CHAPTER 9

Proprietary Trading

Proprietary trading firm agreements and tax issues come in all forms and sizes, with a variety of tax, legal, and risk issues. Proprietary trading offers greater leverage than what is available to retail traders. That leverage is a double-edged sword, though. Leverage has an upside to greater and faster profits, but the downside is more risk, more costs, and pitfalls. Before you leap to "take the money and run," become an educated consumer first.

In addition to this chapter, there is more tax information for proprietary traders in Chapter 1.

Currently, many of the proprietary trading firms use the limited liability company (LLC) model, inviting you to join the firm as an LLC member. Some firms also offer to hire you as either independent contractors or employees. Other firms will allow you to trade with them as customers just like other retail traders, but then you don't get additional leverage over the pattern day trader rules (currently 4:1 leverage). If the firm is a broker dealer or a member of an exchange, you are required to have a brokerage license.

Before you leap into one of these deals, read the fine print of the agreements and see how they stack up.

A Note of Caution: WorldCo, during the bull market one of the largest and most successful proprietary trading firms, recently went out of business. Many of their prop traders got burned (they did not get their capital back). Recent rumors claim the SEC is looking closer at the proprietary trading firms, and that they are forcing some changes. Now is a good time to ask your firm questions, get better educated on the legal and tax issues, and reevaluate your situation.

LOOK CLOSELY AT AGREEMENTS

When you take a job or position with a proprietary trading firm (which allows you to trade the firm's capital), it's important to read the fine print of the agreements and policies and understand what you are signing.

Many firms ask you to deposit money up front, to be responsible for your trading losses, and some even ask you to indemnify the firm for losses in excess of your deposit amount. Most firms have a laundry list of expenses they will charge your account and restrictive policies for how you may trade (no overnight positions and much more). Take careful note of their margin and lending policies.

A proprietary trading opportunity may suit your needs, predominantly by giving you access to much greater trading capital than you have available or are prepared to risk in your own trading business. Pattern day traders with "customer accounts" may only have margin up to 4 to 1, whereas proprietary traders may have margin of 10 or 20 to 1 within a firm (even though the firm itself is limited to less margin overall). Your margin is not supposed to be directly connected to your deposit, but it often is, in an unofficial manner.

A day trading business is a high-risk activity to begin with. and proprietary trading with far greater leverage can be even more risky. Prop trading firms explain the point that they are on the hook for your losses, but they can control your trading and risk and usually make sure to limit your losses to the extent of your deposit, which most can ask you to replenish after a draw down.

Proprietary trading firms (PTFs) offer three types of agreements:

- Employment contracts or deals without signed contracts
- Independent contractor agreements or deals without signed agreements
- LLC operating agreements

Employment Contracts or Deals Without Signed Contracts

Some PTFs offer employment by hiring you to trade their firm's capital and paying you a salary, which is reported on a W-2. As a legal employee, you are eligible to participate in the firm's employee benefit programs including health insurance plans, retirement plans, and other fringe benefit programs. Because you get these benefits and a salary, employment prop trading deals offer significantly lower payout percentages from the trading gains you generate. Some employment deals require deposits, while others do not. Most offset future payouts with prior losses, so you are responsible for losses in a sense. Few employment deals require you indemnify the firm for losses.

For tax purposes, you have employment tax status. You have the following taxes withheld from your paychecks: payroll taxes (social security and Medicare taxes) and federal and state income taxes, based on your number of W-4 allowances. The firm pays 50 percent of the payroll taxes and you pay the other 50 percent through withholding. Employee tax status is inferior to trader tax status, independent contractor tax status, or LLC member (partner) tax status. All these other statuses have business treatment, which means they can deduct all possible business expenses from gross income without limitation. Employees don't have business tax breaks, but may deduct nonreimbursed employee business expenses on Form 2106. These miscellaneous itemized deductions are only deductible in excess of 2 percent of your adjusted gross income (AGI). Plus, these deductions are added back when computing alternative minimum tax (AMT). Home office expenses are not allowed unless your home office is required by your employer under strict conditions, which are rarely the case.

For legal purposes, don't just rest on the laurels of figuring you are an employee and therefore have no risk. Read the fine print of your agreement. The firm may require you to indemnify them for losses, which is rare, but possible. It's always wise to consult with an attorney before signing any important agreement.

The PTFs maintain a subtrading account for your trading activity, and your W-2 compensation is usually 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.

Independent Contractor Agreements or Deals Without Signed Agreements

Many firms that offer employment deals also offer independent contractor (IC) deals as well. Independent contractors are similar to employees in that they perform work for a company, but they are different in tax and legal ways.

