CHAPTER 1

Are You a Business Trader?

Active traders who rise to the level of "trading as a business" (as a sole proprietor or in an entity) qualify (in the eyes of the IRS) for trader tax status. These traders have two principal tax benefits over investors. The first is that traders may consider their trading losses (if mark-to-market) and business expenses as "ordinary" deductions from gross income, and they can be deducted without any kind of limitations. Investors are severely limited under the tax code from deducting their trading losses and expenses. They are subject to capital loss limitations, wash sale loss deferral rules, and limitations on deducting their investment interest expenses and investment expenses as itemized deductions. Investors have no tax benefits over traders, although both may benefit from long-term capital gains rate relief.

The first part of trader tax status, ordinary business expenses, is mandatory and always beneficial taxwise. It provides a lot of leeway. Trader tax status may be applied (claimed) to a trader's tax returns after the fact, which means that you may take this trader tax status benefit for all "open year" tax returns. Open years include the current tax year, the tax year just ended (for which you may or may not have filed a tax return already), and filing amended tax returns limited to the prior three tax years. In other words, you can read this book, determine whether you qualified for trader tax status, and then file amended tax returns to claim tax refunds for your trading business expenses.

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The average trader saves significant taxes each year by using the first part of trader tax status: ordinary business expenses. The average trader is able to deduct computer hardware and software costs, home office expenses, margin interest expenses, Internet services, and other traditional trading expenses (such as research, books, periodicals, online subscription services, chat room services, seminars, travel to conventions, meals and entertainment with other traders, professional tax service and guide expenses, phone, furniture, fixtures, and more). Remember, investors may only deduct a fraction of these types of expenses, and the amounts they can deduct are severely limited, due to an itemized deduction phase-out, a 2 percent AGI miscellaneous expense floor, and no deduction for the alternative minimum tax calculation.

The second part of trader tax status is mark-to-market accounting. The details of mark-to-market will be discussed in Chapter 2.

HOW TO QUALIFY FOR TRADER TAX STATUS

Qualification: The First Step

Before you are able to use trader tax status benefits (i.e., business expenses and the opportunity to elect mark-to-market accounting), you first must qualify as a trader in the eyes of the IRS. Even if you don't choose mark-to-market accounting, gaining trader tax status is beneficial in all instances. It allows you to report your trading expenses on an individual tax return, Schedule C, and you may amend past tax returns after the fact (up to three years prior) if you qualify as a trader for those years. MTM accounting may not be taken after the fact.

The Tax Laws for Qualification

Unfortunately, no objective tests establish qualification. It is dependent on existing tax court cases, most of which happened well before the online trading revolution. The tax court developed a two-part test, and both parts must be satisfied for a trader to qualify for trader tax status. As you will see, however, both parts are ambiguous and leave plenty of room for interpretation:

1. The taxpayer's trading must be substantial, regular, frequent, and continuous. Sporadic trading won't be a trade or business.
2. The taxpayer seeks 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.

Many traders need more help in determining whether they qualify. The following scenarios are situations our firm encountered over the years, but they are hypothetical and you are not automatically disqualified if you do not fit into one of the categories. Your best bet is to consult a trader tax professional.

If you are a full-time trader (and you have no other major sources of income to pay your living) and you spend all day, every day trading, you qualify without question (unless you lose money every year).

If you are a part-time trader because you have another business activity (a business or a job), the IRS will scrutinize your qualification for trader tax status, especially if you elect mark-to-market accounting and carry back a huge net operating loss (NOL), which will be described in detail later on in the book. You can still qualify as a part-time trader if you can prove to the IRS that you spend more than three hours per day in your trading business. If you trade less than once per day, the IRS may reject your trader tax status.

If you qualify as a pattern day trader (PDT) under the rules implemented by the Securities and Exchange Commission (SEC) in 2001 (i.e., you make more than four day trades in a five-day period), it is a big plus if you are being questioned by the IRS. However, if you are not a PDT, it does not automatically mean you will not qualify.

IRS PUBLICATION 550: SPECIAL RULES FOR TRADERS IN SECURITIES

What follows is an excerpt of the special rules for traders from IRS Publication 550. We add our observations in italics.

> Special rules apply if you are a trader in securities in the business of buying and selling securities for your own account. To be engaged in business as a trader in securities, you must meet all the following conditions.
>
> - You must seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation.
>
> *Observation: Most active securities traders easily meet this condition; their dividends received are a tiny fraction of their sales proceeds.*
>
> - Your activity must be substantial.
>
> *Observation: Most active traders easily meet this condition. They have one or more active online or direct-access brokerage accounts, they spend countless hours watching and reading business news, they buy trading books and online services, they buy computers and software just for their trading business, and they generate millions of dollars in sales proceeds from "churning" their own accounts.*
>
> - You must carry on the activity with continuity and regularity.
>
> *Observation: Most active traders easily meet this condition, although part-time traders may have a difficult time. Full-time traders are busy in the markets throughout every trading day. However, certain other traders are not able to trade every trading day or throughout the trading day—traders such as part-time traders who have other jobs or business activities.*

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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.

Observation: Most active traders easily meet this condition. They don't hold positions open for longer than a few weeks, and in the case they do, they usually are trading around that position as part of a hedge. Some traders hold positions for a day (day traders), others for a few days, and still others for a few weeks to a month (swing traders).

All of these types of traders may qualify. The longest holding periods are with swing traders. One site on the Internet describes swing trading as follows: "Taking advantage of brief price swings in stocks lasting anywhere from one day to a month and using technical analysis to pinpoint entry and exit points." It is not high-speed day trading or scalp trading. Nor is it buy, hold, and pray (otherwise known as investing). Some people call it momentum investing, because you only hold positions that are making major moves. By rolling your money over rapidly through short-term gains you can quickly build up a great deal of equity.

- The frequency and dollar amount of your trades during the year.

Observation: Most active traders easily meet this condition, because they trade daily and their sales proceeds total more than several million dollars per year. The IRS receives a copy of a trader's Form 1099 from the trader's broker showing each and every stock sale transaction and the total amount of sales proceeds. If you have pages and pages of sales, and one almost every day, the IRS will conclude on its own that you qualify. If the opposite is the case, the IRS may ask you questions.

Equity options are not listed in the front part of the Form 1099 (the part the IRS gets); they don't get the Supplemental Information. Options are only given in totals by most online and direct-access brokers.

Commodities are also not reported in detail per transaction. Instead, they are only listed by "aggregate profit and loss." As a result, the IRS can't see your

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frequency and dollar amount of proceeds on commodities. As a rule of thumb, qualified traders need at least one trade per day, whether they are trading full-time or part-time. See more rules of thumb that follow.

- The extent to which you pursue the activity to produce income for a livelihood.

Observation: Most active traders can meet this condition. However, this IRS requirement is the one that may provide the most trouble to some traders in their pursuit of trader tax status qualification.

This "livelihood" requirement is rather vague when applied to the trading business. Most traders may only enter the trading business if they have sufficient capital to trade with; after all, "it takes money to lose money." Some traders have more than sufficient capital to cover their future "livelihood" and the risk of trading. The following types of traders fall into this category: Retired persons who are not ready to clip coupons and play bridge all day, and who would rather operate a trading business, while enjoying retirement activities on weekends; downsized Wall Streeters and other corporate executives who leave employment with a huge nest egg, can't find other work, and decide to hire themselves in their own trading business.

