CHAPTER 3

Entities for Traders

Business traders are, by default, considered sole proprietors. However, many traders choose to incorporate their trading business. A good reason for forming a trader entity is it allows you to establish a retirement plan or other tax-deductible and tax-deferred employee benefit plans. These options are not available for sole proprietor traders (who otherwise receive all trader tax status and MTM accounting benefits). Another good reason is that a trader entity can deliver business tax breaks to your spouse or investors. If you miss the April 15, MTM election, you can form an entity to elect MTM for the balance of the tax year.

Entities are also useful for part-time traders who just barely qualify for trader tax status and want to use a separate entity tax return to reduce their chance of IRS questions or to combine trading activity with other traders or investors (prop traders, family members, and more). However, forming a separate legal entity to conduct your trading activity without rising to the level of trading as a business will not automatically entitle you to trader tax status. You still may have an investment entity and must use investment tax rules, which allow few breaks.

When it comes to entities for traders, the correct and best way happens to be the simple and easy way. We usually advocate a pass-through entity in your home state. Pass-through entities mean that your entity does not pay a tax; instead, gains, losses, or expenses on the entity are passed through to your individual tax return to be taxed there. Pass-through entities file their own tax return and allocate income, gain, loss, and expense to partners on a Form K-1.

In many cases, the best approach is a single-member LLC (SMLLC). With this entity, you do not file a partnership tax return. Instead, you report all the entity-level income, gain, loss, and expense on your individual return directly. This approach is by far the simplest, and it is the same as being a sole proprietor, except that with the LLC you may have a retirement plan.

SINGLE-MEMBER LLCS

A single-member LLC is a pass-through entity. However, because it includes only one member (you), a partnership tax return may not be filed (as would be the case with two or more partners). This news is good because you don't have to spend extra time and money filing a separate tax return for the entity.

SMLLCs can be formed quickly, providing you with mark-to-market accounting and the opportunity to create earned income, which is required for retirement plan contributions and health insurance premium tax deductions (from adjusted gross income). An unincorporated trader does not have earned income, and therefore cannot receive any of these tax benefits. There is one exception for a commodities, futures, or options dealer registered on an exchange—those traders do have earned income (IRC § 1402(i)).

The ability to deduct health insurance premiums is quite helpful. Self-employed taxpayers with earned income can deduct 100 percent of their health insurance premiums. This deduction is a dollar-for-dollar deduction from adjusted gross income (AGI), just as an ordinary business expense would be. If you don't qualify for an AGI deduction then you may deduct health insurance premiums as "medical expenses"—part of itemized deductions on Schedule A—but only in excess of 7.5 percent of AGI. Few taxpayers get a benefit here, so an AGI deduction is preferred.

If you missed the mark-to-market accounting election, you can still achieve MTM status for the balance of the trading year, but not for the year to date. With a new entity, you can elect MTM status internally (no IRS filing is required) within seventy-five days of inception. This election will provide you with "tax loss insurance" for the balance of the calendar year.

A single-member LLC tax return is basically the same as a sole proprietor (unincorporated) trader's tax return. In both cases, all trading expenses are reported on Schedule C (Profit or Loss From Business), MTM trading gains and losses are reported on Form 4797 (Sale of Business Property—Part II Ordinary Gain or Loss), and interest and dividend income are reported on Schedule B (Interest and Dividends).

The differences with the single-member LLC are that the LLC tax identification number (EIN)—as opposed to the sole proprietor's social security number—is reported on the Schedule C, and the LLC is entitled to pay the owner a fee to create earned income. The key tax difference (and source of tax benefits) is that a single-member LLC may have a second Schedule C, filed by the administrator of the LLC trading business. The second Schedule C reports a fee from the LLC trading business, which is the filer of the first Schedule C. This reporting creates a wash and results in no overall difference in income—the first Schedule C deducts an amount equal to what the second Schedule C reports as income. The tax benefit comes from the second Schedule C being earned income, which unlocks retirement plan and health premium deductions, saving income taxes in excess of self-employment taxes.

The one thing to be cautious about is that when a partner contributes an asset to a partnership where the asset has a built-in capital loss in the hands of the partner (i.e., the cost basis of the asset is more than the fair market value at the date of the contribution to the partnership), the loss from sale of the asset is still treated as a capital loss by the partnership if the asset is sold within five years of the date it was contributed to the partnership. This treatment applies even if the partnership has trader status and has properly elected MTM. Internal Revenue Code § 724(c) specifically prevents the conversion of built-in capital losses on security transactions to ordinary losses by contributions from a cash basis trader/

investor to a trading entity that has properly elected MTM. This restriction applies also to an LLC, including a single-member LLC. However, it does not apply to S-corporations.

