



Taxes for Traders
At the NY Traders Expo
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**Instructor: Robert A. Green, CPA/CEO
Green & Company CPAs, LLC**

info@greengreentrader.com; www.greentrader.com

(877) 662-2014 (toll-free), or (646) 216-8061

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Speaker Bio:

Robert A. Green

- **Robert A. Green, CPA, is CEO and founder of Green & Company CPAs, LLC (GreenTraderTax.com & GreenTraderFunds.com), a virtual tax and accounting firm catering to traders and investment management businesses; Green & Company Inc., a publishing company; and GTT Alliance for Traders, an advocacy alliance for traders.**

He is a leading authority on trader tax and hedge funds. Mr. Green writes the monthly "Business of Trading" section for *Active Trader* magazine. He is also the author of *The Tax Guide for Traders* (McGraw-Hill 2004), *Green's 2008 Trader Tax Guide* (W&A Publishing 2008) and the annual GreenTrader tax return examples guides. Mr. Green is frequently interviewed and has appeared in the *Wall Street Journal*, *Forbes*, *Fortune*, *Barron's*, brokerage firm newsletters, and many other media. Mr. Green has also appeared on CNBC, Bloomberg Television, Forbes.com Video Network, CBOT Webinars, and several radio shows. He is the main tax speaker at the TradersExpo, Forex TradingExpo, MoneyShow.com University and other trade shows.

Items for discussion:

- **Active securities, options, futures and forex traders can claim “trader tax status” (business treatment) on their tax returns; it’s still not too late for 2007 and 2008.**
- **Many business traders can file as sole proprietors using Schedule C, included with their Form 1040 individual tax returns.**
- **However, a separately filed trading entity is an option. It allows you to deduct health-insurance premiums, and retirement-plan contributions (AGI deductions).**

Items for discussion (continued)

- **Learn the key tax differences between trading securities, futures and forex. IRC 1256, IRC 475 and IRC 988 are different but dueling regulations.**
- **Foreign futures may not qualify for lower 60/40 tax breaks (1256 contracts).**
- **Forex and futures tax laws often intertwine and there are important elections to make on a timely basis, such as electing out of IRC 988 (ordinary gain or loss treatment on forex) for IRC 1256 60/40 tax treatment.**
- **If you hold a full membership on an options or futures exchange, your IRC 1256 trading gains are subject to self-employment taxes (IRC 1402i); otherwise, all trading gains are exempt from SE taxes.**

Trader tax status

- **Do you qualify for “trader tax status” (business treatment vs. the default investment treatment)?**
- **Business treatment gives full ordinary loss deductions (including home-office, education, start-up expenses, margin interest and much more), whereas investment expenses are very limited, only allowed in excess of 2 percent of Adjusted Gross Income (AGI), and not deductible at all against the Alternative Minimum Tax (AMT). AMT may be repealed in 2009.**
- **There are special rules for (pre-business) start-up expenses (IRC 195) and education.**

Qualifying for Trader Tax Status

- **A business trader meets most of the following qualifications:**
 - Trades full-time or part-time, all day every day.
 - Spends more than four hours per day, every day, with few sporadic lapses.
 - Makes more than 500 round-turn trades per year, but there is no magic number in case law. Futures trades are not listed line-by-line on your tax return (as securities trades must be).
 - Mostly day trades or swing trades, and few positions are held for more than a few weeks. Investment positions are segregated.
 - Has the full intention to run a business and act accordingly with formal record keeping.
 - Has significant business tools, business expenses and a home-office.

Qualifying for Trader Tax Status (Continued)

- **If your trading activity is anything less than the current golden rules stated above, it's wise to consider a consultation with a trader tax expert to review your particular facts and circumstances.**
- **Robert A. Green, CPA and our CEO handles these consultations for our clients.**
- **Green's 2008 Trader Tax Guide has good bullet points for qualification and several examples of close calls.**
- **You can claim trader tax status after year-end; it doesn't need to be elected in advance (like IRC 475 MTM).**

IRC 475 Mark-to-market accounting is “tax loss insurance”

- **IRC 475 MTM can be applied for securities traders only, and not for futures traders.**
- **Learn about IRC 475 mark-to-market (MTM) accounting (ordinary gain or loss treatment) and how to elect it on time.**
- **A trader can protect their capital with “tax loss insurance,” as MTM allows unlimited ordinary trading losses rather than restricted capital losses.**
- **Trader tax status is a prerequisite. It also applies on the entity-level in hedge funds and proprietary trading firms.**

IRC 475 MTM election procedures

- **IRC 475 is a three-step process (election, correct application, and filing a separate Form 3115 with an IRC 481[a] adjustment).**
- **Miss any of the three steps on a timely basis and the IRS can seek to deny your ordinary loss treatment.**
- **MTM exempts traders from wash sales.**

Net operating losses (NOL)

- **If a trader chooses, futures trading capital losses may be carried back three tax years and only applied towards futures trading gains in those years; and/or they may be carried forward.**
- **Securities capital losses may only be carried over to future tax years to offset capital gains.**
- **NOLs are comprised of your MTM ordinary trading losses and trading business expenses.**
- **NOLs may be carried back two tax years and/or forward 20 tax years.**
- **NOLs may offset any type of income in prior and future years, whether you were/are a business trader then or not.**