Other traders already have a job or business activity that "produces income for a livelihood." Nothing in this requirement mentions anything about not being able to have two or more "activities to produce income for a livelihood." Isn't that what a second job is all about—providing more income to support your family? See the section on part-time traders. The IRS website says, "Your day trading activity . . . is expected to be your primary income for meeting your personal living expenses" and "you do not have another regular job." Notice how the IRS slipped in that part about not having another regular job. However, their website is older than the IRS Publication 550 section, and the latter is official, whereas the website is not, which is good news for part-time traders.

Before entering a trading business, most traders are aware of the inherent risk of losing all their capital. Most traders manage this business risk by

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first learning the business (reading trading business books, attending trading seminars, and subscribing to trading business services). The majority of traders enter the business because they are hungry to "produce income for a livelihood."

- The amount of time you devote to the activity.

Observation: Most active traders easily meet this condition. They spend way too much time (according to their spouses) on the computer in their trading business. Do yourself a favor: Log that time and save your cache, and/or keep a diary. If you get examined, the IRS will be overwhelmed when they see how much time you actually spent trading.

As a rule of thumb, you should spend at least three hours per day in your trading business. Although it is a significant amount of time, it is feasible for part-time traders.

Part-time trader tax status should remain a focal point in IRS exams and tax court cases for traders. You should check for free updates at www.greencompany.com/Book/index.shtml (user: greentaxbook and password: mh04x729).

If your trading activities are not a business, you are considered an investor, and not a trader. It does not matter whether you call yourself a trader or a day trader.

What About Commodities?

Notice that IRS Publication 550 states "special rules for traders in securities." It does not mention commodities. Don't worry, all the new mark-to-market trader tax laws are written for "traders in securities or commodities."

It may be easier for commodities traders to qualify as being in the business of trading than securities traders. Consider the special rules for securities traders in Publication 550. Few commodities traders seek capital appreciation, and you cannot receive interest or dividend income on commodities.

The nature of commodities trading is short-term trading. Not too many taxpayers "invest" in commodities, so the IRS may not scrutinize commodities traders as much as they will scrutinize securities traders, who are not as active. However, a commodities trader needs to meet all the conditions of IRS Publication 550.

Securities and commodities trading businesses are normally separate businesses, although at times they can be one.

It is not written in the law, but an analysis of the law indicates that securities trading and commodities trading are two separate businesses. You may actively trade in tech stocks for your securities trading business and actively trade in currency futures for your commodities trading business. Your currency futures trading has nothing to do with your tech stocks.

On the other hand, you may have one trading program that requires side-by-side trading in securities and commodities. For example, one of your trading plans could be to trade tech stocks and tech stock indexes (indexes that are treated as commodities). You might hedge your tech stocks with the indexes.

If you need to address securities and commodities trading as two separate businesses, then you need to qualify for each separately. If you can combine the businesses per the preceding example, then you can qualify for the trading business of securities and commodities together. Combining can be helpful if the following scenario applies: You trade securities 200 round-trips per year and commodities 200 round-trips per year. Each alone is perhaps not enough to qualify. Together, though, they are enough to qualify.

Many types of traders may not qualify for trader tax status. Let's look at a few different types.

Part-Time Traders

The definition of trader tax status is vague. It is based on tax court cases rather than tax law. Part-time traders need to proceed with caution. They should be prepared for the IRS to question or challenge their trader tax status. However, we strongly believe that many part-time traders qualify for trader tax status and they should not be scared off from using it.

Here are three reasons why we believe the IRS may challenge a part-time trader's use of trader tax status.

1. Our firm has been engaged by a few part-time traders to represent them in an IRS exam. The IRS denied a commercial airline pilot trader tax status because they could not understand how she could both fly a plane as her full-time occupation and operate a trading business. We had to fight hard to explain to the IRS that while the pilot flew the plane, her trading business was on auto-pilot (using "stop" and "stop limit" orders, monitoring software, beepers, phone and laptops, etc.), and on the many days she was required by law not to fly, she operated her trading business full-time.
2. The IRS website specifically states problems for part-time traders. It states that trading is "expected to be your primary income for meeting your personal living expenses, i.e., if you do not have another regular job, your trading activity might be a business."
3. IRS Publication 550 section "Special Rules for Traders in Securities" also states "the extent to which you pursue the activity to produce income for a livelihood." This requirement is vague.

The good news is that the IRS does not mention anything about "part-time" or "another regular job" in IRS Publication 550. This publication was completed after the IRS website section. Also, IRS Publication 550 is an official position, whereas the IRS website is not.

The IRS website indicates you can't use trader tax status if you have another job. It states the following:

> A business is generally an activity carried on for a livelihood or in good faith to make a profit. Rather than defined in the tax code, exactly what activities are considered business activities has long been the subject of court cases. The facts and circumstances of each case determine

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> whether or not an activity is a trade or business. Basically, if your day trading activity goal is to profit from short-term swings in the market rather than from long-term capital appreciation of investments, and is expected to be your primary income for meeting your personal living expenses, i.e., you do not have another regular job, your trading activity might be a business.

Notice the two problematic statements: "your day trading activity . . . is expected to be your primary income for meeting your personal living expenses" and "you do not have another regular job." Don't panic. As we pointed out previously, IRS Publication 550 is more current than the IRS website (as of this search) and IRS Publication 550 is official, whereas the website is "unofficial" (according to an IRS agent and a person in charge of writing the new trader tax mark-to-market laws).

The preceding IRS statement says "another job." It does not say "another business." The fact is that many people do operate more than one business (or even more than one job) at any given time. Nowhere in the tax code does it say a taxpayer is allowed employee tax status for only one job at a time, or business tax status for one business at a time. For example, one might have a full-time job, but also be partners with their spouse in a family business. They spend time at work, but they spend nights and weekends running the business (or handling their particular area of the business). As another example, consider certain people you know who operate many businesses at one time, such as real estate, law, or a new Internet business.

The bottom line is that nothing in the tax law states a business can only receive business tax treatment if it's the exclusive business operated by the taxpayer. It is probably why the IRS was not able to unequivocally point this out in IRS Publication 550.

Needless to say, the IRS will not be happy about active investors claiming trader tax status and using mark-to-market accounting to carry back hundreds of thousands of dollars in NOLs for six-figure refund checks. So, if your case is not solid, proceed with caution and perhaps contact our firm for more help. We have important updates on part-time trader tax status at www.greencompany/Book/index.shtml.

Why a Part-Time Trader with Another Job Can Qualify

In these times, given today's advances in technology and ability to virtually (i.e., through the Internet) be in more than one place at one time, it is possible for taxpayers to operate more than one job or business. A person can operate two jobs at once, each for 30 hours per week. One could consider each a "full-time" job.

Trading is a job that can be done easily while operating another business or job. For example, we have many clients in California who have jobs in Silicon Valley and operate active trading businesses. These clients qualify for trader tax status.

Example: Here is a composite example of how many part-time, qualified traders spend their week timewise. They actively trade in the markets from 6:30 A.M to 9 A.M. PST, which is 9:30 A.M to noon EST, prime time in the markets. They leave for work at 9 A.M PST and, while in their office from noon to 6:30 P.M EST, monitor their positions, make some trades, and do some research during breaks. After dinner at home, they spend the evening in their trading business, doing administration, accounting, research, and planning trades for the next morning. At the end of the week, they made several round-trip trades every trading day, they held trades open only for minutes, their entire strategy was to look for short price swings, they spent six hours per day in the trading business, and they ended the week with more profits from trading than from their salary. The IRS would be hard-pressed to deny them trader tax status. If our firm prepared their returns, we are highly confident we would successfully prevent the IRS from making any changes to their taxes as far as trader tax status is concerned. In fact, we already won a few similar IRS exams.