INVESTOR VERSUS SOLE PROPRIETOR VERSUS SINGLE-MEMBER LLC

The following example shows how a business trader gets tax breaks beyond that of an investor, and how a trader who forms a single-member LLC gets even more tax breaks.

Joe Trader is single, twenty-six years old, and a resident of California. He trades securities (no commodities) every day and all day from his one-bedroom office (in his two-bedroom apartment).

Joe assumed he would qualify for trader tax status, so he elected mark-to-market accounting (MTM) by April 15, 2002.

Joe has the typical business expenses for margin interest ($15,752), depreciation on equipment ($6,413), amortization on software ($646), supplies, travel, meals and entertainment, postage, telephone, tax and accounting services, chat rooms, Internet service providers, online information services, publications and books, and seminars.

Joe has a trading account at a direct-access brokerage and in 2002 his realized trading gains on securities was $248,558. He did not keep any open positions at year-end. Because Joe has MTM, he reports his trading gains on Form 4797, Part II Ordinary Gain or Loss. His trading account had interest income of $795 and dividend income of $99.

If Joe had fewer than 400 round-trip trades for the year and he held positions open for sixty days on average and he did not meet the other tests for sole proprietor status, he might consider filing as an investor.

On the other hand, if Joe had more than 1,000 round-trip trades and kept the positions open for minutes to a few days and if he easily meets the other tests, then he should file as a sole proprietor.

If Joe filed as an investor, his Schedule A itemized deductions (from restricted investment expenses) would be $21,789. If he were able to file as a sole proprietor, he would have net (unrestricted) deductions of $48,600, comprised Schedule C ordinary deductions of $43,900, and the standard deduction of $4,700. The sole proprietor version unlocks more of the exemption amount. The net effect is lower taxable income of $27,831 on the sole proprietor return. The tax savings as a sole proprietor versus an investor is $12,415 (44.6 percent of the additional deduction savings).

Had Joe formed a single-member LLC in 2002, he could have saved an additional $7,345, providing he executed the primary beneficial trader tax strategy for forming an entity; which is forming and funding a retirement plan.

Forming a SMLLC in Joe's home state of California costs about $215 (with an online incorporator) and is simple and quick to do. The only entity-level tax is a fixed state tax of $800 and a nominal fee depending on the level of income. In many states, either no stealth taxes (hidden entity-level taxes) are assessed on a SMLLC or there is an annual fee or charge of up to a few hundred dollars. These taxes are deductible.

A SMLLC has the same tax treatment as a sole proprietor in the following ways: all trading business expenses are reported on a Schedule C; all trading gains are reported on a Form 4797; and all interest and dividend income is reported on Schedule B.

A SMLLC has different tax treatment from a sole proprietor in the following beneficial ways, providing the retirement plan strategy is executed.

Joe's SMLLC pays a fee to himself for administration, reported on a second Schedule C. Joe pays the minimum fee necessary ($152,320 for 2002) to drive the maximum Mini 401(k) retirement plan contribution of $40,000 (the 2002 limit, which rises in future years—$41,000 for 2004).

The second Schedule C with the $152,320 of net income is subject to self-employment (SE) taxes. Adjusted gross income deductions in the amount of $49,719 are taken. These are not available on the sole proprietor return. These additional deductions lower the federal and state income taxes, which offset the SE taxes created in this scenario (but do not apply on the investor and sole proprietor returns, because traders are not subject to SE taxes).

Joe could have saved $7,345 more in taxes with this SMLLC and replaced "bad" income taxes with "good" SE taxes (SE taxes provide retirement benefits, but income taxes provide no benefits). Joe cashed in on this incentive from the IRS to fund a retirement account, which is wise financial planning. Joe can actively trade his Mini 401(k) plan assets and grow this account tax-free until he retires. Joe can also borrow money from his Mini 401(k) plan. Mini 401(k) plans and other retirement plans will be explained in greater detail in Chapter 4.

Another good idea for a trading entity is the husband-wife partnership.

