



**Tax Benefits for Active Traders  
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# Speaker Bio:

## Robert A. Green (1/2)

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- **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; and Green & Company Inc., a publishing company.**
- **Robert Green is a leading authority on trader tax and investment management businesses. Mr. Green writes the "Business of Trading" column for *Active Trader* magazine. He is also the author of *The Tax Guide for Traders* (McGraw-Hill 2004), *Green's 2009 Trader Tax Guide* (W&A Publishing 2008) and the annual GreenTrader tax return examples guides.**

## Speaker Bio: Robert A. Green (2/2)

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- **Mr. Green is frequently interviewed and has appeared in *Barron's*, the *Wall Street Journal*, *Forbes*, *Fortune*, *Fidelity* and other brokerage firm newsletters, and many other media.**
- **Mr. Green has also appeared on CNBC, Bloomberg Television, Forbes.com Video Network, Webinars for CBOT and many brokerage firms, and several radio shows. He is the main tax speaker at the TradersExpo, Forex TradingExpo, MoneyShow.com University and other trade shows. Mr. Green hosts a free weekly conference call at [www.greentradertax.com](http://www.greentradertax.com).**

# Overview:

## Trader Tax Status

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- **Active traders in securities, futures/commodities, or forex can claim “trader tax status” (business treatment) on their tax returns.**
- **Qualifying business traders are treated as sole proprietors by default, and they don’t need to file forms or elections to claim this status with the IRS in advance. They simply include a Schedule C (Profit and Loss from Business) with their Form 1040 individual tax returns.**
- **It’s still not too late for 2008 and 2009. Traders can also file amended tax returns to claim this status for any of the three prior tax years.**

# Overview:

## Entities for Traders (1/2)

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- **Separately filed trading entity tax returns are better options for business traders, rather than filing Schedule Cs.**
- ***Reduce red flags:* Entity tax returns significantly reduce IRS challenges on trader tax status. The IRS recently denied trader tax status in a key tax court case (*Holsinger vs. Commissioner*) and qualification is becoming a bigger concern for traders.**
- ***AGI-deductions:* Entities also provide more opportunity for tax savings, like AGI-deductions for health-insurance premiums and retirement-plan contributions.**

# Overview:

## Entities for Traders (2/2)

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- ***Late year MTM elections:*** Newly formed entities are “new taxpayers” which may elect Section 475 MTM treatment later in the year. If a trader misses the April 15<sup>th</sup> external MTM election deadline, they can still get ordinary loss treatment by forming a new entity later in the tax year. Use entities to best manage application of capital loss carryovers and/or to generate new ordinary losses.
- The best types of entities for traders are general partnerships, multi-member LLCs (filing partnership returns), or S-Corporations (best for single owners). C-Corporations have many pitfalls.
- A pass-through entity is simple and easy to form at low cost in most states.

# Overview:

## Tax Treatment (1/2)

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**There are key tax treatment differences between:**

- **Trading securities (stocks, stock options, bonds, mutual funds, single stock futures and more);**
- **Stock options (securities) and narrow-based index options (securities) versus broad-based index options (futures);**
- **ETFs based on securities versus ETFs based on commodities (futures), and options on ETFs (unclear, but probably futures);**

# Overview:

## Tax Treatment (2/2)

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- **Domestic futures (with 60/40 treatment) versus foreign futures (often without 60/40 treatment, unless the foreign exchange received an approval letter from the CFTC);**
- **Forex spot, forward and OTC option contracts by default have Section 988 ordinary gain or loss treatment. Traders may file an internal “capital gains election”;**
- **Precious metals have the higher “collectibles” tax rate (28%) and there are nuances versus base-metals (commodities).**

# Overview: Elections

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## Key tax elections for traders to make on a timely-basis:

- **Qualifying business traders (only) may file a timely Section 475(f) MTM election, for ordinary loss treatment (then exempt from capital loss and wash sale limitations).**
- **All futures traders may elect to carry back futures losses three tax years; but only applied against futures gains.**
- **All forex traders may elect to opt out of Section 988 (ordinary gain or loss treatment) into Schedule D (capital gains and loss treatment). On forex forwards - and perhaps spot contracts in major currencies too - lower 60/40 treatment is possible.**

# Trader Tax Status & Benefits

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- **Highly-active traders may 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 reformed or repealed in 2009.**
- **There are special rules for (pre-business) start-up expenses (IRC 195), education and home-office expenses.**

# Golden Rules: Qualifying for Trader Tax Status (1/4)

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**Business traders need to meet all the below requirements to qualify for trader tax status:**

- ***Job:*** Trades full-time, or part-time like another fulltime job. West Coast traders often trade early in the day before going to a job. East Coast traders may trade forex at night. There are several examples in Green's 2009 Trader Tax Guide.
- ***Frequency:*** Executes trades on more than 75 percent of available trading days, in a consistent, frequent and continuous manner, with no sporadic lapses. *Holsinger* lost his tax court case with only 45 percent of available trading days.