Example of the IRS Partially Ruling Against a Part-Time Trader

We did have a difficult time with the exam for the pilot mentioned previously. We did not prepare her tax return—she engaged us to help defend her trader tax status after she received an IRS exam notice. She traded less than once per trading day and had fewer than 200 round-trip trades for

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the year. She also held some positions for a month or more. She was serious about trading, but her factors just did not add up and she was a close call. The IRS initially said no, because they did not even understand trader tax status. After we educated them on trader tax status, they still wanted to say no, but settled by allowing trader tax status for one year and denying it for another. It was not worth going to IRS appeals.

Rules of Thumb for Part-Time Traders

As a general rule of thumb, we think a part-time trader should have at least one round trip per day (preferably three or more per day), every trading day (with some exceptions allowed); they should hold securities for no longer than a few days; they should have total proceeds at year-end in the millions of dollars; they should spend at least three hours per day, every day, in their trading business; they should have serious trading business expenses and services; and they should not rely on others for trading decisions.

Perennial Money-Losing (or Not-for-Profit) Traders

The IRS has its "not-for-profit activity" rules to prevent taxpayers from deducting tax losses in certain business activities that produce losses every year. The IRS considers these activities to be either "hobbies," continual losing activities, or not serious businesses. The IRS utilizes application of these rules to deny a taxpayer normal business tax treatment, which would entitle that taxpayer to unlimited ordinary business losses.

Ordinary trading business losses can be the focus of the not-for-profit activity rules. Not-for-profit activity rules can be a problem for traders, especially if they lost money in their trading business for many years in a row (some traders never show a profit). Trading business losses—the potential focus of these rules—come from trading business expenses (reported on Schedule C for individuals) and ordinary trading losses (if the trader elected and uses mark-to-market accounting). If a trader has capital losses (i.e., doesn't use MTM), that part of their losses is not subject to application of the not-for-profit activity rules, because the taxpayer could resort to investor treatment, where these rules cannot be applied.

Mention of These Rules on the IRS Website

On the IRS website, one of their answers about traders mentions the following: "For details about not-for-profit activities, refer to Chapter 1 in Publication 535, Business Expenses. That chapter explains how to determine whether your activity is carried on to make a profit and how to figure the amount of loss you can deduct." This mention by the IRS indicates that the IRS believes these rules can be applicable to traders.

To date, we have not yet heard of the IRS deeming a trading business a "hobby," or a business that is not serious in nature. The problem is that a trading business is similar to an investing activity, and the difference is just in the degree of volume (time spent, number of trades, holding periods, etc.).

The good news is that these rules are not specifically mentioned in the section on traders in IRS Publication 550. We analyzed the actual rules and believe traders can win on this issue.

How to Avoid the Hobby Loss Rules

The hobby loss rules were created to take the subjective assessment out of the equation and to have a benchmark objective test to determine whether the taxpayer has a profit-making intent. This objective test is summarized in an excerpt from the IRS website. [A more detailed and informative listing should be read at IRS Reg § 1.183-2. "Activity not engaged in for profit": paragraph (b) Relevant factors.] After reading the relevant factors in detail in IRS Reg § 1.183-2, we believe most qualified traders will easily avoid the hobby loss rules based on meeting the profit-making intent test.

A trader can use two ways to avoid the hobby loss rules. The first is to meet the profit-making intent test. The IRS regs themselves say that the

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hobby loss rules won't apply if the facts and circumstances show that you have a profit-making objective.

The second way is to show a profit in at least three out of five consecutive years (two out of seven years for breeding, training, showing, or racing horses). The key point here for traders, is that you can avoid hobby loss rules just based on the profit-making intent test.

This point is key for traders. It is this writer's opinion that traditional hobby businesses can more easily fail the profit-making intent test, and they are then forced through the hoops and elections of the 3-out-of-5-years profit-making test. Be strong and don't fail the first test.

Relevant Factors for the Profit-Making Intent Test

Is it a business or a hobby? (excerpt from www.irs.gov)

It is generally accepted that people prefer to make a living doing something they like. If you are thinking of starting a business but it does not provide you with "a living," or make a profit, your expenses may not be deductible. Expenses connected with your business activities may be tax deductible or limited to the rules for hobby expenses. The limit on not-for-profit (hobby) losses applies to individuals, partnerships, estates, trusts, and S corporations. It does not apply to corporations other than S corporations.

In determining whether you are carrying on an activity for profit, all the facts should be taken into account. No one factor alone is decisive. Among the factors to consider (*this is the profit-making intent test*) are whether:

- You carry on the activity in a businesslike manner.
- The time and effort you put into the activity indicate you intend to make it profitable.
- You depend on income from the activity for your livelihood.
- Your losses are due to circumstances beyond your control (or are normal in the start-up phase of your type of business).

- You change your methods of operation in an attempt to improve profitability.
- You, or your advisors, have the knowledge needed to carry on the activity as a successful business.
- You were successful in making a profit in similar activities in the past.
- The activity makes a profit in some years.
- You can expect to make a future profit from the appreciation of the assets used in the activity.

The IRS is increasing its examination of traders and has indicated a willingness to apply the hobby loss rules to traders. Congress and the IRS were right to create the hobby loss rules to combat the types of tax shelter abuse mentioned previously. But the IRS will be wrong to apply the hobby loss rules to traders.

The online trading revolution is new to the IRS; it just got into full swing in the late 1990s. IRS agents are beginning to examine trader tax status tax returns, and some IRS agents have expressed concern about the IRS paying six-figure refund checks to traders who lost money trading year after year.

IRS agents are mostly inexperienced with the new trader tax laws. IRS agents can be expected to question trader tax reporting (Schedule C and Form 4797), qualification for trader tax status, and application of the hobby loss rules in the case of losses.

At www.irs.gov under the "Tax Topic" for "Day Trader" the following is stated:

> A business is generally an activity carried on for a livelihood or in good faith to make a profit. Rather than defined in the tax code, exactly what activities are considered business activities has long been the subject of court cases. The facts and circumstances of each case determine whether or not an activity is a trade or business. Basically, if your day trading activity goal is to profit from short-term swings in the market rather than from long-term capital appreciation of investments, and is expected to be your

primary income for meeting your personal living expenses, i.e., you do not have another regular job, your trading activity might be a business.

This page further states,

"For details about not-for-profit activities, refer to Chapter 1 in Publication 535, Business Expenses. That chapter explains how to determine whether your activity is carried on to make a profit and how to figure the amount of loss you can deduct."

This page implies that the IRS might want to apply the hobby loss rules (otherwise known as the not-for-profit activity rules).

Recently, during our representation of a trader client in his IRS exam (his return was prepared by another preparer who botched many things), the agent stated she wanted to apply the hobby loss rules to disallow this client's large ordinary trading losses. We strongly objected and said our trader client clearly met the profit-making intent test and that the IRS would never prevail on applying hobby losses to traders. To date, the agent has not presented a formal application of the hobby loss rules to that case, but the case is ongoing as of the time of this writing. The agent mentioned the IRS may want to pursue hobby loss rules against traders to set a precedent in a court case.

A Good Case to Overcome the Hobby Loss Rules

Trading businesses differ from traditional hobby/businesses such as farming or sports activities. Traditional hobby/businesses have a hard time showing a profit-making intent and the IRS has grounds to be skeptical. When in doubt, the IRS strong-arms no profit-making intent and forces the taxpayer to show a profit under the 3-out-of-5-years test. The IRS likes to take the easy road on these matters. The IRS prefers this second test because it is easy to apply; the taxpayer either has a profit in 3 out of 5 years, yes or no.

