

CHAPTER 10**IRS Exams****TURNING UP THE HEAT ON TAXPAYERS**

Recently, the IRS has started to examine more traders, as well as other types of taxpayers. The IRS has a new blessing from Congress to get tough on tax cheats, and Congress needs to raise revenue quickly to balance new budget deficits. Better compliance and enforcement are a key part of the strategy.

The IRS is auditing more trader tax returns and attempting to deny tax loss deductions (expenses and trading losses) for money-losing traders and some part-time traders. Many traders made a fortune in the markets before 2000, and they paid their fair share of taxes on those gains. The IRS was happy to look upon them in those years as good tax-paying customers. The markets crashed in early 2000, and the majority of traders gave back all their prior years' gains.

Many traders set up their sole proprietor businesses properly with trader tax status and mark-to-market accounting, allowing them by law to carry back their net operating losses to prior tax years. These traders filed Form 1045 NOL refund claim tax returns, and some are still expecting to receive large refund checks, plus interest, from the IRS.

Now it seems that some traders are receiving tax notices and tax exams instead of tax refund checks. The IRS is unable to attack the tax law concepts

of trader tax status, mark-to-market accounting, and net operating loss tax laws. Instead, the IRS is interested in making sure that a taxpayer claiming a large NOL or regular refund is fully entitled by law to use trader tax status and mark-to-market accounting. For example, the IRS may want to make sure a trader reaches the threshold of qualifying for trader tax status (being in the trading business) versus merely being an active investor. Investors are not entitled to business deduction treatment and ordinary loss treatment with mark-to-market accounting. In order to use mark-to-market accounting, which converts capital losses into ordinary losses, a trader must first qualify for trader tax status. Then, the trader must duly elect MTM on time (by April 15 of the tax year) and also file a timely and proper Form 3115 (Change of Accounting Method). Some traders elected MTM too late and/or filed a late or improper Form 3115.

One problem is that the IRS itself has generated little useful guidance on the qualification issue.

To accommodate the growing number of questions received from traders, on November 19, 2001, the IRS added a new section to its IRS Publication "Investment Income and Expenses—(Including Capital Gains and Losses)—For Use in Preparing 2001 Returns" titled "Special Rules for Traders in Securities." Unfortunately, this guidance is still vague and does not offer concrete objective standards.

Another problem for the IRS is the fact that online trading is basically a virtual business that sole proprietors may operate from their home, office, or on the road.

The IRS seems to be having a hard time understanding the business and respecting it as a real business. The trading business is not a retail store that an IRS agent can visit to see proof of business activity. An active investor may have the same computer and home office setup as someone in the business of trading, and it is difficult for the IRS to tell the difference.

Lastly, the IRS seems bent on classifying the buying and selling of securities as an investment activity rather than a business activity. Perhaps, for the IRS, it seems too good to be true that someone can quit his or her job or have a second job at home, trading for a personal account. The IRS figures if you lost money, you don't have a profit-making intent, which is

the key to overcoming the hobby loss rules.

The fact is that anyone with capital and computer savvy can put themselves in the same position as professional traders on Wall Street, which are well respected by the IRS as being in the business of trading. The IRS is catching up fast on e-commerce, so it's time for their agents to understand new business opportunities on the Internet. Online trading businesses are probably the biggest new Internet businesses.

The Bottom Line: The IRS has few guidelines for traders, and those that exist are quite vague. Moreover, the IRS has a motive to balk on paying refunds, and it seems bent on not respecting trading as a bona fide business activity. At every step of the way, we disagree with the IRS in this context. But the IRS has the power to examine traders, and many agents around the country are not experienced in trader tax laws and exams. This combination can lead to trouble for traders being examined. The IRS can make your life difficult, but don't back away from your rights to use trader tax status, mark-to-market accounting, and net operating losses, which would be unfair to you.

Some actual examples of IRS exams that have been resolved in favor of the taxpayer follow in the next sections:

Case 1: NYC Trader Exam

Facts

A NYC money-losing trader filed his 2001 Form 1045, Application for Tentative Refund, in order to carry back his 2001 net operating loss and recoup prior taxes paid in the preceding two years of \$115,500.

