Green's 2014
Trader Tax Guide

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

by Robert A. Green, CPA

Endorsements and Advance Praise:

"Robert Green and his associates have their fingers firmly on the pulse of tax law and how it affects professional and frequent traders. I frequently lean on Robert to help explain the nuances of the tax code to my "Electronic Investor" readers in Barron's. 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"

"Running a brokerage firm that caters to active traders, each year we hear concerns from our clients about their local accountant's inability to properly handle tax returns involving voluminous securities transactions. It is gratifying to know that we can refer our clients to Robert Green, a leader and expert in active trader tax accounting. Over the years, Robert has handled tax education and actual tax preparations for hundreds of our clients, and through the process, saved them a great deal of money and aggravation. Trader tax reporting is becoming more complicated every year due to new regulations. It would behoove anyone who considers themselves an active trader to read *Green's Trader Tax Guide*."

— Michael Sedek, Chief Customer Officer, Lightspeed Trading LLC

"Trader tax status, Section 1256 contracts, Section 475 MTM — it's all so confusing. And although there are lots of tax breaks available to traders, most don't take advantage which costs them thousands! *Green's Trader Tax Guide* is well structured and explains the tax breaks available to you. Robert Green puts a lot of time and money in researching the ever-changing tax laws and lays out his findings in 14 chapters. Learn how you can deduct home office and education expenses, how to deduct losses, how to form entities, retirement plans for traders and much more. This guide costs you less than $50, but it could save you thousands. Your local accountant doesn't know about these specifics! It doesn't matter whether you are new to trading or have been trading for a while. It doesn't matter whether you are making money trading or you had a rough year. This guide will show you how to maximize tax benefits on your tax filing and get even more tax breaks for the current year."

— Markus Heitkoetter, CEO of Rockwell Trading

"Bob's advice has saved me tens of thousands of dollars and he has guided several of my friends safely thorough an audit. I trust no one else more on the subject of trader taxes."

— Rob Booker, Host, The Trader's Podcast

"I've known of Bob Green for years, and started working with him and his team to help me with my own taxes. I'm impressed with Bob's contributions to industry; he led the way when it came to helping active traders like myself figure out the wash-sale tax law implications, and so much more, with his webinars, industry appearances and publications like his *Trader Tax Guide*. I highly recommend Bob Green and his CPAs at GreenCompany.com for all active day and swing traders. It really helps to work with someone like Bob who specializes in trader taxes; something that was beyond my regular CPA's knowledge. Bob and his staff are friendly, professional, responsive and accurate."

— Ken Calhoun, President, DaytradingUniversity.com

"Robert Green is the preeminent trader tax expert in the country. Anyone who trades part time or full time should tap Robert's vast experience by reading this book. Without his specialized knowledge, you could be setting yourself up to make costly mistakes. Don't guess on the tax rules — let Robert be your guide."

— 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. His advice and wealth of knowledge has laid vital groundwork for forex trading tax guidance, without which many traders would be lost."

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

"Robert Green is the 'go-to' guy for trader taxes. It has always been a pleasure working with him."

— Dan Blystone, Founder TradersLog.com

Green's 2014 Trader Tax Guide

The savvy trader's guide to 2013 tax preparation and 2014 tax planning

By Robert A. Green, CPA

About GreenTraderTax & Green NFH

Green & Company, Inc. (GreenTraderTax.com) offers extensive educational resources for investors, active traders and investment managers on its website, 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.

Green NFH, LLC, our CPA firm, caters to investors, active traders and investment managers providing tax compliance services, accounting, consultations, entity services, and IRS/state tax exam representation services.

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 aggressive, but keep it legal. You deserve excellence in content, ideas, judgment, decision-making, and service. Give us a chance at 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.

I'd like to acknowledge and thank my co-managing member Darren L. Neuschwander CPA and other members, CPAs and tax attorneys in Green NFH, LLC for all their fine help in researching tax law, and crafting the strategies in this guide.

Sincerely,

Robert A. Green, CPA, CEO of Green & Company, Inc.
Owner of GreenTraderTax.com
Managing Member of Green NFH, LLC (our CPA firm)
888-558-5257 (toll-free in US only) or 646-224-6923 (worldwide)
888-310-6707 fax
www.greentradertax.com

Table of Contents

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 underreporting 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.

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 after business commencement, start-up expenses, margin interest and 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) (indexed for inflation). Business expense treatment is much better.

The average trader saves more than $5,000 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. 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. (But filing amended tax returns may increase your odds of IRS questions or exam.)

Full-time active traders generally qualify for trader tax status. 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 rather than capital-loss limitations. Sole proprietor traders filing a Schedule C draw more IRS attention than business traders using pass-through entities.

QUALIFYING FOR TRADER TAX STATUS

While the IRS hasn't issued specific rules with objective criteria for how a trader qualifies for trader tax status, an increasing number of trader tax court cases are better defining the ranges for required volume of trades, frequency and average holding period. Read about the 2013 Endicott and Nelson trader tax court cases in Chapter 11. We see a pattern developing which resembles a bright-line test.

Similar to hobby-loss businesses, traders face more scrutiny from the IRS. But hobby-loss rules shouldn't apply to a trading business (more on this topic later). Arizona tried to apply hobby-loss rules to a trader, but we objected and won the case.

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 and recent trader tax court cases have reiterated these requirements:

- "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 further 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 hope to make further 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.

GOLDEN RULES BASED ON CASE LAW

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

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

Full-time options traders actively trading significant portfolios may not qualify because they don't have enough volume and frequency and their average holding period is over 31 days. On the other hand, a part-time trader with a full-time job may qualify as a day trader in securities meeting all our golden rules. It's unfortunate that the IRS rewards the day trader over the options trader.

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 its "trading rule" exemption. Without this exemption, taxpayers could generate passive-activity income by investing in hedge funds and the IRS did not want that.

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 business 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 (CBA) standard. Keep good records of your time spent.

Recent comments from an IRS official about the Chen trader tax court case point out the IRS doesn't respect individual traders who are brand new to a trading activity and who enter and exit it too quickly.

Some traders must temporarily stop for several months for health reasons. It's not clear if the IRS will respect that as a valid interruption of a trading business activity. That seems unfair, but it may be the reality.

Executes trades on close to four days per week, every week. After the Holsinger, Endicott and Nelson tax-court cases (see Chapter 11), it's wise to prevent an IRS challenge by trading close to four days per week or 75% of available trading days — 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, and any trading you do for TTS must have true economic risk.

Holsinger, Endicott and Nelson, options traders with less activity than equity or futures traders, only traded on close to two days per week – around 40% of available trading days. Three days per week may be cutting it too close, so try to get closer to four. While we feel the IRS should also count working days during which no trades are executed, it currently does not as evidenced in the Endicott and Nelson cases.

Continuous business activity focuses on business work performed rather than trade executions, but the IRS still hasn't opined on the CBA argument in a trader tax court case. From what we've seen, no trader has seriously made that argument in tax court yet. We hope to make the CBA argument in tax court soon.

Makes close to 500 round-turn trades per year, or 1,000 trades in total on an annualized basis. The buy and sell are counted as one round trip. Recent cases talk about total trades more than round trips, so we are moving in that direction, too. Day traders have round trips in a given day, but not swing traders.

In Holsinger, Endicott and Nelson, the IRS mentioned around 1,000 total trades per year. Some cases have allowed trader tax status with a lower number of 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 tax returns (unlike securities trades), so the IRS doesn't see those numbers. Report a strong number in your tax return footnotes about trader tax status.

In the 2013 Endicott and Nelson cases, the IRS further delineated between "substance" and "volume." Substance refers to the size of trades and materiality, whereas volume is the number of transactions during the year. See Chapter 11 for further information about the case on this point.

Has proceeds in the millions of dollars per year. 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 and the IRS won't see the proceeds amount

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.

Option traders face many challenges. Options traders may have average holding periods of over one month if they trade monthly options and hold them for one or more months. (Note: Holsinger was an options trader and his holding periods averaged between one to two months.) The IRS was clear in the Endicott case that average holding periods for option traders must be under 31 days.

Many option traders face challenges qualifying for trader tax status. Many now trade weekly options, thereby shortening their average holding periods to under 31 days. Their other challenge is frequency, as many still only trade two to three days per week, rather than the requirement closer to four days per week. It's a challenge for option traders to be that frequent. Some fill in the blanks by trading securities, futures and or forex.

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. You probably can count each leg of an option credit spread as a separate trade.

Option traders should consult a trader tax expert.

Has the intention to run a business and make a living. You must have the intention to run a separate trading business — trading your own money — but it doesn't have to be your exclusive or primary means of making a living. The key word is "a" living.

Many traders enter an active trading activity while still performing their full-time job. Using advances in technology, it's possible to carry on both activities simultaneously.

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. It's better to form a new trading entity. Trading an existing business's available working capital seems like a treasury function and side line, which can deny trader tax breaks.

While filing as a sole proprietor on a Schedule C is allowed and used by many, it's not the best tax filing strategy. Your individual tax return shows your job and other business activities or retirement, and that may undermine trader tax status in the eyes of the IRS. 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.)

Has significant business equipment, education, business services 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 operation. 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 multiple monitors? If you use the office exclusively for business rather than personal use, don't skip reporting 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, equities traders can't day trade and they will have a very hard time qualifying for trader tax status. The $25,000 amount seems substantial enough to impress the IRS.

Many new traders don't want to risk $25,000 day trading securities; they prefer to trade options, futures or forex, all allowing mini-account sizes of $5,000 or less.

A small $5,000 account size, which can be typical for forex, options and futures trading, won't impress the IRS — you probably need more capital to qualify. We like to see over $15,000 for options, 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. You may be able to factor in equipment and startup 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?