HUSBAND-WIFE PARTNERSHIP

One benefit for married traders is that marriage can unlock some incredible tax savings strategies in connection with your trading business.

It is not necessary for your spouse to also be a trader in your business or otherwise active. However, a few requirements must be met:

- You must qualify for trader tax status.
- You must have some or all of the following husband-wife trading business factors:
  (a) Your spouse is listed on your trading statements.
  (b) Part of your trading capital belongs to your spouse.
  (c) Your spouse participates in your trading business, as a trader, manager, or administrator.

If your spouse is passive in your trading partnership, he or she will be subject to investment interest expense rules, which are not a big deal.

Many traders list their spouse's name on their trading business brokerage accounts for various reasons: joint tenancy, in case one spouse dies, the money belongs to both spouses, or both spouses are in the trading business. If your spouse is part of your trading business (a co-trader, manager, or otherwise), the IRS does not allow a joint sole proprietor Schedule C (Profit of Loss From Business) filing. Instead, it requires you to report the trading business activity on a general partnership tax return (Form 1065).

Don't be alarmed by this IRS tax rule clearly stated in the Schedule C instructions. It can be beneficial in many instances. The IRS does not require a formal partnership agreement or any filing whatsoever, except the partnership tax return. It is a "general partnership" for legal purposes and not a limited or other type of partnership. Other types of partnerships may require formal agreements or state filings. Most states follow the federal rules and don't have minimum taxes for general partnerships. Check with your home state or their website.

In the case of a husband and wife trading partnership, the entire partnership activity ends up on the "married filing joint" (or separate) individual tax return. The only difference is that instead of having a Schedule C for the trading business expenses and a Form 4797 for mark-to-market trading gains and losses, the entire net amount (trading gains minus losses minus expenses) is reported on your individual tax return Schedule E, page 2, Part II (Income or Loss from Partnerships and S-Corporations), Non-Passive Income and Loss section. In both cases, you get tax-beneficial ordinary loss treatment.

New taxpayer trading entities (never filed a tax return before) may elect mark-to-market accounting by filing an internal resolution within seventy-five days of inception. Existing taxpayers must file external MTM elections. If a spouse joins your trading business, you implicitly formed a partnership on the date he or she joined your business, and you have seventy-five days from that partnership inception date to elect MTM internally.

This option can be beneficial to traders who missed the April 15 MTM election deadline. Their spouse can join their trading business and they can then elect MTM for this partnership after the April 15 date (assuming you start your partnership during the year). Be careful with this tax strategy. If your spouse was part of your trading business from January 1, you had to elect MTM by March 15.

In the case your spouse joins mid-year, split your trading business activity between Schedule C for the prepartnership period and the partnership return afterwards. Use the cash method of accounting for the Schedule C period and the MTM method for the partnership return.

Your Spouse Listed as a Joint Tenant Only

If your spouse is not part of your trading business, and you merely listed him or her on your trading brokerage statements (and Form 1099s) for joint tenancy reasons, that approach should not affect your sole proprietor trading business reporting on Schedule C.

Watch out, though, for complications. Assume you lose your spouse's share of the trading account assets and your spouse is not part of your trading business. If you are using mark-to-market accounting, you may not use ordinary loss treatment for your spouse's lost money. First of all, you don't have basis; secondly, your spouse may not use MTM accounting. Rather, your spouse should take a capital loss for his or her share of the loss.

Names on the Trading Accounts

If your spouse is not in your trading business, be careful not to list his or her name as the only name on your trading brokerage accounts. The IRS may prevent you from using trader tax status and MTM because the money belongs to your spouse. One solution involves using a note payable to show that you borrowed the money from your spouse and it's your money to gain or lose trading. If any of the tax returns are prepared incorrectly and don't have the correct footnotes, you are putting the tax benefits in jeopardy.

As is the case with SMLLCs, a husband-wife partnership has built-in capital losses.

Example of a Husband-Wife Trading Partnership Solution

Joe and Nancy were happily married in 2000. Joe was a stock broker and Nancy a banker.

In June of 2001 Joe wanted to pursue his dreams of being an entrepreneur, and he left his job to start a trading business.

Joe opened a direct-access trading account in 2001 and funded the account with some of his and Nancy's capital. They agreed that Nancy would help Joe manage the trading business, but that Nancy would not interfere with Joe's day-to-day trading decisions. Nancy agreed to help with bookkeeping, strategy, risk assessment, and general business and finance issues.