# Golden Rules: Qualifying for Trader Tax Status (2/4)

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- ***Hours:*** Spends more than four hours per day, every day.
- ***Volume:*** Makes close to 500 or more round-turn trades per year. The IRS can easily verify this factor and they overweight it in their analysis.
- ***Taxable activity:*** Only trading in taxable accounts counts for trader tax status. Trading in retirement plan accounts does not qualify, although it can be a good idea too.
- ***Holding periods:*** Mostly day trades or swing trades, and few positions are held for more than a few weeks (which is more understandable for option strategies). Investment positions are properly segregated.

# Golden Rules: Qualifying for Trader Tax Status (3/4)

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- ***Intention:*** Has the intention to run a business-activity; to make a living from trading, and acts accordingly with formal record keeping and planning.
- ***Resources:*** Has significant business tools (like multiple computers and monitors), business expenses (trading services), training, and a home-office.
- ***Account size:*** Has a material account size for staging a serious business effort. For example, \$25,000 to be a “pattern day trader” in securities. A mini forex account of \$5,000 is too low to impress the IRS on trader tax status.

# Golden Rules: Qualifying for Trader Tax Status (4/4)

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- **Traders falling short of these golden rules should consult with a trader tax expert.**
- **Robert A. Green, CPA handles these consultations for clients of GreenTraderTax. Simply contact us to schedule a phone appointment with him right away.**
- **Green's 2009 Trader Tax Guide expands on these bullet points and it includes lots of examples of close call business traders. It's available at <http://www.greencompany.com/Traders/Guides.shtml>.**
- **An entity is better for claiming trader tax status, since the IRS raises the bar on the golden rules for part-time individual traders.**

## Business traders may elect 475(f) Mark-to-Market (MTM) (1/4)

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- **Qualifying business traders should generally timely-elect Section 475 MTM accounting treatment on securities only.**
- ***Report unrealized gains and losses:* Section 475 MTM imputes sales on open positions at year-end in business positions in securities only; not on segregated investment positions in securities too. This is usually not a factor for day traders with no positions open at year-end.**
- ***Tax loss insurance:* The more important element of Section 475 MTM is ordinary gain or loss treatment. The biggest pitfall for traders is getting stuck with capital loss carryovers, wasted losses and wash sales and this is solved with MTM.**

## Business traders may elect 475(f) Mark-to-Market (MTM) (2/4)

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- **MTM accounting is also much easier than cash accounting, since there are no open positions or loss deferrals.**
- **Short-term capital gains – which securities business traders have anyway - are taxed at ordinary tax rates; so there is no difference on gain treatment with MTM.**
- ***Recommended for securities only:***  
**Unless a trader has a capital loss carryover, they should generally elect Section 475 MTM on securities only, and not on futures too.**

## Business traders may elect 475(f) Mark-to-Market (MTM) (3/4)

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- **Section 475 MTM is free tax loss insurance for securities traders; but expensive for futures traders, who want to retain lower 60/40 tax rates (in Section 1256).**
- **Futures traders can benefit from Section 475 MTM ordinary loss treatment too, but they then must give up lower 60/40 tax treatment on subsequent year gains.**
- **Section 1256 includes an election to carry back futures losses three tax years, but only against futures gains.**

## Business traders may elect 475(f) Mark-to-Market (MTM) (4/4)

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- ***Warning & Problem:*** Capital loss carryovers may only be applied against subsequent year capital gains and not Section 475 MTM trading gains. For this reason, far too many traders skip MTM elections, thinking they will generate capital gains to use up capital losses. Only they often generate even more unutilized capital losses.
- ***Solution:*** Use an internal MTM election in a new entity to reduce the gamble in filing a MTM election. Elect MTM to lock in new ordinary losses and form another new entity for a “do over election”; for example with the cash method to use up prior capital loss carryovers. Without entities, traders are stuck with MTM until they exit their individual trading activity.

