth IRA conversions, making it possible for taxpayers at any income level to convert money from traditional IRAs, 401(k) s, and other tax-deferred accounts for 2010 and subsequent years. Prior to 2010, the Roth conversion option was available only to taxpayers with a modified adjusted gross income (MAGI) of $100,000 or less for both joint and single filings. Now, traders don't have to wait until year-end to see if they qualify under an income threshold rule, which means they may safely consider a conversion earlier in the year. You may benefit from converting some of your money into a Roth IRA because you can trade on the account and withdraw the earnings and contributions tax-free once you have held the account five years after the conversion and are older than age 59½. In retirement, Roth IRAs may help with income tax on Social Security benefits. The government taxes Social Security benefits if your combined adjusted gross income (AGI) surpasses the IRS income threshold. If you surpass the threshold, up to 85% of Social Security benefits are subject to income tax. If AGI falls under that income threshold amount, Social Security benefits are tax free. Unlike traditional retirement-plan distributions, Roth IRA distributions don't count toward the threshold amount as long as they meet the requirements for tax-free distributions.

This same concept applies to avoiding Obama-era tax hikes on taxable income over $450,000 (married) and $400,000 (single); the top individual income tax rate rises to 39.6% in 2013 from 35% in 2012. Manage your taxable income over time by converting to a Roth IRA when you're in a lower tax bracket. Plan your taxes so you can take just enough Roth conversion income to use up your tax bracket, but not too much to rise into the next higher tax bracket. You can "bust up" your retirement plan into pieces (separate rollover accounts) in order to convert one of those pieces with your desired income amount to a Roth.

Roth IRA distributions may help taxpayers qualify for other middle-class tax breaks too (also dependent on AGI) if the distributions are tax free, including various tax credits and deduction phase-outs.

One appealing feature of the 2010 Roth conversion is that it came with an election to defer the conversion taxes equally over two years; half the income resulting from the conversion will be included in gross income in 2011 and the other half in 2012. If you did this in 2010, don't forget to include this income in 2011 and 2012. Some taxpayers may be tempted to leave it out, since there's no form 1099 involved, but we expect the IRS to assess high penalties for those that try to cheat in this regard. The IRS monitors this closely. Last year, we advised upper-income taxpayers to consider a Roth conversion before year-end 2012 to accelerate income into 2012 before their top-bracket tax rates were expected to climb higher in 2013. That did in fact happen and we hope high-income traders followed this advice.

Roth conversions require cash from outside the plan to pay the taxes. The biggest drawback to the Roth conversion is you need sufficient cash flow from outside of your retirement funds to pay the conversion income taxes, unless you are over the age of when excise taxes apply. You generally want to avoid using withdrawals from your traditional IRA to pay those conversion taxes, as that part would then be subject to 10% excise taxes if you're under age 59½ with an IRA conversion or under age 55 with a qualified plan conversion You should also consider potential tax deductions offered by making annual contributions to a traditional retirement plan during high-income years. By making such a contribution, if eligible, you can take a tax deduction in years you make more money and are therefore taxed at a higher rate, then convert to a Roth IRA in lower-income years, paying the conversion taxes at a lower rate. Traders' income fluctuates significantly. This is a good way to manage tax rates over time.

Soak up losses and wasted itemized deductions with a Roth conversion. Traders have fluctuating income and loss each year. In a year with losses and otherwise wasted itemized deductions, consider a Roth conversion to generate enough income to use your itemized deductions fully, as well as losses, and use some of the lower marginal tax brackets, plus personal exemptions. It's an ideal time for this type of conversion, and it could wind up costing you little to nothing in taxes.

You're allowed to change your mind. Suppose you convert to a Roth IRA and then face a large loss in the Roth IRA (even in the following tax year). This unfortunate loss on permanently tax-free money can't be deducted on your taxes. It would have been better to have these losses in the IRA before conversion, so you would get the benefit of the tax losses and your tax bill on conversion would have been much lower.

Not to worry: The IRS allows taxpayers to change their minds. The process is known as a Roth IRA recharacterization. Generally, a taxpayer has until the extended date of Oct. 15 of the following tax year to undo a Roth conversion. For example, a Roth conversion completed in December 2012 may be recharacterized by Oct. 15, 2013. If a taxpayer files his or her 2012 tax return before Oct. 15, 2013, the return will need to be amended.

This is a good reason to file a 2012 tax extension by April 15, 2013. Make sure your extension is valid by paying 90% of your tax liability. See our blog on tax extension strategies and avoiding late-filing and late-payment penalties.

ENTITY VS. INDIVIDUAL RETIREMENT PLANS

As pointed out in Chapter 7, to create the earned income component required for a retirement plan contribution, administration fees are used with partnership returns and formal salaries are preferable with S-Corps.

General partnerships and multi-member LLCs filing a partnership return pay the trader an administration fee, which the owner reports on a Schedule C (administration) on his individual tax return. Because the trader has administration business earned income, he should open an individual-level retirement plan with his name and Social Security number.

Conversely, S-Corps — including single-member LLCs filing an S-Corp tax election — should pay the owner a formal salary, reported on a W-2. In this scenario, the retirement plan has to be established in the name of the entity using the entity tax identification number. If you miss setting up payroll before year-end, you can use an administration fee if you took distributions during the year, but that may invite IRS questions. For administration fees use an individual-level retirement plan. Consult a trader tax expert.

Note that investment managers have underlying earned income from fees, so the S-Corp structure is useful in reducing SE tax. See Chapter 13 for further details on taxation for investment managers.

TRADING WITHIN YOUR RETIREMENT ACCOUNTS

As noted earlier, if you're a close call on trader tax status, consider alternative strategies. Trade actively in your retirement plan and seek to deduct your investment expenses and trading losses within it, rather than suffer investment expense restrictions on your taxable account. Usually, an intermediary trust firm is required to allow this feature for direct payment or reimbursement of trading expenses on behalf of the retirement plan. Few brokerage firms allow it.

Not every expense can be deducted in the retirement plan. Generally, if the expense qualifies as a Section 212 "investment expense," it can be deducted within your retirement plan. Section 212 expenses are narrower than Section 162 trade or business expenses. Section 212 doesn't allow home-office, education start-up, or seminar costs, whereas Section 162 does. Trader tax status is Section 162.

Note that trader tax status is achieved through trading taxable accounts. Trading activity in retirement accounts doesn't qualify, but it can be a good way to build tax-free compounded returns and deduct your expenses, especially if you don't qualify for trader tax status in your taxable accounts.

Note that IRS rules for wash sales apply to trades between a taxable account and your IRA. The wash sale loss is not allowed in the taxable account when you trigger a wash sale by buying a substantially identical position back 30 days before or after in your IRA. Section 475 MTM traders are exempt from wash sale rules. Consider trading in a separately filed entity to disconnect that account from your IRA trading accounts, because they are different taxpayers.

UNRELATED BUSINESS INCOME TAX

In certain cases, activities within your retirement plans can bring about income taxes and unrelated business income taxes (UBIT), even though retirement plans are by design tax-free accounts. Be aware of potential tax traps within retirement plans.

When retirement plans contain activities not permitted by the Department of Labor (DOL) or Employee Retirement Income Security Act (ERISA), the IRS has various rules in place to tax a portion of these plans. More information on self-dealing and prohibited transactions is located here: http://tinyurl.com/lj9o8e.

In some limited cases, your IRA custodian may permit you to invest your IRA into your incubator fund and hedge fund. You may actively trade within your retirement plans without calling it a business activity. After all, it's trading financial instruments in the eyes of the IRS. In some limited cases, your IRA can invest in your own C-Corp in a special manner, but C-Corps are not good for trading businesses. Consult with us if you're interested.

Your retirement accounts shouldn't pay you a fee for managing your own retirement funds; the IRS would deem that self-dealing. Conversely, it's not self-dealing for your retirement plan to reimburse you for appropriate investment expenses.

IRAs are cash accounts (not margin accounts). Yet margin accounts are allowed for "qualified plans" such as an Individual 401(k)s. Be aware of the potential problems.

Having a margin account alone doesn't trigger UBIT. UBIT is triggered when investment/margin-interest expense on securities is paid within your IRA or qualified plan account. Investment-interest expense only relates to trading securities on margin. Futures and forex may have notional leverage with higher risk, but that's not considered margin-interest expense, so these accounts don't trigger UBIT issues.

Publicly traded ETFs and private hedge funds are pass-through entities, requiring trust or partnership tax returns. They issue the investor a Schedule K-1 which passes through the character of the underlying tax matters to the investor. These ETFs and hedge funds may pay margin interest on their investments, which is passed on to a retirement plan investor. In that case, UBIT may be triggered. Avoidance of UBIT is the reason U.S. pension funds invest in offshore funds rather than domestic hedge funds; those offshore funds are known as UBIT-blockers.

See our Executive Summary "Retirement plan updates."

BOTTOM LINE

Traders are often hungry to get their hands on retirement assets to finance their business capital. But it's important to avoid the pitfalls and do it in the right manner. It's wise to save for retirement and to grow your retirement assets tax-free. Roth conversions are an excellent way to manage a trader's fluctuating income to avoid wasting tax deductions and credits in some years and avoid the higher tax brackets in others. It may not be smart to risk your retirement assets in very active day trading, especially if you aren't great at it. Be smart and prudent at the same time.

Chapter 9: Tax Planning, Law Changes & Reform

Planning your taxes well before year-end is important for traders. Whether it's pre-paying state income taxes for an additional tax deduction — without triggering the alternative minimum tax (AMT) or the 2013 Pease limitation — or accelerating other expenses and deferring income and therefore taxes, it's important to get a handle on trader tax status, your trade accounting and other tax matters. Obama-era tax hikes on the upper income start in 2013, so try to avoid those, too.

Most tax planning articles in the mainstream media focus on tried-and-true strategies — what I call "plain vanilla" strategies. We focus on unique tax planning strategies that affect business traders and investment managers, including trader tax status (business treatment), tax treatment elections, Roth conversions, avoiding wash sale loss deferrals, managing tax rate brackets, special strategies with entities, maximizing retirement plan deductions and reducing self-employment, payroll and new Medicare taxes on unearned income.

2013 TAX CHANGES

Congress forged a last-minute fiscal cliff decision — The American Taxpayer Relief Act — before the lame-duck session expired on Jan. 3. Unfortunately, no one could plan taxes with certainty before year-end. Now that the deal has been reached, hopefully we can make better tax planning moves in 2013.

Fiscal cliff news dissected. The good news is Congress and the President made the Bush-era tax cuts and rates permanent for taxpayers, excluding the top 2% with incomes over $300,000 (joint filers) and $250,000 (single filers). (To get a good handle on the amounts due, use calculators like this one: http://calculator.taxpolicycenter.org.)

If you thought the thresholds were $450,000 and $400,000, you're not alone. Congress and the media focused on the top tax rate returning to the Clinton-era rate of 39.6% only on incomes over $450,000 for couples and $400,000 for individuals.

Besides adding a new top tax rate of 39.6%, the legislation included Speaker Boehner's original offer to raise revenue through reducing tax expenditures. Starting with incomes over $300,000 (joint) and $250,000 (single), the act brings back old tax law for Personal Exemption Phaseout (PEP) and Pease provisions. The Pease provision eliminates itemized deductions up to 80% on incomes over those levels, and PEP eliminates exemptions. In high-tax states, it can raise families' official 33% tax rate to an effective rate of 38%.

My partner Darren Neuschwander, CPA agrees that the Pease provisions can materially raise taxpayers' effective marginal tax rates. The Pease rules were set to return for all taxpayers with expiration of the Bush-era tax cuts, but Congress protected the middle class from this stealth tax hike. It's a good idea to run a proforma tax return for 2013 to see how you come out with these changes. It's ironic that Congress was expecting trouble in limiting state taxes, mortgage interest and charitable deductions, yet these itemized deduction are limited with Pease rules.

In effect, President Obama got what he wanted with tax hikes on the two top tax brackets, using a combination of official tax rate hikes and reductions of tax expenditures. After you factor in ObamaCare 3.8% Medicare tax hikes which went into effect Jan. 1 on incomes over $250,000 (joint filers) and $200,000 (single), Obama-era taxes on the rich are higher than Clinton-era taxes.