Nancy insisted that her name be listed on the trading brokerage accounts, as a joint tenant, because some of the money was hers and if anything happened to Joe, she could immediately have access to these funds. Unfortunately, their prior accountant did not inform them about MTM accounting or husband-wife partnerships.

On their 2001 individual income tax returns, their prior accountant treated Joe as a sole proprietor and reported trading business expenses, including margin interest expenses, on Schedule C (Profit or Loss From Business) for full ordinary loss treatment. These Schedule C losses offset Nancy's W-2 wage income and generated a tax refund.

The bad news was that Joe and Nancy did not know about MTM; even if they did, it was too late to elect MTM in June 2001, when Joe started the trading business. Joe's 2001 trading losses were $53,000, but their prior accountant limited them to a $3,000 capital loss limitation. Had Joe elected MTM by April 15, 2001 (with good planning), they could have deducted the entire $53,000 as an ordinary loss and received additional tax refunds of $20,000.

Their prior accountant put them into a tax predicament, because they had a capital loss carryover of $50,000 for 2002. He then compounded the error by skipping the MTM election for 2002. He made this decision because Joe had gains year-to-date in 2002, and the accountant figured by not electing MTM, he could offset 2002 capital gains with 2001 carryover capital losses. Had Joe elected MTM for 2002 (by April 15, 2002) and had gains for 2002, those gains would be ordinary gains and he could not deduct his capital loss carryover. As a result, they would increase his 2002 tax liabilities.

As it turned out, though, Joe ended up losing $43,000 more in trading for 2002, and the decision to not elect MTM was the wrong one. When Joe and Nancy visit their prior accountant for preparing their 2002 tax returns, he tells them the bad news. He tells them, "Tough luck. You can only deduct the $3,000 capital loss limitation, and you'll have to carry over a capital loss of $90,000 to 2003" ($50,000 from 2001 and $40,000 from 2002).

Joe and Nancy need to lose this accountant and seek better advice from a proven trader tax expert.

The Potential Fix for 2001

Joe and Nancy may have a de facto general partnership for 2001 from the inception date of their trading business. As new taxpayers (a new general partnership), Joe and Nancy could have verbally elected MTM accounting internally within seventy-five days of inception of their trading business. An IRS Form SS-4 can later be filed to get a tax identification number for their trading general partnership. They can file a late (but acceptable) general partnership tax return (Form 1065) for calendar year 2001, using MTM accounting. Late penalties are only $500.

Additionally, federal and state amended individual tax returns for 2001 are filed, reporting the partnership return Form K-1 ordinary losses (from trading losses and expenses) on Schedule E. The result of these new tax return filings are refunds of approximately $20,000 or more, depending on the marginal tax rates. Rather than having nondeductible capital losses, Joe and Nancy have full ordinary loss treatment on the $53,000 worth of trading losses for 2001.

The Fix for 2002

Partnership and individual tax returns for 2002 are filed using MTM. The result is approximately $16,000 or more of additional tax refunds from a full ordinary loss on the $43,000 trading loss. It is preferred if the 2002 partnership tax extensions are filed by April 15, 2003, but late partnership tax returns can still be filed, with a small penalty. The penalty is $50 for each month or part of a month (for a maximum of five months) after the due date of the return (April 15, 2003), multiplied by the total number of partners in the partnership.

Tax Planning for 2003

Joe and Nancy turn it around and as of mid-year 2003 are on target to make about $200,000 trading in 2003. Having the general partnership in place will afford them the opportunity to benefit from having a separate legal entity.

Joe plans to open a Mini 401(k) retirement plan and contribute and deduct up to $40,000 to that plan. This retirement plan deduction will save Joe and Nancy several thousand dollars in taxes and provide Joe with tax-deferred retirement assets. Paying into social security and Medicare will also benefit Joe come retirement. If Joe was a sole proprietor, he could not establish a retirement plan.

Joe and Nancy get immediate tax refunds for all of their trading losses and are not stuck with 2003 capital loss carryovers of $90,000.

Note: Assuming Joe generates large trading gains in 2003, he could utilize $90,000 of capital loss carryovers from 2002 (assuming no fix herewith). It should be noted that many traders don't turn it around like Joe and wind up with large capital loss carryovers they have little chance of ever recovering. Certainly, getting immediate refunds on ordinary trading losses with MTM is much better then hoping to generate capital gains in the future.