FALLING SHORT

If your trading activity falls short of these conditions based on trader tax court cases, the IRS may scrutinize your return and challenge your trader tax status. The IRS may examine you anyway, 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 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.

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.

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 in 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 and automated trading 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.

If you spend a lot of money on automated trading systems and services, and it doesn't qualify as part of your trading business, then those expenses are at least deductible as investment expenses on Schedule A (miscellaneous itemized deductions).

Don't assume the IRS won't connect the dots to realize you are using automated trading systems and solutions. A full-scale exam can uncover these facts.

2. Engaging a money manager. Hiring an investment adviser or CTA to trade your account doesn't count toward qualification. However, hiring an employee under your supervision 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 independent outside manager vs. a supervised inside trader. If the engaged trader is a registered investment adviser, he's clearly in the business of being 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. You can actively trade retirement accounts and at the same time qualify for trader tax status in taxable accounts.

ADD A SCHEDULE C FOR TRADER TAX STATUS

If you realize you qualified for trader tax status in 2013 and you have material trading business expenses, you can add a Schedule C to your 2013 tax return. Even though you may not be able to 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 2013 can help in deducting year-end 2013 wash sale losses as ordinary business losses in 2014 — with a 2014 Section 475 MTM and Section 481(a) adjustment from year-end 2013. That election adjustment is made on Jan. 1, 2014.

Some business traders feel 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 and state 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. In their landmark losing trader tax court cases, both Nelson and Endicott triggered IRS exams with large Schedule C business losses. Most traders have a reasonable level of business expenses (under $15,000) and if you don't also report a large Form 4797 ordinary trading loss under Section 475, it may not be enough to draw IRS attention.

We suggest qualifying business traders consider using a Schedule C for 2013 (if you didn't have an entity) and forming a trading entity soon for 2014. A Schedule C works well for 2013 business expense treatment, but an entity works better and it also unlocks additional tax breaks like deductions for retirement plans and health insurance premiums.

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. 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. (Chapter 8 contains more on Roths.)

After filing approximately 10,000 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 based on trader tax court cases determines the outcome. However, the IRS focuses on the objective factors such as frequency of trades, including the number of trades, the number of actual trading days with trade executions 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.

CLOSE CALLS

Here are 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 in the morning session. Many traders have browser-based trading platforms which they can easily access at their jobs, with or without employer approval. Many traders use iPads and iPhones to execute trades when not in their home office. These traders often spend considerable amounts of time trading 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 and document your time spent in diaries. Establish a reasonable daily trend line in your calendar.

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 profes-

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 1,000
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.

sionals work flexible hours and are able to structure their day jobs around trading and 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 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.

Stay-at-home 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 or help pay the bills while taking care of the children. 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. Be very professional in your approach and discipline.

Early retiree wants to enhance insufficient retirement assets. While many people may decide to retire from their full-time careers around age 65, they are not ready to call it quits on staying mentally active and they want to enhance their income. Retirees seek new income opportunities, and a trading business is ideal for some. Many retirees self-direct their retirement funds and investment accounts, so they already have one foot in the trading business door.

Others are offered early retirement or are laid off in their 50s due to downsizing before they want or need to retire. They may decide to pursue a trading business.

The IRS tends to be skeptical toward retirees, thinking they are retired from business entirely. That's not true, so impress the IRS with your professionalism and business acumen.

An unemployed person's last resort and dream may be a trading business. While waiting for the labor market to improve 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 unemployment benefits while operating a trading activity. In most states, traders can also form a trading entity without jeopardizing those benefits, either. However, we advise against taking an administration fee or salary from the trading entity. A fee or salary is 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 or salary just before year-end, which still allows the health insurance and retirement plan deductions for the entire year. It's a good idea to check with your state or unemployment benefits/disability benefits provider.

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.

The longer you can continue your business trading activity, the better your chances are with the IRS.

ALTERNATIVE STRATEGIES

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 health insurance and retirement plan 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.

BOTTOM LINE

Trader tax status drives many key business tax breaks like business expenses, business ordinary trading losses with the Section 475 election and 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 and Pease limitations, and there are capital-loss limitations and wash-sale loss deferrals to contend with as well. Unfortunately, only a small fraction of active traders qualify for trader tax status, and the rules are vague and difficult to understand. Try to claim trader tax status on a Schedule C until the current date, and form a trading entity to conduct your trading business for the future. If you're not sure if you qualify for trader tax status, consult a trader tax expert. Green NFH, LLC also offers a "Trader Tax Status Determination Service." With so much riding on trader tax status, you need to get it right!

Chapter 2: Section 475 MTM Accounting

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

One of the biggest problems 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). Individual business traders who miss the Section 475 MTM election date (April 15, 2014) can't claim business ordinary-loss treatment for 2014. 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, 2014 can deliver Section 475 MTM for the rest of 2014 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.)

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.

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 (Chapter 1) 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 or botched elections, overpayment of taxes and missed opportunities for significant refunds. Consult with a trader tax expert.

Section 475 MTM trades are reported on Form 4797 Part II, which means you avoid problematic cost-basis reporting on Form 8949.

RESTRICTED VS. UNRESTRICTED

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 cannot 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 IS TAX-LOSS INSURANCE

Because Section 475 MTM allows current-year capital losses ($3,000 cumulative net limit per year) to be treated as unlimited ordinary business losses, it 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.

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.

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 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, 2014, he or she might prefer to elect Section 475 MTM for 2014 by that election date to have business ordinary-loss treatment retroactive to Jan. 1, 2014. That trader can form a new entity afterward to use capital gains treatment and get back on track with using up capital loss carryovers. Short-term capital gains are taxed like ordinary income and short-term capital losses are limited; but Section 475 MTM ordinary trading losses are unlimited.

...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 and don't need tax-loss insurance with Section 475 MTM. Many hedge fund investors want capital gains treatment to use up their own capital loss carryovers; they don't want or expect Section 475 ordinary income.

… AND OFTEN NOT ADVISED FOR SECTION 1256

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 2014), and 40% are short-term capital gains taxed at ordinary tax rates (up to 35% in 2012 and 39.6% in 2013 and 2014). The maximum 2013 tax rate on Section 1256 is 28% vs. 39.6% for securities, a meaningful 12% difference. 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, 2014 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 HOLE

We design our trader tax strategies to prevent traders from falling into a hole of having unused 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 one 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. 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 2014 and your Q1 2014 trading gains are $50,000, consider skipping the 2014 Section 475 MTM election as a sole proprietor, since you want to offset your capital loss carryover against current-year capital gains. In this example, you're at breakeven on using up your capital loss carryovers before the April 15, 2014 MTM election deadline, so it would be wise to form a new entity to trade with Section 475 MTM for the rest of 2014. 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 will be an ordinary business loss.

Conversely, if you have a $50,000 capital-loss carryover going into 2014, and you lose $50,000 in Q1 2014, 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 for the entity trading. 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 and entity traders who exit a trading business must suspend Section 475 MTM accounting as of that date and resume it when they qualify for trader tax status again. The second Form 3115 to return to the cash method requires a filing fee to withdraw Section 475 MTM, and it's not automatic, unlike the first filing to elect Section 475. It seems more practical and less expensive to "suspend" your election rather than file the second Form 3115.

To exit from a sole proprietor trading business, apply Section 475 MTM to open positions — even mid-year setting the "mark" — 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.

SECTION 475 ELECTION PROCEDURES

Existing taxpayer individuals and partnerships that qualify for TTS must file a 2014 Section 475 election statement with their 2013 tax return or extension by April 15, 2014. Existing S-Corps file in the same manner by March 15.

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. 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, 2014 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.

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 2013 MTM election filed by April 15, 2013 is reported and perfected on a 2013 Form 3115 filed with your 2013 tax returns in 2014. 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 jeopardize 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 goes to the IRS national office. There's no fee 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 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. The IRS has provided relief for traders who missed the Form 3115 filing deadline, 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.

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. Accelerate the proration if you exit the trading business. 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 2014 GreenTraderTax Guide: 2013 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 2013 and $15,000 of wash sale loss deferrals, the latter becomes part of your Section 481a ordinary loss on Jan. 1, 2014 if you elect Section 475 by April 15, 2014. 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.

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 2013 MTM election filed by April 15, 2013 is reported on a 2013 Form 3115 filed with your 2013 tax returns in 2014. (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.)

NULL AND VOID AND SUSPENDED ELECTIONS

We have had discussions with the IRS regarding Section 475 MTM elections for traders who never qualified for TTS or those who exited 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 this year, but he must file the Section 475 MTM election by April 15, 2014. If he doesn't end up qualifying for TTS, he may not use Section 475 MTM. In that case, his Section 475 MTM election would be "null and void" and he can skip filing a 2014 Form 3115. If he wants Section 475 for futures years, he needs to file another 2015 Section 475 MTM election statement by April 15, 2015.

Suppose an existing sole proprietor business trader elected and used Section 475 MTM in 2013. She stopped trading at year-end 2013. What should she do for her 2014 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 the Section 475 MTM election as "suspended." If she qualifies for TTS later, she must resume use of Section 475 MTM at that time. The IRS office in charge of Form 3115 and Section 475 agreed with this solution.

In a January 2014 *TaxAnalysts* article, a senior counsel in the IRS Office of Associate Chief Counsel (Financial Institutions and Products) said "Former traders can elect out of section 475 mark-to-market accounting if they are no longer engaged in trading." The article went on to say "The IRS will apply a final mark to the taxpayer's exit from section 475 … Technically, the change would be an accounting method change requiring IRS permission and a section 481(a) adjustment, but the IRS is not requiring a section 481(a) adjustment in those cases. There is no written procedure for making that change in that manner, but [the senior counsel] confirmed that the IRS is granting permission for getting off mark-to-market with what he called a modified cutoff method."