Traders should not give up on the profit making intent test for two reasons. First the 3-out-of-5-years test is a hassle and requires an election to be filed to presume profitability.

Second and more importantly, a trader cannot concede the profit-making intent test, because that would also inadvertently concede their qualification for trader tax status. It also hinges on your intent to profit from quick swings in market price (rather then merely investing for long-term profit appreciation).

The Bottom Line: If you have large trading losses in 3 out of 5 years or even in your first year or two trading, you need to learn about the hobby loss rules and how they relate to trading businesses. If you get examined by the IRS and have trading losses, you should immediately contact a trader tax expert to review how you can avoid application of the hobby loss rules and defend your trader tax status and reporting. IRS agents make their hay on strong-arming taxpayers directly; you need a trader tax expert in your corner.

Non-U.S. Resident Traders

Many international taxpayers, who otherwise do not pay U.S. taxes, have opened U.S.-based brokerage accounts and they have questions about what U.S. taxes they owe in the United States. We provide a full set of resources for international investors, traders, and proprietary traders.

If the nonresident is a member of a U.S.-based pass-through taxable entity (like a partnership or LLC) in the business of trading securities or commodities, then that person has “effectively connected income” (ECI). That person must file a nonresident tax return, U.S. Form 1040NR, to report any ECI income and pay U.S. taxes on that income.

Here is a composite of the typical questions that come from foreign-based traders:

> In 2003, I lived outside the United States, but my business was trading in U.S.-based securities with a U.S.-based “direct-access” brokerage firm. In addition to that trading account, I also joined a U.S.-based

> "proprietary trading firm," which is organized as a U.S.-based Limited Liability Company and taxed as a partnership.
>
> When I opened my direct-access brokerage account, I notified the broker that, for tax purposes, I was not a U.S. resident. The broker said it was required to withhold taxes on my interest and dividend income in accordance with tax law and tax treaty rates, if applicable. The good news was the broker told me it would not withhold taxes on my capital gains. At tax time, the broker sent me a Form 1042-S, reporting my U.S. tax withholding on interest and dividend income. I also understand that I don't have to file a U.S. nonresident tax return (Form 1040NR), because the tax withholding took care of my responsibilities to pay U.S. taxes.
>
> My proprietary trading firm sent me a Form K-1, reporting my share of trading gains in the firm, based on my sub-trading account performance (see information on proprietary trading). What shall I do with this K-1? Am I required to file a U.S. tax return and pay taxes on this income?

Others questions we receive indicate the firms withheld taxes on this income, and traders want to know what to do in this situation as well.

Quick Answer: Based on the information provided (and assuming the trader doesn't have a green card, meaning he isn't a legal U.S. resident and doesn't meet the "substantial presence test"), the IRS will consider the trader a nonresident for U.S. tax purposes.

Good News: Because the trader did not spend more than 183 days in the United States in 2003, his capital gains income is not taxable in the United States.

Good News: The IRS exempts the income generated by the foreign trader's direct-access business income from the effectively connected income (ECI) rules for operating a business in the United States.

Other types of businesses operated in the United States are deemed to have ECI income, and they must pay U.S. taxes on that ECI income. We believe the IRS exempted traders because it would be hard to determine where the business was operated from. Many international taxpayers trade remotely from abroad, and it would have been unfair to tax them on ECI income in the United States. One note of caution: If you come to the

United States to trade, you may trigger residency. If this occurs, you will have to pay taxes on your trading income based on the residency rules rather than the ECI rules for nonresidents.

Bad News: The IRS does not exempt a foreign trader's K-1 income resulting from proprietary trading business activity from the effectively connected income rules for operating a business in the United States. In this case, you are required to prepare a U.S. income tax return for nonresidents, Form 1040NR. You should report this K-1 income and pay the appropriate U.S. taxes on this income.

Don't be alarmed by paying U.S. taxes. Be aware that your home country most likely allows you to claim a foreign tax credit for the U.S. taxes you pay on this ECI K-1 income. If your home country has a higher tax rate than in the United States, then you may get a dollar-for-dollar tax (foreign tax) credit.

Another Note of Caution: Answers to international tax questions for traders, investors and others are complex, and the answers depend on each taxpayer's individual facts and circumstances. Many countries have income tax treaties with the United States, and taxpayers may find relief provisions in those treaties. Each treaty varies considerably. Our international tax attorneys at GreenTraderLaw.com can help.

Summary

International taxpayers who are deemed non-residents (no U.S. green card and do not meet the substantial presence test) are subject to U.S. taxes in the following situations:

- If the nonresident has a U.S.-based brokerage account as a trader (in the business) or investor, their U.S. broker will withhold taxes on interest and dividends only (using lower tax treaty rates if applicable). No withholding will be made on capital gains. The international taxpayer does not need a U.S. tax identification number, and they are not required to file a U.S. nonresident tax return, Form 1040NR.

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- If the nonresident has a U.S.-based brokerage account as a trader (in the business) or investor, and they spend more than 183 days in the United States, they owe U.S. taxes on their net U.S. source capital gains. Many tax treaties contain provisions that reduce or eliminate taxation on capital gains.
- If the nonresident has a U.S.-based brokerage account and qualifies as a trader (in the business), they are exempt from the effectively connected income (ECI) rules for international taxpayers conducting business activities in the United States.
- If the nonresident is a member of a U.S.-based pass-through taxable entity (such as a Limited Liability Company [LLC] taxed as a partnership, a general partnership, a limited partnership, or S-corporation), in the business of trading securities or commodities, then that person has effectively connected income (ECI). That person must file a nonresident tax return, Form 1040NR, to report their ECI income and pay U.S. taxes on that income.
- An international proprietary trader who is an LLC member in a U.S.-based LLC proprietary trading firm (taxed as a partnership) has ECI income (K-1) and must file a Form 1040NR and pay tax on that ECI K-1 income. (See ideas for foreign tax credits mentioned previously.)
- An investor in a U.S.-based hedge fund limited partnership (or other pass-through entities like a LLC) with trader tax status also has this ECI problem, which is why foreign investors chose to invest in "offshore" hedge funds instead.

SOME TAX LAW DETAILS WITH OBSERVATIONS

General Tax Rules for Nonresident Aliens

Foreign aliens who have a green card (U.S. permanent resident card) are considered "legal" U.S. residents, and they are taxed like any other U.S. cit-

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izen or resident on their worldwide income. Foreign aliens, without a green card, may also be considered U.S. residents if they meet the "substantial presence test" in the United States.

Useful information can be obtained at the IRS website by searching for such topics as Topic 851: Resident and Nonresident aliens; international taxpayers; and green cards.

Tax Rules for Nonresident Investors

If a nonresident alien opens a U.S. brokerage account and buys and sells U.S.-based securities as an investor or a trader, and that person does not spend 183 days or more in the United States in a given tax year, that nonresident alien is not subject to U.S. taxes on his or her U.S. brokerage account capital gains.

If the nonresident does spend more than 183 days in the United States, they owe U.S. taxes on their net U.S. source capital gains. See an excerpt from "International Taxpayer—The Taxation of Capital Gains of Nonresident Alien Students, Scholars, and Employees of Foreign Governments," published on the IRS website.

In general, all nonresident alien investors are subject to U.S. tax withholding by their U.S.-based brokerage firms on their interest and dividend income, and certain master limited partnerships (e.g.. oil and gas deals) from U.S. securities. Search the IRS website for Form 1042-S.

Tax Rules for Nonresident Traders

Generally, when a foreign person engages in a trade or business in the United States, all income from sources within the United States other than certain investment income, is considered to be effectively connected income (ECI).

