The xxx Tax Guide for Traders & Investors

(How to Cut Your Taxes to the Legally Lowest Amount)

Congratulations!

By reading the XXX start-to-finish guide on trader taxation, you're taking the first step towards lowering your taxes—and therefore increasing your income. Whether you're satisfied with last year's tax return or not, we'll show you how to cut even more off your tax bill.

If you're an investor, making trades with long-term benefits in mind, this guide will show you the tax benefits of filing as a trader using a business status, which lets you spend business money for your trading activities versus spending your personal funds.

And if you're already a trader, looking for profits today, we'll show you *all* the benefits available under the IRS' entity rules. By following our step-by-step instructions, you'll cut your taxes to the legally lowest amount, and make your trade accounting easier.

Included in this guide are two special bonuses: one covering the tax treatment of various forms of trader income, and another on the most profitable way to manage retirement funds. Consider these extras our gift to you. We applaud you for taking this important step as you begin to exceed your financial goals.

You may use this guide in one of two ways:

1. Read it through from start to finish, taking notes of important issues along the way. It's a proven fact that you'll retain more if you actively participate while reading, so go ahead—jot down notes and questions as you think of them, and feel free to email us at xxx, or call us any time at xxx. Who knows? You may pick up a tip that will allow you to conduct your next transaction in a slightly different way, giving you even more profit or more tax deductions.

2. Or, make use of our extensive index to find topics quickly whenever you need them—all throughout the year.

And most importantly, please visit our Web site at xxx for a clear overview of all issues that matter to traders, as well as for expert trader entity and accounting guidance.

Here's wishing you many profitable trades and scores of deductions,

XXX, CPA
Tax Director

Investor versus Trader—What's the Difference?

What makes you an investor rather than a trader? Maybe you purchased a few securities a while back and you're planning to hang onto them for a long time. Perhaps for your child's college fund, or for that once-in-a-lifetime trip around the world. Maybe you live on dividend income associated with your investments, or perhaps you're rolling the interest over and creating a nice nest egg for retirement.

In any case, like the rest of us, you pay your capital gains tax, and are lucky to realize even a small amount of associated deductions. If that sounds like you, then you're counted among the most hardworking American citizens struggling to save money for a rainy day. You are an investor.

Traders, on the other hand, are just as hardworking, but they work smarter. As a result, more of your money stays in your own pocket, instead of going to Washington. You buy and sell securities frequently, taking advantage of short-term price changes. You don't seek out dividend income, but instead, make your money moving in and out of short-term positions using a variety of trading strategies. Expenses of your "work" are deductible, and are not dependent on being over 2% of your adjusted gross income, as an investor's expenses are.

Is Trader Status Enough Protection?

Our guide will help both traders and potential traders understand the varying methods of tax reduction, starting with an appetizing explanation of mark to market accounting and important filing information, followed by the main course—maximizing your deductions.

Trader status alone is insufficient protection from the long, greedy arm of Uncle Sam though. We're going to tell you how and why you should do your investing and trading under the umbrella of a business, as that's where the richest deductions are found. We'll talk about your legal entity choices, and tell you what we think is best—and why.

The end result? A complete and thorough examination of the issues surrounding trader taxation, our take on why you should trade as a legal entity versus as an investor, and how you'll cut your tax bill dramatically by doing so.

Trader Taxation

An interesting facet of trader taxation is that no real definition of a "trader" exists in the tax code. The data we have now is gleaned from tax court cases, the results of which add to a surprising lack of information available on the topic. Lack of clarity and research makes for a very ambiguous and fluid definition, so a clear understanding of past court cases is mandatory.

Before we discuss pertinent court cases, a better explanation of trader is warranted. A trader buys and sells securities to take advantage of short-term market changes. Profit comes from price changes, not from dividends and interest. Short-term holding periods mark the trader, with the majority of periods being a day at most. And since long-term growth is neither expected nor desired, many traders aren't concerned about which company issues the securities, and therefore forego due diligence research common among investors. A trader's single concern is the profit they make from holding a position for a very short time.

Another telltale sign of a trader is his or her ability to devote substantial amounts of time to their business. According to the IRS, traders need to show an earnest intent to be a trader. Conducting one trade a day does not show serious intent. A trader spends a significant amount of time in trading activities, from managing transactions and conducting strategy sessions, to making frequent trades on a consistent and regular basis. These defining points come from case law, and the IRS will diligently fight what it feels is an unsubstantiated trader election. It's been proven in case after case after case.

What do the Courts Have to Say?

Two early cases speak directly to establishing trader status. In Higgins v. the Commissioner (1941), the Supreme Court denied the deductibility of Higgins' investment expenses. Higgins ran a vast operation, which included offices and employees, who recorded and managed all aspects of his trading activity. Even so, the court concluded that business function did not exist related to Higgins' trading. According to the court, Higgins' business existed solely to record his investments.

Estate of Yaeger v. the Commissioner (1989) is a similar case. Yaeger, according to definition, was the very picture of a trader. Trading was his full-time job, and he made substantial profits buying and selling securities. He equipped himself with offices and a staff, and continuously educated himself regarding financial matters. Yet this was not enough to convince the IRS or the Supreme Court that he was a trader. At issue was the fact that Yaeger held his securities for long periods of time, so the court ruled that Yaeger conducted investing activity, and did not run a trading business.