While it's good the IRS is showing a little leniency in granting formal requests to change accounting back to the cash method on a Form 3115, we think the "suspended" approach may work better and cost a lot less. Again, traders may not use Section 475 MTM on investment positions, and when they exit a trading business, they only have investment positions.

According to the email from *TaxAnalysts*, the senior counsel went on to cite the Chen trader tax court case (see Chapter 11), saying, "We are going to deny mark-to-market treatment in a typical Chen case." Chen only traded for three months and he lost most of his trading capital fast and then exited the business. The IRS won in tax court denying Chen TTS and Section 475.

I'm concerned the IRS official made threats against individual traders reporting large Section 475 MTM ordinary trading losses. These comments reinforce our recommendation that business traders form entities and not file as individual trading businesses on Schedule C. Traders should still carefully assess their qualification for TTS and consider our help in doing so.

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 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. 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.

BOTTOM LINE

Don't assume you can deduct trading losses. Unless you navigate through trader tax laws and elections, you may be stuck with no tax refunds on losses.

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 2013 and 2014, the top Section 1256 contract tax rate is 28%, 12% lower than the top ordinary rate of 39.6%.

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, and we covered this topic in detail on our blog: "Tax treatment for swaps." We also recently covered bitcoin and plan to cover NADEX binary options soon.

TAX TREATMENT 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.

While you might expect that broker-issued 1099-Bs would handle these difficult issues for you, they do not. Broker compliance rules are different than the rules taxpayers must follow. It also depends on the taxpayer's facts and circumstances and elections made. You can't expect a broker to police your elections and to determine if you qualify for trader tax status. You are on your own!

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, currently up to 39.6% (2013 and 2014). (See "Cost-basis on Form 8949" 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 — 0 to 20% (2013 and 2014) — 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, mostly doing away with opportunities for tax deferral without substantial economic effect.

Qualifying business traders often elect Section 475 marked-to-market (MTM) on securities. 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. But, where Schedule D capital losses are limited to $3,000 per year against ordinary income, Section 475 MTM losses are unlimited as business losses (see Chapter 2).

SECTION 1256 CONTRACTS

In the famous tax reform bill of the 1980s, Congress added Section 1256 contracts. They 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), options on broad-based indexes, forward forex with the opt out election into Section 1256g, options on commodities/futures ETFs taxed as publicly traded partnerships and other non-equity options. Our firm and some tax attorneys believe the fairly new Nadex binary options are probably treated as 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. Many, including the DAX, have this approval.

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 realized at year-end.

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 one, 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 of 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, 2013 and 2014; 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.

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 Form 8949 and 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.)

Spot forex: 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 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. (We have upcoming forex tax Webinars in 2014, too.)

> We've learned from discussions with the IRS Chief Counsel's office on forex taxation that the authors of Section 988 never contemplated retail trading in spot forex transactions.

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.

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 losses can be classified as capital-loss carryovers and not wasted forever.

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.

BOTTOM LINE

Tax treatment affects tax rates, loss deductibility, deferral and so much more. Get it right.

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, 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.

SECURITIES TRADERS

Cash method traders 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 with new cost-basis reporting rules for securities brokers and taxpayers 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.)

Cost-basis on Form 8949. Before 2011, a securities Form 1099-B only reported proceeds, and it did not provide cost-basis information. In 2011, Form 8949 replaced Schedule D-1 attachments, which used to feed into Schedule D. The new form is constructed to mirror and receive the 1099-B with cost-basis reporting. Part A is for those trades which the broker has reported cost basis information to the IRS, Part B is for the trades for which cost basis information has not been reported to the IRS by the broker and Part C is used for the trades that have not been reported on a 1099-B at all (i.e. options, etc.).

The IRS is phasing in the rules over four years to allow brokers to add reportable items one year at a time, but that's making things even more complex. The new rules define what's a "covered security" — what must be included on the 1099-B. Covered securities include: equity securities acquired on or after Jan. 1, 2011; mutual fund and dividend reinvestment plan (DRIP) shares acquired on or after Jan. 1, 2012; and debt securities, options and all other financial instruments acquired on or after Jan. 1, 2014. The IRS extended this date from the previously announced date of Jan. 1, 2013. Hopefully there will be less confusion with 2013 tax filings since there are no changes from last year.

We recommend TradeLog for securities traders and investors. TradeLog software downloads trades directly from the broker, skips over 1099-B accounting confusion and generates an accurate Form 8949 with line-by-line reporting and proper handling of options and wash sales.

The IRS does not allow summary reporting on Form 8949. 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 may use rough calculations to generate summary amounts. But, that approach cannot account for wash sales and therefore it's very wrong.

These accountants write "details available on request" and hope the IRS doesn't ask for those details, which is unwise since the IRS is clearly looking for detailed cost-basis reporting now. While this practice may have been OK in the past, in 2005 the IRS forcefully warned tax professionals and taxpayers against it, 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 to 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 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.

The IRS released its 2013 Form 8949 in early January 2014. In the release, the IRS pointed out when a taxpayer may use "details attached" pointing to an attached Form 1099-B. It's only allowed if there are no wash sales to report on Form 8949 during the year, and all items reported are covered securities, which leaves out options.

Most active traders have wash sales to report during the year — even if melted away by year end — and they traded options or other non-covered securities in 2013, so they must do their own line-by-line reporting on Form 8949; they can't just attach their Form 1099-Bs.

For this same reason, it doesn't make sense to import a broker's 1099-B or profit and loss report into TurboTax or other tax preparation software. You need TradeLog to identify wash sales across all individual accounts including IRAs, and no one broker can ever do that. TradeLog handles options trading correctly, too.

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 do that for 2013 tax filings and generate plenty of tax notices as a result.

There are a few limitations with TradeLog. It doesn't automatically account for corporate actions such as reinvested dividends and stock splits, so you need to incorporate those manually. 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.

TradeLog only reconciles to the 1099-B in total, not line-by-line as required in the instructions to Form 8949. We recommend a footnote attachment. We include the TradeLog footnote in our 2014 GTT Guide: 2013 Tax Return Examples for Securities Traders (Individual and Entities. There are pros and cons to reconciling differences in gross form on the bottom of Form 8949.

We are working with TradeLog and other vendors on improved solutions for 2014 to comply with line-by-line reconciliations. So far, we are not sure it's achievable, as there are so many differences in the rules for taxpayers vs. brokers, and we've notice odd and unexplained aggregation of accounting data by brokers on profit and loss reports, which brokers use to generate their 1099-Bs. We doubt brokers will allow us to look under their accounting hood on how they do their accounting aggregation. When in doubt, accountants like to turn to raw debits and credits; in other words trade confirmations and the historical data that TradeLog downloads from brokers.

Wash sale confusion on 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 "disallowed wash sales", don't panic. Instead, use TradeLog to see your actual wash sales at year-end, 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 requires 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.

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.

Another cause of confusion on wash sales reported on securities 1099-Bs is that many brokers report "disallowed wash sales for the year" rather than "actual wash sales" at year end. This is problematic because most wash sale conditions are resolved during the year and they aren't actual wash sale loss deferrals 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. We attribute this problem to Form 8949 instructions and the makeup of the form. Brokers report the same wash sale over and over as it's passed from one trade to another — as they should. Totaling up all wash sales reported during the year shows a huge number which can be deceiving since actual wash sales open at year-end may be a small amount. This throws many traders and tax preparers off track.

Accounting for foreign securities can be confusing. Many traders have trading accounts in foreign countries and the reporting can be challenging. The tax rules involve an election to keep your books in a foreign currency — a qualified business unit — 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.

FUTURES TRADERS

Futures traders, and other section 1256 contract 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.

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 (in most cases) 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. (See our companion GreenTraderTax Accounting Guide.)

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, some experts view the "roll open, roll close" method used by some forex brokers as true interest income or expense; we are taking a closer look at that tax treatment soon.

Most spot forex brokers 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.

Using a foreign currency to purchase foreign trading instruments. Traders are stuck with Section 988 ordinary gain or loss treatment for physical currencies used for investing and trading purposes. They can't opt-out of Section 988 with a capital gains election as forex traders may, since currency is physical whereas forex is a forward contract — even spot.

Sometimes taxpayers purchase foreign currencies to use to buy and sell foreign equities or futures 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 a 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. Don't forget to file your FBAR reports on TDF 90-22.1 on time, otherwise the penalties are huge.

Performance record reporting can help. TradeLog does not work with most forex brokers. If broker reports aren't available, we often turn to the performance record approach. 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.

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 general ledger accounting program, or use our worksheet templates for tracking assets and expenses. 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, and distributions. 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 if you pay yourself an administration fee. If you set up your accounting program correctly, the 1099 issuance can be much easier to accomplish.

Use an accounting program or app 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, especially with problems in securities 1099s and no spot forex or foreign 1099s. 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 without good software to do trade-by-trade accounting — it's laborious, expensive and will most likely lead to errors. Use the accounting 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 $5,000 per year on average. Business-expense deductions hinge on qualifying for trader tax status, of course. Investors, on the other hand, are very limited. Investment managers have business expense treatment, too.

The good news is you can still claim trader tax status for 2013, 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 2013.

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, indexed for inflation); some taxpayers are better off using the standard deduction than the itemized deduction. When you have negative taxable income, investment expenses are wasted as they don't carry over to subsequent tax years. Bottom line: Many investment expenses wind up on the cutting room floor.

If Congress flattens the tax code as proposed for tax reform by some members of Congress, it will do away with more itemized deductions, but business deductions will be safeguarded. Investment expenses may face repeal faster than the mortgage deduction and charity.