This categorization applies whether or not any connection can be made between the income and the trade or business being carried on in the United States during the tax year.

Generally, you must be engaged in a trade or business during the tax year to be able to treat income received in that year as ECI. You usually are considered to be engaged in a U.S. trade or business when you perform personal services in the United States. Whether you are engaged in a trade or business in the United States depends on the nature of your activities. Deductions are allowed against ECI, and it is taxed at the graduated rates or lesser rate under a tax treaty. The discussions that follow will help you determine whether you are engaged in a trade or business in the United States.

Certain kinds of fixed, determinable, annual, or periodical (FDAP) income are treated as ECI income because:

- Certain Internal Revenue Code sections require the income to be treated as ECI.
- Certain Internal Revenue Code sections allow elections to treat the income as ECI.
- Certain kinds of investment income are treated as ECI if they pass either of the two following tests:
  - *The Asset-Use Test.* The income must be associated with U.S. assets used in, or held for use in, the conduct of a U.S. trade or business.
  - *Business Activities Test.* The activities of that trade or business conducted in the United States are a material factor in the realization of the income.

In limited circumstances, some kinds of foreign source income may be treated as effectively connected with a trade or business in the United States. Refer to Publication 519, U.S. Tax Guide for Aliens.

The following categories of income are usually considered to be connected with a trade or business in the United States.

- You are considered to be engaged in a trade or business in the United States if you are temporarily present in the United States as a nonimmigrant on an F, J, M, or Q visa. The taxable part of

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any U.S. source scholarship or fellowship grant received by a nonimmigrant in F, J, M, or Q status is treated as effectively connected with a trade or business in the United States.

- If you are a member of a partnership that at any time during the tax year is engaged in a trade or business in the United States, you are considered to be engaged in a trade or business in the United States.
- If your only U.S. business activity is trading in stocks, securities, or commodities (including hedging transactions) through a U.S. resident broker or other agent, you are not engaged in a trade or business in the United States.
- You usually are engaged in a U.S. trade or business when you perform personal services in the United States.
- If you own and operate a business in the United States selling services, products, or merchandise, you are, with certain exceptions, engaged in a trade or business in the United States. For example, profit from the sale in the United States of inventory property purchased either in this country or in a foreign country is effectively connected trade or business income.
- Gains and losses from the sale or exchange of U.S. real property interests (whether or not they are capital assets) are taxed as if you are engaged in a trade or business in the United States. You must treat the gain or loss as connected with that trade or business.
- Income from the rental of real property may be treated as ECI if the taxpayer elects to do so.

Note: Certain kinds of income that are normally treated as ECI or FDAP may not be treated as ECI or FDAP for withholding tax purposes.

Applicable Tax Rate

Income you receive during the tax year that is effectively connected with your trade or business in the United States is, after allowable deductions, taxed at the rates that apply to U.S. citizens and residents.

Tax Year

Generally, you can receive effectively connected income only if you are a nonresident alien engaged in a trade or business in the United States during the tax year. However, income you receive from the sale or exchange of property, the performance of services, or any other transaction in another tax year is treated as effectively connected in that year if it would have been effectively connected in the year the transaction took place or you performed the services.

Observations

If you are a member of a partnership that at any time during the tax year is engaged in a trade or business in the United States, you are considered to be engaged in a trade or business in the United States.

This law requires a nonresident member of a proprietary trading firm, organized as a limited liability company (LLC) in the U.S. (taxed as a partnership), to pay U.S. taxes on this effectively connected income on a Form 1040NR nonresident tax return.

If your only U.S. business activity is trading in stocks, securities, or commodities (including hedging transactions) through a U.S. resident broker or other agent, you are not engaged in a trade or business in the United States.

This rule saves direct-access traders from paying taxes in the United States. Other types of businesses operated in the United States are deemed to have ECI income, and they must pay U.S. taxes on that ECI income. We believe the IRS exempted traders because it would be difficult to determine where the business was operated from. Many international taxpayers trade remotely from abroad, and it would have been unfair to tax them on ECI income in the United States. One note of caution: If you come to the United States to trade, you may trigger residency. Then, you will have to pay taxes on your trading income based on the residency rules rather then the ECI rules for nonresidents.

Notice that this investment income is exempt from effectively connected income. See the following rules on investment capital gains.

These ECI rules only deal with business income and they recognize "U.S. business activity is trading in stocks, securities, or commodities (including hedging transactions) through a U.S. resident broker or other agent," as being exempt from ECI.

INTERNATIONAL TAXPAYER: FIXED, DETERMINABLE, ANNUAL, PERIODICAL

Fixed, determinable, annual, or periodical (FDAP) income is all income except the following:

- Gains derived from the sale of real or personal property (including market discount and option premiums but not including original issue discount)
- Items of income excluded from gross income without regard to the U.S. or foreign status of the owner of the income, such as tax-exempt municipal bond interest and qualified scholarship income

Income is fixed when it is paid in amounts known ahead of time. Income is determinable whenever a basis is established for figuring the amount to be paid. Income can be periodic if it is paid from time to time. It does not have to be paid annually or at regular intervals. Income can be determinable or periodic even if the length of time during which the payments are made is increased or decreased.

Tax Treatment of FDAP Income That Is Not Effectively Connected Income

Tax at a 30 percent (or lower treaty) rate applies to FDAP income or gains from U.S. sources, but only if they are not effectively connected with your

U.S. trade or business. The 30 percent (or lower treaty) rate applies to the gross amount of U.S.-source fixed or determinable annual or periodic gains, profits, or income. Deductions are not allowed against FDAP income.

The following items are examples of FDAP income:

- Compensation for personal services
- Dividends
- Interest
- Original issue discount
- Pensions and annuities
- Alimony
- Real property income, such as rents, other than gains from the sale of real property
- Royalties
- Scholarships and fellowship grants
- Other grants, prizes, and awards
- A sales commission paid or credited monthly
- A commission paid for a single transaction
- The distributable net income of an estate or trust that is FDAP income and that must be distributed currently, or has been paid or credited during the tax year, to a nonresident alien beneficiary
- A distribution from a partnership that is FDAP income, or such an amount that, although not actually distributed, is includible in the gross income of a foreign partner
- Taxes, mortgage interest, or insurance premiums paid to or for the account of, a nonresident alien landlord by a tenant under the terms of a lease
- Prizes awarded to nonresident alien artists for pictures exhibited in the United States
- Purses paid to nonresident alien boxers for prize fights in the United States
- Prizes awarded to nonresident alien professional golfers in golfing tournament in the United States

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Notice capital gains income does not fit into any of the preceding FDAP definitions. Rather, special rules for capital gains apply. Further note that those special rules apply to investment activities with additional complications arising for trading business activities.

Social Security Benefits

A nonresident alien must include 85 percent of any U.S. social security benefit (and the social security equivalent part of a tier 1 railroad retirement benefit) in U.S.-source fixed or determinable annual or periodic income. This income is exempt under some tax treaties. Refer to Table 1 in Publication 901, U.S. Tax Treaties, for a list of tax treaties that exempt U.S. social security benefits from U.S. tax.

Capital Gains

If you were present in the United States for 183 or more days during the tax year, and you are still a nonresident alien, your net gain from sales or exchanges of capital assets is taxed at a 30 percent (or lower treaty) rate. For purposes of the 30 percent (or lower treaty) rate, net gain is the excess of your capital gains from U.S. sources over your capital losses from U.S. sources. This rule applies even if any of the transactions occurred while you were not in the United States. The 183-day test here is not the same as the 183-day test used in the substantial presence test. See the "Taxation of Nonresident Alien Students, Scholars, and Employees of Foreign Governments" section for further information.