In a more recent case, Fredrick R. Mayer (1994), the court established that even if a trader devotes substantial time to trading activities, trader status would still be denied unless other factors are met. Mayer, like Higgins, ran a vast operation and hired eight money managers to handle his funds. Mayer set the company's goals and monitored his managers closely. He did everything a good businessperson should do to increase profits, yet the IRS and the Tax Court denied him trader status, and disallowed his business deductions. Like Yaegar, Mayer profited from long-term holding periods. Buying frequently negated selling infrequently.

The case of Rudolph Steffler (1995) differs from others because the court denied trader status based on trade infrequency. Steffler conducted a very small number of trades each year, and the Tax Court denied trader status on that ground alone.

Compare Steffler to Higgins, Yaeger and Mayer, where trade frequency was not at issue. In those cases, the court denied trader status due to lengthy holding periods. It's an important distinction, and a significant feature of IRS and court-approved trader status: your intention must be to hold securities for short-term periods, and you must conduct a large number of transactions.

The Tax Court, in the case of Stephen A. Paoli (1991), established a preface to the frequency test. In Paoli, the court focused on the consistency of trading activities. Paoli conducted numerous trades, but most were made during a particular time of the year. Throughout the remainder of the tax year, Paoli engaged in little to no trading activities. The court ruled that although both the transaction and frequency tests were met, Paoli's activity should have been conducted continuously over the course of the year, just as a business does business all year long.

As we've mentioned, you won't find one specific part of the IRS code that deals with securities traders. However, due to the exponential growth in online trading in the last few years, and the overwhelming advantages conferred upon traders, the IRS has been forced to issue statements regarding the definition. Recently in Tax Topic 429, the IRS says that to qualify as a trader in securities:

- You must seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation.
- Your activity must be substantial, and
- You must carry on the activity with continuity and regularity.

In addition, the IRS says that the following circumstances must 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.

What does that really tell us? Not much, forcing lawyers and CPAs representing traders to rely on court cases that more clearly define who is eligible for the trader classification. The bottom line is that without adequate definition by the IRS, an individual who files as a trader in securities will always be in jeopardy of losing their privileged status based on a new, overriding court case that raises the bar on required qualifications.

The area of trader taxation is constantly changing as new cases are brought before the Tax Court, and it's an area in which xxx can be of significant help. Not only do we have the means and methods of keeping abreast of changes in the IRS' ambiguous definition of traders, we consolidate and communicate that information in a clear way, and pass it on to you. For more information on traders, direct from the IRS, click here.

Benefits of Trader Status….an Example

Johnny Investor and Janet Trades, LLC have identical incomes, expenses, gains and losses. The only difference is that Johnny Investor isn't in the business of trading, and Janet Trades, LLC is.

SCENARIO 1: TRADING GAIN OF $40,000
BOTTOM LINE BENEFIT:
$5,625 IN ADDITIONAL CASH IN POCKET

Total household income:	$140,000
Trading profits:	$40,000
Trading expenses:	$24,230
Johnny Investor's Tax Savings:	$1,644
Joan Trades, LLC Tax Savings:	$7,269
Additional Benefit to Trader:	$5,625

Explanation: Johnny is subject to the 2% threshold for deductible investment expenses, and many of his expenses don't qualify, such as education and travel. Joan Trades, LLC, on the other hand, is able to write-off 100% of her expenses.

SCENARIO 2: TRADING LOSS OF $40,000
BOTTOM LINE BENEFIT:
$19,269 IN ADDITIONAL CASH IN POCKET

Total household income:	$140,000
Trading profits:	$40,000
Trading expenses:	$24,230
Johnny Investor's Tax Savings:	$984
Joan Trades, LLC Tax Savings:	$19,269
Additional Benefit to Trader:	$18,285

Explanation: Johnny Investor is still stuck in the same situation as before, unable to write-off many of his expenses. Because of his trading loss, he lost the ability to write-off any of his interest expenses. However, he was able to take a $3,000 capital loss deduction.

Again, Joan Trades, LLC wrote-off 100% of her expenses. Plus, since she's a trader who elected mark to market, she offset her regular income of $100,000 with her $40,000 loss, bringing her AGI to $60,000. Joan saves another $12,000, for a total savings of $19,269 in taxes.

Mark to Market Accounting

There are many nuances to trader accounting, and one of the most important is your decision whether or not to elect mark to market accounting (MTM). The rules are new and complex, so we're going to give you a thorough understanding of MTM and its potential advantages and disadvantages, as you can't make an election that you don't understand.

When you select MTM accounting, you tally up any securities you're holding at the end of the year, and account for them as if they're sold based on the price that day, creating an unrealized gain or loss. Then, on the first day of the next year, you account for the securities as if you repurchased them at that day's current price. Another element of MTM is that you treat realized gains and losses as ordinary income, versus the capital treatment accorded to investors and non-MTM traders.