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, margin interest paid on business positions is treated as a business-interest expense, which is fully deductible on Schedule C or the separate entity business tax return. Non-active 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 non-active and if margin interest is material, you may want to give your spouse 1 to 10% interest rather than 50% interest in the pass-through entity to avoid investment-interest expense treatment. However, with the entity changes for new IRS guidance on earned income explained in Chapter 7, we are suggesting that a non-active spouse receive a higher percentage. Consult with us.

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%), bonus, and or regular depreciation on computers, equipment, furniture and fixtures. "Tax extenders" expired at year-end 2013 and the capped amount allowed for Section 179 and bonus depreciation dropped down considerably to $25,000 for 2014. That's still enough for most business traders.
- Amortization on start-up costs (Section 195), organization costs (Section 248) and software.
- Education expenses paid and courses taken after commencement of your trading business activity. Otherwise, pre-business education may not be deductible, or it may be included in Section 195 startup costs.
- 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 for the business portion of your home

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 deductible against your 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 in ordinary loss treatment.

NET INVESTMENT TAX

According to draft Form 8960/Net Investment Income Tax released in January 2014, both trading business expenses and investment expenses are deductible against net investment income (NII). The new net investment tax (NIT) is calculated on Form 8960, which starts in 2013 on AGIs over $250,000 (joint) and $200,000 (single).

In the instructions to draft Form 8960 and the NII regulations, the IRS clarified that trading business expenses may be deducted against self-employment income. Up until these clarified instructions were released, we took the more conservative position of not allowing this. (See more on NIT in Chapter 15.)

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, Section 988, and the various code sections for capital gains and losses.

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, 2013. The trader starts classes in December and continues them through March 2014. The trader commences his trading business halfway through the training in early 2014. The cash method classifies the $10,000 as a start-up cost, with $5,000 deducted in 2014 as "expense allowance" amortization and the balance amortized over 15 years. With the accrual method, the trader will have the same amortization amount ($5,000) on his 2014 tax return, and he can deduct the other $5,000 in full as a post-business-commencement education expense in 2014. 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 for 2013 are much higher than what most small business traders spend on fixed assets ($500,000). Tax extenders expired so the capped amount drops down to $25,000 for 2014. (But there's a chance Congress may retroactively extend the 2013 rules.)

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.

Based on the final regulations effective for years beginning Jan. 1, 2014, capitalization of assets with a cost of over $500 is required. There is an election statement to be filed with your return to allow you to expense assets costing less than $500. Check with a tax professional for more information.

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.

> Fees from an outside-managed account or an expert adviser system in forex are investment expenses, as they aren't part of your trading business.

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. Stay clear of tax promoters promising business deductions for pre-business education using C-Corps and going back over six months. We covered this on our blog in February 2010.

TRAVEL, MEALS AND ENTERTAINMENT

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. 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. The IRS likes to scrutinize T&E in tax exams.

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.

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 phone, Internet, 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. We prefer a home-office reimbursement plan in S-Corps. You still need offsetting income to unlock the home-office deduction, but it looks better than Form 8829 and Schedule C.

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 2013 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.

> The IRS recently provided new guidance stating that trading business expenses may offset self-employment income.

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: "Cost-basis on Form 8949" and "Wash sale confusion on 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 individual 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 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. This form has unlimited business ordinary loss treatment and avoids those capital loss limitations

Futures traders should use Form 6781 (unless they elected Section 475 for commodities; in that case, Form 4797 is used). 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! (In this paragraph, "futures" refers to all Section 1256 contracts.)

In the forex arena, if the trader doesn't qualify for trader tax status, he should use line 21 (other gross income or loss) on Form 1040. What's the difference between Forms 1040 and 4797? Form 4797 Part II losses contribute to net operating loss (NOL) carrybacks against any type of income, whereas Form 1040's "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's 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.

TRANSFER TRADING GAINS TO SCHEDULE C

In some cases, a good 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 otherwise trading gains are exempt from. (Traders who are full members of a futures or options exchange are an exception here, though.)

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. (Explain it in Part C (Other) of Form 8949.)

Self-employment income and SE tax. The IRS recently provided new guidance stating that trading business expenses may offset self-employment income (SEI), and through 2012 tax filings our position was it did not. If you have material SEI outside of trading, then skip the income transfer strategy to Schedule C so you can offset trading business expenses against it to reduce the SE tax. (See our companion examples guides.)

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 must explain how they allocate their time between other activities and trading. Money-losing traders must explain how hobby-loss rules don't apply since there's no personal or recreational intent. We offer many different example footnotes in our yearly companion examples guides.

SEPARATE ENTITIES ARE BETTER

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. Partnership and S-Corp tax returns show 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. After the new IRS guidance on self-employment expenses, we recommend that some partnerships and LLCs elect to be taxed as S-Corps too (Chapter 7).

Under the "trading rule," trading business entities 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, whereas sole proprietorships must list securities capital gains 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. Pass-through entities file Form 8949 too.

Entities provide additional tax breaks including opportunities for retirement plans and health-insurance premium tax deductions, two tax breaks that sole-proprietor traders can't do unless they have a source of 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, but note the new content about Schedule C offsetting SEI above.

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 8938 (Statement of Specified Foreign Financial Assets).

The IRS is busy busting thousands of taxpayers for not filing Foreign Bank Account Reports (FBARs) and/or hiding unreported income offshore. You might not even realize you need to file an FBAR. If you have any connection with foreign matters, it's important to read Chapter 14.

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. Don't import 1099-Bs to tax preparation software as that imports a 'apples and oranges" and leaves important things out like options (see Chapter 4). 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 included in our 2014 GTT Guide: 2013 Tax Return Examples for Securities Traders.

OUR TAX COMPLIANCE SERVICES

Our core business is offering tax preparation and planning to thousands of active traders. We specialize in business retail traders, proprietary traders, investment managers, active investors and casual investors. If you prefer to self-prepare or hire a local accountant, consider our consulting service and Trader Tax Return CheckUp Service.

Chapter 7: Entities for Traders

> We've changed our entity strategies to conform to new IRS guidance stating trading business expenses can now be included in self-employment income.

If you're thinking about creating an entity for your trading business, you have options — you can form an LLC, general partnership or S-Corp as your trading entity vehicle. 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.) Management companies need liability protection in an LLC or corporation.

NEW ENTITY STRATEGIES FOR 2014

We've changed our entity strategies to conform to new IRS guidance stating trading business expenses can now be included in self-employment income (SEI); before this our position was they were not.

The partnership fee/AGI-deduction strategy can still work on some partnership tax returns. Prior to 2013, the simplest entity for a husband and wife was a general partnership filing a partnership tax return. To unlock AGI deductions for health insurance and retirement plans, the partnership paid an administration fee to the trading owner's individual Schedule C, creating the earned income needed for the AGI deductions. But the trading business expenses passed through from the partnership — including the fee payment — were not included in SEI.

With new IRS guidance requiring an SEI deduction for partnership expenses, it's harder to achieve the SEI necessary for maximizing these AGI deductions. Consider this example of a husband and wife 50/50 general partnership or LLC filing a partnership tax return for 2013. The partnership has trading business expenses of $20,000 before paying an administration fee to the husband, who is the active trader (assume the wife is non-active). Before the new IRS guidance, the partnership could pay an administration fee of $30,000 to the husband to cover AGI deductions for health insurance (close to $12,000) and Individual 401(k) elective deferral ($17,500). Now, the partnership needs to gross up the fee to cover the husband's 50% share of partnership Schedule E SEI deductions. Therefore, the partnership needs to pay a fee of $80,000 to have a net SEI of $30,000. Fifty percent of the trading partnership's loss (equal to $50,000 in this example) from trading business expenses ($100,000) is allocated to the husband. (The $100,000 is comprised of the $20,000 expenses and $80,000 fee.) The wife's 50% allocation with negative SEI has no effect, as SEI and SE tax are calculated separately.

This change is not as simple as it may sound. The partnership needs to generate more income to justify a higher fee — an increase of $50,000 — and it needs the cash flow to execute it. If the husband owned a lower percentage of the partnership, the fee increase can be lower. But, in many husband-wife general partnership entities, the non-active owner holds 1% of profit and loss, and that is a problem for this potential solution. They should consider changing to 50/50 or even 20/80.

If you want net SEI of $30,000, calculate the fee payment as follows. Trading expenses times allocation percentage = a negative SEI. You want to add an amount to get to $30,000 positive SEI and divide it by the other spouse's allocation percentage to get the administration fee amount. For example, with 20/80, the negative SEI is: $20,000 times 20% = ($4,000). To get to the target $30,000 SEI, pay $34,000. Next, gross up $34,000 by dividing it by 80% which equals the administration fee of $42,500 (and is only $12,500 more than the $30,000 target). Total expenses are $62,500 ($20,000 expenses + $42,500 fee). Total expenses times the 20% allocation = a negative SEI of ($12,500) + the administration fee of $42,500 = target SEI of $30,000.

If this approach doesn't work for you, then arrange salary instead. The key issue for claiming health insurance and retirement plan deductions is to arrange these employee benefits in connection with a salary. The IRS does not allow partnership tax returns to pay a salary (payroll) to owners; it requires guaranteed payments or administration fees. The solution is to convert an LLC or a general partnership to an S-Corp, or add a C-Corp as a 1% partner, because an S-Corp or C-Corp can pay salaries to owner/employees.

An existing general partnership or multi-member LLC filing a partnership return can elect to be taxed as an S-Corp for 2014 by filing a federal Form 2553 S-Corp election by March 15, 2014. Most states conform to federal "check the box regulations" allowing general partnerships or LLCs to elect S-Corp tax treatment. Some states rely on the federal form and other states have their own election form. Consult with us about whether an S-Corp election is beneficial for you and allowed in your state.

