Green's 2014
Trader Tax Guide

The Savvy Trader's Guide to 2013 Tax Preparation & 2014 Tax Planning

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

Use *Green's 2014 Trader Tax Guide* — and our companion trader tax return examples guides — 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 it 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. We offer a Trader Tax Return CheckUp service. Consider our tax preparation services and/or our TradeLog accounting service.

Unfortunately, it may be too late for some tax breaks on your 2013 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 2014.

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

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

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 Section 475 mark-to-market (MTM) election, no retirement plans and more. Business traders who qualify for trader tax status (TTS), though, are entitled to several tax breaks.

Don't confuse TTS with the related tax-treatment election of Section 475 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 TTS 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, 2013 for 2013), or within 75 days of inception of a new taxpayer (i.e., a new entity). For more on TTS, see Chapter 1.

CAN YOU DEDUCT YOUR TRADING LOSSES FOR 2013?

Many traders bought this guide hoping to find a way to deduct their 2013 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's 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 by April 15, 2013 as an "existing taxpayer." 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 elect Section 475 by April 15, 2014, your 2014 business trading gains will be ordinary rather than capital. Remember, you need capital gains to use up capital loss carryovers.

If you have losses from trading 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, you can file a Section 1256 loss carryback election. 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. Sixty percent is a long-term capital gain even on day trades.

If you have losses trading spot or forward forex contracts in the Interbank market, you may be in luck. By default, Section 988 for forex transactions 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 often 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, which is wise if you have capital loss carryovers.

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 IRS Form 8949, which then feeds into Schedule D (capital gains and losses). You can no longer enter a securities trade directly on Schedule D. Form 8949 came about after the IRS beefed up compliance for securities brokers starting in 2011, causing headaches, confusion and additional tax compliance cost. Congress found tax reporting for securities to be inadequate and thought many taxpayers were under-reporting capital gains.

Broker-issued securities Form 1099-Bs provide cost-basis reporting information, but they do leave out many items — like options for 2013 — so they're inappropriate for inputting into a taxpayer's tax return. The best solution for generating a correct and compliant Form 8949 is TradeLog software. See Chapter 4 for more about these changes and common taxpayer and tax preparer mistakes.

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. But two 2013 trader tax court cases for option traders (Nelson and Endicott) indicate the IRS requires more frequency than just trading two days per week. See Chapter 11 for details on these two cases. 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 simple one-page 1099. 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.

Spot forex is not a "covered security" and it's not by default a Section 1256 contract. Therefore, spot forex brokers should not issue a 1099-B. Spot forex brokers do offer online tax reports and taxpayers should report the summary amount, with or without attachment of those reports on their tax returns. See our Aug. 16, 2012 blog "Why do forex forward dealers issue 1099s, yet retail spot forex brokers do not?"

KEY TAX DIFFERENCES FOR VARIOUS TRADING INSTRUMENTS

There are complexities in sorting through different tax-treatment rules and tax rates. It's often hard to tell which financial instrument falls into which category, but in Chapter 3, we cover the many trading instruments and their tax treatment. Bitcoin treatment is a new topic we covered this year. We believe it's an intangible asset with short and long-term capital gain or loss treatment for traders and investors. See our blog dated Dec. 3, 2013 "Bitcoin is a hot commodity, but is it taxed like commodities, assets or currencies?"

UPDATES ON SECTION 475 MTM ELECTIONS

Since Congress changed the 1997 tax law to allow business traders to elect Section 475 MTM, GreenTraderTax has helped thousands of business traders save a fortune in taxes by simply making this free election on time and filing a Form 3115 for automatic change of accounting method (free of IRS fees). 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 for trades reported on Form 4797. Wash sales still apply to investments in securities and you must include your IRA accounts in that analysis, too. If you have a large capital loss carryover, you need to follow our special strategies for considering and electing Section 475 MTM, since Section 475 ordinary income can't be offset with capital loss carryovers.

See Chapter 2 for the full details on Section 475 MTM. There are many nuances and pitfalls and this code section is widely misunderstood by other tax professionals.

BUSINESS TRADERS SHOULD USE AN ENTITY

We strongly recommend a trading entity to claim and use trader tax status related tax breaks. Business deductions save traders around $5,000 or more per year. 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.

Due to January 2014 IRS guidance on deducting trading business expenses against self-employment income, we've reconfigured some of our entity strategies. It's very important that customers and clients who used our entity strategies consider our suggested changes. For example, a husband and wife with 99/1 ownership/profit/loss may want to change to 1/99 to maximize AGI deductions for health insurance and retirement plans. General partnerships and LLCs may want to elect S-Corp status. Partnerships may want to add a C-Corp to own 1%.