The fiscal-cliff deal made the qualifying dividends and long-term capital gains tax rates permanent. It raised the Bush-era 15% qualifying dividends and long-term capital gains tax rate to 20% when incomes exceed $450,000/$400,000. (The higher 20% tax rate only applies to qualifying dividends and long-term capital gains income that exceed the threshold.)

Taxes were raised on the middle class, too. The temporary 2% payroll tax cut expired, reducing the net pay in every paycheck. Traders are not affected by the payroll tax, as trading gains are not subject to payroll taxes. However, when traders pay themselves a small fee to unlock AGI deductions for retirement plans and health insurance premiums, they do owe payroll taxes on salaries or self-employment taxes on administration fees.

The good news is that many traders have incomes under the new tax hike thresholds, so they will continue to benefit from Bush-era tax cuts, which the act makes permanent — if you believe in such fantasies. Most traders won't see their taxes hiked, unless they have a very good year in the markets or they are married to a high-income earner.

Unsure how much profit you will make?

It's often hard to predict if you will be over the $450,000 threshold. Our tax attorney Mark Feldman suggests creating a partnership or an LLC (taxed as a partnership) to hold the IP. So long as it's a partnership, this will not really affect your tax situation. When it becomes clear you're going to exceed the threshold, you can make a "check the box" election to treat the partnership or LLC like a corporation for tax purposes. The election can be retroactive for 75 days (with the possibility of going back further if you made a mistake and have a good excuse). From that point forward, all income received by the check-the-box corporation will not be considered your income as an individual (it's corporate income), and you can thereby avoid hitting the $450,000 threshold. (Note that once you make the election, you cannot reverse it for five years.)

More tax reform is on the way. Don't get too comfortable with tax planning certainty for 2013. Before signing the fiscal cliff legislation, President Obama promised he will try to raise more tax revenue as part of a grand bargain to reform taxes, spending and entitlement programs.

Will tax reform discussions focus on further limiting itemized tax deductions and credits for the upper income, rather than hiking more tax rates? With the PEP and Pease provisions already added back, how much more can Congress raise in taxes from limiting tax expenditures? The good news for business traders is 2013 tax reform will probably not undermine our trader tax strategies and related tax breaks. Small business is favored by both political parties.

Trader tax status and more. First, consider trader tax status. If you qualify, you are able to use "above the line" business expense deduction treatment, rather than "below the line" itemized deductions for investment expenses. Investors stand to lose a lot in tax reform, but business traders should be saved any damage on their expensing. If you qualify in 2012, but don't expect to in 2013, try to accelerate deductions into 2012. Or, vice versa. Keep an eye out for Section 195 start-up expenses too, as we don't think you should go further back than six months for capitalizing these items. The fiscal cliff deal extended bonus depreciation for one year and favorable Section 179 depreciation.

Qualifying business traders may elect Section 475 MTM accounting (ordinary gain or loss treatment), which we call "tax loss insurance" because it exempts business traders from onerous wash sale loss deferral rules and the dreaded $3,000 capital loss limitation against ordinary income. (Existing taxpayer individuals and partnerships must file 2013 Section 475 MTM elections with the IRS by April 15, 2013). We haven't heard any discussion in Congress or the administration about reversing these tax breaks for business traders. In 1997, Congress expanded Section 475 MTM from dealers to qualifying business traders. Economic and marked-to-market (MTM) reporting makes more sense and its good public policy.

We also haven't heard any discussion about denying forex trading gains into Section 1256(g) treatment, after a duly filed Section 988 opt-out "capital gains election."

If Congress raises revenue from disallowing corporate tax deductions for employer-provided health insurance, then we expect it to carry through across the board, disallowing health insurance premium AGI deductions for everyone. Strategies using an entity for retirement plan deductions will still make sense.

Is the 60/40 futures tax break in jeopardy? While some in Congress called Section 1256 and its lower 60/40 tax rates a tax loophole, others defended it.

I defend the rates and Warren Buffett calls them a loophole in the *New York Times* article "An Addition to the List of Loopholes" by Andrew Ross Sorkin.

As long as there are two rates there should be a blended (long-term and ordinary) tax rate for Section 1256. With MTM baked into Section 1256 by default, traders and investors may not defer capital gains to get the lower long-term capital gains tax rate or enjoy tax deferral over years, but investors in securities (Mr. Buffet) can. Hopefully Congress and the President won't try to change the blended mix of rates from 60/40 to 40/60 or some other mix.

Top individual rates are 10% higher than the corporate rate. Marginal tax rates are "progressive" meaning they climb higher as income goes higher. Taxpayers often seek opportunities to manipulate or manage their income to avoid higher tax rates, or to arbitrage diverging individual vs. corporate tax rates. Other taxpayers seek to convert ordinary income into long-term capital gains, but that cottage industry on Wall Street was mostly shut down with tax shelter reform.

The 2013 top individual tax rate returns to the Clinton-era tax rate of 39.6%, and after PEP and Pease limitations are factored in, it's almost 41%. The second top Bush-era rate of 33% remains, but after PEP and Pease, it can range up to 38% for large families in high-tax states. Plus there's the ObamaCare 3.8% Medicare tax on unearned income.

Compare these new tax rates to the corporate income tax rates of 15%, 25% and 34%. If you pay royalties to a corporation, make $50,000 per year in the corporation taxed at 15% and then pay qualifying dividends taxed at 15% (plus the 3.8%), that's a total of 34%, vs. Obama-era top individual rates of 45% (41% plus 3.8% Medicare tax). The difference is 11%.

In 2012, the top individual rate was just 2% higher than the second rate (35% and 33%), and the top rate was equivalent to the small business corporate tax rate of 34%. It wasn't worth the trouble and cost of dealing with an extra corporation. Now the gaps in tax rates have increased, so some upper income taxpayers may consider income shifting with a corporation and income re-characterization with an S-corporation. Chapter 7 explains these strategies in detail, and also provides a specific example of how to save in 2013 using an entity.

Financial-transaction tax. Our Executive Summary contains an update on financial-transaction taxes snowballing in the EU and how they may be applied in limited fashion in the U.S. We address many foreign tax matters including changes in Chapter 14, too.

For more information. There are plenty of articles explaining the fiscal cliff tax changes. Here are a few that I liked.

- Congress passes fiscal cliff act, Journal of Accountancy Jan. 1, 2013
- The Stealth Tax Hike, WSJ Opinion Jan. 4, 2013
- How Much Will Your Taxes Jump?, WSJ Tax Report Jan. 4, 2013, By Laura Saunders
- Farm CPA Today: 2013 Maximum Capital Gains Rates Examples Paul Neiffer
- Pease rules explained on the TPC site

The media and leading tax publishers have published plenty of details on the fiscal cliff negotiations and the final tax changes. That's why we focus on ideas for savings for our trading business and investment management clients. We're working on these ideas further and we expect to publish updates soon.

PLAIN VANILLA DOESN'T CUT IT FOR ACTIVE TRADERS

Active traders need more customized tax advice. For starters, traders should use a trade accounting program like TradeLog to get a handle on trading gains and losses before year-end; Form 1099-Bs are distributed in February. Brokers were late issuing 2011 1099s, as many struggled with the new IRS cost-basis reporting rules. We expect more trouble, delays and corrected 1099-Bs for 2012, too. It's always best to prepare a pro forma income tax return before year-end — which is fairly easy to do with tax software — to see exactly how things will work out tax-wise. You'll need TradeLog after year-end anyway, as it's the best solution for the new challenging IRS tax form 8949 (see Chapter 4).

AVOID OR EMBRACE AMT & PEASE LIMITATIONS

Congress patched the alternative minimum tax for 2012 as part of the fiscal cliff deal, and made the patch permanent. It saves millions of taxpayers from "bracket creep" (which means AMT rates aren't indexed for inflation, unlike regular tax rates). The patch raises the AMT exemption level.

AMT preferences — which means disallowing deductions for calculating AMT income — include the following types of itemized deductions: state taxes (income, real estate and property), miscellaneous itemized deductions including investment expenses (if you don't qualify for trader tax status) and Form 2106 unreimbursed employee business expenses. (See Form 6251 at irs.gov for more on AMT.) Doesn't this remind you of some of the flat tax proposals? Similarly, the Pease limitations that have returned include charitable contributions, mortgage interest, miscellaneous itemized deductions including investment expenses and state, local and property taxes.

Some states have raised tax rates on the wealthy and have significantly reduced their itemized deductions. (New York's have been reduced significantly.) Make sure you're aware of your state's tax changes.

Your pro forma return will indicate if the AMT and Pease is triggered. For regular income tax purposes, it's smart to prepay all state income taxes before year-end for an additional tax deduction. But if you trigger AMT, prepaying some or all of your state income taxes is a big mistake because state taxes aren't deductible for AMT. Instead, you can pay just enough fourth-quarter estimated state income taxes before year-end to equal the AMT threshold and pay the balance when due the following year. That's either Jan. 15 (for the estimated income tax safe harbor exception) or by the April 15 tax return due date or extension due date. If you can't avoid AMT, consider embracing its lower rate vs. the higher regular tax rates. The highest AMT rate is only 28% vs. 35% ordinary rates for 2012 and 39.6% for 2013. AMT rates did not raise with expiration of the Bush-era tax cuts, so the relative difference in rates is greater in 2013.

WASH SALES ARE USUALLY A PAIN

A wash sale occurs when you trade securities at a loss, and within 30 days before or after, you trade substantially identical securities (which include options on that security). Rules require wash sales to be computed across all accounts, including IRAs. Year-end trading gains often absorb wash sales from earlier in the tax year. Remaining year-end wash-sale losses must be deferred to the following tax year.

It's almost impossible for active traders and tax professionals to figure wash sales by hand. The best software program we know that calculates wash sales correctly for active traders is TradeLog (sold on our website). It calculates wash sales between multiple trading accounts, as well as between stocks and their underlying options, as required by the IRS. When wash sales are triggered in a taxable account as a result of buying back the position in an IRA account, that wash-sale loss is wasted tax-wise, so this should be avoided if possible.

Sometimes wash sales can be a good thing. A Section 475 MTM election (Chapter 2) exempts you from wash-sale reporting on your business trading accounts. If you elect Section 475 MTM in 2013, 2012 carryover wash sales on trading business positions only become part of your 2013 Section 481a ordinary-loss adjustment, which converts wash sales into ordinary losses as of Jan. 1, 2013. The 2013 Section 481a adjustment is the 2012 year-end unrealized gain or loss. In this example, wash sales are better than capital loss carryovers, as the latter can never be converted into ordinary loss treatment.

See Chapter 7 for ways to avoid wash sales using an entity. Wash sales are not triggered between your entity and your individual taxable and IRA accounts because they are different taxpayers.

NOL PLANNING

Net operating loss (NOL) carrybacks are a huge tax break for business taxpayers only. Business taxpayers are entitled to carry back NOL business losses two tax years to claim immediate tax refunds with interest paid by the IRS. Alternatively, taxpayers may elect to forgo the NOL carryback on tax returns filed on time, and instead carry it forward for 20 years. NOL carry back rules are complex and nuanced, so consult a trader tax expert.

In general, NOL carrybacks for business traders might be a risky proposition in 2012 and the years ahead since the IRS has recently turned up the heat on all taxpayers and traders in particular. If a trader just barely qualifies for trader tax status in 2012, he or she should consider carrying the NOL forward instead. Another solution is to soak up the loss with a Roth IRA conversion; this could eliminate the NOL. Note: NOL carrybacks were frozen in California and Hawaii for certain years; those states allow NOL carry forwards only. For certain years, California also limited NOL carryforwards for taxable income under certain thresholds. Other states may join that trend, so check their websites.

TAX-LOSS SELLING

"Tax-loss selling" is a major factor in the markets each year and is recommended as a simple year-end tax strategy for investors. If an investor is holding a security with an unrealized capital loss, he might want to sell it before year-end to reduce taxes due on capital gains.

Tax-loss selling might not be a factor for taxpayers who exceeded their $3,000 capital-loss limitations earlier in the year. Also, futures traders with Section 1256 MTM and securities business traders with Section 475 MTM accounting don't need year-end tax-loss selling to take losses. MTM accounting imputes their losses and gains at year-end.

Be careful when buying a mutual fund at year-end, as you may fall into a tax trap. You may qualify for a taxable capital-gains distribution, offset by a capital loss you can't deduct if you're over the $3,000 capital-loss limitation or you haven't sold that position by year-end.