These solutions are less disruptive and lower in cost than opening and closing entities. You can keep your existing trading business, including its trading accounts and bank accounts, in place.

S-Corp tax treatment is inappropriate for a hedge fund or trading company with special allocations like "carried interest" to owners as that is considered a second class of equity and is not allowed. These types of partnerships should consider adding a C-Corp as a 1% owner.

There are few changes to the partnership when adding a C-Corp: It keeps filing a partnership tax return and pays the C-Corp an administration fee and 1% or more allocation of profits. The C-Corp then has sufficient income to pay the owner a salary to unlock C-Corp-level employee benefits for health insurance and retirement plan contributions.

C-Corp owners have added benefits that are not available with partnership and S-Corp returns. The owner can have a medical reimbursement plan, which increasingly is an attractive idea considering higher deductibles and out-of-network health costs under ObamaCare plans. You can also shift individual income to lower C-Corp tax rates or operate the C-Corp close to break even if state corporate taxation is a concern.

Read our Jan. 14, 2014 blog "New IRS guidance on SE tax deductions affects partnership AGI-deduction strategies."

AN ENTITY CAN HELP AVOID WASH SALES

A new entity for Jan. 1 is your ticket out of wash sale loss 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 2014 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.

WHY ENTITY?

Although entities aren't absolutely necessary for business traders as they can file as sole proprietors, 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 on your individual tax return where sole proprietors include a Schedule C.

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.

C-Corp owners can have a medical reimbursement plan, which is an attractive idea considering the rising cost of deductibles.

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 provide an opportunity for tax deductions for retirement plans and health-insurance premiums (at 100%). Business traders often use entities to pay salary to the owner in connection with a retirement plan contribution, 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.

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, you don't need legal protection when trading your own money in an entity since you don't have any customers or investors. Investment managers trading other peoples' money, however, most certainly 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. Consult a local attorney on trusts.

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. 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.
- As discussed earlier, new IRS guidance states trading business expenses offset SEI for SE tax. Any remaining amount over SEI then offsets net investment income for NIT on Form 8960.

Some traders with investor tax status may want to consider an entity, even if they can't efficiently use the deduction strategies for health insurance and retirement plan contributions, 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 nitpick 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. Consider allocating a low minority percentage of profits and losses to the active trader partner, and a high majority percentage to the non-active partner. That will mitigate the negative effect of new IRS guidance covered at the beginning of this chapter. The active trader's fee income will be offset with a low percentage of partnership expenses, thereby maximizing SEI and related AGI deductions for health insurance and retirement plans. The second partner can be active, but don't pay them a fee.

IRS law now treats husbands and wives in non-community property states 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 or salary for AGI deductions.

As another option for claiming deductions for health insurance and retirement plan contributions, a general partnership can either elect S-Corp tax treatment or add a C-Corp as a 1% owner to keep filing a partnership tax return. The S-Corp or C-Corp can arrange those deductible employee benefit plans. (See "New entity strategies for 2014.")

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. When a general partnership makes an S-Corp election, it triggers S-Corp taxation, including minimum and/or franchise taxes in some states.

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.

The IRS may 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, 2014 deadline. Adding a second member (a spouse) to your SMLLC in order to file a partnership tax return is safer and solves these issues.

Consider electing S-Corp status on your SMLLC. The S-Corp election can be filed late (after the 75 days required) with IRS relief provided you intended to elect S-Corp status on time. 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 the trading entity and have a C-Corp as a 1% partner. You can't be partners with yourself, but you can be partners with your own SMLLC/S-Corp or C-Corp.

S-CORP

Corporations start out as C-Corps 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 and general partnerships may elect S-Corp status in almost all states. (We prefer this method of achieving S-Corp status in most states, but not all.) Corporations have rules for annual meetings whereas LLCs and general partnerships do not.

As required by the IRS, "officers' compensation" (salaries) are used 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. 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. 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 underlying earned income from trading, so they don't need to report officers' compensation. Explain this factor in footnotes.

> As another option for claiming deductions for health insurance and retirement plan contributions, a general partnership can either elect S-Corp tax treatment or add a C-Corp as a 1% owner to keep filing a partnership tax return.

Pay a salary if you want deductions for health insurance and retirement plan contributions. Otherwise, business traders can skip salaries if they don't need those deductions. With salary, the retirement plan should be on the entity level.

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 two reasons:

- Lower 60/40 rates tax on Section 1256 contracts aren't allowed in C-Corps.
- 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 rather to claim health insurance and retirement plan deductions in connection with a related trading business filing a partnership tax return. The C-Corp can also be used to hold intellectual property to avoid or reduce Obama-era income tax hikes on upper-income taxpayers starting in 2013. For a specific scenario of how this works, see our Jan. 5, 2013 blog "Post fiscal cliff tax planning for traders" and scroll down to the heading "Example: 2013 tax savings using entities."

Shift income with a corporation. The federal corporate tax rates for small businesses are 15% on the first $50,000, 25% on the next $25,000, 34% on the next $25,000, 39% on the next $235,000 and 34% between $335,000 and $10 million (see www.taxpolicycenter.org/taxfacts/content/pdf/corporate_rates.pdf). 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-Corp is otherwise called a "corporation" and it has entity-level taxes. Public companies are corporations. Certain small businesses may elect S-Corp tax status, which makes the corporation a pass-through entity. S-Corps have no entity-level federal 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 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.

If you don't qualify for having IP, then consider having your trading entity pay an administration fee to the C-Corp.

We prefer IP over administration fees with the C-Corp. In all dual entities, it's important to execute contemporaneous transactions with economic substance and a profit motive, otherwise you risk the IRS declaring the C-Corp and the related party transactions "sham transactions." We suggest you discuss the structure and transactions with us in advance.

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. Again, use that S-Corp to own 1% of a general partnership, 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 and Nebraska are the only two states left in the nation with this archaic publishing stipulation.

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. (In Texas, you can add the C-Corp, but don't have it be a partner in the general partnership to avoid Texas' 1% margins 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.

When you elect S-Corp tax treatment on a general partnership, it's subject to S-Corp taxation including minimum taxes. Yet, you don't have the limited liability protection available in an LLC or corporation.

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 DON'T MAKE UP FOR FAILING TRADER TAX STATUS

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 or general partnership pays administration 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.

We recommend a C-Corp as a 1% owner of an LLC or general partnership only if that entity qualifies for trader tax status. 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.

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 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 salary in Q4 to claim deductions for health insurance and retirement plan contributions.

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 (business expenses), and to claim valuable deductions for health insurance and retirement plan contributions to save thousands of dollars more. 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

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 self-employment (SE) tax or wage income in connection with an entity retirement plan. 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 can use entities like partnerships to pay fees and S-Corps or C-Corps to pay salaries to claim these employee-benefit deductions. (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.

INDIVIDUAL PLANS ARE BETTER THAN SEPS

Individual 401(k) plans — also called Mini or Solo 401k plans — often generate the most tax savings for traders. An Individual 401(k) plan minimizes SE or payroll tax while maximizing income tax savings. (SE and payroll tax consists of the FICA and Medicare tax.) 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 considered compensation, starting with none. Conversely, with other types of small business income reported on a Schedule C or through a partnership tax return, the entire income is considered earned income for SE tax, the equivalent of payroll tax, 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, and a materially higher compensation subject to SE or payroll tax is required to reach that 20%. 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 ($17,500 for 2013 and 2014), 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 2013 and 2014). 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 tax deductions for Individual 401(k) retirement plans and family health insurance premiums in connection with receiving salaries from an S-Corp.

Let's say a husband and wife each have a $17,500 Individual 401(k) elective deferral, plus the $5,500 "catch up" provision for those over the age of 50, plus family health insurance premiums of $13,000 per year. This doesn't take into account additional contributions available in the profit-sharing plan element to the Individual 401(k) plan. Their total employee-benefits deduction through the S-Corp is $59,000 times individual federal and state tax rates of 46% (39.6% federal, with phase-outs 41%, plus state), generates income tax savings of around $27,000.

Their payroll taxes of 15.3% are just over $9,000 and with other payroll-related costs (federal and state unemployment insurance, workmen's compensation and payroll compliance), that figure is probably around $10,000. Income tax savings exceed payroll tax and other related costs by $17,000. Additional income tax savings are achieved from deducting payroll taxes and related payroll costs; so the total savings is over $17,000. Even with lower tax brackets, the savings is significant.

With a husband and wife general partnership, it only makes sense to have the Individual 401(k) plan deduction strategy for one partner.

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 $51,000 for 2013 and $52,000 for 2014), plus the $5,500 more for those over age 50.

Trader tax status saves the average business trader around $5,000 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 payroll 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 may be 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

Upper-income traders and investment managers impacted by the Obama-era tax hikes may want to consider a defined-benefit plan where they can deduct $210,000 for 2014 (and $205,000 for 2013) from gross income. The related compensation can be less than $100,000. It's an incredible trade-off of income tax savings over payroll tax costs. Consistently profitable traders and investment managers should consider defined-benefit plans. It's not as simple as the defined contribution plans offered in cookie-cutter fashion from many brokers; you need to work with an actuary and we suggest an employee-benefits attorney. It's worth the extra cost and work. We are surprised more of our clients don't do it.

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 beyond. Before that change, 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 up to 85% of your Social Security benefits if your combined adjusted gross income (AGI) surpasses the IRS income threshold. If AGI falls under that income threshold amount, those 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 rose 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.

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 (federal and state), 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.

