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A Trader Tax Review

The IRS is turning up the heat on traders, small business taxpayers, the upper-income class, pass-through entities, offshore entities, and more. It's crucial to know the ins and outs of trader tax law. With tax rates headed higher, not claiming and electing your rightful trader tax breaks can cost you a fortune. Don't miss out on trader tax status if you do in fact qualify; and if you don't, learn about the other tax savings available to you.

Trader Tax Status

Qualifying for trader tax status unlocks hefty tax savings for traders. It allows you to use business tax treatment as opposed to investor tax treatment, opening the door to tax savings. For example, only business traders can deduct home-office expenses and travel costs associated with trading seminars; investors may not. Also, margin interest is a fully deductible business expense with trader tax status, whereas it's only deductible as investment interest under investor tax status. Investment expenses are very limited, only allowed in excess of 2% of adjusted gross income (AGI), and not deductible against the alternative minimum tax (AMT).

The average trader saves more than $10,000 with trader tax status. You can still claim trader tax status for the tax year that just ended and even for the prior three tax years by filing amended returns. Unlike other aspects of trader tax benefits, trader tax status does not need to be elected in advance.

Qualifications

IRS Publication 550 Chapter 4 Special Rules for Traders states: The following facts and circumstances should be considered in determining if your activity is a securities trading business.

- Typical holding periods for securities bought and sold.
- The frequency and dollar amount of your trades during the year.
- The extent to which you pursue the activity to produce income for a livelihood.
- The amount of time you devote to the activity.

Full-time traders generally qualify quite easily for trader tax status. Part-time traders can also qualify, however it is often more difficult to convince the IRS of their trader status (especially if they have losses).

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 500 (or more) round-turn trades per year (note that there is no magic number in case law). Forex and futures trades are not listed line-by-line on tax returns (as stock trades are), so the IRS cannot see the number of forex or futures trades.
- 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, business plans, and other documentation.
- Have significant business tools, business expenses, and a home office.
- Has a material account size.

Number of round trip trades, frequency of trades, average holding period, and number of days on which trades were executed vs. total available trading days are the biggest bones the IRS picks. These qualifications are easy to analyze and verify. Conversely, number of hours per day and intention are subjective and hard to prove by the IRS. Indeed, IRS agents are carefully scrutinizing those who elect trader tax status and might not meet all of the qualifications above. Traders who are a "close call" on trader tax status should calculate the tax scenario both with and without it. If you decide the best course of action is to do without it, you are still eligible for many import tax breaks.

If You Don't Qualify

All traders and investors may benefit from significantly lower income tax rates on trading Section 1256 contracts. These contracts enjoy a 60/40 treatment, meaning 60% of gains or losses are taxed as long-term capital, and 40% are taxed as short term. Section 1256 contracts include regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and dealer securities futures contracts.

If you are a part-time trader and you don't have many trading expenses, or you can deduct most of your general business expenses in another manner (as investment expenses without much of a haircut or in another business activity), consider skipping trader tax status.

Also, most traders are exempt from the self-employment (SE) tax (15.3% of the first $106,800 — the 2009 base amount — of earned income and 2.9% thereafter). There are a few exceptions, such as those who trade futures as a member of a futures or options exchange. Their trading gains are considered self-employment income.

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Also, if you don't qualify, keep in mind excess investment interest expense and capital losses may both be carried over to subsequent tax years, so they are not officially lost. Practically speaking, they may not be very useful if the trader has little capital to risk in the markets to generate capital gains. At least interest income and dividends are investment income, which can provide the means for carryover investment interest expense deductions.

Forming an Entity

If you feel you qualify, then you should look into creating a separate trading entity (used only for trading). The entity will help you to claim trader tax status, elect Section 475f MTM (marked to market) later in the year, and have the key AGI deductions for health insurance premiums and retirement plans. Also, the IRS won't see your W-2 or other business activity because the entity tax return is filed separately.

We recommend a simple pass-through entity such as a husband-wife general partnership, or a single-member LLC in your home state electing S-Corp. tax status. How does this work? The entity pays an administration fee; turning non-SE trading income into SE earned income. An administration fee is not subject to payroll tax compliance, unemployment insurance, and workmen compensation payments.

Once you have a trading entity or a rock-solid unincorporated Schedule C for your trading business, you can consider deducting your Section 195 start up costs, including some or all of your trading school and seminar costs. These costs can be amortized over 180 months and there is a $5,000 first-year expense election too.

Bottom Line

I've just scratched the surface with the trader-tax information presented here. There are many more rules, nuances to the tax law, and breaks for traders. It's a good idea to discuss your situation with a trader tax expert. Don't miss out on all the tax breaks you are entitled to.

To learn more about trader tax benefits see Mr. Green's videos and webcasts at www.MoneyShow.com