OFFSETTING POSITIONS

Before the IRS closed tax loopholes, professional traders used strategies to defer investment income and accelerate trading losses. For the most part, these loopholes have been closed with tax rules for wash sales, straddles, offsetting positions, constructive receipt, and shorting against the box. You're entitled to reduce market risk on individual stocks with offsetting positions in futures and indexes. Bottom line, you need to show a distinct economic risk to avoid offsetting position rules in general. Don't be cute with the IRS on this front; it's going to get you into trouble.

ENTITIES AND AGI DEDUCTIONS

If you have a trading entity for 2013 and plan to use it for 2013 retirement-plan and/or health-insurance premium AGI deduction strategies, you should have taken certain vital actions before year-end 2013. All earned income fees and officer salaries have to be paid before year-end. If you have an S-Corp election, you should use formal payroll rather than administration fees. Administration fees are possible in some situations, but consult a trader tax expert. The AICPA recommends payroll-tax compliance service provider Paychex (www.paychex.com).

There are some benefits to payroll over fees, such as using year-end tax withholding through payroll to avoid underestimated income tax penalties from earlier in the year. With payroll, you may qualify for unemployment insurance benefits too.

If you're filing a partnership tax return for an LLC or general partnership, use administrative fees rather than payroll. See Chapter 7 on entities and Chapter 8 on retirement plans to learn more about these tax strategies. Watch our Webinar dated Dec. 18, 2012, "Close out 2012 with smart year-end tax planning, and start 2013 with a new entity."

BOTTOM LINE

Consider the big picture on taxes affecting traders and investment managers, and don't forget to prepare a pro-forma year-end tax return using current tax software to deal with your tax matters for 2013. Try to find a way around AMT and Pease limitations if triggered. Assess your trader tax status and capital gains and losses year-to-date along with all unrealized gains and losses on open positions. Develop the right strategy to reduce or increase capital gains and maximize the $3,000 capital-loss limitation — but don't exceed that amount if possible. Carefully plan your Section 475, NOL carry back/forward, or Roth conversion strategies. If you missed out on any of these tax strategies for 2012, start planning now for 2013.

Chapter 10: Tips for Handling IRS Notices & Exams

Recently the IRS has been making life more difficult for traders. In 2009, it announced major new tax-exam programs on the upper income. "Upper income" is defined as those making more than $250,000 per year. Those making more than $1 million per year face even more scrutiny.

The IRS has indicated more audits are coming. It's facing more pressure than in prior decades to "close the tax gap" and improve taxpayer compliance. Plus, advanced new IRS computer systems seem trigger-happy these days, sending out tax notices left and right, especially on Schedule C (used by sole proprietors). These mini tax exams are stressful, costly and unfair.

Many traders pushed the envelope on qualifying for trader tax status and using tax treatment elections they were not entitled to, like Section 475 MTM ordinary loss treatment. The IRS busted these taxpayers, and the traders wouldn't accept huge tax bills so they proceeded recklessly into tax court. As expected, they lost their weak cases and set a bad precedent for other traders. (One such case that comes to mind this past year is *Richard Kay, Jr. v. Commissioner*, TC Memo 2011-159.)

We hope more traders assess trader tax status properly. Don't play the audit lottery by trying to cheat the IRS and your state on tax treatment. This gives the trading industry a bad name and makes our job more difficult. If you have trouble with the IRS or your state, please consult with us, and if you can't afford us, maybe TradersAdvocacy.org can help.

One of our competitors has caused our industry a lot of damage. They told traders who don't qualify for trader tax status they could deduct large amounts spent on education. In one case recently, we heard they told a trader to deduct $30,000 and the trader only had five trades during the year, even though a business trader needs closer to 500 round-turn trades per year! Education expense is clearly disallowed as an investment expense under Section 274(h)(7) and a dual-entity scheme cannot fix this problem either. Be very wary of trader tax advisers that are not CPA firms (the firm I mentioned is not a CPA firm). If you work with a bad-apple firm, watch out because the IRS may bust them and ask for their client lists.

The IRS also announced closer examination of pass-through entities, C-Corps, global businesses (on transfer pricing) and foreign offshore accounts. In 2013, the IRS announced several high-profile prosecutions of U.S. residents and offshore banks who allegedly conspired to evade U.S. taxes.

IRS COST-BASIS REPORTING

The big news for 2011 and 2012 is new IRS rules for cost-basis reporting from securities brokers. Congress and the IRS felt compliance was very lacking on taxpayers and brokers reporting trading gains and losses for securities, and they wanted brokers to report cost-basis and holding period information, designating short-term vs. long-term capital gains and losses.

Taxpayers are forced to deal with a challenging new tax form 8949, which captures the beefed-up Form 1099-B cost-basis and holding period information. We expect many taxpayers and brokers will make errors on Form 8949 and 1099-Bs and key reconciliations — the purpose of Form 8949 — will be off. That will invite IRS tax notices and perhaps tax exams. Random tax notices will likely occur to measure compliance with the new rules.

See "The cost-basis saga continues" in Chapter 4 for more about problems on Form 8949.

AVOID IRS PROBLEMS BY USING AN ENTITY & PROPER TAX REPORTING

The first tip in dealing with the IRS is to get help before setting up your trading business and preparing your tax returns. This includes considering the best entity structure, dealing with startup costs properly and adopting tax reporting strategies to reduce red flags and explain your trader tax status and treatment in well-written footnotes accompanying the return. A proper business setup and trader tax return filed on time will generally not be questioned, except for those with large net operating loss (NOL) carrybacks, which tend to draw more IRS attention. Large NOLs based on weak trader tax status should be carried forward instead. Large ordinary forex trading losses over $50,000 reported on Form 8886 draw more IRS attention too — but filing Form 8886 is unavoidable.

In this more challenging IRS environment, I suggest all traders — especially part-time, losing, and less-than-hyperactive full-time day traders — form an entity in order to file a separate entity-level tax return (with trader tax status) apart from their individual tax return. The IRS won't be as skeptical about trader tax status on entity tax returns because W-2 wages are reported on separate individual tax returns. Choosing the best type of entity for your situation is key.

Sole-proprietor business traders get the shaft on using tax forms. Business trading expenses are reported on Schedule C (Profit or Loss from Business), but trading gains and losses go on different tax forms — Form 8949 and Schedule D (cash method), Form 4797 (MTM) and Form 6781 (Section 1256 contracts).

Traders should tie these tax forms together with income transfers and explain it along with trader tax status in footnotes. Historically, the IRS has higher audit rates for Schedule C businesses because many cash businesses under-report income. Business traders should use separate tax-filing entities such as partnerships, LLCs and S-Corps in lieu of Schedule C to reduce this risk.

Another important strategy for individual traders is to transfer trading gains to Schedule C to do away with a tax loss and show a break-even business. Net trading income on Schedule C invites questions on the self-employment (SE) tax.

Some traders err in thinking they don't have to file taxes, or that they can procrastinate. Perhaps they think their trading losses offset their other income, such as consulting fees. They may be counting on using ordinary trading loss treatment — based on qualification for trader tax status and a Section 475 MTM election — but this could present problems. If trader tax status and Section 475 MTM is denied, traders might only be allowed a $3,000 capital-loss limitation, which may lead to significant taxes being owed, plus penalties and interest. It's more important than ever to deal with your tax matters on time. Whatever you do, don't skip filing a tax return, as the IRS will surely catch up with you, especially with beefed-up 1099 filings and more advanced IRS computer matching systems. If you have losses and don't owe taxes, it's important to file a return so you can apply your losses in later tax years; otherwise they are lost for good.

For more information about late-payment and late-filing penalties, see Appendix B.

TAX NOTICES AND EXAMS

If the IRS or your state's department of revenue contacts you with questions or a notice of tax due, or to schedule an exam, don't panic or reply on your own. Consult a trader-tax professional and proceed under this person's advice, either representing yourself (the inexpensive approach) or by engaging the expert as your tax representative, with power of attorney. Your direction should depend upon your financial resources and the complexity of your case. Rushing to offer answers — especially the wrong answers — can start a snowball rolling down the mountain against you. It's a big mistake to tell IRS agents trading is a hobby for you.

If you simply made an error on your tax return but you clearly qualify for trader tax status and elected Section 475 MTM on time, you may be able to fix things quickly with a little expert advice. On the other hand, if you're a close call on trader tax status and potentially messed up your MTM election or other matters, engage your trader tax expert to be your formal tax representative. In some cases, a CPA may decline to be your representative if he or she thinks you aren't entitled to relief — perhaps because you clearly botched the MTM election. Even if we can't be your formal representative, we can provide very key advice and help behind the scenes.

EXAM RECONSIDERATION IS UNLIKELY

Traders can reply to the IRS with a "reconsideration" request, asking the IRS to close its exam before it gets underway. If the exam was prompted because a trader filed a Schedule C with a loss, even though the trader had trading gains in excess of expenses, the trader should be able to get the exam closed (assuming he or she easily qualifies for trader tax status). Other types of notices or exams can be closed with little work, too.

The solution can be as simple as filing a corrected tax return with the proper tax treatment, i.e., filing Form

4797 rather than MTM losses incorrectly on Schedule C, and including a detailed footnote.

We haven't noticed many IRS exams being "reconsidered" much lately. It seems the exams are initiated, and the IRS agent wants to delve into the items listed on the tax notice. It's important to keep the agent on a close leash and limit his scope so it doesn't grow to more areas of your tax return or more years. Often, once the IRS finds a problem, it seeks to expand the exam to prior and subsequent tax years.

IRS notices may include questions about business status. But these agents often use standard questions geared to assess "hobby-loss" treatment. Trader tax status requires the intention to run a business, thereby trumping the hobby-loss rules. Trading is not a recreational or personal activity, two key requirements for a hobby loss business. Read our blog article on hobby loss rules (Feb. 17, 2011).

Arizona tried this hobby loss approach against a few traders we helped last year. We won one case after appeals. It wasn't easy, but we were right. Arizona does not de-couple from federal law and federal hobby loss rules do not apply to trading businesses. Still, don't talk about trading being your hobby to the agent. That will confuse things and make it very difficult and expensive for you.

The reconsideration reply letter should state the exam isn't necessary because of your facts and circumstances. Next, explain how you qualify for trader tax status. State that your business expenses are very low compared to other businesses. Make it clear you have no cash income (which is the IRS's main focus point on small business exams) and that your 1099-B and supplemental information show all proceeds, cost-basis and many elements of net income. Demonstrate that you have good accounting for your securities transactions and more.

Proceeding improperly can jeopardize ordinary-loss treatment, deny business expenses, and leave you with capital-loss treatment, which can increase your tax bill significantly. Inappropriate responses may also lead to stiffer penalties and less opportunity for penalty abatement requests.

It's unlikely in this atmosphere to get your exam reconsidered or closed without really being opened. But, you still want to close out the exam with "no tax change" fast to keep it from growing. Handling things right can achieve that. Handling things incorrectly can open a monster of an exam and for multiple years.

EXAMS, APPEALS AND TAX COURT

If you're faced with an exam, it's smart to be represented by a trader tax CPA or tax attorney. You should have little to no contact with the IRS agents. Don't meet the IRS agent in person or answer his or her questions directly. This is what a tax expert is for. Help your expert by providing all the information needed in an organized manner.

If you have a difficult agent and supervisor in the exam process who refuse to understand the nuances of trader tax, it's often wise to "agree to disagree" at the exam level and take your case to the next level — the appeals process. During an appeal, trader tax status and MTM treatment may be realized, provided you elected MTM on time. Sometimes it's wise to accept disallowance of some business expenses so the IRS feels justified in its exam efforts; winning trader tax status and MTM is much more important. Appeals officers often focus on the big picture, such as trader tax status, and they may skip over expense items.

The last resort is tax court — often an expensive and more grueling process than a tax exam. If you go to tax court, you must show you acted in one manner or another contemporaneously and that you didn't change your position in hindsight, which costs the IRS a lot of money.

A common example of this mistake is skipping a timely MTM election because of capital-loss carryovers, and later stating you elected MTM on time. The IRS will disallow MTM on technical grounds and easily win in tax court on this issue.

There's a legal procedure to file a MTM extension within six months of the original election due date. But this procedure is expensive and unlikely to win MTM. It involves the private letter ruling process, and to win you must demonstrate no hindsight or prejudice to the government and unusual and compelling circumstances. The IRS recently published streamlined methods for obtaining advanced approval on tax positions that may prove helpful.