Consider the effect of state taxes. If you live in a tax-free state like Florida and are planning to move to a high-tax state like New York, consider a Roth conversion before the move to save state taxes. Normally, the reverse is true with snow bird executives retiring to Florida; in that case, it may be better to wait until you move before doing a Roth conversion.

Soak up losses and wasted itemized deductions with a Roth conversion. 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 it (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 the 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 2013 may be recharacterized by Oct. 15, 2014. If a taxpayer files his or her 2013 tax return before Oct. 15, 2014, the return will need to be amended.

This is a good reason to file a 2013 tax extension by April 15, 2014. 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.

Our traders are below the averages. We read a report recently that said 10% of upper-income taxpayers execute Roth IRA conversions. But we've noticed a lower percentage among our clients and we wonder why. Traders can do better with this strategy than other taxpayers, because they probably have more income growth from trading and investing. Perhaps some traders don't trust Congress to respect the Roth deal over the long-term. If you have available cash flow to pay the Roth conversion taxes and the capability to generate significant income growth, then you should consider a Roth conversion in 2014. Many traders have off years with lower income, which is an ideal time to do a Roth conversion.

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 used with S-Corps and C-Corps.

With new guidance from the IRS on SEI, partnerships may prefer to elect S-Corp tax treatment or add a C-Corp as an owner so they can use a salary rather than administration fees to maximize deductions for health insurance and retirement plans. In this case, you need to have an entity-level retirement plan rather than an individual-level plan.

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. But starting with 2013 tax years this strategy may not be as beneficial as it was before based on new IRS guidance.

Conversely, S-Corps — including single-member LLCs filing an S-Corp tax election — and C-Corps 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.

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. The wash sale is permanently lost in the IRA; it's not just deferred in taxable accounts. For this reason, it's catastrophic and to be avoided wherever possible.

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.

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

IRAs should be 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, but if personally guaranteed, it's considered a prohibited transaction. 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 (with one exception discussed in the next section).

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, as they are organized as corporations without pass-through treatment.

DO'S AND DON'TS

Read our major blog update and watch our related Webinar: Jul 24, 2013 blog "Learn the DOs and DON'Ts of using IRAs and other retirement plans in trading activities and alternative investments."

This article expands on some very important points:

Traders can use intermediary retirement firm administrators offering non-prototype retirement plans to facilitate alternative investments like hedge funds, rental real estate and certain types of self-directed trading. But, be careful in choosing trust firms and vet their content and suggested strategies carefully. There are many unscrupulous operators offering some bad advice, like on "IRA-owned LLCs with checkbook control," and IRA-owned trust account with margin and personal guarantees. We, including our employee-benefit experts, don't believe these schemes work, as we consider them IRS prohibited transactions. These can "blow up" your retirement plan, meaning your retirement plan funds all become taxable income which are subject to excise tax penalties too.

Some traders may want to trade futures or forex in their retirement plans, but their brokers don't provide a plan 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. This should pass muster with futures — and on some forex accounts — since there is no margin interest paid triggering UBIT, or personal guarantees triggering a prohibited transaction on futures. Some forex accounts have interest expense, whereas most have "rollover interest" which is not interest (see Chapter 3).

This is often a problem with a securities margin account. Brokers generally require a personal guarantee, which is a prohibited transaction, since the individual is giving an economic favor to his IRA. Plus, margin interest paid on securities triggers UBIT.

BOTTOM LINE

Deductions for retirement plan contributions can save a trading business thousands of dollars more per year. 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.

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 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.

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 investors, 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.

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, 2013. Unfortunately, no one could plan taxes with certainty before year-end 2012.

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 House Speaker John 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 — indexed for inflation each year — 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%.

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 2014 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 three top tax brackets, using a combination of official tax rate hikes and reductions of tax expenditures. After you factor in the 3.8% Medicare tax hikes which went into effect Jan. 1 2013 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.)

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 (the marriage penalty).

2014 TAX REFORM

A large list of important "tax extenders" tax breaks expired at year-end 2013, including R&D credits and very generous Section 179 (100%) depreciation caps. Over the past several years Congress renewed them every year — sometimes retroactively — as of January 2014, Congress had not done so yet.

This time may be different. Congress is under tremendous pressure to justify spending, including on tax expenditures, and money is very tight. Both parties want tax reform but how does handing out tax extenders jive with tax reform based on a reduction of tax expenditures?

We have a good peek behind the tax reform curtain and traders seem to fare pretty well. Leading tax writer Chairman Rep. Dave Camp (R-MI) wants mark-to-market accounting and other streamlined economic reporting for some financial products like derivatives. Read our Jan. 9, 2014 blog "A major tax reform bill in 2014 is unlikely, and tax extenders may be history, too" for more information.

FORM 8960 (NIT) AND NEW IRS GUIDANCE ON TRADING BUSINESS EXPENSES FOR SEI AND NII

The NII final regulations and the January 2014 IRS-draft release of Form 8960 instructions bring forth another opportunity for tax planning.

New IRS guidance indicates that Section 162 trading business expenses for individuals and partnerships are deductible against self-employment income (SEI) for purposes of calculating self-employment taxes (SE), which include FICA and Medicare. To date this question of tax law was unclear, and we've taken a conservative approach that since trading gains are exempt from SEI, so are trading business expenses.

Many traders will be happy with this new IRS guidance since it reduces SE taxes. Form 8960 (NII) points out business traders should offset SEI with trading business expenses and when SEI is zero, deduct the excess against NII on Form 8960.

But, there are some troubling implications from this new IRS guidance. It affects our AGI-deduction strategy using partnership tax returns for 2014 and 2013, too. We feel prior years are grounded in our tax posture before this new IRS guidance. With this SEI deduction for trading business expenses, it's harder to achieve SEI using the partnership structure that is necessary for purposes of maximizing these AGI deductions. We show an example how to do it.

The new IRS guidance affects our AGI-deduction strategy using partnership tax returns for 2014 and 2013 too.

Chapter 15 provides more NIT specifics. Also, for details on the new IRS guidance and how traders should consider changes to their entity structures, see Chapter 7. We offer several good solutions to this problem. Consult with us on how these changes affect your tax file.

TAX PLANNING FOR TRADERS

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 2013, but don't expect to in 2014, try to accelerate deductions into 2013. 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.

Qualifying business traders may elect Section 475 marked-to-market (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 2014 Section 475 MTM elections with the IRS by April 15, 2014.) 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 MTM reporting makes more sense and is good public policy. Chairman Camp seems to like MTM, too.

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."

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 (including Mr. Buffet) can. In fact, Mr. Buffet pays most of his taxes at the lower long-term capital gains tax rate. Hopefully Congress and the President won't try to change the blended mix of rates 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. The higher rate applies to income over the margin. 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.

As we covered earlier in the chapter, the top 2013 individual tax rate can range from 39.6% to almost 41% plus, with PEP and Pease limitations. Compare this new tax rate to the corporate income tax rates of 15%, 25% and 34%. If you pay royalties or administration fees to a C-Corp, make $50,000 per year in the corporation taxed at 15% and then pay qualifying dividends taxed at 15% (the top rate is 20%), that's a total of 34%, vs. Obama-era top individual rates of 45% (both rates factor in the 3.8% Medicare tax). The 11% difference is significant.

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. Chapter 7 explains these strategies in detail.

PLAIN VANILLA DOESN'T CUT IT

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 on securities before year-end; Form 1099-Bs are distributed in February. 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 permanently as part of the fiscal cliff deal. It saves millions of taxpayers from "bracket creep." The inflation 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 and 2014. AMT rates did not rise when the Bush-era tax cuts expired, so the relative difference in rates is greater in 2013 and 2014. Be aware that AMT and Pease limitations work oddly together.

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 permanently wasted tax-wise, so this should be avoided if possible.

Sometimes wash sales can be a good thing. With a Section 475 MTM election (Chapter 2), you are exempt from wash-sale reporting on your business trading accounts. If you elect Section 475 MTM in 2014, 2013 carryover wash sales on trading business positions only become part of your 2014 Section 481a ordinary-loss adjustment, which converts wash sales into ordinary losses as of Jan. 1, 2014. The 2014 Section 481a adjustment is the 2013 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.

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 2013 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 2013, he or she should consider carrying the NOL forward instead. Another solution is to soak up the loss with a Roth IRA conversion before year-end; 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 carry forwards for taxable income under certain thresholds. Other states may join that trend, so check their websites or with Green NFH.

It's smart to engage a trader tax CPA to prepare your NOL carryback tax returns. Filing a botched return can slow down refunds, cause an exam and lead to denial of trader tax status, undermining the entire refund. It's worth the extra cost. Trader tax NOL carryback returns are complex and nuanced.

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.

Payroll benefits include using year-end tax withholding to avoid underestimated income tax penalties from earlier in the year, and you may qualify for unemployment insurance benefits.

ENTITIES AND EMPLOYEE-BENEFITS DEDUCTIONS

If you plan to use your trading entity for 2014 retirement-plan and/or health-insurance premium deduction strategies, you should take certain vital actions before year-end. Officer salaries from S-Corps and C-Corps and administration fees from partnerships have to be paid before year-end. Qualified retirement plans like an Individual 401(k) must be opened before year-end. Funding can take place after year-end, before the tax return filing date, including extensions for qualified plans. The AICPA recommends payroll-tax compliance service provider Paychex (www.paychex.com).

Payroll benefits include using year-end tax withholding to avoid underestimated income tax penalties from earlier in the year, and you may qualify for unemployment insurance benefits too.

See Chapter 7 on entities and Chapter 8 on retirement plans to learn more about these tax strategies. Note we modified our entity strategies in mid-January 2014, so follow our new guidance included in this guide.