If you were in the United States for fewer than 183 days during the tax year, you will not be taxed on your capital gains except for the following types of gains:

- Gains that are effectively connected with a trade or business in the United States during your tax year

- Gains on the disposal of timber, coal, or domestic iron ore with a retained economic interest
- Gains on contingent payments received from the sale or exchange of patents, copyrights, and similar property after October 4, 1966
- Gains on certain transfers of all substantial rights to, or an undivided interest in, patents if the transfers were made before October 5, 1966
- Gains on the sale or exchange of original issue discount obligations

Many tax treaties contain provisions that reduce or eliminate taxation on capital gains.

Capital Gains from the Sale of Property

These rules apply only to those capital gains and losses from sources in the United States that are not effectively connected with a trade or business in the United States. They apply even if you are engaged in a trade or business in the United States. These rules do not apply to the sale or exchange of a U.S. real property interest or to the sale of any property that is effectively connected with a trade or business in the United States.

Reporting Gains and Losses

Traders must report gains and losses from the sales or exchanges of capital assets that are not connected with a trade or business in the United States on page 4 of Form 1040NR. Gains and losses from sales or exchanges of capital assets (including real property) that are connected with a trade or business in the United States are reported on a separate Schedule D (from Form 1040) and page 1 of Form 1040NR. Schedule D is attached to Form 1040NR.

Most nonresidents who are in the United States for more than 183 days meet the substantial presence test and they are taxed like U.S. residents, making this point moot.

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Taxation of Nonresident Alien Students, Scholars, and Employees of Foreign Governments

The following discussion assumes that the capital gains in question are not effectively connected with the conduct of a trade or business in the U.S.

Under the residency rules of IRC § 7701(b), most foreign students, foreign scholars, and alien employees of foreign governments and of international organizations in the United States are considered to be exempt individuals. That is, they are exempt for extended periods of time from counting days of presence in the United States for the purposes of determining their residency in the United States. Thus, most foreign students, foreign scholars, and the alien employees of foreign governments and of international organizations in the United States remain nonresident aliens in the United States for extended periods of time. Many of these nonresident aliens make personal investments in the United States, which generate income from capital gains.

IRC § 871(a)(2) imposes a flat tax of 30 percent on U.S.-source capital gains in the hands of nonresident alien individuals physically present in the United States for 183 days or more during the taxable year. The 183-day rule of IRC § 871(a)(2) bears no relation to the 183-day rule of the substantial presence test of IRC § 7701(b)(3) and the exceptions to the residency rules (e.g., exempt individual/days not counted) of that section. Thus, in some situations the 183-day rule of IRC § 871(a)(2) may apply to individuals who have not crossed the threshold of U.S. residence under IRC § 7701(b)(3). For example, a foreign diplomat, consular officer, or other nonresident alien employee of a foreign government, or nonresident alien employee of an international organization who is visiting the United States in A or G nonimmigrant status for a period longer than 183 days in a calendar year would be subject to the 30 percent tax imposed by IRC § 871(a)(2) on U.S.-source capital gains. The same rule applies to a foreign student or scholar visiting the United States in F, J, M, or Q nonimmigrant status whose presence in the United States exceeds 183 days in any calendar year.

Because IRC § 871(a)(2) applies only to U.S.-source gains, the sourcing rules of IRC § 865(g) must be considered when addressing the appli-

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cation of section 871(a)(2). If, under the rules of IRC § 865(g)(1), an alien is determined to be a nonresident of the United States, then the alien's U.S.-source capital gains would be treated as foreign-source and thus non-taxable. The key factor is whether the alien's "tax home" has shifted to the United States. Here, we must rely upon the tax home rules of IRC § 162(a)(2), IRC § 911(d)(3), Revenue Ruling 93-86, and Revenue Procedure 2000-9.

In general, under the tax home rules, a person who is away (or who intends to be away) from his or her tax home for longer than one year shifts tax homes to the new location upon arrival in that new location. Thus, under this rule, most foreign students and scholars and most alien employees of foreign governments and of international organizations shift tax homes to the United States on the day of their arrival in the United States unless the particular program or employment that brings them to the United States clearly terminates in less than one year and they have no intention to remain in the United States after the termination of such program or employment.

Conclusion

Nonresident alien students and scholars and alien employees of foreign governments and international organizations who, at the time of their arrival in the United States, intend to reside in the United States for longer than one year are subject to the 30 percent taxation on their U.S.-source capital gains during any tax year if during such tax year (usually calendar year) they are present in the United States for 183 days or more, unless a tax treaty provides for a lesser rate of taxation. This assumes that such capital gains are not effectively connected with the conduct of a U.S. trade or business. These capital gains would be reported on page 4 (not page 1) of Form 1040NR and would not be reported on a Schedule D because they are being taxed at a flat rate of 30 percent under IRC § 871(a) or at a reduced flat rate under a tax treaty.

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PATTERN DAY TRADERS

The NASD passed new margin rules in September 2001, which require $25,000 of trading capital for pattern day traders (PDT). The SEC has a distinct definition of pattern day traders: anybody who makes four or more day trades in a five-day period in considered a PDT.

Being labeled a PDT does not mean the IRS will automatically grant you trader tax status. The details surrounding the PDT rules can be found at www.nasdr.com.

Our firm received this e-mail:

> I've learned from (my broker) that a new account will be created that will be considered a "Day Trading Account," and it has various requirements and restrictions. Explicitly, to be termed a day trader, you must make four intraday trades in a five-day period. Sometimes I do, sometimes I don't . . . sometimes I hold overnight . . . sometimes I hold a month or so. So, am I a day trader or not? My concern is that the IRS will pull up the new "Day Trading Account" ruling and say . . . if you didn't participate in this kind of account . . . you are not a day trader and therefore unable to claim MTM status . . . which I am heavily counting on for 2001 taxes. Am I going to be able to claim MTM status in 2001?

Here was our answer:

> The new NASD regulation margin requirements for "pattern day trader" are not coordinated with the IRS rules for trader tax status. The new margin rules do not set precedent for the IRS classification of who qualifies for trader tax status (i.e., rises to the level of being in the trading business). Therefore, this new rule does not affect nor change the current IRS requirements for who qualifies for trader tax status.

Example: An active trader has four brokerage accounts, but he is not classified as a PDT in any of the accounts. When you look at all four accounts together, the trader would be deemed a PDT and also qualify for trader tax status. It seems obvious to us that if you are classified as a PDT, the IRS would be more willing to accept on the face of things (without examining your trading records) that you might qualify for trader tax status.

Note of Caution: We have been contacted by many traders who complained about the new PDT rules. These traders don't have the necessary $25,000 of capital required to open a PDT account. Prior to the new PDT rules, smaller traders could operate a trading business with $5,000 of capital. Now, smaller traders have few choices if they want to be in the trading business. One option is to take one of the many proprietary trading jobs or LLC opportunities currently being advertised.

PROPRIETARY TRADERS

When you take a job or position with a proprietary trading firm and trade the firm's capital (instead of trading with your own money), you are considered to be proprietary trading. Proprietary firms handle tax matters in a variety of ways: employees get a W-2; a Form 1099-Misc is used for independent contractors; and Form K-1s for LLC members.

In Chapter 1, we discuss some tax information for proprietary traders. Learn move about proprietary trading agreements, legal, tax, and business matters in Chapter 9.