DON'T BE INTIMIDATED

Yes, the IRS is a heavyweight, but don't be intimidated. Traders are small businesses but they are non-cash businesses with few dollars in expenses, so you certainly shouldn't be scared if you have a strong case for trader tax status.

If you're a "good customer" — meaning you have large trading gains and pay taxes on them — you can safely be a little more aggressive on business-expense treatment.

Conversely, if you're a "bad customer" — for example, a perennial money-losing or part-time trader — it's wise to be more conservative, since the IRS may be more prone to deny your trader tax status. In this case, consider skipping a NOL carryback refund return. Rather, carry the NOL forward instead, when it will cause much less attention from the IRS. Or, try to absorb your ordinary loss with a Roth IRA conversion.

If necessary, you may also consider other less attractive but useful alternatives to trader tax status, such as trading in your retirement plans and deducting reasonable investment expenses within them.

DON'T LET THE IRS FILE YOUR RETURN

If you trade securities, the IRS received a 2011 1099-B that showed proceeds on securities, plus cost-basis for stock purchased in 2011. (The beefed-up 1099-B for 2011 still does not report options and many other instruments.) For 2012, the 1099-B phases in cost-basis information for mutual funds and dividend reinvestment plans purchased in 2012. Prior to 2011, the IRS sent a tax notice to non-filers claiming all or most proceeds were income. For 2011, the IRS has some cost-basis information and a clearer picture of approximate trading gain or loss. Tax notices for tax years prior to 2011 will have tens or hundreds of thousands of dollars in back taxes, plus interest and a full assortment of nasty penalties. Going forward, jeopardy assessments from the IRS may be much more tame.

Contact the IRS before it contacts you, enhancing your chances of reduced penalties. Interest is statutory and it can never be abated. File your late tax returns as soon as possible, reporting your capital losses. Then, you can carry over capital losses to subsequent tax years, which isn't possible unless you file the prior year tax returns. Don't wait more than three years or it will be too late to apply these capital-loss carryovers.

If you can't pay your taxes on time, at least file on time and request an installment plan; you can make corrections later. Failing to file a tax extension (calculated in good faith) is a mistake because "late filing" penalties are much higher than "late payment" penalties.

Be honest and forthright with the IRS; don't ignore it. Forget about cheating on your taxes with offshore and tax-free state schemes.

AVOID BAD ADVICE

The sad reality is a large percentage of active traders don't handle their tax affairs properly, or they're underserved by trusted "professionals" and tax software providers.

A part-time accountant working in a locally branded tax storefront may not be qualified to deliver trader tax services. We have seen many cases where traders have gotten into tax trouble using a general tax store. Some of these firms offer audit guarantees, but they don't pay back taxes or for a new CPA to fix things. That's a hollow guarantee. How can you recover lost tax savings working with these "professionals"? Other TV ads offer free reviews or prior-year tax filings, but what good is that offer if the person doesn't know trader tax benefits and rules?

The IRS recently enacted new standards for tax preparers to address what it perceives as too much bad advice coming from tax preparers who don't have sufficient education or experience. The tax preparers' requirements include registration, competency tests, continued professional training, and complying with a set of ethical standards. CPAs are exempt because they already reach and exceed these standards, but most storefronts and many enrolled agents don't. In early 2013, a federal appeals court overturned these new IRS requirements.

Many accountants, tax preparers and CPAs are giving the wrong advice to traders on wash sales reported on 1099-Bs. See our Executive Summary for more information on these problems.

In the end, far too many active traders miss out on trader tax benefits — they don't deduct allowable business expenses or elect and use ordinary-loss treatment on time. They overpay their taxes and don't receive the tax refunds they're entitled to. Even when they do most things right, they file a return with a red flag, causing an IRS and/or state exam.

You need an experienced trader tax expert in your corner from day one to handle this challenging IRS environment.

Chapter 11: Traders in Tax Court

Unfortunately for traders and their tax advisors, trader tax status remains vague in statutory law, leaving it open to interpretation in tax court. Recently, tax-court judges have complicated matters by adopting varying definitions, creating a checkerboard of relevant case law. Due to these court cases, many traders expecting to qualify for trader tax status have been denied. Some had unreasonable expectations.

CONTINUOUS BUSINESS ACTIVITY

We made some good headway on easing qualification for trader tax status (business treatment), and we think it can help many traders who face difficult qualification standards on "frequency of trades." This area of tax law is called "continuous business activity" (CBA).

CBA is not yet a salvation or replacement for hitting your "frequency of trades" numbers which includes volume of trades, days per week with executed trades and average holding periods. But we think CBA can save the day on trader tax status when frequency of trades comes up a little short. Keep in mind a large Section 475 MTM ordinary loss is contingent on having trader tax status, so trader tax status is worth defending in many cases.

Over the years, we raised our "golden rules" bar for frequency of trades from 300 in some cases to 500 round-turns. We did this because the IRS was getting tougher in exams, appeals and tax court cases, and we wanted to be more conservative.

CBA can plug the holes on frequency of trades. Let's say a trader has closer to 300 round turn trades rather than 500, trades three days a week instead of four and has longer holding periods such as 30 days for options. If that trader can establish CBA, and if we argue the appeal or tax court case correctly, the trader may win his case for qualification for trader tax status.

In our research, we found the IRS inappropriately adopted "frequency of trades" as its gold standard after the landmark trader case *Paoli vs. Commissioner*. That's the nature of tax court case law: The IRS keeps making arguments based on prior cases and the law takes on a life of its own. What went wrong for traders here? Paoli tried to cheat the IRS and tax court by claiming he was a full-time business trader, but he only had a handful of trades in one month during the year. His attempt was a complete fiasco. The tax court rightfully said we need a way to verify a wild statement by a taxpayer, and a way to prove his activity. Hence, the court turned to the frequency of trades argument to check on CBA, but not to replace it. It's important to note that other types of businesses don't have to go through frequency of business standards either — it's often presumed they have CBA.

The IRS conveniently overlooked this important distinction and it has elevated "frequency of trades" as the standard that counts most in its audit manuals. But this is wrong, because CBA still trumps frequency of trades, which is meant as a backup test only.

Impress the IRS with your CBA. Many traders work all or most of the day, every day, conducting extensive research, back testing, writing code, making unexecuted trades, demo trading, learning new areas, making live trades, doing administration, accounting, IT and much more. During a tax exam, the IRS is often impressed by the amount of work involved, the sophisticated level of technology used and time spent for research and administration. CBA is not hard to prove for most active traders who trade on their own. If a trader establishes CBA, the court should not have the right to overturn that business treatment by arguing a trader falls a tiny bit short on some of its often quoted tax court case standards. The tax court never says that 500 trades is the absolute standard, but it refers to ranges of trades. Why hold a trader to the very top of that range, when he has CBA too? That should not stand.

If a trader matches up with Holsinger (see the *Holsinger vs. Commissioner* section) with 160 round turn trades on 45% of available trading days, we agree he probably doesn't have trader tax status. But there are lots of traders who fall in between Holsinger and our golden rules. These traders should have a right to trader tax status too, under the right facts and circumstances. If you trade every day all day in terms of time, effort and energy, but come up a little short on your frequency of trades, you shouldn't be out of luck.

Speak with us about it. This area of trader tax law is developing, so handle it with great care. Our CPA tax preparers may say you are too weak on frequency of trades and you need to be very strong on establishing CBA, so keep good records all year. It may be necessary to discuss your case with me.

We don't want to disappoint traders here. Overall, we're still pretty tough on our analysis and we don't want to be too liberal and invite the IRS to challenge our clients.

BACKGROUND

In 1997, Congress recognized business traders as a separate and respected tax-class and legislated trader tax status (business treatment) by expanding Section 475 mark-to-market accounting (MTM, ordinary gain or loss treatment) from dealers to business traders too. As a result, some IRS agents confuse traders with dealers in exams too.

Congress added the new Section 475(f) for "traders in securities" and "traders in commodities." Section 475(f) is recommended for many securities business traders but not generally commodities/futures traders, because the latter prefer to keep the lower tax rates of Section 1256 60/40 tax treatment. While 15 years have passed since enactment of Section 475(f), the IRS has failed to sufficiently clarify these tax laws, which has made life unduly difficult for traders and their accountants. The IRS did expand Publication 550 to include a new Chapter 4, "Special Rules for Traders" (available at www.irs.gov), but it continues to speak in generalities.

By failing to create clear statutory law on trader tax status, the IRS is leaving the matter to tax-court judges to write case law. And the IRS appears to be winning this game, because its agents are depicting unsettled law as settled law and scaring taxpayers into conceding trader tax status, when they rightfully used it on their tax returns.

A few recent IRS tax court victories are setting bad precedent for all non-hyperactive traders, especially part-time and money-losing traders. Familiarize yourself with these cases so you don't make the same mistakes.

CHEN VS. COMMISSIONER (2004)

Chen was a part-time trader with a full-time job who entered and exited his trading business in three months after losing almost all his money in hyperactive trading.

Chen botched many things in this case. First and foremost, he lied to the IRS about electing Section 475(f) MTM on time, and then used MTM when he wasn't eligible. Second, he brought a losing case to tax court and made the mistake of representing himself.

Once Chen realized he was busted on the phony MTM election, he caved in on all points, including trader tax status.

The problem for traders is that once MTM ordinary loss treatment is lost — by far the biggest tax benefit on the line — poorly represented traders in tax court too easily concede trader tax status, which may only deliver another $8,000 of tax benefits. If you're paying for legal counsel, why continue to pay an attorney to win just a few thousand dollars of tax benefits?

Even though Chen only traded for three months while keeping his full-time job, it doesn't mean he didn't start a new business — with every intention of changing careers to business trading — and make a full investment of time, money and activity. Tax code or case law doesn't state that a business must be carried on for a full year's time or as the primary means of making a living. Countless businesses start up and fail in a few short months. Chen probably could have won trader tax status had he been up front with the IRS and engaged a tax attorney or trader tax expert to represent him in court.

HOLSINGER VS. COMMISSIONER (2008)

Here is how we viewed Holsinger before we made headway on CBA: Holsinger was a close call at best on trader tax status. (Our CPA firm would not have allowed his trader tax status if we had been preparing his tax returns, as he fell short of our golden rules based on the facts we learned in his sub-par presentation to the court.)

Holsinger also made several errors on his tax return, which rightfully drew IRS attention and an exam. Holsinger formed an LLC for his trading business and he correctly filed an internal MTM election. (New taxpayers are permitted to elect MTM internally within 75 days of inception.) The problem: Holsinger never traded in the LLC's name and instead traded in a joint individual account with his wife. He didn't elect MTM on the individual level and the IRS easily won this denial of MTM in tax court.

Holsinger has similarities to Chen. Holsinger wasn't entitled to use MTM, yet used it anyway and tried to defend it in tax court. Like Chen, Holsinger got off on the wrong foot and lost credibility with the IRS. He unsuccessfully argued that he individually acted as an "agent" for the LLC. In addition, he was retired and that raises the bar on trader tax status qualification in the eyes of the IRS, as is the case with part-time and money-losing traders. Had Holsinger traded in the LLC, the exam may not have come up in the first place, based on a partnership tax filing.

Holsinger's number of round-turn trades was less than 160 — well below our golden rule, which generally requires 500 round-turn trades at a minimum. Business traders can have fewer, but other factors need to be strong. A business trader should generally have one or more trades per trading day. Business traders should have an average holding period of days to a week (not months), and Holsinger's average holding period was more than one month. This can be a problem for option traders who trade monthly expirations and he didn't raise this point in court. His total cost basis on trades was well under $1 million per year, which is low by trader tax standards. Business traders usually have cost basis and proceeds well in excess of several million dollars per year, indicating rapid turnover and materiality.

In the Holsinger decision, the IRS cited all the usual tax court cases on trader tax status, which included a broad range of total trades. On one end of the range, one court case denied trader tax status on fewer than 50 round-turn trades. On the other end of the range, the IRS agreed to trader tax status with 1,100 total trades, which approximates 550 round-turn trades. Holsinger fell somewhere in the middle of these ranges.

One IRS argument in this case seems to be that Holsinger traded on only 40% of available trading days in 2001 and 45% in 2002. There was no mention of subsequent years, which is an important missing point. Subsequent events can add credence to prior tax year positions.