# Section 475(f) MTM Election Procedures (1/4)

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- ***Procedure:* Section 475(f) MTM is a three-step procedure:**
  - **Timely-election statement made early in the tax year;**
  - **Correct application of MTM on tax return filings;**
  - **and filing a separate Form 3115 (Change of Accounting Method) - including an IRC 481[a] adjustment) - with the regular tax return filing (and in duplicate).**
- ***IRS technicalities:* Miss any of these three steps on a timely-basis and the IRS will seek to deny ordinary loss treatment; and there are no excuses or relief allowed.**

## Section 475 MTM

### Step 1: timely election statement (2/4)

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- **The 1<sup>st</sup> step is filing a timely election statement with the IRS.**
- **Existing individuals and partnerships must elect Section 475 MTM with the IRS by April 15 of the current tax year (March 15 for S-corporations).**
- **Attach and file the MTM election statement with the prior year tax return or extension.**
  - **For example, elect MTM for 2009 by attaching the election statement to the 2008 tax return or extension, filed by April 15, 2009.**
  - **New taxpayer's elect internally within 75-days of inception.**

## Section 475 MTM

### Step 2: Correct application (3/4)

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- **The 2<sup>nd</sup> step in the MTM election process is to make sure you qualify for trader tax status in the year of the election; otherwise you can't use Section 475.**
- **If you do in fact qualify for trader tax status and have timely elected MTM, you will need to calculate and report a 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 Section 1256 contracts already include year-end unrealized gains and losses, there is no IRC 481(a) adjustment for futures traders.**

## Section 475 MTM

### Step 3: Form 3115 & 481(a) adjustment (4/4)

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**The 3<sup>rd</sup> and final step to complete the change in your accounting method from cash to Section 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 2008 by April 15, 2008 with the filing of your 2007 tax return or extension. You will need to complete and file a Form 3115 with your 2008 tax return by the due date of the 2008 tax return, including extension. Therefore, the Form 3115 is due by Oct. 15, 2009 if your 2008 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.**

## Immediate Tax Refunds Using Net Operating Loss Carry Backs (1/2)

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- **Net Operating Losses (NOLs) are comprised of business losses; which include Section 475 MTM (securities and/or futures) and Section 988 (forex) ordinary trading losses and trading business expenses.**
- **Business losses offset current year income of any kind (portfolio, capital, business or passive).**
- **NOLs arise in a negative taxable income situation. At that point, many deductions are wasted, unless they are carried over to subsequent years, like home-office, investment interest and charitable contribution expenses.**

## Immediate Tax Refunds Using Net Operating Loss Carry Backs (2/2)

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- **NOLs are carried back two tax years, unless the taxpayer timely-elects to forgo the carry back to carry it forward instead (and it must be used up within twenty years).**
- **After carrying back an NOL two tax years - oldest year first is a must - any remaining NOL amount is carried forward.**
- ***Warning:* If a trader is a “close call” on trader tax status, it’s wiser to forgo the NOL carry back and utilize the NOL in subsequent tax years.**
- **NOL carry back refund claims attract much more IRS-attention and can lead to an IRS exam; where the IRS seeks to deny trader tax status and all these related benefits. NOL carry forwards are much safer.**

## Don't Get Trapped with Capital Loss Carryovers

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- **The biggest tax pitfall for traders is getting trapped with unused capital loss carryovers and wasted trading losses.**
- **Most problems occur when traders are uneducated on available elections and strategies in starting their trading activity.**
- ***Section 475(f) MTM elections:* If a business trader has a large current year-to-date trading loss as of April 15, it's wise to elect Section 475 to lock in ordinary loss treatment; even on futures too.**
- **Next, form a new entity for a “do over” internal Section 475 election (decision) for the balance of the year.**

## Don't Get Trapped With Wasted Forex Losses

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- **Forex traders start off in Section 988 with ordinary gain or loss treatment, whether they have trader tax status or not.**
- ***Potential problem for non-business forex traders:* Ordinary losses offset income of any kind. But, if forex losses are significant and other taxable income is low, there will be a large amount of permanently-wasted negative taxable income. Conversely, with trader tax status, forex ordinary losses are business losses for NOL treatment.**
- ***Solution:* Non-business forex traders should consider an internal capital gains election, to have capital loss carryover treatment.**

# How to claim trader tax status and prepare business trader tax returns?

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- **Assess 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; and income is required for home-office deductions and IRC 179 (100 percent) depreciation.**

# Trading gains and losses are reported on different tax forms

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- **Futures trading gains and losses are reported on Form 6781, where the 60/40 treatment is applied; before moving over to Schedule D.**
- **Securities trading gains and losses are reported on Schedule D (cash method). If you elect Section 475 MTM, you report your trading gains and losses on Form 4797 Part II (ordinary gain or loss treatment).**
- **Section 988 forex is reported on line 21 Other Income of Form 1040, or Form 4797 for business forex traders. If you file the internal capital gains election, use Schedule D (and/or Form 6781 first).**