Start with a half-hour consultation to be sure an entity is right for you. Next, purchase our entity formation service. Robert Green will suggest the best entity for your needs and will direct our outside attorneys on preparing the legal documents. Green also consults on startup tax, accounting, compensation, retirement plan, brokerage and banking issues and strategies. It's one of our best-selling services.

For more details on entities, see Chapter 7.

RETIREMENT PLANS

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. Trading gains are not earned income, so traders use entities to create earned income by paying compensation to themselves. Compensation payments can also reduce ObamaCare 3.8% Medicare tax on unearned income. A married couple can save up to $17,000 by establishing defined-contribution Individual 401(k) plans for each of them. (One exception: Members of a futures exchange are subject to SE taxes on their trades made on those exchanges.) Chapter 8 delves into various retirement plan options and provides the math so you can see exactly how this tax savings strategy works.

Also, read our important July 24, 2013 blog "Learn the DOs and DON'Ts of using IRAs and other retirement plans in trading activities and alternative investments" and watch the related Webinar recording. Consult with us about ways you can tap your retirement funds in a tax-efficient manner. Whatever you do, don't "blow up" your IRA with a prohibited transaction and cause a tax bomb.

NEW MEDICARE TAX

The ObamaCare 3.8% Medicare tax on unearned income started in 2013 for taxpayers with AGI over $250,000 (married) and $200,000 (single). We focus on what affects traders and investment managers in particular. One key point is that the net investment income tax (NIT) now applies on net investment income (NII). 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.

Business traders fare well with the final regulations for NII (after we fought for changes to the proposed regulations). With the final regulations, business traders are not disenfranchised from using their business trading losses and expenses for calculating NII. Just be sure to prepare Form 8960 (NIT) correctly.

For more on the new Medicare tax and the rocky rollout of the NIT, see Chapter 9 and Chapter 15.

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 (CCC) helped win Ponzi or "theft loss" tax treatment using Rev. Proc. 2009-20 safe harbor relief for PFG account holders. Generally, that's more favorable than using Section 165 loss treatment, which applies to MFG account holders.

Rev. Proc. 2009-20 allows loss deductions in the year of discovering the loss, whereas Section 165 requires waiting for the loss to be "sustained," which can be years later. Read our March 2013 blogs "PFG investors can deduct theft losses on 2012 tax returns with Rev. Proc. 2009-20 safe harbor relief" and "MF Global & PFG Best deposit losses have nuanced tax treatment."

WORDS OF CAUTION

Many IRS agents don't understand or respect individuals pursuing qualification as a trading business. While there is no bright line test for trader tax status, recent trader tax court cases better defined the volume of trades required (1,000), frequency of trades (3-4 days per week) and average holding period (under 31 days). 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.

In the past, too many traders brought weak cases to tax court and have failed to defend themselves properly. That was certainly the case again in 2013 with Nelson and Endicott, who did not use tax attorneys and lost their court cases. 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.

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.

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.

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 trade from the firm's office. 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-Corps. 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 in 2014. Learn more about investment management taxation in Chapter 13.

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.

TAX REFORM IS IN THE WORKS FOR 2014

Read our Jan. 9, 2014 blog "A major tax reform bill in 2014 is unlikely, and tax extenders may be history, too." Stay in touch with the tax reform debate and be ready to act in case there are tax changes in 2014.

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. Stay on our email list to receive guide, blog and Webinar 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 contain information covered in other chapters.

LINKS

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

Endorsements and Advance Praise for Green's 2014 Trader Tax Guide:

"Given the ongoing changes to the tax codes, it's great to have Green's *Trader Tax Guide* available to explain how the changes affect your particular tax situation, and how to manage your tax bill effectively."

— Theresa W. Carey, Contributing Editor,
Barron's, "The Electronic Investor"

"Robert Green is the preeminent trader tax expert in the country."

— Tim Bourquin, TraderInterviews.com

"Robert has become a go-to industry expert for forex traders, helping them navigate what can appear to be an intimidating and insurmountable task during tax time."

— Jason Andrus, Vice President,
Social Media and Brand Management, FXCM

About the Author

Robert A. Green is a CPA and founder and CEO of Green & Company Inc. (GreenTraderTax.com), a publishing company, and managing member and founder of Green NFH, LLC, a tax and accounting firm catering to investors, active traders and investment management businesses. He is a leading authority on trader tax. Green writes the "Business of Trading" section for *Active Trader* magazine and is a *Forbes* blogger for the "Great Speculations" column. He is also the author of *The Tax Guide for Traders* (McGraw-Hill, 2004) and the annual *GreenTrader Tax Return Example Guides*. Green is frequently interviewed and has appeared in the *New York Times, Wall Street Journal* and *Barron's*. Green has also appeared on CNBC, Bloomberg Television and Forbes.com Video Network. He is the main tax speaker at the MoneyShow University and Traders Expo.

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