The biggest problem with the Holsinger decision in my view is the court seemed to give credit only to days traded and not days spent on business activity where no transactions were consummated. The decision doesn't mention if Holsinger raised the idea that a business trader spends significant amounts of time on trading business activity, even if he doesn't execute trades on every available day.

There are many examples of other types of businesses where a person is devoted to his business almost every day, but doesn't execute transactions every business day. For example, real estate and other commissioned salespersons but don't always generate a sale every day.

I think the IRS heavily weights the number of actual trading days because it's easily verifiable. It's far more difficult for the IRS to assess time spent and activities other than actual trades. Business traders don't punch a clock like factory workers. That being said, business traders should develop and implement systems to document time spent in their trading business. Save login sessions with online brokers, send daily emails about your time spent, keep online diaries, document unexecuted trades and more.

Holsinger seems to have failed to raise other verifiable factors in his favor in tax court as well. He had business tools, business expenses and a home office, all of which demonstrate serious business activity. Holsinger had the typical serious business trader's home-office set-up with multiple monitors, computers and more.

The IRS also raised the concept of "daily market movements rather than long-term price appreciation," which is part of settled case law. This brings up the point of average vs. mean holding periods and the need to segregate out long-term investments from these average/mean calculations. "Daily market movements" doesn't mean day trading only — certainly swing trading is allowed too. As already pointed out, Holsinger's average holding periods were too long. But Holsinger seems to have allowed long-term investments into the calculations when they should have been set aside. He never raised the concept that as an option trader, he was trading monthly expirations. He also should have explained that an options expiration is like another transaction and should be counted too.

Holsinger lost credibility by claiming he executed many day trades, when in fact he did not. It's important to have proper line-by-line trade reporting for securities and analyze it well before filing a trader tax return. Don't put yourself in danger of an IRS exam or expensive tax court process.

DAY TRADING VS. POSITION TRADING

Some trading experts now advocate option trading strategies (such as iron condors and other income strategies) and position trading rather than hyperactive day trading of securities. Option traders and position traders share much in common with hyperactive day traders. Both spend the majority of every market day busy in their trading business — researching and monitoring positions, executing trades and handling administration, accounting, training and much more.

Yet, in the Holsinger case, the IRS discounted the daily hard work of an option position trader, and many others have set bad legal precedent as well. Active stock traders often buy and sell positions daily, whereas many stock and index option traders often trade around monthly option expiration dates, thereby stretching their average holding periods. Option traders may tweak positions, but for the most part, they don't execute trades on a daily basis. Traders also initiate many unexecuted trades, such as stop loss and limit orders.

HOTEL ANALOGY FOR OPTIONS TRADERS

A business person may check into a hotel on Monday morning and out by Friday afternoon. That's two days per week with executed transactions, as is the case when buying and selling an option. However, the hotel must provide services to that guest for five days. An options trader monitors and tweaks positions daily and often has many unexecuted trades. He makes changes to complex positions such as credit spreads.

This options trader is working every day on his trades — we feel he has CBA and the IRS should not challenge his trader tax status business treatment. Some option traders just write options for income and they don't monitor and tweak trades on a daily basis. They may not qualify. There are lots of factors to consider. (See our Jan. 11, 2011 blog about how we won a favorable decision in IRS appeals for an options trader.)

BOTTOM LINE

The IRS has been getting the upper hand with traders by twisting the tax court in the direction of "frequency of trades" and setting that bar very high. Traders, CPAs and tax attorneys need to press the IRS and tax court on returning to continuous business activity, which is a friendlier standard to traders. Why should a poor interpretation of tax law by the IRS encourage day trading at the expense of swing trading for business profit? That's not what Congress wants.

Chapter 12: Proprietary Trading

Proprietary traders are significantly different from retail traders and have special legal, regulatory, business, and tax compliance needs.

Proprietary traders don't trade their own capital. They trade the firm's capital, usually accessed from a sub-trading account within the firm. A prop trader becomes associated with a prop trading firm either as an LLC member (Schedule K-1) — the preferred method by regulators — an independent contractor (1099-Misc), or an employee (W-2).

If you fall in the prop trader category, here's what you need to know.

BEHIND PROP TRADING

The Dodd-Frank Financial Regulation law enacted in July 2010 includes the controversial Volcker Rule, which went into effect in July 2012. The Volcker Rule forces commercial banks to close their prop trading desks and exit almost all of their internal alternative hedge fund investments by July 2014, as many of the rules are not yet written.

But working for a big bank as a trader is very different than working at a prop trading firm. These businesses are formed by entrepreneurs to recruit armies of traders. The recruits pay the entrepreneurs for education, software, desk charges, and other services. (In some cases, brokerages pay prop firms a rebate on their traders' commissions, which sometimes isn't appropriately disclosed.)

The entrepreneurs hold out the carrot of access to a large stockpile of their own cash to trade, yet many also demand prop traders maintain material deposits of their own money within the firm, which is tapped to cover the traders' losses. In effect, these traders are trading their own risk capital and they have leverage of 10:1 or more than 100:1 rather than being pinned down by the strict Regulation T (2:1) margin rules for retail traders.

There is a lingering charge by some in the industry over the past decade that prop trading firms are really disguised customer (retail) accounts offering illegal leverage from unregistered broker-dealers. FINRA's Regulatory Notice 10-18 implies that some prop trading firms have this problem and the regulators are trying to force brokerage firms to stop this practice for their prop trading firm clients. The notice tells clearing firms how to spot this type of inappropriate behavior: Look for prop trading firms with sub-trading accounts for traders where the firm pays the trader more than 80% of trading gains. Some prop trading firms pay close to 100% and it's clearly an issue. Other telltale signs are trader deposits and commission rebates.

This story has lingered for some time, but the regulators have not yet pounced on it in the way many assumed they might. Dodd-Frank reins in prop trading in banks, but FINRA allows this type of activity to continue without much restriction.

Ironically, pattern day trader (PDT) rules are having a perverse effect. Retail securities traders can day trade only if they have $25,000 on deposit with their broker, and they're limited to 4:1 intraday leverage. As mentioned, the leverage offered in a prop trading firm is far higher. Retail securities traders with less than $25,000 on deposit can't day trade at all under these PDT rules, plus their leverage is limited to 2:1. When regulators reined in securities day traders with these rules, they buttressed the growth of the prop trading firm industry: Undercapitalized traders who want to stick with securities are attracted by the leverage in prop trading firms. Many allow new recruits to put up deposits of $2,000 or $5,000.

PROCEED WITH CAUTION

Many smaller prop trading firms aren't always complying with regulation. The firms that are more compliant are set up as non-customer account broker-dealers, some on the Chicago Stock Exchange (CSX). As broker-dealers, they're subject to regulatory oversight. CSX broker-dealers don't require prop traders to have a brokerage license, but customer-account broker-dealers do.

Some broker-dealer prop-trading firms want a deposit of $25,000 or more to be in line with the pattern day trading rules. CSX firms argue they can take a lower deposit, or none at all.

Many prop trading firms are not broker-dealers, but they associate with broker-dealers. Regulators refer to these firms as "sub-LLCs." These firms may skirt regulation. But FINRA published Notice 10-18 precisely to flush out these sub-LLCs. If you trade with one such firm, be very careful with your money. Keep taking profit distributions and don't risk too much — or consider other options. Why trade with a sub-LLC that uses a business model that may not pass muster with regulators?

LIABILITY ISSUES

Read the fine print of the LLC Operating Agreement and you will see you're generally liable for all losses that you generate — even losing positions the firm required you to exit. Even if management doesn't sue you, if the firm blows up a trustee has a fiduciary obligation to sue you to recover the funds. If it's tiny, a lawsuit is unlikely, but you may face fierce collection efforts.

As a Class C or D member of the LLC, you're probably not responsible in any manner for general obligations and liabilities of the firm overall. (However, we did see a few agreements which charged firm-wide losses to all prop traders.) It's wise to have an attorney advise you on these agreements before signing them. Get your questions answered in writing and confirm the details with the compliance officer. Don't rely on verbal statements from salesmen at the firm. Some firms have non-compete clauses. Other don't allow you to trade outside of the firm. A few firms may allow you to carry on retail trading, perhaps in futures or forex, provided you trade all securities within the firm.

> Read the fine print of the LLC Operating Agreement and you will see you're generally liable for all losses that you generate — even losing positions the firm required you to exit.

EDUCATION/PROP HYBRIDS

A new trend is to combine education with prop trading firms, muddying the regulatory waters. These firms charge $5,000 for education and promise access to prop trading within the firm after graduation. But many prop traders never advance to actual live trading after completing education courses. If you pay a higher amount such as $10,000 for education, you may receive limited prop trading firm rights later on. But isn't that extra $5,000 really a deposit for prop trading?

These education/prop trading hybrid structures seem intent on avoiding broker-dealer registration, compliance, and regulatory oversight. Rather than a sub-LLC, these firms call themselves education firms and later morph clients into sub-LLC trading.

Are these hybrid education/prop trading firms more interested in selling education, finding great prop traders, or both? Probably both. Unsuccessful traders are put out fast or not given capital to trade, unless they keep covering their losses at no risk to the firm and there's room for them. Some firms focus on desk charges in an office, whereas others offer remote trading, too. Prop firms obviously prefer profitable traders and make more money if they share in 20% of the gains. If the firm makes money on commission rebates, it leaves the account burning and churning. (Some firms don't share in the gains at all.)

If you're going to trust a prop trading firm with your money and career, a registered broker-dealer with full compliance responsibilities is a safer bet.

TAX MATTERS: INDEPENDENT CONTRACTORS

Profitable independent contractor (IC) proprietary traders receive a 1099-Misc. for "non-employee compensation." If they are a sole proprietor, they use a Schedule C to report fee revenue and deduct their business expenses, including home-office deductions, if they qualify. Schedule C net income is subject to federal and state income taxes.

Firms don't issue 1099s to losing IC traders, since they don't pay those traders a fee. Losing IC traders are still working, so they're entitled to file a Schedule C, which reports expenses only.

Plus, that net income is deemed "earned income" subject to self-employment (SE) tax. The SE tax rate is normally 15.3% of the base amount ($110,100 for 2012 up from $106,800 in 2011). With the temporary payroll tax cut, the SE rate is 2% less for 2012.

What's the difference tax-wise between retail traders and IC prop traders? Retail trading gains aren't subject to the SE tax. IC prop traders have earned income enabling them to contribute to tax-deductible retirement plans and deduct health-insurance premiums (AGI deductions). A retail trader needs to form a trading entity to create earned income for these deductions. While the retail trader then owes SE tax on the fee amount, that fee might be far less than the IC prop trader's fee. So, the retail trader may have a much lower SE tax than the IC prop trader, while each have the same AGI deductions. IC prop traders may also trigger local tax or earned-income related tax credits.

Some prop trading firms may allow the IC trader to form a single-member LLC with an S-Corp election, so the trader may be able to reduce SE taxes by up to 75%. Some firms may try to fool around with the 1099-Misc., checking off the "other" box rather than "non-employee compensation." This is often a problem and it's wrong.

It's wise to take your profits out of the firm regularly, so if things go awry, your capital is safe.

TAX AND LEGAL ISSUES FOR LLC MEMBERS WITH K-1S

LLC prop traders don't have earned income reported on their Schedule K-1s, so they save SE tax but can't contribute to a retirement plan or deduct health-insurance premiums. A few firms tried to play around with this on K-1s in the past and they were wrong. They sought to deliver health insurance AGI deductions to their K-1 traders.

A few prop trading firms allow LLC member traders to form a 100% owned entity and then the trader can create some earned income. That may be the only way to get those valuable AGI deductions. Regulators generally require members to be individuals, not entities.

These LLC members also don't file a Schedule C as they don't have their own business. They're members of a trading firm that reports the business trading activity on a Form 1065 partnership tax return. The Schedule K-1 reports the trader's share of the firm's activity — really just a share of the gains and expenses they generated — in summary form by tax treatment.

Schedule K-1 line one is for ordinary income or loss. Most prop trading firms elect Section 475 MTM for securities, so the income is considered ordinary income. Other firms pass through capital gains and losses and Section 1256 futures or Section 988 forex income too. The firm qualifies for trader tax status (business treatment) on the entity level, and it passes it to you on the K-1.