In 2001 the trader reported trading losses of \$346,680 and trader expenses of \$2,239. Total trading proceeds were more than \$729,000,000 with thousands of short-term intraday trades made during the year. Taxpayer was trading full-time with no other sources of income except for some interest income.

The trader filed his carryback claim in early summer 2002. Normally it takes ninety days for the IRS to process this form. Some problems with

the originally submitted Form 1045 included the option in 2001 of carrybacking two years or five years. The accountant who prepared the carryback claim did not indicate that the taxpayer was waiving the five-year carryback and carrying back two years instead.

The taxpayer and his accountant straightened out this issue with the IRS and submitted the election to waive the five-year carryback. Despite these delays, the trader received his refund checks in November.

Then about five months later in March 2003 the taxpayer received a letter from the IRS stating his 2001 return was selected for examination and to call and schedule an appointment. The trader handled the exam on his own. He told the agent a mistake must have been made in selecting his return for audit.

The agent responded that his return was indeed being selected for examination. The trader explained he submitted all the documents and paid all his prior taxes in order to claim those refunds. The taxpayer explained what he did for a living being a full-time trader.

The agent disallowed his trading losses as ordinary, converting them to capital losses, and changed his carryback return requesting the entire \$115,500 in refunds back plus penalties and interest. The agent verbally told the taxpayer only broker-dealers (and not traders) could use mark-to-market accounting treatment as the reason for the disallowance. After the agent made his changes on Form 4549 Income Tax Examination Changes, the trader came to us for help.

Exam Process

The taxpayer represented to us that he had duly filed his 2001 mark-to-market election on time with his 2000 tax return by April 15, 2001. His accountant sent us a copy of the 2001 Form 3115, Change in Accounting Method, that was also filed on time with his 2001 tax return as well as a copy sent to the IRS National Office. Once we were satisfied that the trader did have mark-to-market accounting, the next step was educating the agent about IRC § 475(f).

The IRS agent initially would not listen to reason and was hostile with us at first. He wanted us to go directly to appeals. We told him that was unnecessary because we could resolve the case at this level. In fact we were trying to save the agent from embarrassment with his supervisor. The agent denied ever telling the taxpayer that only broker-dealers could make the mark-to-market election.

The agent claimed he had tax research to support his position that mark-to-market trading losses belonged on Schedule D as capital losses and not Form 4797 Part II as ordinary losses. We knew this was completely wrong. We sent a detailed explanation of the facts and circumstances of the taxpayer as well as trader tax law to educate the agent. We faxed over to the agent a copy of the special rules for traders in Chapter Four of IRS Publication 550 and FAQs about traders from the IRS's own website.

Finally, the agent came around after being educated about trader tax law and mark-to-market accounting treatment and section 475(f) by phone, fax, and correspondence from us.

He realized that his conclusions were wrong and that the taxpayer's 2001 Form 1045 as submitted was correct as filed.

Lesson: Don't approach every IRS exam as a full-fledged exam. First, find out what the IRS focus is, and win on those points early. You may be able to close the case at that point.

Exam Results

The agent went back and revised his Form 4549 as a no change showing zero due the IRS. The trader's 2001 Form 1045 was upheld and his refunds allowed. This particular examination did not take long for us to resolve. We got involved in the case in April and by May had closed the case in favor of the trader. Not all examinations get resolved that quickly, but the agent was clearly misinformed about trader tax law and was willing to concede once the overwhelming evidence was presented. If we had not persisted with the agent and gone to appeals instead, it would have taken much longer to resolve. Notice that this agent was not interested in check-

ing the underlying income, losses, and expenses. Rather it was solely a question of IRC § 475 MTM application.

Case 2: Part-Time Trader Exam

Facts

This real-life example describes how we won without going through a formal examination. In August 2003 the taxpayer received an IRS letter stating his 2000 trader tax return had been selected for examination. What was unique about this particular letter was that the IRS was only interested in examining every single line item on his trader Schedule C. This request was a new line of attack by the IRS toward sole proprietor taxpayers.

Normally in a request for examination, the IRS will not ask for supporting documentation for every single line item on a particular form or schedule.

They typically focus on a couple of areas such as travel and entertainment where historically the IRS has found weakness in taxpayers not having enough substantiation to support those types of deductions.