BOTTOM LINE

Consider the big picture on taxes affecting investors, business 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 2014 tax matters. Determine if you qualify for trader tax status and if you do, consider an entity with compensation and a retirement plan before year-end. The compensation should cover the health insurance and retirement plan deductions. 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. Monitor your AGI thresholds to avoid or limit ObamaCare NIT and other Obama-era tax hikes. If you missed out on any of these tax strategies for 2013, start planning now for 2014.

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. (Cases that comes to mind this past year are Kay, Endicott and Nelson.)

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.

Recently, an IRS official cited the 2004 Chen trader tax court case as being very important. He said the IRS will go after and seek to deny large ordinary loss treatment for individual traders who do not qualify for trader tax status — just like Chen. First and foremost, be sure you qualify for trader tax status. If you are not sure, consider a consultation with our firm.

One of our competitors — a trader tax adviser that is not a CPA firm — has caused our industry a lot of damage. This firm told traders who don't qualify for trader tax status they could deduct large amounts spent on education. Apparently they told a trader to deduct $30,000 when the trader only had five trades during the year, even though a business trader needs closer to 1,000 total trades per year on an annualized basis. 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 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. The IRS budget has been cut every year since 2010 and its budget is currently stretched very thin. Its workload increased with handling ObamaCare-related taxes and reining in offshore unreported income. Recent reports indicate that audits are declining. Will Republicans agree to more funding of the IRS?

IRS COST-BASIS REPORTING

Filing a sloppy tax return with cost-basis reporting errors on Form 8949, including mishandling wash sales or reporting trades on Schedule C rather than the correct forms, can initiate a painful tax exam. Don't just import 1099-Bs into TurboTax or let your accountant cut corners by attaching 1099-Bs — you may seriously overpay or underpay your taxes.

We expect many 2013 Form 8949 preparation challenges. Options aren't included on 1099-Bs until 2014, and brokers report wash sales differently from what taxpayers need to report. This toxic combination may cause plenty of tax exams and IRS notices for 2013. The AICPA asked the IRS not to match Form 8949 with 1099-Bs for 2012, but this could be a an issue for 2013 tax filings. We hope the IRS holds off on matching notices until after cost-basis reporting is fully phased-in with 2014 tax filings.

We suggest you first investigate 1099-B differences and push your broker to correct Form 1099-Bs when appropriate. Make sure your broker files the corrections with the IRS because otherwise it doesn't do you much good. Your broker's 1099-B may be correct based on the different compliance rules, and results may be materially different from what you need to report on Form 8949. File an extension to leave yourself adequate time to receive 1099-B corrections. We expect corrected 1099-Bs to arrive throughout the summer months.

> In this challenging IRS environment, our firm suggests all business traders — especially part-time, losing and less-than-hyperactive full-time day traders — form an entity.

See "Cost-basis on Form 8949" 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 ordinary losses, including 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, our firm suggests all business 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) or Form 4797 (MTM) and Form 6781 (Section 1256 contracts).

In some cases, traders should tie these tax forms together with income transfers, explaining this 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 those are denied, traders might only be allowed a $3,000 capital-loss limitation, which may lead to owing a significant amount of taxes, 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 capital loss carryovers in later tax years; otherwise they are lost for good.

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" lately. It seems the IRS agent wants to delve into the items listed on the tax notice. It's important to keep the agent on subject 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.

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.

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 defending your business-expense treatment during the exam.

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, be very cautious and get professional help.

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 2011 form still did not report options and many other instruments.) For 2012 and 2013, the 1099-B phased in cost-basis information for mutual funds and dividend reinvestment plans purchased in 2012 and 2013, respectively. Options and debt-instruments are not covered on 1099-Bs until 2014 because the IRS delayed the phase-in one year. The IRS often initiates tax exams a few years later, but before the year closes (normally three years). You can get a 2011 exam notice in 2014 and many taxpayers are still dealing with open exams from prior years, too.

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 — one benefit from cost-basis reporting.

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 or other 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 nationally 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 pay 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, 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. But in early 2013, a federal appeals court overturned these new IRS requirements. That's unfortunate.

Many accountants, tax preparers and CPAs are giving the wrong advice to traders on wash sales reported on 1099-Bs. See Chapter 4 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 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.

Conversely, some accountants professing to be trader tax experts disrespect trader tax status and set up schemes for investors to misuse business treatment and Section 475 MTM. Their clients clearly don't qualify for trader tax status and they face a heap of trouble from the IRS in 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

> One big lesson from the 2013 Nelson and Endicott trader tax cases is to segregate your investments from a trading business activity.

In 2013, the IRS did an excellent job in the Nelson and Endicott trader tax court cases, both in terms of laying out the trader tax laws and requirements for qualification and in their analysis of the taxpayers. We agreed with the court's decisions to side with the IRS and deny Nelson and Endicott trader tax status and all the other tax breaks that hinge on it. The facts of these cases were similar: Both defendants managed their substantial investments with options and they were clearly not business options traders. The IRS recap of trader tax law presented in these cases was very informative. There are clearer lines for options traders not to cross like the average holding period of 31 days, close to 1,000 total trades and frequency well over 60% of available trading days. One big lesson in these cases is to segregate your investments from a trading business activity. Otherwise, it all looks like an investment program.

Taxpayers should bring reasonable and winning cases to tax court. The lesson of the Nelson and Endicott cases is amateur taxpayers without professional representation should not bring losing cases to tax court.

Read our Nov. 15, 2013 blog "Another non-business trader gets busted in tax court trying to cheat the IRS" and Aug. 30, 2013 blog "The tax court was right to deny Endicott trader tax status."

CONTINUOUS BUSINESS ACTIVITY

Unfortunately, this past year we didn't make any headway with our "continuous business activity" (CBA) argument on easing qualification for trader tax status (business treatment). We've been hoping it can help many traders who face difficult qualification standards on "frequency of trades."

CBA is not yet a salvation or replacement for hitting your numbers including 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" (based on trader tax court cases) bar for frequency of trades from 300 in some cases to 500 round-turns — 1,000 total trades on an annualized basis. 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 20 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 trader tax status.

Nelson and Endicott and other traders in tax court have not yet properly raised our CBA argument. So there is still hope in our view. Contact us if you are a good candidate.

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 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.

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 1,000 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.

Traders like Nelson and Endicott, who match up with Holsinger (see the *Holsinger vs. Commissioner* section) with 160 round turn trades on 45% of available trading days, probably don't have trader tax status. But many traders fall in between Holsinger and our golden rules. Some of 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, 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.

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.

Endicott was a substantial investor and he spent considerable time managing his investments, including using options to manage risk. The tax court did not give him credit for time spent in a business, but rather time spent managing his investments. Endicott would have been better off segregating his investments from his efforts to conduct a trading business if in fact that was his intention.

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.

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 more than 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 and well communicated 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)

It's been a decade since this case went to tax court, but an IRS official recently reiterated the importance of it, deeming similar cases "Chencases." 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 $5,000 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?

The Endicott decision said only option buys and sells — not expirations — count when calculating volume of trades.

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 and many times the entrepreneur hasn't left his or her job while experimenting as a business person. Chen may 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)

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. 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. Holsinger's average holding period was more than one month. 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, or approximately 550 round-turn trades. Holsinger fell somewhere in the lower middle.

Holsinger traded on only 40% of available trading days in 2001 and 45% in 2002.

In last year's guide, we focused on Holsinger and this year we drop that content to focus instead on Nelson and Endicott, as they are similar but more current cases.

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; 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 active 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.)

The Endicott decision said only option buys and sells — not expirations — count when calculating volume of trades. The court seemed to discount days on which option trades were open, too.

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 an unfavorable 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

Working for a big bank as a trader is very different from 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. The Financial Industry Regulatory Authority's (FINRA) Regulatory Notice 10-18 is trying to force brokerage firms to stop this practice. The notice tells clearing firms how to spot this type of inappropriate behavior: Look for prop trading firms with sub-trading accounts 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.

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 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 higher leverage. 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 them. 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.

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

As a Class C or D member of the LLC, you're probably not responsible for general obligations and liabilities of the firm overall. (However, we did see a few agreements that 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. Others 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.

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. 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." Sole proprietors 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 the self-employment (SE) tax. The SE tax rate is normally 15.3% of the social security base amount ($117,000 for 2014 and $113,700 for 2013).

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. A retail trader needs to form a trading entity to create compensation for these deductions. While the retail trader then owes SE or payroll tax on the compensation amount, that compensation might be far less than the IC prop trader's fee. So the retail trader may have a much lower SE or payroll tax than the IC prop trader, while each has the same health insurance and retirement plan 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 50-75%. Some firms may try to fool around with the 1099-Misc., checking the "other" box rather than "non-employee compensation." This is wrong.

Under new IRS guidance, K-1 trading business expenses can be included when calculating self-employment income.

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. (With the exception of a prop trading firm that trades futures as a member of a futures or options exchange per Section 1402i.) A few firms tried to deliver those deductions to K-1 traders in the past and they were wrong.

A few prop-trading firms allow LLC member traders to form a 100% owned entity and then the trader can create some compensation. That may be the only way to get those valuable retirement and health insurance 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 — trading 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 with business expense treatment.

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.

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.)

Under new IRS guidance (discussed in Chapter 7), K-1 trading business expenses can be included when calculating self-employment income (SEI). But Section 475 MTM trading losses can not. Check to see if your K-1 separately accounts for trading business expenses and doesn't net them against Section 475 ordinary trading gains.

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 face 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 if the trader 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 loss-recognition event.)

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

For IC traders who spent $10,000 on education before becoming a prop trader in an education/prop trading hybrid firm (not during a period when they qualified for retail trader tax status), that money is considered pre-business 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 (i.e., 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.