The Bottom Line: Take advantage of all the benefits of marriage, which include some tax benefits for traders. If you have a clear opportunity to file amended tax returns for immediate refunds, consider that strategy. Note that the IRS frowns on paying large tax refunds on amended tax returns, so you should carefully weigh all factors beforehand.

Here is an excerpt from the IRS website as well as an observation:

> If spouses carry on a business together and share in the profits and losses, they may be partners in a partnership whether or not they have a

formal partnership agreement. Spouses should report income or loss from the business on Form 1065, U.S. Partnership Return of Income. They should not report the income on a Form 1040 Schedule C, Profit or Loss From Business in the name of one spouse as a sole proprietor.

If each spouse is a partner in a partnership, each spouse should carry his or her share of the partnership income or loss from Form 1065, Schedule K-1, Partner's Share of Income, Credits, Deductions, etc., to their joint or separate Form(s) 1040. Each spouse should include his or her respective share of self-employment income on a separate Form 1040 Schedule SE, Self-Employment Tax. Self-employment income belongs to the person who is the member of the partnership and cannot be treated as self-employment income by the nonmember spouse, even in community property states. This generally does not increase the total tax on the return, but it does give each spouse credit for social security earnings on which retirement benefits are based. However, this may not be true if either spouse exceeds the social security tax limitation. Refer to Publication 553, Highlights of 2001 Tax Changes, for further information about self-employment taxes.

Observation: The preceding explanation hints at what the IRS is after with de facto partnership treatment. The government's goal is collecting more self-employment taxes to improve funding of social security and Medicare. Allocating net income between a husband and wife versus just one of the spouses creates two rather than one self-employment tax bases. Trading gains are not subject to self-employment taxes.

NASDAQ Data Feed Fees

One potential drawback to forming an entity is that NASDAQ charges higher data fees to professionals, and an entity might increase your chances of being deemed a professional. NASDAQ offers significantly lower fees to nonprofessionals, but qualifying for these lower fees is a challenge for some traders.

In general, if you trade for your own individual account, are not registered as a security professional, and use the NASDAQ market information for your own personal use, you qualify for the lower nonprofessional rates. By default, everyone is a professional unless you can document that you meet the facts and circumstance NASDAQ tests to qualify for nonprofessional status.

The first test is whether you are a registered security professional. If you are exempt from registration but still a security professional such as an exempt investment advisor, you fail this first test.

If you pass the first test, the second test is whether you are a natural person or your trading account is opened in the name of an entity. Only individual trading accounts pass this test.There may be some new exceptions here.

Finally, the last test is whether you are using the NASDAQ market information for your own personal use or for the benefit of others. If you are managing money for investors or friends (family members are exempt here), or operating a website or financial newsletter, you are using this market information for third parties and not just for your personal use. In that case, you fail the third and final test.

The spirit of the rules is clear. You can be a hyperactive trader and qualify for business tax treatment with the IRS, and still qualify for the lower nonprofessional NASDAQ rates, if you are not a security professional, trade as an individual, and do not share your market information for the benefit of others. Most traders fall into this window of nonqualification.

Triggering Higher Rates

Forming an entity for additional tax savings is wise, but it is important to figure out beforehand whether you will be forced into the higher professional data feed rates and how much that additional cost will be. Keep in mind that many brokers cover the cost for nonprofessional data feed fees, so the entire amount of the professional fees may be additional costs to your trading business. If you are using a lower tier of NASDAQ services, this additional cost may be small versus the tax savings you will generate with a business entity tax strategy.

A few ways are possible to form an entity and still qualify for the nonprofessional rates. The first one is the previously mentioned husband-wife general partnership. This type of partnership means the brokerage accounts can be left in the individual names of the husband and wife. In that case, when your broker executes the NASDAQ data feed agreement, the agreement is in the name of a natural person. To avoid further confusion, it is best to sign that agreement with the name of one spouse only, to prevent the case of possibly owing two sets of fees.

Another possibility is that your broker may be able to help. Some brokers may allow you to open an entity account and still not charge you for the professional rates. Perhaps they will eat the additional cost themselves or finesse the NASDAQ subscription agreement to claim you still are a nonprofessional.

