PRO TRADER TAX

TAX NEWSLETTER FOR TRADERS

June 2010

TAX BENEFITS FOR BUSINESS TRADERS

There are significant tax consequences for those individuals that are engaged in the trade or business of trading securities. The term" trade or business" appears in the Internal Revenue Code (IRC) over 300 hundred times, including at least 60 Code sections, and can be found in 170 different places within the Code. Despite being mentioned in so many places in the IRC, nowhere is the term, "trade or business" defined. Usually, when Congress decides not to define statutory language, the process of defining important terms in the Code is left to the courts. Unfortunately, the courts have failed to articulate properly a standard of activity that encompasses what a trade or business is that will stand the test of time. The definition needs to be broad, yet not too restrictive. If a taxpayer is able to qualify their trading activities as a trade or business for tax purposes, several benefits exist.

Under the current Tax Code, individuals who buy and sell securities, including equities, options, futures, commodities and foreign currencies fall into one of four categories:

(a) investors;

(b) traders (cash method of accounting);

(c) traders (electing the mark-to-market (MTM) accounting method), and;

(d) securities dealers.

We won't discuss securities dealers in this article our focus is on active traders, who trade for their own account. However, it is important to know that a securities dealer is someone who regularly purchases securities from, or sells securities to customers in the ordinary course of a trade or business. Dealers in securities maintain inventory and are required to use the MTM accounting method. For the most part, these people make their money from the fees they charge customers, not from gains made in trading securities. Dealers include stockbrokers and specialists who buy and sell securities on the floors of stock and commodity exchanges.

A taxpayer's classification will determine the tax consequences of how certain items of income and expense are treated, which is illustrated in the chart below.

Part-Time Traders

Not everyone can be a full-fledge Pro Trader or active business trader for tax purposes. Unfortunately or fortunately whatever the case may be, many of us are not going to make the cut due to other time commitments such as having a real job, a career, going to school, etc. Many of us are going to fall into the category of part-time trader or investor. For those of us that fall into this category, I am here to tell you that it is going to be okay. There are still many opportunities to save on your taxes. In this issue, we will look at part-time traders.

For those part-time traders interested in qualifying for active trader tax status, but are worried they may fall short in meeting all the criteria, there is hope. It is possible to qualify for trader tax status as a part-time trader, but be prepared to face questions from the IRS. In fact, be prepared to fight that proverbial uphill battle with the Tax Man. If you however follow the guidance offered in this book, you can greatly improve your odds of qualifying as an active trader. Since the decision made in each trader

Table 2.1: Comparison of Tax Consequences by Classification

		Classification	
Items	**Cash-Basis Trader**	**MTM Trader**	**Investor**
Treatment of gain or loss	Capital; $3,000 net loss limit reported on Schedule D.	Ordinary; no $3,000 net loss limit reported on Form 4797, Part II	Capital; $3,000 net loss limit reported on Schedule D.
May elect to use mark-to-market accounting	No	Yes	No
Subject to wash-sale rules	Yes	No	Yes
Subject to self-employment tax	No	No	No
Treatment of investment expenses, including depreciation	Deductible for AGI on Schedule C	Deductible for AGI on Schedule C	Miscellaneous itemized deduction on Schedule A.
Eligible for Pension/IRA	No	No	No
Treatment of investment (margin) interest expense	Deductible as business-related interest expense on Schedule C.	Deductible as business-related interest expense on Schedule C	Investment interest expense deductible on Schedule A, subject to the net investment income limitation.
Home office expenses	Deductible up to amount of gross income if portion of dwelling is a qualified home office.	Deductible up to amount of gross income if portion of dwelling is a qualified home office.	Not deductible
Allowed net operating loss carryback refund claims	Yes, on business expenses only	Yes, on business expenses and trading losses	No

Tax Treatment

Gains and Losses

As shown in Table 2.1, gains and losses are treated differently for each classification of taxpayer and are further explained in IRC Sec. 1222. One classification is not necessarily better than another is, and determining which works best for you will largely depend on your individual circumstances. For example, if you incur stock losses, you may benefit from being classified as a trader instead of an investor in order to avoid capital loss limitation. Generally, taxpayers are permitted to deduct against ordinary income capital losses in excess of capital gains of up to $3,000 ($1,500, if married filing separately). In comparison, a securities trader, that has properly made the MTM election, incurring losses in the ordinary course of doing business, generally is not subject to these limitations, and may be able to deduct the amount in full against ordinary income (e.g., from dividends, salaries, businesses).