PROP TRADER EXPENSES

Like retail traders, many prop traders have material trading-related expenses. The expenses charged by the firm to the trader are deducted at the firm level and the K-1 ordinary income is already net of those expenses. The trader isn't reporting those expenses separately on his or her individual tax return.

Some prop trading firms have an "Accountable Reimbursement Plan" and the prop trader needs to "use it or lose it" before year-end. If your firm doesn't have such a plan, then you can deduct your own trading business expenses outside of the firm, including your home office, as Unreimbursed Partnership Expenses (UPE). Schedule K-1 ordinary income is reported on Schedule E in the active column, as it's not a passive loss activity under the "trading rule" in Section 469. UPE is deducted in that same area on the next line under the Schedule K-1 ordinary income or loss. Most of the home-office deduction requires income. (This treatment is very similar to how retail traders report their taxes when they conduct their retail trading business in an entity.)

TRADING LOSSES

Most prop trading firms take all trading losses at the firm-owner level. They only pay IC traders when they reach new high net profits, a concept used in investment management, too. With LLC-member prop traders, the Class-A member (that is, company management) also takes losses on his own K-1 and doesn't report ordinary income to the prop trader until he makes new high net profits.

WRITING OFF LOST DEPOSITS

A key tax issue prop traders is when to write off deposits lost within the firm. If you incur a trading loss, the firm may take the loss on the owner/managers' K-1, but it will use your deposit to cover it. How can you write off the lost deposit on your own tax returns?

For an IC trader, the lost deposit is not reflected on the annual Form 1099-Misc. When the deposit loss is realized, the IC trader can deduct a business bad debt on Schedule C, as another ordinary and necessary trade or business expense. It's lost when the trader has to replenish it due to trading losses, or has to leave the firm and the firm doesn't repay it. (If the trader is making money and still has that deposit on file, there's no issue.)

If an LLC-member prop trader has a lost deposit, he or she deducts the deposit as UPE on Schedule E.

For IC traders in an education/prop trading hybrid firm who spent $10,000 on education before becoming a prop trader with the firm — not during a period when they qualified for retail trader tax status — that money is prebusiness education and it's either not deductible or a portion can be capitalized in Section 195 business startup costs.

If they reclassify part of the $10,000 to a deposit and subsequently lose that money, then it could be treated as a deposit loss. Or, if they reclassify some of the education to post business education (they start prop trading and take some classes afterward), they may have a business education expense.

Some IC prop traders never get paid a dime and they don't get a 1099-Misc. Can they deduct post business education or a deposit loss? If they really work as a prop trader, they may be able to; check with an expert to learn how.

IT'S NOT AN EMPLOYER/EMPLOYEE RELATIONSHIP

Employers pay a salary and take a risk on you. An employee doesn't put up risk capital with deposits, eat 100% of what they kill, or pay 100% of their trading losses and expenses.

It's all about the leverage, but leverage is a two-edged sword. It can speed up the journey to failure or success. Prop trading firms keep traders on a very strict program, disallowing overnight positions with risk and demanding they exit positions and take losses when they see fit. The firm can trigger a loss that the trader must pay for. To be successful, a trader needs to be able to adhere to the firm's risk management restrictions (generally a good thing), use lots of leverage, and "churn baby churn."

Some prop traders do very well. While there are success stories, the majority aren't as successful, which frankly is the case in retail trading, too. With all prop trading opportunities, it's wise to take your profits out of the firm regularly, so if things go awry, your capital is safe. Don't sign on the dotted line until you get the right professional advice.

Chapter 13: Investment Management

After tense moments in the great tax and deficit debates of the prior few years, including the 2012 fiscal cliff tax agreement, two important tax breaks for hedge funds and investment managers survived repeal efforts from Democrats in Congress and the White House. Although Democrats tried hard in 2010 to repeal "carried interest" tax breaks for investment managers, along with a related repeal of the S-Corp self-employment (SE) tax reduction breaks for professionals (including investment managers), Republicans saved the day and blocked those tax increases. We covered the drama on our blog and in our podcasts.

While President Obama has continued to seek repeal carried-interest tax breaks for managers — in each of his budgets, on the campaign trail, in negotiations over the fiscal cliff and in continued efforts in 2013 to raise more tax revenues — carried-interest breaks have survived. But don't necessarily count on it staying that way!

It should be harder for Congress to repeal the S-Corp SE tax reduction break. See my predictions and alternative ideas in the Executive Summary.

2013 TAX HIKES FOR SUCCESSFUL ADVISERS

The fiscal-cliff tax agreement raised 2013 tax rates on the top tax brackets for ordinary income (35% to 39.6%), long-term capital gains and qualifying dividends (15% to 20%) on taxable incomes over $450,000 (married) and $400,000 (single). The new legislation also limits itemized deductions (Pease) and personal exemptions (PEP) on adjusted gross income (AGI) over $300,000 (married) and $250,000 (single).

The ObamaCare Medicare surtax on earned income (0.9%) and unearned income (3.8%) started Jan. 1, 2013 on AGI over $250,000 (married) and $200,000 (single). The Medicare surtax on unearned income applies to net investment income including carried-interest income. Many successful investment managers may be affected by these tax hikes and should consider our alternative tax strategies, addressed in detail in Chapter 7. Also, see "Fiscal cliff news dissected" in Chapter 9.

CARRIED INTEREST

Carried interest is a huge tax break now for both managers and investors. If Congress and President Obama repeal carried interest, much will be riding on the final legislative details. Will they repeal it for both manager and investor, or managers only? A 2010 proposal to repeal carried interest only called for managers. Why does it matter? If Congress allows investors to retain carried-interest tax breaks, then managers should still consider including these provisions in their PPMs and operating agreements. If Congress repeals carried interest for both managers and investors, new alternatives should be considered.

One big tax advantage of hedge funds vs. separately managed accounts (SMAs) is that carried-interest tax breaks can be used on hedge funds, but not with SMAs. Under current tax law, managers can continue to start up new hedge funds and structure in a "profit allocation" clause. So they receive performance income — it's not compensation or pay — based on their profit allocation share of each income tax category in the fund. The carried-interest tax break means the manager/partner receives a special allocation (his share) of long-term capital gains and qualifying dividends taxed at lower tax rates (up to 15% for 2012 and 20% for 2013), futures gains taxed at lower 60/40 tax rates (up to 23% for 2012 and 28% for 2013), and short-term capital gains taxed at ordinary income tax rates (up to 35% for 2012 and 39.6% for 2013). This is not subject to separate SE tax rates (up to 15.3% of the base amount; $110,100 for 2012 and $113,700 for 2013) and 2.9% unlimited Medicare tax portion thereafter (with a 0.9% Medicare surtax on AGIs over $250,000 married and $200,000 single). The temporary payroll tax cut reduced the SE rate by 2% for 2012 (but not 2013). See the Executive Summary for more information on carried interest.

CARRIED-INTEREST TAX BREAKS CAN BE GOOD FOR INVESTORS

By default, investors are stuck with restrictive investment-expense treatment and investment-interest-expense limitations for their expenses that pass through an investment partnership. The biggest expense is often advisory fees paid to the investment manager. Most of these expenses end up being wasted due to miscellaneous itemized deduction thresholds (2% AGI), and the alternative minimum tax (AMT) doesn't allow these deductions. Plus, the Pease limitation on certain itemized deductions including investment expenses returns in 2013 on AGIs over $300,000 (married) and $250,000 (single).

Carried interest solves this problem for most investors. It reclassifies incentive fees from potentially non-deductible investment expenses into reduced capital gains, tantamount to a deduction from gross income.

For example, an investor allocated a $100,000 capital gain has a net capital gain of $80,000 after applying the 20% carried-interest provision. But without carried interest, it would be a $100,000 capital gain; the investor may have a wasted investment expense of $20,000.

If the investment partnership has trader tax status, the incentive fee would be a business ordinary loss. But carried interest is still better for the manager. Even with trader tax status in the fund, interest expense retains "investment interest" expense treatment.

THE S-CORP SE TAX REDUCTION STRATEGY

Although investment managers can't use profit-allocation clauses on SMAs, they can at least use the S-Corp SE tax reduction break. This could become even more important if carried-interest is repealed, with incentive fees being classified as earned income (rather than profit allocation of trading gains). Managed accounts pay advisory fees which include management and incentive fees, whereas funds using profit allocation clauses only pay management fees.

In an LLC management company filing a partnership tax return, earned income passes through to the LLC owners subject to SE tax, unless an owner is not involved in operations (which is beyond the scope of this content).

Investment managers can only use profit allocation with investment funds because only partners can share special allocations of underlying income. Special allocations are permitted and useful on fund partnership tax filings, but not with S-Corp tax returns, since special allocations reverse (taint) S-Corp elections. The IRS only allows S-Corps to have one class of stock and they insist on equal ownership treatment.

That makes S-Corp elections a wise choice for management companies focused on reducing the SE tax on underlying advisory fee earned income. Conversely, partnership tax returns are a better choice for investment funds focused on carried-interest tax breaks using special allocations, plus there is generally no underlying income subject to the SE tax, anyway.

Check with us about these strategies, as there are some states such as California that have higher franchise taxes on S-Corps, but usually materially less than the possible SE tax savings. New York City taxes S-Corps like C-Corps and those tax rates are high.

An existing LLC or C-Corp can file an S-Corp election (Form 2553) by March 15 of the current tax year. The IRS automatically grants late relief under a special Revenue Procedure up until the due date of the tax return including extensions. Check with us about your home state.

The IRS is well aware of this S-Corp SE tax reduction strategy and it insists owners pay themselves "reasonable compensation." We and many CPAs suggest that 25% to 50% of net income is reasonable compensation, so potentially up to 75% may avoid SE or payroll taxes. The IRS is turning up the heat on S-Corps with tax exams and forcing this type of compensation. The IRS has a computer program to look for reasonable "Compensation of officers" on Form 1120S S-corp tax returns. Recent case law is in favor of the IRS so don't skip this requirement. It's best to consult a CPA or tax attorney.

Chapter 14: Foreign Matters

Many traders living in the U.S. have offshore trading and bank accounts to trade on foreign exchanges. Some forex traders used them to get higher leverage and hedging even after the CFTC closed that door to retail traders in 2010 and 2011. Some offshore brokers encourage traders to form foreign entities as a requirement to get access or to set up a foreign brokerage account. Look before you leap: Tax compliance for a foreign entity is significant and there are few to no tax advantages for traders. International tax compliance is very complex, often nuanced and risky if you botch the tax reporting. Plan to pay top dollar to international tax professionals. Ask yourself if that red tape and audit risk is worth the trouble. It's very rare to achieve material deferral on offshore income, and there are plenty of significant tax penalties for non-compliance. Be prepared for more oversight, as regulators and the IRS seem determined to rein in foreign income.

But all this being said, there are plenty of good reasons to trade foreign markets and have foreign bank accounts, brokerage accounts and corporations. Just get the right advice beforehand and make sure the reason to do it is compelling.

REGULATIONS

Although the IRS has always been strict on reporting foreign accounts and income, it has recently gotten much tougher, busting UBS and other foreign banks for hiding American accounts and income and passing new Foreign Account Taxpayer Compliance Act (FATCA) regulations. The IRS and U.S. Treasury are intimidating foreign banks into reporting their American clients — even banks in countries like Switzerland known for bank secrecy.

FATCA penalizes foreign banks and brokers for not helping with U.S. tax compliance on U.S. citizens and residents. The FATCA rules are so onerous, tedious and costly to comply with that many smaller foreign banks and brokers now refuse to do business with Americans; it's just not worth the burden and risk. Some of these brokers ask their U.S. clients to form offshore entities as a means of navigating around FATCA, but that often doesn't work and it can wind up being a huge problem for U.S. taxpayers. FATCA is highly controversial in this regard and it could be watered down, but don't count on that either. Stay tuned with our blog.

In addition, the CFTC prohibits foreign forex brokers and banks from doing business with retail off-exchange forex traders unless the broker or bank registers in the U.S. with either the NFA or bank regulators. They're permitted to deal with eligible contract participants, which are basically high net worth people and companies.

> Tax compliance for a foreign entity is significant and there are few to no tax advantages for traders.