A company is responsible for its employees, but not for its ICs. Many large companies try to save on employee benefit costs by using ICs since the company is not responsible to pay payroll taxes for ICs. But the IRS and state unemployment divisions challenge companies on the "20-part test" to determine whether the ICs really are not disguised employees. States are hungry to collect more unemployment insurance and workmens' compensation. ICs are not entitled to unemploment insurance, whereas employees are.

Ask your prop trading firm if your IC terms and conditions and actual fact pattern will pass these tests. If you don't have any other trading accounts outside of the firm, or any other work besides this job trading for the firm, and you report to work at the firm's office, and they supervise and direct your trading efforts closely, you may fail the independent contractor tests. To learn more, see Employees vs. Independent Contractors at www.irs.gov.

Independent contractors are responsible to pay their own taxes. Read the fine print in your IC agreements. IC agreements are similar to employment agreements, except you may be asked to deposit higher amounts of money and you should be granted higher payouts versus employees. IC agreements usually don't provide for advances, and you are just paid from your trading gains generated. Many firms will hold back reserves. IC agreements usually provide for full loss responsibility with the firm recouping your losses and expenses before they pay out new high net profit gains.

Watch Out: Some firms may require indemnification for losses even if you don't generate future gains, meaning the replenishment of deposits to cover losses or a promissory note to pay back losses over your deposit amounts. As an IC, you are engaged to trade the firm's capital, and you are paid for your work. You have earned income from management services, not a share of trading gains. So you owe SE taxes and you can contribute to tax deductible retirement plans and deduct your health insurance premiums. See the tax section for IC proprietary traders in Chapter 1 to learn about some ways to possibly avoid SE taxes.

LLC Operating Agreements

Many PTFs are organized as limited liability companies (LLCs). Some of these firms previously hired traders as ICs and provided their tax information on a Form 1099-Misc, but the SEC and exchanges forced broker-dealer PTFs to change their business model to become LLCs. The SEC and exchanges also required that all proprietary trader members of these LLCs organized as broker-dealers be registered with the SEC (Series 7 or other).

These PTF LLCs usually require LLC members to pay a minimum deposit of $25,000 to the LLC. This $25,000 may be related to the $25,000 required for the pattern day trader rules. When you read the fine print of the LLC operating agreement, you see similar provisions to those mentioned on IC deposit accounts. 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 first charged against the LLC member's capital account and ultimately charged against their deposit account. The proprietary traders are usually a different type of LLC member from the member-managers, the real owners who manage the company and share in a portion of the LLC proprietary traders gains, as well as firm-wide profits (from commissions, etc.). Unless a proprietary trader receives commission overrides from recruiting other proprietary traders for the firm, in general proprietary traders don't receive a share of commissions.

Most LLC operating agreements are written in favor of the Class A true owner/managing members. These agreements tend to be one-sided, and much of what these firms say you are entitled to is actually stated as "at the managing members discretion" in the agreement. In other words, management can make any changes they like at year-end or otherwise.

With an LLC operating agreement, you are signing up and committing yourself in connection with your deposit and capital. It is a serious legal agreement, and you should consult with a lawyer, who represents you alone and not the company, to avoid a conflict of interest.

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 taxwise 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).

Independent Contractors Receiving a Form 1099-Misc

In most cases, these independent contractor (IC) proprietary traders work for a broker-dealer and get paid by them as individual sole proprietors to manage a subtrading account within the firm. For tax purposes at year-end, the firm reports their compensation on Form 1099-Misc (nonemployee compensation). The proprietary trader is considered a sole proprietor and required to report this income on their individual tax return Schedule C (Business Profit and Loss, line 1, Gross Receipts).

An IC proprietary trader should deduct any trading business expenses on that same Schedule C, including but not limited to (qualified) home office deductions (from Form 8829) and travel if he or she has a home office (otherwise commuting is not deductible), meals and entertainment, (qualified) education expenses, supplies, Internet, research, and much more. For a list of many possible trading business expenses, see our trader tax return examples earlier in this book. Proprietary traders have similar business deductions as retail business traders.

The main difference between IC prop traders and retail "customer" traders, who are also sole proprietors, is that an IC prop trader's net income is deemed earned income and therefore subject to self-employment taxes on Schedule SE. Trading gains for retail traders are not earned income and not subject to SE taxes. Per the IRS website, the total self-employment tax rate is 15.3 percent of net earnings from self-employment. The tax is made up of two parts. The maximum amount subject to the social security part for tax years beginning in 2004 is $87,900. All net earnings of at least $400 are subject to the Medicare part, 2.9 percent.