Taxpayers choosing the MTM election enjoy certain tax advantages that other cash-basis traders and investors don't. MTM traders are required to segregate those securities that constitute trade or business activity from those held on a long-term basis. Securities related to trading activities are deemed by the IRS to comprise an inventory of securities. At the end of the year, inventoried securities are classified as marked-to-market. Any resulting gain (or loss) is calculated based on a security's fair market value (FMV) at year-end. Realized gains or losses resulting from the sale of securities outside of the inventory during the year are then added, and the ensuing gain (or loss) is recorded as ordinary income, per Sections 475(f)(1)(D) and 475(d)(3).

For an MTM trader incurring a net trading loss in any given year, there is no limit on the amount of deductible loss they can claim, because it is regarded as ordinary, not capital by the IRS. As an ordinary loss, it is not subject to the $3,000 loss limitation rules defined in IRC Sec. 1211(b). Furthermore, any net gain by a MTM trader is deemed as ordinary income. While this ordinary income is subject to regular tax rates, the tax result is no worse that it would be without the MTM election.

case has been based on facts and circumstances, make sure your facts and circumstances meet the criteria covered in Chapter One.

If any one person could expect to be more highly scrutinized by the IRS, it is the part-time trader claiming business trader tax status. Part-time traders have been targeted by the IRS for several years now. In the 'Frequently Asked Questions' section of the IRS website regarding trader status, it states:

"Basically, if your day trading activity goal is to profit from short-term swings in the market rather than from long-term capital appreciation of investments, and is expected to be your primary income for meeting your personal living expenses, i.e. you do not have another regular job, your trading activity might be a business."

Since many part-time traders may have another regular job or another business that provides a source of income, the above statement may cause some anxiety. It should not however deter you from pursuing trader tax status. Nowhere in IRS Pub 550 does it explicitly state that taxpayers cannot have more than one job, or operate more than one business at the same time. Nor does it limit a taxpayer from enjoying business tax treatment only if that individual exclusively operates it. Nowhere in any tax court case dealing with traders has a decision stated that a taxpayer was precluded from owning and operating

With this said, MTM traders should proceed cautiously. This deduction should not be abused, as the IRS tends to scrutinize returns that claim large losses. The IRS could easily invoke the "not-for-profit" activity rule provided under IRC Sec. 183 and challenge these types of deductions.

Wash-Sale Rules

A wash sale as defined by the IRS is "a sale of stock or securities at a loss within 30 days before or after you buy or acquire in a fully taxable trade, or acquire a contract or option to buy, substantially identical stock or securities." The wash sale rule under IRC Sec. 1091 is geared to stopping investors from generating and recognizing artificial losses in situations where they do not plan to reduce their holdings in the securities sold.

Under this ruling, a taxpayer is typically prevented from deducting losses associated with the sale of a security if, within a 61-day window (30 days before to 30 days after the sale), the taxpayer purchases a similar security. Traders and investors are generally subject to wash-sale rules, but MTM traders are not.

Self-Employment Income

Gains and losses resulting from securities transactions are not subject to self-employment tax. This is true for investors, cash-basis traders and MTM traders.

Trading-Related Expenses

General

Traders tend to have a significant amount of investment-related expenses used in the course of doing business such as software, newspaper and periodical subscriptions, and computer software and hardware. Investors usually can only deduct these types of expenses as miscellaneous itemized deductions subject to 2 percent of adjusted gross income (AGI), with some exceptions for higher income taxpayers subject to the itemized deduction phase-out rules of IRC Sec. 68. Traders and MTM traders can deduct these expenses from AGI on Schedule C of Form 1040 without limitation.