We prepared this taxpayer's 2000 tax return, and the client came to us immediately as soon as he received the IRS notice. We reviewed the trading facts again with the client. In 2000 the taxpayer traded part-time while working a full-time job. Because the taxpayer lived on the West Coast and took advantage of the time differential, the taxpayer was able to conduct activities of trading in the morning, going to his regular job, and then doing market analysis and trading research at night.

According to the taxpayer's trading fact sheet, he would start his day about 5:30 A.M. PST by reading and watching business news. Then he would make trades and watch the markets from 6:30 A.M. to 1:00 P.M. PST. From 1 to 7 P.M. PST he would go to work either in the office or hold meetings with clients with respect to his job in sales. Then he would go back to his trading business from 8 to 10 P.M., reviewing the market news and preparing for the next day's trading.

Total round-trip trades were 470 with average holding period of one day. The taxpayer averaged two trades a day and traded all year long. Total trading proceeds were more than \$1 million dollars. Our conclusion was all these facts, including his trading expenses of \$21,871 and time spent, were sufficient for qualifying for trader status in 2000. The taxpayer did not elect mark-to-market for 2000 and was a cash basis trader, meaning he could report his trader expenses on Schedule C but not treat his trading losses as ordinary. Trading gains and losses were reported on Schedule D.

Exam Process

After reviewing the facts again with our client, we discussed our approach to his examination. The IRS was focusing in on trader expenses totaling \$21,871, which were deducted on his 2000 return and helped offset income from other sources such as his wages. If the IRS disallowed his trader status and corresponding trader expenses, our client would be looking at an additional tax bill of \$6,739 plus penalties and interest.

We discussed a particular strategy that had worked in the past and that we wanted to try again for this exam. We decided to correspond with the IRS to ask for a retraction of their examination. The IRS calls it a reconsideration, or recon procedure. We believed the facts and circumstances warranted such a request; the IRS lacked sufficient reason to conduct a full-blown examination, wasting valuable IRS resources not to mention the costs to the client for our time spent dealing with an exam.

We drafted and submitted a detailed letter explaining the taxpayer's facts and circumstances, trader tax law, why the taxpayer qualified as a trader, and why those trader expenses were ordinary and necessary business expenses under IRC section 162. We explained that we believe the taxpayer was selected for examination in error because of the unique way traders report their trading income on either Schedule D (for cash basis) or Form 4797 Part II (for mark-to-market) with trading expenses reported elsewhere on Schedule C.

When the IRS sees just expenses on Schedule C, it raises eyebrows and

invites further scrutiny, but money-losing traders have no choice because it is the proper way to report their trading business on two separate schedules. We've seen many tax preparer mistakes where trading losses are erroneously reported on Schedule C. Trading gains or losses belong on Schedule D or Form 4797 Part II and the instructions are quite clear about it.

We do suggest a strategy of transferring gains from Schedule D or Form 4797 to Schedule C to reduce the chance at IRS questions and for other reasons. More on this follows.

Exam Results

After faxing our letter to the IRS district office, we received a phone call from an IRS supervisor. We went over the facts again, and the supervisor agreed with us that no good reason existed for them to conduct an exam. She realized it would wind up being a no-change audit, which the IRS prefers not to do. The IRS is not in the examination business to waste valuable resources chasing after taxpayers that will result in no audit adjustments or additional monies the government can assess or collect from taxpayers.

The next step was sending our request to the IRS's Area Compliance Director for final approval. By mid-September 2003 it was approved. The IRS response stated the following:

We are pleased to tell you that after further review of your tax returns for the above periods, we have accepted them as filed. Do not consider this as an examination that resulted in no change in your tax liabilities. You were not examined for these years.

This case is an example of a win without going through hoops defending trader status and spending hours with an agent educating them on trader tax law and going over receipts and cancelled checks for all those trader expenses. Again, we were able to resolve this exam quickly in less than two months because of the facts and circumstances and the fact that the client came to us first rather than dealing with this exam on his own, which would have been a big mistake. Could the IRS come back later you

ask? No, the statute of limitations ran out. Any reexamination of a 2000 trader return had to be made before April 15, 2004.