Caution: It is important for you to understand what position your broker is taking on your behalf and to fully understand the questions and forms your broker asks you to answer and fill out. NASDAQ will hold you responsible for your claimed non-professional status. Your broker will rely on your representations on the subject. NASDAQ will only hold your broker partially responsible if your broker purposely attempts to skirt any responsibilities in this regard. For example, if your broker knows you don't qualify for nonprofessional status and tells you to just sign the forms without explaining them, then you can seek some indemnity from your broker, but again you are at risk and the responsible party.

SMLLCs and S-Corporations and Nonprofessional Status

A husband-wife general partnership can navigate around the NASDAQ rules and keep nonprofessional status. However, other trader business entities such as SMLLCs, LLCs, and S-corporations will be considered professionals by default.

Our firm has been working with NASDAQ to clarify their definition for nonprofessional rates. Our goal is to change the current definition so that traders, who trade solely for their own accounts, but use an entity (i.e., for retirement plans and health insurance deductions) may still qualify for nonprofessional rates. As of the time of this writing, all entities without exception should pay the professional rates. You should visit the free update area at www.greencompany.com/Book/index.shtml for any changes.

Again, speak to your broker. Perhaps the broker can take a position that you own 100 percent of your SMLLC and as a sole proprietor you qualified as a nonprofessional. In spirit, you should otherwise still qualify except for the SMLLC technicality. Perhaps, they can find a way for the NASDAQ agreement to be executed in your individual name. This option may or may not pass muster with the NASDAQ. In theory, it seems fair and not abusive to the spirit of the rules.

Trader Tax Status and the "Trading Rule" for Business Tax Breaks in Entities

Active traders/managers in hedge funds, family trading entities, and other types of trading companies can use trader tax status and the trading rule to deliver business tax breaks, including mark-to-market accounting, to their investors.

Investors in businesses are normally subject to the passive activity loss rules, but the trading rule tax loophole exempts investors from passive activity rules in a trading company. The net result is your investors get full business expense treatment for all expenses in your entity, including but not limited to all trading expenses (supplies, services, chat rooms, seminars, travel, meals and entertainment, professional fees), your management fees (payments to you as manager), depreciation on computers and equipment, and more. The one exception is investment interest expense, which is discussed next.

This option provides a huge edge. Your competitors in investment company hedge funds pass through deductions from portfolio income on their K-1s, and their investors are stuck with limited investment expenses. The bottom line is that your investors can have a higher after-tax return, which is a huge benefit in marketing.

The second key tax benefit is your ability to use mark-to-market accounting on the entity level. With MTM, if you lose money while trading, you can pass through those losses as ordinary losses to your investors, rather than loading them up with even more unusable capital losses, which your competition did during recent bear markets.

Sure, you plan to have gains, but your investors will really value this tax loss insurance when evaluating your private placement memorandum against your investment company competition.

Don't worry if you have gains, MTM still comes in handy.

Unique Trading Hedge Funds

Thousands of new hedge funds have sprung up the past few years, but the majority of their trading programs are not short-term trading. Only short-term trading programs have a shot at qualifying for trader tax status. Non-short-term trading funds are investment funds and they are stuck with the less tax-beneficial investment company rules.

Difference Between Business and Investment Treatment

First, all income and losses are broken down between business and investment treatment. Business treatment is only for situations when you are involved in a trade or business. The IRS considers this effort serious and allows you to deduct every type of expense and loss in connection with pursuing business income.

Investment treatment applies when a taxpayer pursues growth in assets and is not doing this activity on a daily or full-time basis. All taxpayers focus their main efforts on making a living from a job or a business, and they try to grow their assets with investments.

The IRS has special tax rules for investment activities including, but not limited to, lower long-term capital gains tax rates, capital loss limitations, wash sale and straddle loss deferral rules, investment interest expense limitations, and investment expense limitations. Basically, the IRS gives taxpayers a break on long-term capital gains and then really makes you pay for that one special break with severe limitations on losses and expenses.

The problem for investors is that it takes money to make money. You need special tools and skills, and it costs money to acquire them. The IRS restricts investor's abilities to deduct those expenses. The markets are dangerous, and a puny $3,000 capital loss limitation is ridiculous. Congress has not increased that amount for decades.

Obviously, business treatment is far superior to investment treatment. A key point to remember is that trading companies with business status can also segregate investments to generate long-term capital gains. So, they can have the best of both worlds.

Passive Activity Loss Rules

If you are an investor in a company with business treatment, unless you are active in management on a daily basis (and the rules are complex), you are subject to the third type of tax treatment: the onerous passive activity treatment. However, the trading rule tax loophole exempts portfolio investors from these passive activity loss rules.