In some cases, the firm handles taxes for its traders in a way contrary to the best tax interests of the trader. Some proprietary traders can benefit from overriding the firm's tax handling, gain trader tax status, and report their true economic gains and losses as a "trader in securities and/or commodities." Consult with a trader tax expert and proceed with caution.

Proprietary traders receiving Form 1099-Misc for compensation generally owe self-employment (SE) taxes on this earned income (net of business expenses). However, in some cases a trader can argue they are truly like retail traders in securities responsible for their own trading gains and losses—and the compensation payments are disguised trading gains. With this override, they can avoid owing SE taxes—a significant savings. If a trader in this cir-

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cumstance wants to contribute to a tax-deductible retirement plan, they may be happy to have "earned income" and not do this override.

Proprietary traders receiving Form K-1s for their share of trading gains, losses, and expense if any are exempt from SE tax plus they have opportunities to deduct nonreimbursed business expenses, including but not limited to home office expenses. However, if your proprietary trading firm has an expense reimbursement plan make sure to use or lose it before year-end.

Many traders are interested in job offers from proprietary trading firms. These offers often allow traders with minimal trading capital the opportunity to trade the firm's capital (in a subaccount). Traders are offered a certain percentage (usually between 60 percent and 95 percent) of their trading gains in the form of an LLC Form K-1, Form 1099-Misc (nonemployee compensation) or Form W-2 employee compensation. The only risk for these proprietary traders is any money they are asked to deposit with the firm.

These offers sound great, but many complex tax and business issues are involved. The good news is that we have figured out tax-advantaged solutions for multiple scenarios. These solutions include avoiding self-employment taxes in certain situations, deducting your trading losses as ordinary with mark-to-market accounting, and deducting all your trading business expenses (which are not reimbursed by the firm). If you are a proprietary trader, you should consult with a trader tax expert. Consider engaging our firm GreenTraderTax.com for a consultation and to prepare your tax returns.

Important Tax Matters for Proprietary Traders

Some proprietary traders are treated as independent contractors (who receive Form 1099-Misc), others are LLC members (who receive Form K-1s), and still others are employees (who receive a W-2). Proprietary traders need to understand their underlying agreements and utilize tax-wise strategies that match their facts and circumstances. Not all proprietary traders and firms are alike, and different tax planning and reporting strategies are warranted.

Proprietary trading firm agreements are complex, and the entire industry is in a state of flux. Our firm is following several new developments that may significantly affect proprietary traders. You should follow these developments in the book's free update area (see Introduction for details).

Independent Contractors Receiving Form 1099-Misc

In most cases, these independent contractor proprietary traders work for a firm and get paid by them to trade a subtrading account. For tax purposes at year-end, the firm reports their compensation on a Form 1099-Misc (line 7, nonemployee compensation). The proprietary trader is generally required to report this income on an individual tax return Schedule C (Business Profit and Loss, line 1, gross receipts). The trader should deduct his or her trading business expenses not reimbursed by the firm on Schedule C, and the net income is then subject to self-employment taxes on Schedule SE. Per the IRS website, the total self-employment tax rate for 2004 is 15.3 percent of your net earnings from self-employment. The tax is made up of two parts. The maximum amount of net earnings subject to the social security part, 12.4 percent, is $87,900 (for 2004). All net earnings of at least $400 are subject to the Medicare part, 2.9 percent.

In some cases, the underlying agreement with the firm can be interpreted to show that the proprietary trader qualifies as a "trader in securities"; in fact, these traders risk their own money (their deposits). Traders in securities are exempt from self-employment taxes, so these traders will have significant tax savings. If the trader lost money against a "deposit" account, in some cases the trader can also deduct losses on his or her tax returns.

LLC Members Receiving Form K-1

These traders usually become a limited liability company (LLC) member in a broker-dealer entity by contributing a certain "deposit" amount (usually about $25,000) to the firm. In most cases, the proprietary trader is assigned a subtrading account, and the trader is allocated a high percentage of the trading gains. If the trader loses money, the firm usually charges expenses and losses to their LLC member capital account and ultimately to the trader's deposit account.

The firm provides the trader with more leverage through the broker-dealer registration. The firm insists on strict trading controls to make sure the trader does not lose their firm money, because the firm is providing the leverage capital at its risk.

In almost all cases, LLCs are taxed as partnerships, and the firm files an annual Form 1065 partnership tax return. The firm gives each LLC member (a partner for tax purposes) a Form K-1 at year-end. Technically, some LLCs can choose to be taxed as C-corporations. However, this case is rare and not tax-beneficial.

Although the proprietary trader is an LLC member and partner in the partnership tax return, in most cases, the proprietary trader does not share in any of the overall gains and losses of the firm or other partners. This arrangement is contrary to what happens in most partnerships, where partners do share in firmwide gains and losses. Most proprietary trading firm LLCs are structured so that the Class A members (i.e., the owners) share in the gains and losses of the firm (including but not limited to their share of the proprietary trader's gains and commissions). The proprietary trader is usually a Class C or D member who only shares the subtrading account gains and losses (the trading gains that he or she generates). Sharing agreements vary widely from firm to firm and among individual traders within each firm. Different classes of LLC equity are designed for these purposes.

The key point for tax purposes is that the allocation of gains and losses must follow "substantial economic effect." Therefore, the K-1 tax reporting must "follow the money."

It is odd that one LLC member may report a $1 million gain and another a loss, but the IRS should accept this tax reporting as proper because it does have substantial economic effect.

LLC members are like traders in securities trading for their own account, except they are trading for a firm's account with more leverage.

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Traders for their own account have more tax flexibility and chances for tax savings strategies.

Most proprietary trading firms use mark-to-market accounting as a broker-dealer, so the proprietary traders do have the benefits of MTM on their individual tax return. However, most firms do not pass through losses to prop traders and instead the Class A owners take these tax loss benefits.

The proprietary trading firm passes through the trading gains to the proprietary trader as being exempt from self-employment (SE) taxes.

If you are a foreign trader LLC member of a U.S.-based proprietary trading firm LLC, you owe U.S. taxes on your K-1 income.

Here are some tax limitations and strategies for proprietary traders in LLC proprietary trading firms:

- Almost all proprietary trading firms allow individuals to join only as LLC members. This restriction is primarily for SEC compliance reasons, because the proprietary trader will be a registered individual member of the broker-dealer firm.
- Several key tax advantages accrue to traders who set up entities, principally the opportunity to set up and fund a tax-deductible retirement account and to deduct health insurance premiums. Proprietary traders in LLC proprietary trading firms are not able to take advantage of these benefits. Some firms are trying to set up plans to accommodate traders in this regard. Ask your firm about it.
- Most LLC firms do not reimburse traders for their trading business expenses outside of the firm, including but not limited to home office expenses, meals, travel, supplies, Internet services, and other trading expenses. Some firms have instituted plans to reimburse traders, but many traders don't know about it or don't take advantage of it. Caution, if your firm has a reimbursement plan, you must "use or loose" the plan benefits before year-end.
- LLC members report their "partnership" ordinary gains and losses on Schedule E, page 2. If you submitted expenses to the

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> firm for reimbursement, your Schedule E income will be lower. If you could not submit any expenses, you should deduct your expenses as a second line item on Schedule E. This strategy is important if you want to save a significant amount of taxes.

Employees Receiving W-2s

These jobs are the real jobs. Employees are rarely asked to put up any money, so they are truly risking a firms' money and none of their own money. There are a few firms that offer "hybrid" jobs, which also require a deposit.

True employment jobs without requiring a deposit are rare. Only the best firms offer them, and they only offer them to proven traders with good performance records. They are not "come-ons" designed to lure new traders.