Computer Software & Hardware

Computer software and hardware expenses need to be reviewed carefully before claiming. Software is not usually an issue, as it is typically amortizable over three years, but writing off hardware costs can prove a bit more challenging. Under IRC Sec. 280F(d)(4)(A), computer hardware can qualify as "listed property." Should you decide to write off computer hardware costs under this designation, then at least 50 percent of its usage must be devoted to trade or business activity, if your intent is to use the modified accelerated cost recovery system (MACRS) of Section 168. Software costs bundled with computer hardware costs, may be eligible for MACRS treatment as well, and deducted as an expense under Section 179, but stand-alone software costs are not.

If using MACRS, you will need to use ADS straight-line depreciation instead of accelerated depreciation. If computer hardware costs are ineligible for MACRS depreciation, then traders and MTM traders may use an alternative approach for writing off these costs. Eligible taxpayers can make a Section 179 election, which will allow these types of expenses to be deducted up to $250,000 for 2009.

Trading Related Expenses

more than one business.

The IRS's website and Form 1040 instructions are misleading as they advocate the taxpayer's sole, or even primary source of income, must be from trading in order for the taxpayer to qualify for "trader in securities" status. It is widely accepted by the tax courts that a taxpayer can be engaged in more than one trade or business. This point is well documented in *Snyder v. Commissioner*, 295 U.S. 134 (1935), *Bell v. Commissioner*, 615 F.2d 226 (5[th] Cir. 1980), and *Cottle v. Commissioner*, 89 T.C. 467 (1987).

It should not matter that the taxpayer may be able to support themselves on the income from one business but not the other, from the two combined, or from neither. The courts have stated, "A taxpayer may have sufficient income-producing assets so that the taxpayer does not need additional income from one or more trade or businesses to subsist. That should not preclude the taxpayer from treating activities that constitute a trade or business as such."

One of the areas that concern me the most is the potential for the IRS to mishandle the criteria that focuses on the extent to which the taxpayer pursues a trading activity. The IRS says that your trading activity must produce income for your livelihood, and the amount of time devoted to that trading activity must be substantial. Pub 550 and the Form 1040 instructions could be interpreted

Purchasing securities on margin is a common practice among traders. In these types of situations, the IRS allows traders and MTM traders to deduct the full amount of this interest expense in the year it is incurred because it is related to their trade or business activity.

Home Office Expense

To deduct certain home office related expenses (utilities, insurance, depreciation, etc.), traders and MTM traders must meet the "exclusivity" and "business use" requirement. If the taxpayer meets these requirements, as defined by the Code, expenses are then subject to the gross income and ordering requirements. This restricts expenses deducted in a specific tax year to the extent of gross income, generated by the home-office business.

In some situations, a trader may find that they are unable to deduct all qualifying expenses incurred during a particular tax year. If this occurs, expenses must be deducted in the following order:

- Other non-home office expenses, such as salaries associated with a business.
- Schedule A expenses associated with the home-office use.
- Business expenses that DO NOT reduce basis (Ex.: utilities and maintenance).
- Business expenses that DO reduce basis (Ex.: Sec. 179 expenses and depreciation).

MTM accounting provides huge tax saving opportunities for traders. However, if you do not make the MTM election or do not qualify, there are still opportunities to save on your taxes. Active business traders that do not make the MTM election are still able to deduct their trading expenses on Schedule C on their personal tax return, or as a deductible business expense on their business tax return. Part-time traders that do not qualify as an active business trader and investors must deduct their trading/investment expenses as miscellaneous deductions, subject to the 2 percent threshold, on Schedule A of their personal tax return.

Summary of Tax Benefits for Business Traders:

- Ability to deduct business expenses including (1) margin loan interest; (2) home office deductions; (3) trading expenses; (4) software expenses; (5) professional services; (6) education expenses (depending on circumstances); (7) start-up expenses; (8)organizational expenses; (9) travel & entertainment; (10) depreciation on equipment .
- Ability to elect Mark-to-Market accounting method to convert restricted capital losses to unrestricted ordinary losses.
- Not subject to self-employment tax on trading profits.
- Not subject to wash sale rules.
- Ability to deduct margin interest in full and not subject to investment interest limitation.
- Net operating losses can be carried back 2 years to offset prior year's income and allows a trader to obtain a refund of taxes paid on income in previous years, or they can elect to skip the NOL carry-back and carry forward the NOL for twenty years.
- Ability to establish a retirement plan by paying yourself a management or administrative fee from your trading operation generating earned income.
- Investors in a business trader's entity such as a partnership, limited partnership, limited liability company or S Corporation are not subject to passive loss rules.