> Leverage is a two-edged sword: It can speed up the journey to failure or success.

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. But 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 blocked those tax increases. We covered the drama on our blog and in our podcasts.

While President Obama has continued to seek repeal of 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 and 2014 to raise more tax revenues through tax reform — 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.

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, since carried interest is a share of portfolio income and capital gains.

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 "2013 Tax changes" 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 20% for 2013), futures gains taxed at lower 60/40 tax rates (up to 28% for 2013), and short-term capital gains taxed at ordinary income tax rates (up to 39.6% for 2013). 2014 tax rates are the same.

Carried interest is not subject to separate SE tax rates on earned income (up to 15.3% of the base amount; $113,700 for 2013 and $117,000 for 2014) and 2.9% unlimited Medicare tax portion thereafter (with a 0.9% Medicare surtax on AGIs over $250,000 married and $200,000 single).

Carried interest is subject to the new ObamaCare 3.8% Medicare surtax on unearned income. It's called the net investment tax (NIT) on net investment income (NII). NIT is calculated on new IRS Form 8960. It's toward the bottom of Form 1040 page 2 and it reminds me of another alternative minimum tax (AMT) — another tax calculation separate from regular tax calculations. See Chapter 9 and Chapter 15 for more information on NIT.

CARRIED-INTEREST TAX BREAKS CAN BE GOOD

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 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). At least investment expenses may be used to reduce NII for calculating the new NIT on Form 8960.

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 with a $100,000 capital gain has a net capital gain of $80,000 after applying the 20% carried-interest provision. But without carried interest, the capital gain would be the full $100,000, and the investor may have a partially 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 for saving payroll taxes. Even with trader tax status in the fund, interest expense retains "investment interest" expense treatment under the "trading rule" in Section 469 (passive-activity rules).

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 because incentive fees would be 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. Check with a tax expert about your state. The IRS has new relief for late S-Corp elections, but it requires a perjury statement saying you intended to elect S-Corp status on time. The prior relief protocol was more generous.

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 25-50% 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 and for other reasons, too. Some forex traders used them to get higher leverage and hedging even after the Commodity Futures Trading Commission (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

When taxpayers have investment accounts in the U.S., their brokers and banks are required to furnish 1099 reports to the account holder and the IRS, so taxpayers can't hide income. Historically, 1099 rules have not applied to banks and brokers outside the U.S., as it would be onerous to ask them to file U.S. tax reports for U.S. resident taxpayers. But that's no longer the case. Although the IRS has always been strict on reporting foreign accounts and income, it has recently gotten 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 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.

U.S. tax attorneys are recommending that their clients rush to enroll in the IRS voluntary offshore disclosure program (more on that later in this Chapter) before the IRS busts them first. The difference can mean avoidance of criminal prosecution and jail time, in addition to much higher penalties.

FOREIGN-BASED FOREX BROKERS AND BANKS

CFTC rules require foreign forex brokers and banks to be registered with the National Futures Association (NFA) and U.S. bank regulator, respectively, if they want to handle U.S. retail off-exchange forex accounts. These CFTC rules limit allowable leverage to 50:1 on major currencies and 20:1 on minor currencies. These CFTC rules don't apply to U.S. "eligible contract participants" (ECP) meeting those high net worth thresholds.

The NFA "hedging rule" requires "First In, First Out" (FIFO) only, which disallows hedging or "spread betting." These U.S. rules have upset many forex traders with their trading programs and they've considered all possible angles for working with offshore forex brokers or banks. Offshore companies don't help evade these rules according to a CFTC enforcement attorney.

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. These past years 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.

Many clients don't tell their accountants or tax preparers about foreign accounts and FBAR is not an income tax form, so it could be overlooked during an income tax preparation engagement. You need to inform your tax preparer about your foreign income since Americans are taxed on worldwide income. Ask them about filing FBAR and other foreign tax compliance forms, too. Choose a tax professional with international tax compliance experience.

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. 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 and accountants. 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 often 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 has plenty of international tax experience; he knows how trader tax intersects with international tax matters and compliance.

In a landmark settlement at the end of 2013, the Swiss government and several Swiss banks agreed to turn over American client names to the IRS without it being deemed a violation of Swiss bank secrecy rules. The banks warned their American clients to enter the IRS OVDI program before disclosing their names. There was a rush to enter OVDI or otherwise come clean before the IRS contacted them first.

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.

Chapter 15: Net Investment Tax

The Patient Protection and Affordable Care Act (also known as "ObamaCare") has many new and different types of taxes to finance the law, starting on different dates.

One of these new tax regimes — the "ObamaCare 3.8% Medicare surtax on unearned income" — affects upper-income traders and investment managers as of Jan. 1, 2013. It only applies to individuals with modified adjusted gross income (AGI) exceeding $200,000 (single), $250,000 (married filing jointly) or $125,000 (married filing separately). (Modified AGI means U.S. residents abroad must add back any foreign earned income exclusion reported on Form 2555.)

FINAL IRS REGULATIONS AND TAX FORM 8960 INSTRUCTIONS WERE LATE

The IRS released its final regulations for "net investment income" (NII) and "net investment tax" (NIT) in December 2013, and draft instructions for Form 8960 (Net Investment Income Tax) in January 2014. The IRS was late because the proposed IRS regulations were highly problematic for many CPAs and industry groups who submitted comments asking the IRS for many changes. The proposed regulations disenfranchised taxpayers from deducting their losses against NII which was unfair and against the spirit of the tax code.

Thankfully, the final regulations are better. We are pleased with the results for business traders, who went from being the most disenfranchised to the most enfranchised. Unlike most taxpayers with NII, business traders may deduct trading business net losses and expenses against NII.

WHAT'S INCLUDED AND EXCLUDED FROM NII?

Notice the term "investment income" is used in lieu of "unearned income." People who receive "earned income" from a job pay FICA (on the social security base amount) and Medicare on their wages or self-employment income. In general, unearned income includes interest, dividends, rents, royalties, capital gains and distributions from companies in which you are passive. Now, this type of income is subject to Medicare taxes, too — albeit at upper-income brackets only.

NII's proposed regulations interpreted the tax code to require segregation of different types of unearned income into three different buckets, for the main purpose of disenfranchising taxpayers from using losses from any given bucket. The final regs make some serious amends here and the Section 475 MTM trader fares very well.

Take a look at Form 8960 and the draft instructions.

The NII buckets include the following:

- ***Bucket 1:*** Portfolio income (includes interest, dividends and annuity distributions), royalties (net of oil and gas depletion expenses) and rents (net of depreciation);
- ***Bucket 2:*** Passive activity income and loss from pass-through entities;
- ***Bucket 3:*** Capital gains and losses from the sale of property not used in an active business. In the final regs, the IRS moved trading businesses into bucket 3, so trading business capital gains and losses are counted with investment capital gains and losses. Smart move!

NII excludes:

- Wages and self-employment income;
- Tax-free municipal bond interest income;
- IRA and qualified plan distributions;
- Income from the disposition of, or pass-through from, active (earned-income related) LLCs, partnerships and S-corps;
- 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 included in NII;
- If you're active in rental real estate, that income is excluded; and
- The "exclusion" portion of a capital gain on the sale of a primary residence. The taxable portion above the exclusion amount is included in NII.

NIT applies to irrevocable trusts and estates. NIT also applies to irrevocable trusts (and estates) on the undistributed NII in excess of the dollar amount at which the highest tax bracket for trusts begins (this amount is $11,950 for 2013 and $12,150 in 2014). You can reduce that trust-level NIT by making DNI distributions, but that moves the potential NIT trigger to the beneficiary level.

THERE MAY BE EVEN BETTER NEWS, TOO

The regulations state: "To minimize the inconsistencies between chapter 1 and section 1411 for traders, the final regulations assign all trading gains and trading losses to section 1411(c)(1)(A)(iii). The final regulations also permit a taxpayer to deduct excess losses from the trading business of a section 475 trader from other categories of income. Part 5.C of this preamble describes the treatment of those excess losses."

Consider the example of a Section 475 MTM trader who arbitrages securities trades against interest income. He has interest income in bucket #1 and securities trading gains and losses in bucket #3. With the final regs, it may be possible for him to offset bucket #1 interest income with net Section 475 MTM ordinary losses in bucket #3.

Also, a $3,000 capital loss and a passive-activity loss — if allowed for regular tax — are allowed against other NII buckets. And the NII components of NOL carry forwards may be used against other NII buckets, too.

NIT CALCULATION EXAMPLE

NIT is assessed on whatever is lower: NII or the AGI amount over the threshold. Here's an example: A single taxpayer has $300,000 AGI, which is $100,000 over the $200,000 modified AGI threshold for filing single. NII is $125,000 after deducting available trading business expenses and investment expenses. (Trading business expenses offset self-employment income first, and any excess may be deducted against NII.) Since NII is higher than the AGI amount over the threshold, NIT is calculated on the lower amount, or $100,000 in this example: 3.8% times $100,000, equaling $3,800 of NIT on Form 8960. If the taxpayer had $75,000 NII, then NIT would be calculated on that lower amount instead (3.8% times $75,000 equaling $2,850).

Many individuals will be shocked by NIT on their 2013 tax returns. Net investment tax will be a nasty surprise to many because institutions didn't withhold it during the tax year. Many taxpayers won't be aware of NIT until being shocked with the first draft of their 2013 tax returns in early 2014. If you are over the modified AGI threshold and have NII, expect to see the new Form 8960 NIT at the bottom of Form 1040, below that other nasty surprise — AMT.

MISCELLANEOUS

While the Medicare tax on earned income is 50% tax deductible, it's not deductible on unearned income.

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.

green TraderTax

WWW.GREENTRADERTAX.COM