FOREIGN BANK ACCOUNT REPORTS

Foreign bank, brokerage, investment and other types of accounts — including retirement and insurance in some cases — must be reported on TDF 90.22-1. This past year we learned that many taxpayers have omitted foreign bank account reports (FBAR) when they should have filed them. Many taxpayers simply didn't realize they had to file the form. Some had interests in family accounts offshore, if they were foreign nationals before moving to the U.S. Or, some taxpayers married a foreign person. Others may have offshore retirement or insurance accounts that they never realized were subject to FBAR reporting.

Most reported their foreign income and were not trying to cheat the IRS by hiding it offshore. Because income was reported properly, many are allowed to file a late FBAR and avoid penalties. Otherwise, there is a highly complex and nuanced penalty regime in connection with late or incorrect FBAR filings. If your foreign bank and financial institution accounts combined are under $10,000 for the entire tax year, you fall under the threshold for filing FBAR. If you do need to file one, they are due by June 30 of the following year. FBAR is beyond the scope of this guide, so check our blogs and Webinars on the subject.

NEW TAX FORM 8938 FOR FOREIGN ASSETS

FATCA brought about the new tax form 8938 (starting with 2011 tax filings), which is more about giving the IRS a heads up regarding your offshore assets. It's not about reporting income and loss — there are other tax forms for that. The filing threshold for Form 8938 is materially higher than the FBAR threshold and it's even higher for Americans living out of the country. Learn more about Form 8938 in our Feb. 2, 2012 blog: "Cost-Basis Reporting on IRS Form 8949 Is a Nightmare and FATCA Makes the IRS a Fat Cat."

U.S. RESIDENTS ABROAD

Many U.S. traders have moved outside the U.S. for various reasons. These "U.S. residents abroad," or expatriates, should learn about "foreign earned income exclusions" and "housing allowances" from Section 911 reported on Form 2555. Setting up a U.S.-based trading entity can unlock those AGI deductions, plus the regular AGI deductions for retirement plans and health insurance premiums. Like U.S.-based traders with foreign accounts, U.S. residents abroad must also comply with FBAR and Form 8938 reporting foreign assets.

COME CLEAN WITH OVDI

Consider entering the IRS Offshore Voluntary Disclosure Initiative (OVDI) program, which has been extended to encourage taxpayers to come clean before getting busted by the IRS. The OVDI penalties are generally high (though there are exceptions). It's not amnesty by any means and it's an expensive undertaking with tax attorneys. But if you wait to get busted by the IRS, your foreign bank or anyone else, the penalties are far higher. Criminal penalties may apply too, unless you join the program first. The current OVDI program has no end date, but the IRS has specifically stated it may revoke it at any time.

While OVDI is a good program for some (such as tax cheats in serious potential trouble), it's not appropriate for those discussed earlier who reported their income but just missed an FBAR filing.

The IRS has also come out with a new "Streamlined Procedure" for those who live abroad and have not been filing tax returns. If less than $1,500 is due for each of the past three years and certain requirements are met, there will be no penalties, and there is no need to enter OVDI.

Check with a tax attorney for more about the OVDI program. Be prepared for plenty of work with your accountant and arrange for the accountant to work through your tax attorney. Our tax attorney Mark Feldman has plenty of international tax experience; he knows how trader tax intersects with international tax matters and compliance.

BOTTOM LINE

Our tax attorney has been very busy helping clients with these issues. He is experienced in this area and can probably help you too. You can hire our tax attorney directly and he then will engage our CPAs on your behalf, so you will maintain your attorney-client privilege. Otherwise, the IRS could call the CPA to be a witness against you on the stand in tax court.

Appendix A: Tax Return Footnote

Here is an example 2012 tax return footnote that we use for our TradeLog accounting clients. We use a modified version of this footnote for our tax preparation clients who use Tradelog software. For background information about the IRS cost-basis reporting issues and problems with 1099-Bs, see our cost-basis reporting website page and related links to blog articles, Webinars, videos and more.

TAX RETURN FOOTNOTE: 2012 FORM 8949 AND COST-BASIS REPORTING RULES

Taxpayer files a Form 8949, which accounts for new IRS cost-basis reporting rules required on securities-broker-issued Form 1099-Bs. As an active investor, taxpayer has hundreds if not thousands of securities trades and compliance with the cost-basis reporting rules is a major undertaking as detailed below. This footnote is intended to explain how taxpayer handled the compliance on Form 8949.

Accurate tax reporting is the responsibility of the taxpayer, not the broker

The IRS continues to place the burden of accurate tax reporting on the taxpayer, as is evident by the requirement for brokers to include a reminder to taxpayers that "taxpayers are ultimately responsible for the accuracy of their tax returns (Pub. 1179 4.3.2)." The Information Reporting Program Advisory Committee noted this problem in its 2009 report to the IRS, stating: "Since it is impractical to require that financial institutions be responsible for tracking all possible events and taxpayer-level elections that affect basis, financial institutions should be treated as passive repositories of basis information, rather than guarantors as to its accuracy" (IRS Notice 2009-17).

Taxpayer used TradeLog software, which calculates wash sales according to IRS Publication 550, whereas, brokers do not

Taxpayer used what is considered to be the most reliable securities trade accounting software program on the market, TradeLog by Armen Computing. TradeLog software generates a compliant IRS Form 8949. TradeLog properly accounts for trading activity with securities brokers and reports the activity on taxpayers' income tax returns. TradeLog imports the actual raw trade data of buys and sells from the brokers. TradeLog then accounts for trading gains and losses with short-term versus long-term capital gains holding periods, and it calculates wash sales in accordance with IRS law.

It's important to note that the IRS subjects securities brokers to different tax rules than taxpayers, so you can't prepare a tax return based on a Form 1099-B alone. For example, IRS rules for broker-issued Form 1099s call for wash sales to be calculated based on "identical positions," whereas the IRS requires taxpayers to use "substantially identical positions," which means wash sales between stocks and options, too. TradeLog is one of the only programs on the market that can handle substantially identical positions. Brokers don't have the means of calculating wash sales across different brokerage platforms, but the IRS requires taxpayers to do so.

Most brokers are issuing incorrect Form 1099-Bs

IRS cost-basis reporting rules are new for 2011, and many brokers are interpreting and applying them in different ways, some of which are incorrect as of this date. Some brokers incorrectly adjust the sale proceeds of some trades for wash sales instead of the proper cost basis adjustment. Some brokers include 2010 cost basis of securities, whereas most brokers only report the required 2011 cost basis of securities purchased in 2011. Other brokers don't exclude open short sales from proceeds, as is now required by the IRS. For more examples of Form 1099-B errors, go to www.tradelogsoftware.com/tax-topics/1099b-problems.

As stated earlier, the IRS has one set of rules for Form 1099-Bs (apples) and a different set for taxpayers (oranges). TradeLog focuses on reporting for taxpayer's tax return filings and determining the correct taxable income/loss, whereas Form 1099-Bs focus on broker rules. Therefore, based on historical evidence we believe the TradeLog-generated Form 8949 is more complete and accurate than the broker's Form 1099-B.

Adjustment displayed on Form 8949

Many taxpayers have been finding errors on their Form 1099-Bs and have been requesting their brokers to correct them. While many have received corrected Form 1099-Bs, some brokers have not provided corrections yet, as it might require a major adjustment to their tax-reporting and accounting systems.

TradeLog provides a feature to reconcile Form 1099-B totals (proceeds and purchases), although it doesn't provide the means to reconcile Form 1099-Bs on a line-by-line, trade-by-trade basis, and the latter is called for in Form 8949 instructions. Without line-by-line reconciliation, if the broker-provided Form 1099-B is incorrect or incomplete, Form 8949 cannot be fully reconciled with it, especially if the results are based on different IRS requirements for the taxpayer versus the broker supplying the Form 1099-B.

If TradeLog finds a difference with Form 1099-B cost-basis, it enters one or more line items for "Adjustment to reconcile difference between accounting software and broker-provided 1099-B" on Form 8949.

Appendix B: Extensions

This is our March 2012 content for 2011 tax return filings. We are waiting to hear if the IRS will allow Form 1127 relief for 2012, and will have an update for 2012 tax extension filings soon.

While extensions are fairly basic one-page filings listing estimated tax liability, taxes paid to date and balances due, you should be aware of several important strategies, pitfalls and relief from the IRS.

NEW FOR 2011 TAX RETURNS: FORM 1127-A RELIEF

Some business traders and other taxpayers may qualify for new relief from the IRS provided by filing new tax Form 1127-A, *Application for Extension of Time for Payment of Income Tax for 2011 Due to Undue Hardship*. If you qualify to use Form 1127-A rather than the automatic extension Form 4868, you will be exempt from nasty penalties associated with paying less than 90% of taxes owed by April 17, and related rules mentioned later.

An automatic extension is for filing later, but paying taxes owed by April 15. This new form allows a qualifying taxpayer to pay later without penalties. But, you still need to file Form 1127-A correctly and on time.

On Form 1127-A, "financial hardship" is defined as:

- *wage earners (or spouse) who have been unemployed at least 30 consecutive days during 2011 or in 2012 up to the April 17 filing deadline, or*
- *self-employed individuals who experienced a 25% or greater reduction in business income in 2011 due to the economy.*

Many traders may qualify for this financial hardship clause and the adjusted gross income (AGI) and tax liability thresholds. Leaving a job to pursue trading full time and losing money may be the ticket.

Profitable 2011, but lost the money in 2012. Some traders can't pay their taxes because they lost 2011 trading gains in Q1 2012 before the deadline. That's a different situation than a financial hardship. If you can't pay your taxes, use one of the following strategies with a Form 4868 extension filing.

Extensions for securities traders. Due to the recent cost-basis reporting crisis, we are advising securities traders to file for automatic extensions, rather than try to rush tax returns filings (with problems). Securities traders need more time to request corrected 1099-Bs from their brokers and hopefully fully reconcile differences in trade-accounting reporting on Form 8949. We don't want traders to be audited by the IRS or to receive tax notices caused by reconciliation differences with 1099-Bs. If you haven't signed our Petition yet, please do soon.

FILE FOR AN AUTOMATIC EXTENSION

It's important to file an automatic extension by April 15, whether you can pay the taxes owed or not. Paying what you owe is the safe way to avoid penalties. If you can't pay 90%, according to Form 4868 instructions your extension can still be valid if you demonstrate reasonable cause and these conditions in the eyes of the IRS:

1. *Properly estimate your 2012 tax liability using the information available to you*
2. *Enter your total tax liability on line 4 of Form 4868, and*
3. *File Form 4868 by the regular due date of your return.*

No. 1 might be the most difficult condition to satisfy. Many traders are unsure of their 2012 trading gains, due to botched wash-sale loss reporting by brokers on 1099-Bs or other reasons. Many traders may underestimate their taxable income and pay too little with their extension. Will the IRS think that you "properly estimated your 2012 tax liability using the information available to you"? We suggest relying on TradeLog if you have it rather than conflicting and botched 1099-Bs.

No. 3 is the easier one. If you skip the extension, you will trigger both late-filing and late-payment penalties.

PENALTIES EXPLAINED ON FORM 4868

Form 4868 states the following:

> *Late Payment Penalty: The late payment penalty is usually ½ of 1% of any tax (other than estimated tax) not paid by April 17, 2012. It is charged for each month or part of a month the tax is unpaid. The maximum penalty is 25%. The late payment penalty will not be charged if you can show reasonable cause for not paying on time. Attach a statement to your return fully explaining the reason. Do not attach the statement to Form 4868. You are considered to have reasonable cause for the period covered by this automatic extension if at least 90% of your actual 2011 tax liability is paid before the regular due date of your return through withholding, estimated tax payments, or payments made with Form 4868*

> *Late Filing Penalty: A late filing penalty is usually charged if your return is filed after the due date (including extensions). The penalty is usually 5% of the amount due for each month or part of a month your return is late. The maximum penalty is 25%. If your return is more than 60 days late, the minimum penalty is $135 or the balance of the tax due on your return, whichever is smaller. You might not owe the penalty if you have a reasonable explanation for filing late. Attach a statement to your return fully explaining the reason. Do not attach the statement to Form 4868.*

Be conservative and pay extra with the extension. We suggest being conservative with the extension payment — pay 100% of the estimated 2011 tax liability. That gives you a cushion if your estimates are wrong. If you aren't sure about qualifying for trader tax status in 2011, then we suggest you prepare the extensions based on investor tax status. Or, consult with us as soon as possible.