Don't get trapped with capital loss carryovers or wasted losses

- **One potential problem for traders is getting trapped with unused capital-loss carryovers or wasted trading losses.**
- **There are ways to limit the damage. It involves many complex and highly nuanced strategies.**
- **The net capital loss deduction allowed for individuals each tax year is \$3,000.**
- **Don't confuse this with the fact that you may apply your entire capital loss in the following tax year, providing you have sufficient capital gains to utilize them.**
- **Forex traders who lack trader tax status may waste their trading losses if they have negative taxable income. Unlike capital losses, which may be carried forward without regard to trader tax status, ordinary forex trading losses may only be carried back or forward as NOLs; and NOL treatment requires trader tax status.**
- **By electing out of IRC 988, forex traders can convert forex losses into capital losses; which can prevent wasted losses if you lack trader tax status.**

How do I claim trader tax status and prepare my tax returns?

- **Trader tax status is NOT elected with the IRS; rather you claim it on your own. Don't confuse this with IRC 475 MTM – that needs to be externally or internally elected on time.**
- **Assess your trader tax status before or after year-end. Since it's based on facts and circumstances, after year-end may be safer.**
- **If you qualify for trader tax status, and have not formed a separate legal entity, then you are classified as a “sole proprietor” or “unincorporated business.”**
- **Report your trading business expenses on Form 1040 Schedule C (Profit or Loss from Business).**
- **Home-office deductions are reported on Form 8829. Depreciation and amortization are reported on Form 4562. Both of these tax forms transfer their deductions to Schedule C; income is required for home-office deductions and IRC 179 (100 percent) depreciation.**

Trading gains and losses are reported on different tax forms

- **Futures trading gains and losses are reported on Form 6781, where the 60/40 treatment is applied.**
- **Securities trading gains and losses are reported on Schedule D (cash method). If you elect IRC 475 MTM, you report your trading gains and losses on Form 4797 Part II.**
- **Forex tax law is confusing and uncertain. See our Web site for more detailed information. Taxpayers can navigate between ordinary gain or loss, capital gain or loss, or futures 60/40 treatment.**

Transfer strategy and footnotes

- **Transfer business trading gains (from futures Form 6781, or forex line 21 or securities Schedule D or Form 4797) to Schedule C to unlock home-office deductions and IRC 179 depreciation. Both of these deductions require income. But do not show a profit on Schedule C (it could invite IRS questions about SE tax).**
- **It's important to attach a good tax return footnote explaining your trader tax status and tax treatment on your return.**
- **You can even amend prior year tax returns to claim trader tax status.**

Trade accounting is a snap for futures & most forex traders

- **Futures traders receive a Form 1099-B showing “Aggregate Profit or Loss,” which includes realized and unrealized gains and losses.**
- **Forex traders usually receive an online report from their broker showing net forex trading gain or loss. Brokers are not supposed to issue a Form 1099 for forex trading gains and losses.**
- **Securities traders receive a more complex Form 1099-B, which only reports proceeds; it does not report net trading gains and losses.**

Accounting is more difficult for securities traders

- **Securities traders should simplify their trade accounting with special trade accounting software, like our GTT TradeLog.**
- **Download your trades into the program. It works with most brokerages.**
- **Securities traders can attach the GTT TradeLog report to be in compliance with the new IRS rule forcing line-by-line reporting for securities only.**
- **Learn how to use the GreenTrader Worksheets and Formulas for annual trade accounting; it may be your last resort for forex and other accounting. It's a simple way to count the forest rather than each tree in the forest.**

Futures and electing forex traders have lower "60/40" tax rates

- **Learn how to pay up to 12-percent lower tax rates with futures (IRC 1256 contracts).**
- **Securities are taxed at ordinary tax rates up to 35 percent, whereas futures are subject to lower 60/40 tax rates (60 percent of capital gains are taxed at lower long-term rates, even for short-term trades, while the other 40 percent are ordinary rates).**
- **Learn the varying tax treatment for:**
 - **Securities (stocks, equity options, mutual funds, bonds, ETFs, single-stock futures and narrow-based indices);**
 - **Commodities & futures (regulated futures contracts, broad-based indices, options on indices, and non-equity options);**
 - **Forex, foreign futures, and precious vs. base metals.**

Forex has special tax rules

- **Learn the special rules for forex, including how to elect out of IRC 988 (ordinary gain and loss treatment) for the more tax-beneficial 60/40 treatment of futures IRC 1256.**
- **Taxation of forex is confusing and uncertain in the tax code, and that makes tax filings difficult for forex traders.**
- **The tax problem is that some types of forex are treated as IRC 1256 contracts with lower 60/40 tax treatment and other types of forex are treated as IRC 988 foreign currency transactions with ordinary gain or loss treatment.**
- **Plus, IRC 1256 and IRC 988 are dueling and conflicting tax code sections.**
- **See the forex tax rules at www.greentradertax.com. Robert Green recently published a new article in February, 2008.**