## Problem and Solution: Transfer of income strategy (1/2)

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- ***Problem:*** Only trading business expenses are reportable on Schedule C, whereas all trading gains and losses are reported on other tax forms. So there is no revenue on Schedule C and it looks like a losing business, even if the trader is highly profitable.
- ***Red flag:*** The IRS will think a trader has a losing business activity with no business revenue reported on Schedule C. The IRS may then seek to challenge trader tax status and business treatment; thereby jeopardizing business expenses, as well as Section 475 MTM ordinary loss treatment on Form 4797.

## Problem and Solution: Transfer of income strategy (2/3)

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- ***Solution:*** Tie the trading business tax forms together by transferring business net trading gains only (not investment capital gains) to Schedule C in an attempt to “zero out” Schedule C.
  - If a trader does not have enough business trading gains to zero out Schedule C, transfer all business trading gains to at least reduce the Schedule C loss amount; and perhaps free-up some home-office deduction.
  - If a trader does have enough business trading gains to zero out Schedule C, transfer only enough business trading gains to zero out Schedule C, and no more.

## Problem and Solution: Transfer of income strategy (3/3)

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- **No SE tax:** Do not show a net income on Schedule C, as that could invite IRS questions about SE tax. Only futures traders who are members of futures or options exchanges owe SE tax.
- **Unlock more deductions:** Zeroing out Schedule C unlocks the home-office and 179 depreciation deductions; both of which require income. Section 179 can look to wages too.
- **Warning, it's not in the tax forms:** This transfer of income strategy is not included in any tax forms or instructions. It's our customary practice.
- **Footnotes:** It's important to attach a good tax return footnote explaining your trader tax status, tax treatment and this transfer strategy.

## Trade accounting is a snap for futures & most forex traders (1/3)

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- **Futures traders receive a simple one page Form 1099-B showing summarized “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 gains or losses. Forex brokers are not supposed to issue a Form 1099 for forex trading gains and losses; but a few do.**
- **Futures and forex traders use summary reporting and they don’t need to use trade accounting software; whereas, securities traders need third-party software for line-by-line reporting.**

## Trade accounting is a responsibility for securities traders (2/3)

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- **Securities traders receive a more complex Form 1099-B, yet it does not provide net trading gain or loss information.**
- **Securities traders need to use line-by-line trade accounting reporting on their tax returns.**
- ***Problem:* Under current tax law, a securities 1099-B only reports proceeds on the sales of securities. It does not report cost basis, holding periods, options, wash sales, or net trading gains and loss information.**
- ***Improved 1099-Bs on the way:* Effective in 2011, securities brokers must add the following to 1099-B reporting of covered securities: average cost basis; and short-term versus long-term holding period information.**

## Trade accounting for securities is easier with the right software (3/3)

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- **Securities traders should simplify their trade accounting needs by using specialized trade accounting programs. See <http://www.greencompany.com/Traders/Software.shtml>.**
- **Consumer tax preparation and money programs have basic trade accounting capability, but they are not adequate or robust enough for business traders.**
- **Download and match your trades from most brokerage firms into specialized trade accounting programs.**
- **Then attach their Schedule D-1 or Form 4797 IRS-compliant reports to tax return filings.**

## Tax Treatment: Futures "60/40" tax rates (1/7)

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- **Section 1256 contracts (US-exchange futures and commodities) are subject to lower 60/40 tax rates.**
- ***60/40 tax rates:* 60 percent of capital gains are taxed at lower long-term rates (up to 15 percent for 2008), even for short-term trades, while the other 40 percent are ordinary rates (up to 35 percent for 2008).**
- ***Up to 12 percent less:* The highest blended tax rate for 60/40 is 23 percent in 2008; that's 12 percent lower than the highest marginal ordinary tax rate of 35 percent in 2008 which applies to all short-term trades in securities.**

# Tax Treatment: Futures & Commodities (2/7)

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- **Section 1256 contracts include: commodities and futures on U.S. exchanges; foreign futures where the foreign exchange received a CFTC approval letter; broad-based indices (defined as being made up of 10 or more securities), options on indices, non-equity options; ETFs based on commodities or futures; and (many tax professionals also think) options on ETFs.**
- **Section 1256 contracts are automatically marked-to-market each day and at year-end, so there are no wash sales. It's not dependent on trader tax status.**