SE taxes are costly, but benefits also come in connection with "earned income." You may contribute to a tax-deductible retirement plan based on earned income, whereas retail traders may not, unless they form an entity. You may also deduct 100 percent of your health insurance premiums from AGI up to the amount of your earned income, whereas retail traders may not, unless they form an entity.

Some tax credits are also based on earned income, such as the child tax credit. Retail traders, using entities, have flexibility in declaring how much earned income they have, and they declare only enough to drive their desired deductions and credits, whereas IC prop traders owe SE taxes on all their net income (without any flexibility). In some cases, it is possible to argue IC income is "other income"—not earned income—thereby saving on self-employment taxes. Of course, without earned income, you can't set up a tax-deductible retirement plan contribution or deduct health insurance premiums from AGI. You should consult a trader tax expert on this issue.

LLC Members Receiving a Form K-1

These traders usually become an LLC member in a broker-dealer entity by contributing a certain amount (usually about $25,000) to the firm as a separate deposit account. In most cases, the proprietary trader is assigned a subtrading account based on his or her own deposit paid into the firm, and the trader keeps 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 those losses to the trader's deposit account.

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, they would rarely do so because it is 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 other partners' income or the firm's overall gains and losses. 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 owner/managing members) 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 different type of class member (like Class B, C, or D) and only shares subtrading account gains and losses (the trading gains that he or she generate). 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, 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.

Most proprietary trading firms elect to use IRC § 475 mark-to-market accounting in connection with their proprietary trading activity in securities only (not commodities so they retain 60/40 treatment benefits). A few firms do not elect IRC § 475 and therefore have capital gains and loss treatment.

The key point to understand is that all tax status, elections and character of income, loss, and expense are determined on the entity level, not the individual level.

As a partner in a partnership for tax purposes, you are required to use the tax elections made on the entity level. You do not have to elect IRC § 475 MTM on your individual level, but you may want to if you have trading accounts outside of the firm on your own account.

The proprietary trading firm K-1 passes through the gains, income, losses, and expenses to the proprietary trader. Most firms won't pass through net losses, because the Class A members will take them on their tax returns—a tax benefit to Class A members—even though they may have charged those losses against your deposit.

Note: Trading gains are not earned income and pass through to your individual return on Schedule E (if MTM) or Schedule D (if capital gains without MTM). Only earned income is subject to self-employment taxes. LLC members therefore don't have to pay self-employment taxes as independent contracts and employee traders do (payroll taxes are the equivalent).

The good part of earned income is that you can set up a tax-deductible retirement plan and also deduct your health insurance premiums. LLC-member propriety traders can't form retirement plans and deduct health insurance premiums on their trading gains from the firm. Some proprietary trader LLC members do have earned income if they get mentor fees for training other traders, or commission overrides on recruited traders (make sure that is legitimate). If that is your case, ask your firm to break down earned income versus trading gains on your Form K-1.

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 accountable plans for reimbursing prop traders expenses outside of the firm. Make sure to use or lose these benefits before year-end.

If your firm does not have an accountable plan, then you can deduct all nonreimbursed expenses directly on your Schedule E, under where you report your ordinary income from MTM trading gains. You can also deduct home office expenses on Schedule E. These deductions are valuable.

Proprietary trading firms using the LLC model are only permitted by the SEC to allow individuals to join as LLC members. A firm may not permit another LLC or entity to join as a member; proprietary traders can't use entities like retail "customer" business traders for added tax benefits including retirement plans and health insurance plan deductions.

Note: Employee and independent contractor prop traders also may utilize retirement and health insurance plans. In this case, the LLC proprietary trader comes up short on some benefits.

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 firm's 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).

Deposits and How to Write Them Off on Tax Returns

Most proprietary trading firms require traders to put up a deposit when they join a firm. Most broker dealer prop firms require $25,000 or more, similar to the account size needed for a pattern day trading retail customer account. Nonbroker-dealer smaller proprietary trading firms allow smaller deposits and do not require brokerage licenses.

The proprietary trading firms claim that these deposits are segregated from capital accounts (for LLC members) or the subtrading accounts of independent contractors and employees. They claim that the leverage provided the trader is unrelated to the deposit amount. When we look closely, however, we think it is fairly related. It's a technical issue for the regulators.