How to elect IRC 475 MTM accounting

- **IRC 475 MTM can be elected for securities only; so you can exclude futures from IRC 475, in order to retain 60/40 treatment on futures.**
- **Trader tax status (the pre-requisite for IRC 475) is determined after year-end, but IRC 475 must be timely elected.**
- **Existing individuals and partnerships must elect IRC 475 MTM with the IRS by April 15 of the current tax year (March 15 for S-corporations).**
 - **Example: If you want to elect MTM for your sole proprietor trading business for tax year 2008, you must file an election with the IRS by April 15, 2008.**

The IRC 475 MTM election process

Step 1: The timely MTM election

- **Three steps are necessary for electing IRC 475 MTM accounting.**
- **The 1st step is filing a timely election statement with the IRS.**
- **Attach and file the MTM election statement with your prior year tax return or extension. If you make any mistakes or file the election late, you will not be able to use MTM for the current year.**
- **“New taxpayers” (entities) may file their MTM election (resolution) in their own books and records within 75 days of entity inception.**

IRC 475 MTM Step 2: Qualify for trader tax status

- **The 2nd step in the MTM election process is to make sure you qualify for trader tax status in the year of the election. Unless you qualify for trader tax status, you are not eligible to use MTM accounting, even if you filed a timely MTM election by April 15.**
- **If you do in fact qualify for trader tax status and have timely elected MTM, you will need to calculate and report an IRC Section 481(a) adjustment on your current year tax return and on Form 3115.**
- **The Section 481(a) adjustment is the unrealized gain/loss on securities held in your trading business as of the end of the prior tax year. Since IRC 1256 contracts already include year-end unrealized gains and losses, there is no IRC 481(a) adjustment for futures traders.**

MTM Step 3: Filing Form 3115 with 481(a) adjustment

The 3rd and final step to complete the change in your accounting method from cash to IRC 475 MTM is filing a Form 3115 (Change of Accounting Method) with your current year tax return. You must also file a duplicate copy with the IRS National Office.

- **Example: You elected MTM for tax year 2007 by April 15, 2007 with the filing of your 2006 tax return or extension. You will need to complete and file a Form 3115 with your 2007 tax return by the due date of the 2007 tax return, including extension. Therefore, the Form 3115 is due by Oct. 15, 2008 if your 2007 tax return has been extended.**
- **If you are a “new taxpayer” (new entity), you are adopting MTM rather than changing your accounting method, so you don’t have to file a Form 3115.**

Entities, retirement plans and health-insurance premiums

- **Entities are helpful for traders and are required for forex and commodity funds. Traders don't need liability protection, but money managers do.**
- **One size doesn't fit all when it comes to entities. Don't go with canned solutions; work with a trader tax expert to pick the best entity for your special needs. It varies by state and there are other factors to consider, too.**
- **Learn the differences between in-state and out-of-state entities. Tax-free states market entities for "asset protection" and tax-avoidance reasons, but both usually fail in practice. If you live and work in your home state, you need to register a foreign entity in that state. It's different for funds.**
- **Most traders don't have earned income from trading, so in order to contribute to a retirement plan they need to form a trading entity.**

Entities, retirement plans and health-insurance premiums (cont.)

- **Learn the self-employment (SE) tax rules for traders (see below).**
- **Learn about different types of entities and retirement plans, and how to choose the best ones for your situation. Multi-member LLCs, general partnerships and S-Corps are good for traders. C-Corps are bad for traders (double taxation, losses are trapped in the entity and there is no 60/40 treatment on futures).**
- **Mini 401(k) retirement plans can generate the most tax savings for traders. Defined-benefit plans and Roth IRAs are also good.**
- **If you missed the April 15 deadline for electing IRC 475 MTM, consider setting up a new entity. A “new taxpayer” (i.e., a new entity) elects MTM internally within 75 days of its inception.**

Self-Employment (SE) Tax

- **A lot of online traders are exempt from SE taxes, which are equivalent to payroll taxes in a job situation (FICA and Medicare).**
- **SE taxes are 15.3 percent of the base amount (\$97,500 for 2007 and \$102,000 for 2008) and 2.9 percent (Medicare only) thereafter.**
- **Traders are exempt from SE tax because trading gains are not considered “earned income,” whether or not you have trader tax status or use MTM. SE tax is assessed on earned income only.**

SE tax exceptions for members & special tax strategies

- **There are two exceptions to the SE tax rules for traders:**
 - **Traders who are members of an options or futures exchange are deemed to have earned income on all their exchange-generated IRC 1256 trading gains (IRC 1402i). Many futures traders on the floor of Chicago exchanges may meet this exception and owe SE tax on their trading gains.**
 - **Proprietary traders who receive a Form 1099-Misc. for non-employee compensation are considered to have earned income.**
- **The GreenTraderTax entity/retirement plan strategies are designed to maximize income tax savings vs. SE tax costs. We can cover entities and retirement plans in a future Webinar.**

Questions and Answers

Instructor: Robert A. Green, CPA/CEO
Green & Company CPAs, LLC
info@greencompany.com;
www.greentradertax.com
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