Green's 2010 Trader Tax Guide

The Savvy Trader's Guide to 2009 Tax Preparation & 2010 Tax Planning

by Robert A. Green, CPA

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About the Author

Robert A. Green is a CPA and founder and CEO of Green & Company Inc. (GreenTraderTax.com and GreenTraderFunds.com), a publishing company, and Green & Company CPAs, LLC, a virtual tax and accounting firm catering to traders and investment management businesses. He is a leading authority on trader tax. Mr. Green writes the "Business of Trading" section for *Active Trader* magazine. He is also the author of *The Tax Guide for Traders* (McGraw-Hill, 2004) and the annual GreenTrader tax return example guides. Mr. Green is frequently interviewed and has appeared in the *Wall Street Journal*, *Forbes*, *Fortune*, and *Barron's*. Mr. Green has also appeared on CNBC, Bloomberg Television, and Forbes.com Video Network. He is the main tax speaker at the MoneyShow University, Traders Expo, Forex Trading Expo, and other trade shows. Mr. Green is also founder and CEO of the GreenTraderTax Traders Association. You can find more information about Mr. Green, his company's services and products, and taxes for traders at www.greencompany.com.

About Green & Company

Green & Company is a full-service tax firm dedicated to the needs of all types of clients, successfully helping traders since 1983. The GreenTraderTax division is solely dedicated to the needs of traders. It provides tax preparation and planning services, accounting, consultations, entity formations, retirement-plan services, and IRS/state tax exam representation services. The GreenTrader Hedge Fund Services division is dedicated to the needs of hedge funds, money managers, and other types of funds. It provides start-up and business services, operations and compliance, accounting services using specialized software, and tax planning and preparation. Green & Company offers extensive free educational resources on its Web site, including a blog covering the latest tax topics, conference calls, podcasts, videos, and articles. For more information or to participate in free conference calls and message boards, visit www.greencompany.com or call (888) 558-5257 or (646) 216-8061.

Overview

Many traders don't take advantage of all available tax-related breaks. Unfortunately, far too many accountants still don't know these breaks or the many nuances and pitfalls that accompany them. You should claim as many tax benefits as possible for the past tax year (i.e., the year for the tax return being filed), file your elections on time, and consider an entity and retirement plan to receive more breaks this current tax year.

Business traders are entitled to several tax breaks, whereas investors are not. By default, the IRS lumps all traders into the category of "investor tax status," and investors get penalized in the tax code, with restricted investment interest and investment expenses, capital-loss limitations ($3,000 per year), wash-sale loss deferrals, no retirement plans, and more.

To qualify for these tax breaks, business traders must first learn these mostly unpublicized rules, navigate around the vague, yet strict business-qualification requirements, make certain tricky tax elections on time, and execute the strategies properly on their tax return (which also is somewhat difficult). The burden is on you, the taxpayer, to get what you're entitled to. That may be unfair, but rules are rules, take them or leave them!

Accounting for trading gains and losses is also the responsibility of securities traders. Good industry-specific software is the only reasonable accounting solution for many securities trades. New 2008 tax legislation requires brokerage firms to report adjusted cost basis and holding periods for securities transactions, whereas current rules only require brokers to report proceeds from the sales of securities on Form 1099-B. In December 2009, the IRS proposed an expansion of these rules to cover options, mutual funds, and more. Tax accounting for securities (including stock options) traders may become easier with the early adoption of these new rules. They will become mandatory in 2011.

There are also complexities in sorting through different tax-treatment rules and tax rates for securities, stock options, ETFs, commodities, futures, indexes, options on futures, forex, physical foreign currency, foreign futures, precious metals, and other types of instruments. Plus, it's often hard to tell which financial instrument falls into which category.

> Although traders have the burden of more complex tax compliance, they also have a greater opportunity for tax savings.

Some business traders are satisfied to operate as sole proprietors (with a Schedule C) because it appears less complicated, they can claim trader tax status after year-end, and it appears to cost less than other methods. But Schedule Cs draw more IRS attention, especially for business traders, because they have trading gains and losses reported on other tax forms. Federal and state tax exams are on the rise, especially for small-business taxpayers (including traders) and upper-income taxpayers.

Profitable business traders often need a separate legal entity to deduct contributions to retirement plans and health-insurance premiums — i.e., adjusted gross income (AGI) deductions. Losing and part-time business traders can also use separate-entity tax returns to deflect IRS prejudice against Schedule C (sole proprietorship) tax filings. There are many other reasons to have an entity as well, such as late-year mark-to-market (MTM) accounting elections and generating performance records to attract investors.

Retirement plans provide significant tax savings for traders in several different ways. Annual tax-deductible contributions to retirement plans generally save traders more in income taxes than they cost in self-employment (SE) or payroll taxes. SE or payroll tax is charged on the declared earned income component only. (One exception: Members of a futures exchange are subject to SE taxes on their trades made on those exchanges.) Traders can also actively trade a retirement plan tax-free, building up cumulative tax-free returns until retirement distributions are taken out. With a Roth IRA, those tax savings become permanently tax-free. Roth IRA conversions are a good idea. The income threshold rule is repealed starting with the 2010 tax year, opening the door to many other taxpayers. Now you don't need to wait until year-end to see if you qualify.

Traders should avoid the pitfall of taking early withdrawals from regular retirement funds; this is often a mistake made by those looking to fund a trading business. Early withdrawals from retirement plans are subject to regular income taxes (at higher ordinary tax rates) plus a 10-percent excise tax. Mini 401(k)s have a plan-loan option — up to the lower of $50,000 or 50 percent of your plan assets — which can be used to finance your trading business. Mini 401(k) plans are the best plans for business traders, because they maximize income-tax savings over offsetting SE or payroll tax costs, resulting in thousands of dollars in net tax savings. (See Chapter 8 for more on retirement plans.)