Case 3: Full-Time California Trader Exam

Facts

In July 2003, the taxpayer received an IRS letter stating his 2001 trader tax return had been selected for examination. Again, it was another letter indicating the IRS was only interested in examining every single line item on his trader Schedule C and nothing else. We noticed these unique examination letters coming out in July 2003. We talked to revenue agents who confirmed this approach is something new the National IRS office in Washington, D.C., came up with and that all IRS service centers started following last year. It's a particularly burdensome request. The IRS claimed they needed to conduct this type of audit to develop statistics to assist them in coming up with computerized red flags. Because of the uproar, those TCM exams (initiated in the late 1980s, which examined every single line of taxpayers' Form 1040) were put on the back burner until recently. The IRS was supposed to start up these TCM exams sometime in 2003 with 20,000 unlucky taxpayers.

We did not prepare this taxpayer's 2001 tax return. The client heard about us through *Active Trader* magazine and contacted us to help him with this exam. He was not in the mist of a full-blown examination, which made our job much easier and allowed us to use our retraction strategy from the beginning. Once an examination gets underway, it is too late to ask the IRS to reconsider because they've already assigned an agent to the case who started work on the exam.

We started by reviewing the taxpayer's 2001 tax return, paying particular attention to the trader portions of the return. We went over the following facts with the client: In 2001 the taxpayer was a full-time trader who traded all year long. Total trades were more than 4,400 with an average holding period of one day. The taxpayer averaged 20 to 30 trades a day. Total trading pro-

ceeds were more than \$46 million. Our conclusion was all the facts, including his trading expenses of \$17,561 and time spent, were sufficient for qualifying for trader tax status in 2001. The taxpayer did not elect mark-to-market for 2001 and was a cash basis trader, meaning he could report his trader expenses on Schedule C but not treat his trading losses as ordinary. Trading gains and losses were reported on Schedule D. We did notice an error in the way his trading losses were reported on Schedule D, which might have precluded an exam had it been prepared right in the first place. The accountant failed to report total trading proceeds on one of his trading accounts. Looking at the Schedule D itself, you would not see trading proceeds in the millions, which was evident when reviewing the 1099s.

Exam Process

After reviewing the facts with the client, we discussed our approach to his examination. The IRS was focusing in on business expenses totaling \$17,561, which were deducted on his 2001 return and helped to offset income from other sources. If the IRS disallowed his trader tax status and corresponding trader business expenses, our client would be looking at an additional tax bill of \$3,000 plus penalties and interest.

We discussed our retraction strategy. We believed the facts and circumstances warranted such a request.

We submitted a detailed letter explaining the taxpayer's facts and circumstances, trader tax law, why the taxpayer qualified as a trader, and why those trader expenses were ordinary and necessary business expenses under IRC section 162. We again explained that we believed the taxpayer was selected for examination in error because of the unique way traders report their trading income on either Schedule D (if cash basis) or Form 4797 Part II (if mark-to-market) with trading expenses reported elsewhere on Schedule C. When the IRS sees just expenses on Schedule C, it may invite further scrutiny.

Exam Results

After faxing our letter to the IRS district office, we called them. The supervisor agreed with us and sent our request for reconsideration or a “survey” as she called it to the area compliance director for final approval. In this particular case after waiting several weeks, we received a fax on IRS letterhead in mid-September 2003 stating the following: “This is written confirmation that, according to our records, the audit for the taxpayer’s 2001 return has been surveyed and the administrative file is back at the Service Center. As we discussed, this action took place on 8/19/03 and there should have been a formal letter sent at that time. We apologize for any inconvenience this may have caused. This fax will serve as your written confirmation for your files.”

This case is another example of a win without a big exam with the IRS. The retraction or reconsideration strategy works, and we have proof based on our own exam experience with two recent cases. IRS resources are spread thin and they are understaffed. They do not have time to waste with honest traders who are only following the law.

We were able to resolve this exam quickly in three months because of the facts and circumstances and because the client came to us first rather than dealing with this exam on his own. An IRS reexamination of this client’s 2001 trader return must be initiated before April 15, 2005, according to the statute of limitations. We highly doubt this client will get another notice, but a remote possibility means we will continue monitoring the situation.

DO SCHEDULE Cs CAUSE IRS TROUBLES FOR TRADERS?