The passive activity loss rules are meant to prevent investors in businesses from getting business tax breaks. The passive activity rules are supposed to suspend those losses into the future. In some cases, this treatment is even worse than getting investment treatment on the losses. The trading rule exception basically gives investors in trading businesses a special break. Rather than force them into investment treatment, it allows business treatment for all income, losses, and expenses, except one item: investment interest expenses.

Origination of This Special Loophole

The IRS created the passive activity loss rules to combat the proliferation of real estate and other tax shelters in the 1980s. Promoters would set up business partnerships in real estate, movies, and other activities, use nonrecourse debt to shield the investors from risk, and then pass through huge business losses to the investors. These were tax losses but not true economic losses.

The passive activity loss rules were successful in killing off these tax shelters. What good were all those business losses if you could not deduct them on your tax return? The losses were suspended until the investor had sufficient passive activity income to offset only true economic losses.

Promoters never take new tax laws lying down. They scurried to create reverse tax shelters that could generate passive activity income. Their first idea was business partnerships engaged in trading to generate portfolio income, which they figured would be easy enough. A proven trader can generate income without much risk, but the IRS fought back with the trading rule, which says that trading partnerships are not subject to passive activity rules.

The end result is that the IRS won their war on those types of tax shelters. The IRS may realize the trading rule gives a tax shelter of sorts to investors in trading companies, but we believe they think it's just for expenses. MTM only came into existence for traders and trading businesses in 1997, and the IRS may not yet realize that investors will be able to get huge MTM trading loss benefits on their tax returns and large refunds with net operating losses. At least these are true economic losses.

The IRS "State of the Law"

The following excerpt from an IRS Field Service Advice document, which is not technically tax law, represents the IRS view of the "state of tax law." The IRS summarized the issues and conclusions as follows:

ISSUES

1. Whether a partner in a "trader" partnership may claim as a trade or business expense the operating expenses of the partnership.
2. Whether a partner in a "trader" partnership should treat his ordinary income or losses from the partnership as arising from a passive activity for purposes of section 469 (the passive activity regulations).

3. Whether section 163(d) (limitation on investment interest) limits the deduction of any interest expense flowing through to a noncorporate partner from a "trader" partnership.

CONCLUSION

1. A partner in a "trader" partnership may claim as a trade or business expense the section 162 (trade or business expenses) expenses of the partnership.
2. A partner must treat his ordinary income or losses from a "trader" partnership as not arising from a passive activity.
3. For noncorporate partners, section 163(d) will limit the deduction of interest expense that is not attributable to the partnership's trading activity. In addition, for those noncorporate partners who do not materially participate in the trading activity, section 163(d) also will limit the deduction of interest expense that is attributable to the partnership's trading activity.

Observation: The passive investor receives complete business tax breaks on ordinary business expenses except for investment interest expenses. The structure helps the investor get maximum possible benefit from those investment interest expenses.

The Best Hedge Fund Tax Strategy

Before you proceed, think about what tax strategy is best for you as the trader/manager of your trading company, and what is best for your investors. In one area your interests are the same as your investors: you both want trader tax status for ordinary loss treatment.

Fee or Profit Allocation

In the case of trading companies, though, your interests may be different from your investors in some areas. A trader/manager in a hedge fund is entitled to an incentive compensation payment (usually 20 percent) for their efforts in managing money for the investors. In the case of investment companies, the structure can either provide for a fee, which is classified as a deduction from portfolio income (a restricted itemized deduction), or it can be structured as profit allocation, which is a share of capital gains. Note that a recent IRS audit manual is claiming profit allocations are disguised fees. Many lawyers are contesting this.

Most investment companies use profit allocations to prevent the investors from being stuck with nondeductible itemized deductions. Deductions from portfolio income are investment expenses reported on Schedule A as miscellaneous deductions. They are only deductible in excess of 2 percent of adjusted gross income. Investment expenses are an alternative minimum tax (AMT) preference item (not deductible for AMT). Many taxpayers are hit with the dreaded AMT increasingly more each coming year.

For an investment company example, rather than report on your investors' K-1s a $50,000 capital gain and a $10,000 investment expense (the incentive fee), it is beneficial to use a profit allocation and report on the K-1 a capital gain of $40,000 and no deductions from portfolio income. You will have to report the other expenses as deductions from portfolio income, unless you are a trading company. In that case, you pass through business expenses without limitation for your investors.