Planning your taxes ahead of time is also important for traders. Whether it's pre-paying state income taxes for an additional tax deduction (without triggering the alternative minimum tax [AMT]) or accelerating expenses and deferring income to defer taxes — or the reverse in some cases (a good idea considering marginal tax rates on the upper-income are set to rise in 2011) — it's important to get a handle on trader tax status.

Many IRS agents don't fully understand the nuances of their own complex and poorly defined rules for trading businesses. Don't let a tax exam (audit) spin out of control; seek to have it "reconsidered" and get the IRS to accept your trader tax status even before the exam gets underway.

If you're a close call on trader tax status, consider alternative strategies.

Trade actively in your retirement plan and deduct your trading expenses and losses within the retirement plan, rather than suffer investment expense restrictions on your taxable account. Usually, an intermediary trust firm is required to allow this feature for direct payment or reimbursement of trading expenses on behalf of the retirement plan. Few brokerage firms allow this feature in their prototype plans.

Futures and forex traders can benefit from lower Section 1256 60/40 tax rates, meaning trader tax status is mainly beneficial for business expense and AGI deductions. If your business expenses are low, and you already saved enough for retirement and are on Medicare coverage, you don't need to push the envelope on trader tax status.

A WORD OF CAUTION

The IRS has been challenging trader tax status and Section 475 MTM ordinary-loss treatment. A tax court case decided in August 2008 (*Holsinger vs. Commissioner*) raised issues related to qualifying for trader tax status based on the percentage of days traded, as well as other troubling issues. See more on the *Holsinger* case in Chapter 11, including suggestions for improving trader tax status and IRS defenses.

Some traders have brought weak cases to tax court and have failed to defend themselves properly. Serving up easy wins to the IRS in exams, appeals, private letter rulings, and tax court encourages the agency to further question business traders based on bad legal precedent. When trader tax status is too difficult to achieve, consider the alternative strategies discussed in detail in Chapter 9.

Not taking care of your trader-tax affairs can be costly. Filing a sloppy tax return with tax treatment or trade accounting errors, or reporting trades on Schedule C, can initiate a painful tax exam. An exam can cause the IRS to challenge your trader tax status in multiple tax years. Learn tips for dealing with the IRS in Chapter 10.

Trader tax status business expenses generally save a trader up to $8,000 per year in taxes. If business-expense treatment is only saving you a few thousand dollars and if you're a close call on trader tax status, it may be prudent in this IRS environment to skip trader tax status for your 2009 tax return.

On the other hand, it's a pity to get stuck with a large wasted trading loss, which could be in the tens or even hundreds of thousands of dollars, when you could otherwise have made the necessary timely elections to have Section 475 MTM ordinary loss treatment (with trader tax status as a prerequisite), generating full and often immediate federal and state income tax refunds. Unutilized or wasted trading losses are the biggest pitfalls for traders.

In late 2009, Congress renewed a version of its five-year net operating loss (NOL) carryback election choice for the 2009 year only, after limiting it earlier to 2008.

Not saving for retirement or paying into Social Security and Medicare (SE tax) can hurt come retirement age. Plus, the government sponsors retirement savings by offering significant tax-saving incentives.

In summary, although self-employed business traders have the burden of more complex tax compliance, they also have a greater opportunity for tax savings. Business traders are far better off than investors and most other types of small businesses facing earned income and ordinary tax rates on most of their income. They can enjoy lower tax rates and avoid SE tax too.

Make sure you qualify for these tax breaks and if you're a "close call," it's wise to consult a trader-tax expert. It's also wise to operate your trading business as a separate, legal tax entity. Make sure to have strong qualification numbers on trading days, number of trades, trading hours per day, and very short holding periods.

CALL TO ACTION

Use *Green's 2010 Trader Tax Guide* to receive every trader tax break you're entitled to this tax season. Whether you self-prepare your tax returns using consumer tax preparation software, or engage a CPA firm, this guide can help you through the process.

Unfortunately, it may be too late for some tax breaks on your 2009 return if you wait until you're actually filing your taxes. If this is the case, then use this guide to execute these special tax strategies and elections on time for tax-year 2010. This will help you in subsequent tax years as well. For example, although it's not too late to claim business treatment (trader tax status) for 2009 as a sole proprietor (filing a Schedule C), it *is* too late to elect Section 475 MTM accounting (ordinary-loss treatment) for this past tax year. In this case, if you qualify for trader tax status, you can deduct all your business expenses for some tax savings, but if you have large trading losses in securities or futures, you will be stuck with capital-loss treatment (capital-loss carryovers). Futures capital losses (including electing forex traders opting out of Section 988 into Section 1256g) may also be carried back three tax years, but only applied against futures capital gains in those years on Form 6781. The next opportunity for individuals and LLC/partnerships to elect Section 475 is by April 15 of the current tax year, or March 15 for S-corps. New taxpayers (i.e., new entities) may elect Section 475 internally within 75 days of inception, so forming a new entity later in the tax year is a good option. When it comes to taxes, the harder you work, the luckier you get.

UPDATES

Several important tax changes are in various phases of development and negotiation in Congress and the administration. Check for updates in our guide login section at www.greencompany.com. Stay on our email list to receive guide announcements in this regard.

DESK REFERENCE

Some readers use our guides as a desk reference, to quickly find answers to specific questions in a given area. Others read this guide in its entirety. To accommodate desk-reference readers, we edit each chapter to stand alone, which inevitably means some chapters will have information covered in other chapters too.

LINKS

For your convenience, the blue areas are links to either a Web site or another section in the guide.