Although they have a good job, when it comes to taxes, employees get reduced tax benefits versus the independent contractor using Schedule C and the LLC member using Schedule E.

Try to get the firm to reimburse you for your trading expenses outside the firm. Report your remaining "unreimbursed employee business expenses" on Form 2106. The problem is that Form 2106 expenses are miscellaneous deductions subject to a 2 percent AGI limitation and additional itemized deduction limitations and not deductible for alternative minimum tax (AMT).

Nonresident Proprietary Traders

Nonresident proprietary traders in U.S. proprietary trading firms are subject to U.S. income taxation and withholding solely on the earnings reported by the U.S. firm.

Most U.S. proprietary trading firms are organized as LLCs, and they file a U.S. partnership income tax return. Each LLC member, including

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nonresident aliens, are given a Form K-1 to report the member's share of gains, losses, income, and expense. In effect, your Form K-1 represents what you earned at the firm. You owe U.S. taxes based on the earnings, not cash distributions. So, even if the firm did not pay you all your earnings, you still owe taxes in the United States.

It is important to note a key difference in U.S. tax treatment. Traders outside the United States have tax benefits in trading direct access (or otherwise) versus being a member of a U.S. proprietary trading firm that files a partnership tax return. The direct-access trader does not owe U.S. taxes on their trading gains, whereas the proprietary trader member of a U.S. LLC does owe U.S. taxes.

Our international tax attorneys are familiar with almost all tax treaties with other countries, and we can help you plan how to best handle your global tax matters (in the United States and your home country).

Take a Close Look at the Firm's Agreements

- When you take a job or position with a proprietary trading firm (allowing you to trade the firm's capital), the first thing you should find out is whether you are required to risk any of your own money. The next thing to find out is how the firm will treat you for tax purposes, and if you will be entitled to trader tax benefits.
- Proprietary trading firms (PTFs) handle tax matters in a variety of ways.
- Some pay their proprietary traders a salary, which is reported on a W-2 for employees. Others pay their traders as independent contractors and report the nonemployee compensation on Form 1099-Misc.
- Finally, other proprietary trading firms are organized as limited liability companies (LLC) and issue their LLC member proprietary traders a Form K-1 (Partner's Share of Income, Credits, Deductions, etc.).

PTFs That Offer True Employment

Some PTFs offer true employment: They hire you to trade their firm's capital and you get paid a salary, which is reported on a W-2. These PTFs do not require you to risk any of your own money, nor do they request a deposit (as many other firms do).

The PTFs maintain a subtrading account for your trading activity, and your W-2 compensation is calculated as a percentage of your net trader profits (after the PTF charges you for various fees and expenses). Compensation percentages vary by firm, but 60 percent is probably average. These firms offer what we consider to be legitimate employer-employee relationships.The problem is that these PTFs only hire experienced and successful traders. You can't blame them, because they are taking all the risk of losses. Some firms may not pay their traders bonus compensation until the trader makes new high net profits, that is, they make back their trading losses.

Some PTFs require you to deposit money for what they consider a job. However, when you look at the fine print, you realize it's not really a job. Some PTFs hire traders only on the condition that the trader deposits some of their own money into the PTF. This deposit will be used to cover the trader's losses and expenses, and some firms require as little as $5,000. When you read the fine print of these employment agreements, you realize that the employee is 100 percent responsible for their own PTF subtrading account losses, trading expenses, and education, but only up to the amount of their deposit.

The employee is also entitled to receive (in the form of W-2 employee compensation) about 60 percent of his or her PTF subtrading account net gains, after all trading expenses have been deducted.

The agreement provides that the PTF may charge all trading losses and expenses against the trader's deposit, and that the trader must add more money to keep the deposit amount at the original amount per the agreement (e.g., $5,000). Many of these types of PTF agreements also require the proprietary trader to pass certain training sessions, which the PTF also charges the trader for in advance.

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When you read the fine print of these agreements, you see that in almost all cases—good, bad, and ugly—the PTF ends up keeping the trader's deposit.

Example of a Small, Inexperienced Trader

Joe Proprietary Trader wants to enter the trading business. Joe will trade actively, and he will be classified as a pattern day trader. Joe does not have $25,000 to open a direct-access trading account, and he sees an ad to join a PTF. He has an interview with the firm and is convinced the firm is willing to train him and sponsor him for his securities registration (Series 7 or otherwise).

Joe thinks that the firm's request for a $5,000 deposit plus $1,000 more for training is reasonable; in any event, that is all he can afford. He figures it is his only chance to enter the trading business, and in a worst-case scenario he will lose $6,000 (or a little more) and walk away with a Series 7 license. So far, Joe is correct.

We caution Joe to read the fine print. We have, and we notice that the PTF has so many strings attached that Joe might end up with large trading losses he is responsible for.

Tax Problems: Joe may end up paying a significant amount of money for the deposit, and he won't be able to deduct those losses as ordinary losses on his tax return as someone with trader tax status could. However, on exit from the firm, he can deduct the lost deposit as an ordinary loss—a business bad debt on Schedule C.

The Bottom Line: If you make money, all is okay, because both the firm and you make money. If you lose money, you lose your deposit and perhaps more. Plus, you subject yourself (in our opinion) to tough conditions, including high leverage (it takes money to lose money), pressure by the firm to close out your positions whenever they want (profitable or not), and trading in proximity to other inexperienced traders (some are not the pros you think they are). Remember the old saying: "If it looks too

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good to be true, it probably is." For some traders, PTFs offer an excellent solution. Find what's best for you.

PTF Limited Liability Companies

Many PTFs are organized as limited liability companies (LLCs). Some of these firms previously hired traders and provided their tax information on a Form 1099-Misc, but the SEC forced them to change their business model to become LLCs.

The SEC also required that all proprietary trader members of these LLCs be registered with the SEC (Series 7 or other).

These PTF LLCs usually require LLC members to contribute a minimum of $25,000 as a deposit or to the LLC member capital.

When you read the fine print of the LLC operating agreement, you see similar provisions to deposit accounts as mentioned earlier. The LLC member proprietary trader must maintain his or her deposit account at $25,000. All the losses and expenses incurred by the trader are charged against his or her capital account. All distributions (advances or compensation, whatever you want to call them) are also charged against the trader's capital account. Deposit accounts are used to cover losses in capital accounts.

The proprietary traders are usually a different type of LLC member from the member managers. They are the real owners who manage the company and share in a portion of the LLC proprietary traders gains, in addition to earning brokerage commissions.

Tax Matters

LLC proprietary traders receive a Form K-1 with special allocations, meaning they receive their exact net trading gain or loss share after all their expenses are charged. Form K-1 does not reflect any companywide gains or losses, only the specific gains and losses of the trader. Taxwise, these

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allocations are correct because they have substantial economic effect, meaning the taxable income and loss follow the money.

Many of these LLC operating agreements do not allow the LLC member proprietary traders to submit their home office or other trading expenses for reimbursement. If reimbursed, the LLC would charge the trader on the Form K-1. That practice would be fine, because it would reduce the trader's net income for tax purposes. The problem is that many of these LLCs do not reimburse their proprietary traders, and the proprietary traders do not know how they can deduct these expenses. Earlier, we showed you how.

CHAPTER SUMMARY

Trader tax status is always beneficial to investor tax status and should be declared by every trader. However, the qualifications to trader tax status mean that a trader should be absolutely certain he or she has reached the level of business trader before proceeding. Because of increased IRS scrutiny of trader tax returns, you should consult with a trader tax expert if you are at all unsure about your status.