# Tax Treatment: Securities (3/7)

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- **Securities include:**

**Stocks, equity options, mutual funds, bonds, ETFs based on stocks, single-stock futures and narrow-based indices (a narrow-based index is defined as being made up of nine or fewer securities).**

- **Single stock futures are confusing, since the term has both stock and futures. Because a single stock future is based on one underlying stock, it's treated like a stock.**

# Tax Treatment: ETFs (4/7)

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- **ETFs are normally treated as securities, even though the ETF may include more than 10 securities. There is an exception if the ETF is based on commodities or futures, then it's taxed like a future.**
- **Gold ETFs based on holding underlying physical gold (warehouse receipts) use the 28 percent collectibles tax rate (2008) if held long-term.**
- **The IRS has promised but not yet issued guidance on options on ETFs. Most accountants and tax lawyers believe they can be treated like futures.**

## Tax Treatment: Forex contracts (5/7)

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- **Forex includes spot, forward, and OTC option contracts traded in the interbank foreign-exchange market, which is off-exchange.**
- **Spot settles in less than two days and forwards settle after two days.**
- **Forex spot, forward and OTC option currency contracts are subject to Section 988 foreign currency transaction rules with ordinary gain or loss treatment.**

## Tax Treatment:

### Forex opt-out election into 60/40 (6/7)

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- **Speculators who trade forex as a capital asset may file a (good to cancel) contemporaneous internal election to opt-out of Section 988 (capital gains election) into Schedule D capital gains and losses treatment.**
  - **With this opt-out election, Section 1256(g) allows forex forwards (and probably forex spot contracts in major currencies too) to use 60/40 tax rates.**
  - **Forex OTC options are barred from Section 1256 60/40 treatment (IRS Notice 2007-71).**

# Tax Treatment: Forex Miscellaneous (7/7)

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- **Foreign currency futures on US exchanges are Section 1256 contracts.**
- **Forex taxation rules are vague and beyond the scope of this presentation. Section 1256 and Section 988 are dueling and conflicting tax regulations.**
- **Forex traders should consult a forex tax expert like Robert A. Green, CPA.**
- **See more information on forex tax rules at <http://www.greencompany.com/EducationCenter/GTTRecCurrency.shtml>.**

# Entities For Traders (1/3)

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- **Entities are recommended for traders and are required for investment management businesses. 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 probably need to register a foreign entity in that state. It's different for funds, which are usually formed in Delaware.**

## Entities For Traders (2/3)

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- **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 and use it to "financially-engineer" an administration fee (earned income).**
- **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).**

## Entities For Traders (3/3)

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- **General partnerships between spouses are a good choice in many states because they are the most inexpensive to form and maintain.**
- **LLCs and S-Corps have state filing fees and most states have annual report charges, minimum taxes and/or franchise taxes. These costs vary by state and are fairly low in most states.**
- **Single-Member LLCs are “disregarded entities,” a tax nothing in the eyes of the IRS. Consider electing S-Corp status.**

## Retirement Plans For Traders (1/2)

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- **Mini 401(k) retirement plans can generate the most tax savings for traders.**
- **Profit-sharing plans, such as a SEP IRA, limit “defined contributions” to 20 percent (net) of earned income.**
- ***A Mini 401(k) plan is better.* It adds an “elective deferral” [401(k) element] to a profit-sharing plan. For the maximum allowed contribution of \$45,500 (for 2008), you can reduce earned income by approximately \$65,000 by investing in a Mini 401(k) plan. That saves on SE tax.**

## Retirement Plans For Traders (2/2)

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- **With a Mini 401k, traders save about \$1,900 per year in SE taxes (2.9 percent Medicare portion) vs. a regular profit-sharing plan.**
- **Mini 401(k) plans also have a catch-up provision for taxpayers 50 or older (\$5,000), and some custodians allow plan loans.**
- **Mini 401(k) plans must be established before year-end, whereas a SEP IRA can be established up until the due date of the tax return including extension.**
- **The GreenTraderTax entity/retirement plan strategies are designed to maximize income tax savings vs. SE tax costs.**

# Self-Employment (SE) Tax (1/2)

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- **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 (\$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 Traders (2/2)

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- **There are two exceptions to SE tax exemption rules for traders:**
  - **Futures traders who are members of an options or futures exchange are deemed to have earned income on all their exchange-generated Section 1256 trading gains (IRC 1402i).**
  - **Proprietary traders who receive a Form 1099-Misc. for non-employee compensation are considered to have earned income.**

# Contact Information

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