Taxpayers with material income in Q1 2012 — which is not subject to tax withholding — should consider paying closer to 125% of their 2011 extension balance due. When they file their actual 2011 income tax return, they can apply the overpayment credit toward 2012 estimated taxes. This strategy has served our firm well for decades. Be conservative with the tax cash paid to the IRS, but be aggressive and legal with the tax return filings, as that is where the real money is.

What if you can't pay on time? If you can't pay 90% of your tax liability by April 15, first see if you qualify to use Form 1127-A for special relief on paying later without penalties. But file this form on time. If you don't qualify, file Form 4868 (Automatic Extension). If you are short cash, pay what you can, and try to impress the IRS with reasonable cause when you request penalty abatement after filing your tax return.

When you file your actual income tax return, the IRS will automatically send you a tax notice assessing the appropriate penalties, plus interest expense. After you receive that tax notice, send the IRS a "penalty abatement request" letter stating your reasonable cause and how you acted in good faith. Hopefully, you can get some or all penalties abated. Interest expense is statutory, so the IRS can't abate it. The current IRS interest rate on late payments is 3% per annum.

STATE EXTENSIONS

Some states don't require an automatic extension if you're overpaid, as they accept federal extensions. But in most states, if you owe taxes, you need to file a state extension with 90% payment. Check the extension rules in your state. States tend to be less accommodating than the IRS in waiving penalties, so it's usually wise to cover your state first if you are short on cash.

DON'T FORGET NEW SECTION 475 MTM ELECTIONS

If you're thinking about electing Section 475 for tax-year 2013, keep in mind you can't attach that election to an e-filed automatic extension. You must paper-file the extension with a Section 475 MTM election statement attached.

Generally, we recommend Section 475 MTM on securities only, providing the business trader doesn't have capital loss carryovers. On the other hand, wash sales from 2011 can be converted into Section 475 MTM ordinary losses in 2012 with a MTM election. See Chapter 2 for more information and consult a trader tax expert about this election.

Appendix C: New Medicare Tax

In this Appendix, I argue that an S-corporation trading company doesn't reduce the ObamaCare 3.8% Medicare tax on unearned income, because unearned income passes through on the K-1. While that statement is true, it may be confusing if you already read Chapter 7 ("Example: 2013 tax savings using entities" and "New strategy: Shift 2013 income with a corporation"). But the ideas expressed in Chapter 7 are different; the strategy is to carve out fee income into an earned-income related S-corporation. The ObamaCare 3.8% Medicare tax applies to "net" unearned income and an administration fee reduces the net trading income in the trading business partnership or S-corporation tax return. Check out those ideas in Chapter 7 if you haven't already done so; it certainly is another idea to consider if you're an upper income taxpayer affected by the new Medicare tax and Obama-era income tax hikes.

The Patient Protection and Affordable Care Act (also know as "ObamaCare") makes a big political point of raising taxes on the rich — defined as individuals with adjusted gross income (AGI) exceeding $200,000 (single), $250,000 (married filing jointly), or $125,000 (married filing separately) — and on the investor class. The first revenue raisers — the Medicare tax hikes on earned and unearned income — kicked in on Jan. 1, 2013. (The more contentious health-insurance mandate or tax penalties don't start until 2014.)

The current Medicare tax rate of 2.9% applies to all earned income. But if you're in one of the previously stated income groups, a new 0.9% Medicare hospital insurance tax raises this rate to 3.8%.

The more significant ObamaCare tax issue is this: Starting in 2013, the 3.8% Medicare tax will be applied to unearned income, too, for individuals exceeding these income thresholds. (Technically, it's modified AGI, which means U.S. residents abroad must add back any foreign earned income exclusion reported on Form 2555.)

Unearned income includes investment or portfolio income (interest, dividends, most capital gains and annuity distributions), royalties (net of oil and gas depletion expenses), rents (net of depreciation) and passive activity income, as well as gains from the sale of property not used in an active business.

The 3.8% Medicare tax on unearned income doesn't apply to wages and self-employment income, tax-free municipal bond interest income, IRA and qualified plan distributions or income from the disposition of, or pass-through from, active (earned-income related) LLCs, partnerships and S-corps, among other revenue sources. If you sell your company for a capital gain and you have been active in the company, that capital gain is exempt from this tax. But if you have been passive in the company, it's subject to the Medicare tax on unearned income. This tax also applies to taxable income in trusts (and estates) with undistributed net income in excess of the dollar amount at which the highest tax bracket for trusts begins (this amount was $11,650 in 2012). You can reduce that trust-level Medicare tax by making DNI distributions, but that moves the potential tax trigger to the beneficiary level.

If you're active in rental real estate, that income is free of the self-employment (SE) tax and the new Medicare tax. It's not 100% clear yet if the exclusion on the sale of a primary residence is exempt. Certainly, the taxable portion of the capital gain on the sale of a primary residence is subject to the tax.

While the Medicare tax on *earned* income is 50% tax deductible, it's not deductible on *unearned* income. Employers pay half the 2012 Medicare tax and withhold the other half from employees' paychecks. Investors have to pay the rest through estimated taxes and with their tax balance due.

We don't suggest selling profitable investment positions before year-end 2013 or accelerating other unearned income if you know you are going to be over the $200,000/$250,000 income threshold in 2013, triggering the tax.

As is the case with SE tax calculations, the Medicare tax on unearned income is assessed on net investment income. That's defined as net trading gains — proceeds minus cost basis on securities — less "properly allocable" expenses. For traders and investors, these allowable expenses include trading expenses. For business traders, all trading expenses are deducted on Schedule C or on a pass-through entity tax return. For investors lacking trader tax status, Section 212 investment expenses don't include education, home office and some other expenses.

SOCIAL SECURITY TAXES ARE LIMITED; MEDICARE TAXES ARE NOT

Historically, social security and Medicare taxes were limited to a social security base amount on earned income only. The 2012 social-security-base amount is $110,100. Congress raises the base every few years by around $3,000 or more. The base was $76,200 in 2000, $51,300 in 1990 and $25,900 in 1980. That's a serious tax hike on the middle class. Benefits have risen too with the inflation index.

In 1994, Congress untethered Medicare taxes from the social security base, applying them to unlimited earned income. While it failed in passing universal health care reform during the first Clinton administration, it did pass this Medicare tax hike, which was intended to pay for that health care reform. Go figure.

TRADERS CAN'T AVOID THE TAX WITH AN S-CORP

Even though the Senate's recent attempt to repeal the S-Corp self-employment (SE) tax loophole on earned income failed, taxpayers won't be able to avoid the Medicare tax by operating their trading activities in an S-Corp. Initial suggestions in the media and tax webinars have indicated otherwise: In the *Wall Street Journal* tax report "About That Investment Tax," a CPA suggested the loophole might work to avoid Medicare taxes on investment income. However, our tax research clearly shows these advisers are wrong.

Our tax attorney Mark Feldman, JD, says recent articles covering the loophole are referring to S-corps that engage in active businesses, such as cleaning carpets, not businesses trading financial instruments. Feldman says even though active income from an operating business normally isn't subject to the unearned income Medicare contribution tax but is subject to SE tax, in the case of these active S-Corp businesses, neither tax applies.

According to Feldman's research, Temp. Regs. Sec. 1.469-1T(e)(6) states, "An activity of trading personal property for the account of owners of interests in the activity is not a passive activity." Some taxpayers may argue that their investment is an active trade or business based on this regulation and thereby the Medicare tax doesn't apply to them. Feldman says Congress expected tax advisers to try this loophole and specifically ruled it out in the new law. ObamaCare specifically lists businesses to which this tax applies, including "a trade or business of trading in financial instruments or commodities."

Here's how the S-corp SE tax loophole works: Underlying earned-income businesses conduct their activities within an S-corp. S-corps do not pass through SE taxable income as LLC partnership returns do. The IRS requires S-corps to pay "reasonable compensation" to officers/owners. This area of the law is under challenge and the IRS is becoming more aggressive. In the past, 25% of income could be attributable to officers' compensation, but the factors are much more complex and beyond the scope of this guide. Check with a tax adviser before you proceed.

THE MARRIAGE PENALTY RETURNS

The single vs. married income thresholds are narrow for the Obama-era tax hikes and Medicare surtaxes. That means that married taxpayers are subject to the tax hikes quicker and more severely than single taxpayers.

Many taxpayers don't remember the significant marriage tax penalties from before the Bush-era tax cuts 2001 in 2003. Read about the history of the marriage tax penalty.

Consider this approach to avoiding the marriage tax penalty in the ObamaCare 3.8% Medicare tax on unearned income. One unmarried partner could report the couple's unearned income on a tax return filing single, and the other partner could report a high wage job on a second tax return filing single. That would save significant income and Medicare taxes vs. filing as a married couple.

I just took an important tax update CPE class with RIA and the instructor suggested that divorce would be good tax planning. Isn't that a little extreme, and have we come to that? But some taxpayers may think twice about getting married sooner, rather than later.

BUSINESS TRADERS WORK HARD, BUT GENERATE UNEARNED INCOME

Even though many traders work full time, their trading gains are still considered unearned income — business-related "portfolio income." Under the "trading rule" in Section 469, trading gains and losses are exempt from passive income or loss treatment. That's good news. Trading losses are deductible in Section 212 (investment up to $3,000 per year against ordinary income) or Section 162 (trade or business) if other tax-treatment elections for ordinary loss treatment are in place, like Section 475 MTM for securities or Section 988 for forex. Congress didn't want taxpayers with suspended passive losses to invest in hedge funds to easily generate passive income.

Ordinary trading losses (Section 475 and 988) are much more powerful than capital loss limitations of $3,000. The ordinary loss reduces both MAGI and net investment income (NII), and both of them can affect the Medicare tax on unearned income calculation. You pay the tax on the lower of the NII or the excess over MAGI, so always try to lower your MAGI, too. Roth IRA distributions don't generate MAGI, but RMD from traditional retirement plans do.

Traders with SE income have the tax benefit opportunity of AGI deductions for retirement plans and health insurance premiums, both of which require earned income. These income tax savings can outweigh SE tax costs.

Business traders who do not generate SE income start with the earned income glass empty, generally a nice thing. If these traders want AGI deductions for retirement plans and health-insurance premiums to put net tax savings in their pockets, they need to form an entity to financially engineer earned income. They use an administration fee in an LLC/partnership and a salary in an S-Corp. These business traders can also save more in income taxes than they pay in SE taxes.

Planning tips: Business traders affected by the Medicare tax in 2013 have more incentive to form an entity to convert trading gains to earned income with a fee or salary to increase retirement plan tax deductions. If they are going to pay Medicare tax on unearned income, they may as well have AGI deductions to offset that tax cost. Consider a defined benefit plan with a maximum contribution allowed up to $200,000 for 2012. That's far higher than a defined contribution plan deduction of $50,000.

Trading within a retirement plan is already a good idea for saving income taxes, and now it can help you save more: Retirement plan earnings and distributions are exempt from the Medicare tax on unearned income. When trading in a Roth IRA or Roth qualified plan, the income and Medicare tax savings are permanent. Conversely, in traditional retirement plans, income taxes are only deferred until retirement, when Required Minimum Distributions must start (no later than age 70½).

We think Roth conversions are better than ever because they will help save this Medicare tax on unearned income. For more on retirement plans, see Chapter 8.

BOTTOM LINE

The ObamaCare Medicare tax changes are on the books and traders should adjust their tax planning accordingly. Whether you trade taxable accounts individually, in a pass-through entity like a general partnership, LLC or S-Corp, or through estates and trust accounts, keep in mind the unearned income passes through to your individual return and it's subject to this new tax if you exceed the income thresholds.

Even if Congress reverses some of ObamaCare, will it reverse these new Medicare taxes? Not if you look to 1994 as a precedent.

BOTTOM LINE FOR THIS GUIDE

If after discussing this guide with your accountants, they give you a blank stare, then hire us — we will be happy to work with you.

Our motto is be smart, creative, forward thinking, cutting edge and even a bit aggressive, but keep it fully legal. You deserve excellence in content, ideas, judgment, decision-making, and service. Give us a chance at GreenTraderTax and Green NFH, LLC to please you with our highly trained and experienced CPAs and tax attorneys. We hope to hear from you soon. Thanks for being our customer and reading our guide.

Sincerely,

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