Traders are usually required to replenish their deposits after the firms take the deposits to cover trader's losses on the firm's trading accounts. The question that often comes up is how to report (on tax returns) lost deposits that are not returned. A deposit can be lost in two ways:

1. When you leave a firm and the firm does not pay you back part or all of your deposit, usually because the firm applied your deposit against your losses in the firm, in accordance with your agreement. It can also happen if your firm goes out of business or simply chooses not to pay you back. Maybe, they just don't have the money.
2. You stay with the firm but you lose part of your deposit (the firm applies it to losses) and the firm requires you to replenish your deposit account to the original amount. The firm only gives you a deposit credit on their books for the original amount, not the replenished extra amount, which then is lost.

For example, if you deposit $25,000, lose money, and the firm takes that $25,000 entirely and you replenish it with another $25,000. To date you have paid $50,000 of deposits and the firm gives you credit on their books for a deposit of $25,000 only. How do you report the lost $25,000 deposit?

First determine if your firm allocated these losses to you on your Form K-1. As stated earlier, some firms do not allocate losses to proprietary trader LLC members and instead take the tax deduction themselves. If this happens, the good news is that in most cases you can take a business bad debt, an ordinary business loss. With this option, you can avoid the capital loss limitations of $3,000 on an individual tax return. So as soon as you pay in more then you are credited for on the firm's books, or you leave and don't get paid back the deposit on the books (or a portion thereof), that deposit loss can be a business bad debt if it's not a Form K-1 loss. LLC members report that business bad debt on Schedule E, when it's officially lost. Independent contractor prop traders report that business bad debt on Schedule C, when it's officially lost. You should consult with a proprietary trader tax expert first.

Nonresident Proprietary Traders

If you are not a U.S. citizen or resident (a nonresident) and are an LLC member of a U.S.-based prop trading firm, you owe U.S. taxes, whether you spend time in the U.S. or not. Your U.S. K-1 income is U.S.-source income on which you owe U.S. taxes. These same rules exist for investing in a U.S. hedge fund with trader tax status organized as a pass-through entity (LLC or LP). 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. proprietary firm and not on any other direct-access customer accounts or other types of income.

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

If a firm does not comply with these rules and fails to withhold taxes, the firm faces penalties. Some firms are rushing to set up international firms outside the United States for their nonresident members to join instead of their U.S. firms in order to avoid these tax withholding issues. International tax planning in this regard is complex, and some firms may not carefully address all tax treaty provisions.

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 trading gains, whereas the proprietary trader member of a U.S. LLC does owe U.S. taxes. Learn more about tax issues for nonresident traders in Chapter 1.

STATE RULES FOR REGISTERED INVESTMENT ADVISORS

Do independent contractor prop traders need to be concerned with state rules for registered investment advisors? The answer may be Yes, but this issue is widely overlooked. A proprietary trader is engaged by a proprietary trading firm as an independent contractor and paid nonemployee compensation for money management advice. How is this arrangement any different from what a money manager does, and should the registered investment advisor rules apply? The SEC and states have rules for registered investment advisors (RIAs). California rules for investment advisors require registration if you have even just one money management client who pays for your advice.

This situation begs an important question. Many proprietary trading firms are organized or operate branch offices in California. These California-based proprietary trading firms engage individuals who are residents of California to be independent contractor traders for their firm. Should those independent contractor proprietary traders in California register with the state of California as RIAs? What about all California proprietary trader independent contractors trading with any proprietary trading firm around the country, it may not matter if the proprietary trading firm is organized in California or has a branch office of presence in California. For California RIA purposes, it really only matters where the investment advisor lives and works. Thousands of proprietary traders live in California, so is this situation a new problem?

No one on the Internet or within these firms is currently addressing questions, but the conservative course would be to register with California as an investment advisor. LLC members may or may not face this same issue—employees do not.

CHAPTER SUMMARY

Proprietary trading firms (PTFs) offer traders a few different types of deals—employment, independent contractors, and LLC members. Each deal has different tax and legal pluses and minuses, and they vary greatly among the PTFs. A few terms and conditions are common. You usually are required to maintain significant deposits in a PTF before having access to trade the firm's capital—with far greater leverage than you could arrange as a retail pattern day trader. Your deposits are usually at risk for all your losses and expenses, and most tax and legal matters are stacked in favor of the firm. Yes, you have greater leverage, but you also have a big brother telling you what to do. That works great for some and not so good for others. At least you have some nice choices in the trading business thanks to the efforts of entrepreneurs in the PTFs.

A Word of Caution: There are rumors flying about the SEC and other regulatory bodies reviewing the practices of PTFs, and the consequences, if any, can hurt proprietary traders in these firms. You don't want to wake up one day and find out you no longer can trade and lost your deposit. Follow the stories at http://www.greencompany.com/PropTraders/Traders.shtml and in the free update website section for this book.