

GREEN'S 2011 TRADER TAX GUIDE



THE SAVVY TRADER'S GUIDE
TO 2010 TAX PREPARATION
& 2011 TAX PLANNING

BY ROBERT A. GREEN, CPA

Green's 2011 Trader Tax Guide

*The savvy trader's guide to 2010
tax preparation and 2011 tax planning.*

About the Author



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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 GreenTraderFunds division is dedicated to the needs of the investment-management industry. It provides a full-service solution including development/formation, accounting services using specialized investment-management accounting 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, Webinars, conference calls, podcasts, videos, and articles. For more information or to participate in free Webinars, visit www.greencompany.com or call (888) 558-5257 or (646) 224-6923.

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Overview

Many traders don't take advantage of all available tax 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 software is the only reasonable accounting solution for many securities traders. New tax legislation effective January 2011 requires brokerage firms to report adjusted cost basis and holding periods for securities transactions, whereas the current rules still in effect for the 2010 tax year only require brokers to report proceeds from the sales of securities on Form 1099-B.

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. It's often hard to tell which financial instrument falls into which category. ETFs can be a confusing area for taxpayers, CPAs, and attorneys, so we've expanded on the topic in this guide. Forex tax treatment also remains vague. We discussed spot forex with the IRS recently; our findings are included here too.

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.

In January 2011, we won a favorable decision in an important IRS appeal, defending trader tax status and Section 475 MTM ordinary business loss treatment for a part-time trader and business executive. We established the importance of the "continuous business activity" standard and think it can help traders who fall short on the required frequency of trades standard. Also in early 2011, Arizona challenged a perennial money-losing trader under the IRS hobby-loss rules. Our Traders Association filed a protest letter laying out a strong case for how hobby-loss rules can't be applied to a trading business.

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. Our incubator fund strategy is ideal for traders who want to start an investment management business at a much lower cost than a for-profit hedge fund. You can include friends and family in the incubator fund providing you don't charge compensation. You are allowed to be reimbursed for your trading expenses.

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 was 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. (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) — 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. The IRS seems to be getting bolder and more aggressive again, so it's wise to engage a trader tax expert CPA and/or tax attorney to help you. If you are a novice and don't have the right help, the IRS may succeed in pushing you around. See how our Traders Association helped an Arizona trader in [Chapter 12](#). We hope you join our Traders Association too.

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 some 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, or you have health insurance through your spouse, you don't need to push the envelope on trader tax status.

Don't let a tax exam 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.

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 in exams, appeals, private letter rulings, and tax court encourages the IRS and states 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 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 2010 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.

This past year, misinformation from other service providers suggested traders could easily deduct pre-business education expenses. They are very wrong. We cover what's allowed and what's not in [Chapter 5](#). Education is a material expense for traders and it's often incurred before a trader establishes trader tax status.

Proprietary trading vs. retail trading is looked at in [Chapter 12](#). More traders are rising to the ranks of investment management, so we added [Chapter 13](#) on investment management this year.

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 2011 Trader Tax Guide to receive every trader tax break you're entitled to this tax season. Whether you self-prepare your tax returns using con-

sumer 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 2010 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 2011. 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 2010 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 some 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.