Below is an example of the tax ramifications between an investor and a business trader using the cash method of accounting versus the mark-to-

to mean that the taxpayer can have only one trade or business and must dedicate all of his or her time to trading to qualify for trader status.

As discussed above, it has been established beyond dispute that a taxpayer can have more than one trade or business. It is only logical that a person does not have to devote 100 percent of his or her time during a working day to a particular trade or business for it to be successful. A taxpayer should be able spend less than full-time trading in order to qualify as a trader for tax purposes as long as he or she meets the case law standard of "active trader".

An Example of a Part-Time Trader

Stan is a practicing accountant also involved in an affiliate marketing business. He owns and operates several websites promoting other companies' products and services, and spends eight to nine hours each week on his affiliate marketing business interests. At the same time, Stan is devoted to trading securities, spending an hour or two each night studying the results of the day's market activity, analyzing technical patterns on his charts and evaluating his current positions. Stan also monitors his positions and tracks market conditions periodically throughout his workday. He actively buys and sells online throughout the day without devoting more than a total of an hour or so of his day to this activity. On occasion, Stan also performs market accounting method:

Facts and Circumstances

- Taxpayer files a joint tax return with his spouse
- Taxpayer suffered losses of $100,000 in the financial markets
- Taxpayer had $50,000 of related-trading/investing expenses, including 10,000 of investment interest expense
- Taxpayer earned $95,000 in unrelated passive income
- Taxpayer's spouse earned $180,000 as a lawyer
- Taxpayer's had $40,000 of other itemized deductions
- Taxpayer's spouse paid in $60,000 in federal tax withholding

	Investor/P-T Trader	**Trader (cash basis)**	**Trader (MTM)**
Spouse's Salary	$ 180,000	$ 180,000	$ 180,000
Schedule C Trading Expenses	N/A	50,000	50,000
Capital Losses - Schedule D	3,000	3,000	N/A
Trading Losses- Form 4797	N/A	N/A	100,000
Rental Income	95,000	95,000	95,000
Adjusted Gross Income	272,000	222,000	125,000
Itemized Deductions Allowed	73,508*	39,448**	40,000
Taxable Income	191,630	175,252	77,700
Tax Liability	54,334	37,453	11,806
Tax Refund	5,666	22,547	48,994
Tax Savings		$ 16,881	$ 43,328

* 2% AGI limitation and investment interest expense limitation ** Deduction phase-out limitation

these activities while working on client matters, talking on the phone with clients, and interacting with his staff.

Prepare to be Scrutinized

I will say it again. Please be aware that there is a risk of an IRS audit as a part-time trader claiming trader status. Essentially, every taxpayer is at risk of a tax audit, but high-risk groups such as part-time traders especially are. Be prepared to have your business expenses and trading losses challenged by the IRS. Be ready to prove that your trading activity is not only **substantial**, but also performed **continually** and **regularly**. Follow the guidelines discussed in our May newsletter if you want to qualify for part-time tax trader status.

Brokerage statements are not a sufficient record to show the time you are devoting to your business. Your brokerage statements will only show the number of trades and the dollar amount of those trades. They do not provide the complete picture of the hours that you spend analyzing, researching, strategizing, etc. If you keep a trading journal, your IRS audit will go much smoother and you will have a better chance of a positive outcome and possibly improve your trading success.

Disclaimer

Because the tax laws and IRS rules are constantly changing and shifting, and each taxpayer's situation is unique and different, this newsletter is not intended to be an exhaustive work on the tax consequences of trader and investor tax law. Taxpayers should seek competent professional advice regarding investment, trading, and financial transactions on an on-going basis. This newsletter should not be a replacement for legal and/or tax advice. However, we hope that it provides some insight into tax issues and complications involved in the investment and trading industry.

Pro Trader Tax is a virtual tax advisory firm specializing in tax planning and counseling, tax preparation, entity formation and retirement plan services for active business traders and investors.

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