After reading the above exam case section, it is apparent that the IRS targets Schedule C business losses for tax exams for all taxpayers including traders. Schedule C has historically been considered a red flag by tax preparers and care should be taken.

Sole proprietor or unincorporated businesses report their business

activity including revenues, expenses, and net income on Schedule C (Profit or Loss From Business), which is part of their individual tax return Form 1040. Other businesses form separate legal entities, many of which must file separate entity tax returns.

Most small business owners prefer pass-through entities, which pass-through items of income and expense to the taxpayer's individual tax return. Traders who choose entities (for retirement plans and health insurance premium deductions) prefer pass through entities, and that means that all business activity still winds up on their individual tax return.

The question often comes up, should a business trader remain unincorporated and file a Schedule C or should they form a multimember LLC, partnership, or S-corporation and report their trading activity on Schedule E?

The IRS has announced new plans to increase their exams of pass through entities and individuals who report that income or loss on Schedule E. The IRS also has a matching program to compare pass-through entities returns with Schedule E, to make sure the pass-through is properly reported.

If a trader has trading losses and large trading business expenses, their individual tax return has the same results whether they are unincorporated with a Schedule C or have a pass-through entity with losses on Schedule E.

If a trader has trading gains and business expenses, here is how GTT suggests they file under both scenarios (unincorporated versus incorporated).

For an unincorporated business trader, trading expenses are reported on Schedule C and trading gains are reported on Schedule D (cash method) or Form 4797 (MTM method). A key GTT trader tax return filing strategy is to transfer sufficient trading gains from Schedule D or Form 4797 to Schedule C to zero out Schedule C, thereby not reporting a Schedule C loss. This strategy serves to prevent most IRS questions or exams.

For an incorporated multimember LLC, partnership, or S-corporation, trading expenses are reported on line 1 of the Form K-1 (ordinary gain or loss). If the entity uses MTM, trading gains are also reported on line 1 of Form K-1, reducing expenses or generating net income if gains exceed expenses. MTM trading losses add to the size of the Form K-1 line

1 ordinary loss, which is reported on Schedule E. If the entity uses the cash method, capital gains and losses are reported on different Form K-1 lines and pass through to Schedule D.

The Bottom Line: Both unincorporated and incorporated pass-through entity traders report business expenses and trading gains and losses on their individual tax returns, and both can cause equal attraction to the IRS audit systems.

Whether you incorporate or not, what's most important is to follow the GTT strategies on transferring trading gains to offset trading expenses to reduce your red flags. It is also key to include tax return footnotes to explain trader tax status, MTM, and how you handle your tax reporting.

As pointed out in our IRS exam cases, you should try to get a recon of your exam before it even starts. If that is not successful, then focus the exam on proving your trader tax status and explain that you have a low level of expenses versus other businesses, and they are at reasonable and believable levels. Query the IRS agent or supervisor. Why waste your valuable time and energy on my small trading business? There is no hidden cash income—the main focus of Schedule C exams—and all trading transactions go through highly regulated broker dealers.

CHAPTER SUMMARY

The first key to winning IRS exams is to prevent them from happening in the first place. Don't raise red flags on your trader tax return; report everything properly and explain it all in well written footnotes. This entire book is dedicated to making this happen. If you do receive an IRS notice or question, don't panic but also don't reply to it on your own. First engage a trader tax expert with good IRS exam experience on trader exams and have that expert reply to the IRS on your behalf. A good expert will first try for a recon and if that does not work, they should try for a quick win by focusing on trader tax status, the trader tax laws, your MTM status, and

the general aspects, but not line-by-line documentation. Only as a last resort should you get into line-by-line documentation. If the agent still wants changes, so be it, go to the next level in appeals. An appeals officer has a different focus; they want to prevent tax court cases that the IRS may lose. If you lose in appeals and owe tens of thousands or more, consider tax court. Again, at every step of the way, you need a proven expert.

A Cautionary Tale: A recent tax court case was recently decided in favor of the IRS (Chen vs. IRS). Chen tried to defraud the IRS with a phony MTM claim, and he was also a part time trader in business for only one quarter of the year. He hurt his own cause and the cause of all traders by representing himself in his exam and trying to fool the IRS. To follow the latest in tax court cases and more news on the Chen case, see the free update section for this book at www.greencompany.com (see Introduction for details).