In a trading company, the trader may want to use a fee structure in lieu of a profit allocation. The investors may prefer an ordinary business loss for fees and a higher capital gain (that $50,000) to offset their unutilized excess capital losses.

Consider the earned income issue for the trader/manager. Fees are considered earned income, whereas a share of capital gains (the profit allocation) are not earned income. This appears to be one reason why the recent IRS audit manual is arguing for fee treatment.

It may work out well for both the manager and the investors to use fees. If the manager wants to limit the earned income and related self-employment taxes due on earned income, an S-corporation can be used for the manager (as the managing member vehicle in the hedge fund LLC).

S-corporations are not subject to self-employment taxes, whereas LLC income is. The S-corporation can pay a smaller salary to the manager to drive the retirement plan strategies, and satisfy the IRS on reasonable compensation rules. This strategy saves a considerable amount of self-employment or payroll taxes.

Commodities traders may prefer the profit allocation over the fee in all cases, because the trader/manager also wants to benefit from the lower taxes on commodities capital gains (a 60/40 split in which 60 percent of gains are taxed at lower long-term capital gains tax rates).

Investment Interest Expenses

The one exception to the trading rule tax loophole is that investment interest expenses are not considered business interest expenses for all passive investors. All the other expenses are business expenses rather than investment expenses.

Passive investors may deduct investment interest expenses only if they have investment income and pass other tests. Investment interest deductions are also an AMT tax preference item.

A hedge fund with capital gains rather than MTM ordinary gains may help investors increase their investment interest deduction, because investors may choose to include capital gains in their investment income formula for this deduction.

Investment Interest Expense Rules

The following excerpt comes from the IRS:

> The amount you can deduct as investment interest expense may be limited in two different ways. First, you may not deduct the interest on money you borrow to buy or carry shares in a mutual fund that distributes only exempt-interest dividends.

Second, your deduction for investment interest expense is limited to the amount of your net investment income.

Net Investment Income This is figured by subtracting your investment expenses other than interest from your investment income. For this purpose, do not include any income or expenses taken into account to figure gain or loss from passive or business activities.

Investment Income Investment income generally includes gross income derived from property held for investment (such as interest, non-qualified dividends, annuities, and royalties). It generally does not include net capital gain derived from disposing of investment property qualified dividends, nor does it include capital gain distributions from mutual fund shares. However, you can choose to include part or all of your net capital gain and qualified dividends in investment income.

Investment Expenses Investment expenses include all income-producing expenses relating to the investment property, other than interest expenses, that are allowable deductions after subtracting 2 percent of adjusted gross income. In figuring the amount over the 2 percent limit, miscellaneous expenses that are not investment expenses are disallowed before any investment expenses are disallowed.

Scams and Alerts Regarding Multiple Entities Schemes

The idea of avoiding taxes on income sounds appealing to many traders, but look before you leap because the IRS considers tax avoidance against the law. Many tax avoidance schemes using multiple entities are marketed to traders, and traders need to stay clear of these schemes and the firms that promote them.

Popular books on the market feature complex strategies for estate and family planning, and fringe benefits. In our opinion, most of these strategies don't work as designed for traders, and they cost thousands of dollars to set up. Finding a good CPA to file these annual returns will be a challenge, because most competent CPAs will balk.

Caution: Some of these books suggest that traders use family limited partnerships as an integral part of their trading businesses. This idea is always bad as far as we are concerned. Trouble may lie ahead for you if you follow this advice.

Avoid those authors who would advise parking your trading business in a flawed corporate structure and promote complex entity strategies that utilize a C-corporation for the management company. We totally disagree with these strategies and find them expensive and a waste of a trader's money. We believe that this tactic sells traders an unnecessary bill of goods just so the firm can make lots of money setting up the entities and filing extra tax returns every year (at additional profit for them, not you).

CHAPTER SUMMARY

A business trader is, by default, a sole proprietor. Although this status is good enough to unlock numerous tax breaks, forming an entity can in some cases be the preferred route for traders. An entity allows a trader to have earned income, which can be used to fund retirement plans and for other benefits. A simple entity is the best, and a husband-wife partnership (if you're married) or a single-member LLC are preferred. Watch out, though, because some entity scams floating around will only wind up getting you in trouble with the IRS.