The New Trader's Tax Guide (Condensed)

TRADERS ACCOUNTING

The I.R.S insider's guide to the home based trading business and the use of legal entities for your trading capital

Published by:

Traders Accounting
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Peoria, AZ 8538-5627

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Dear Trader,

We are continually asked for information on the taxation of futures. Many traders do not realize that there is a substantial difference between the taxation of stocks, options on stocks, and the taxation of futures, commodities, and options on indexes. Of even more concern to us is the fact that many of the accountants that are filling out the tax forms for these traders and investors don't appear to know the difference in the taxation either.

This is troublesome for the trader who is making his living actively trading in the futures marketplace and as a result of hard work and many years of study becomes successful only to end up giving more of his trading profit to the government than necessary, because of an accountant who does not know the rules. If the trader himself were watching a company to invest in that gave away its profits in this manner, he would only short it.

We encourage all that read this booklet to understand that for any active trader, taxes are your biggest expense. It is up to the trader to assume the personal responsibility of understanding and implement a program to minimize the tax burdens. You are to be commended for acquiring this manual.

Our overriding purpose in providing this information is for your use in understanding how to formulate an efficient trading plan for yourself. If you place yourself in the position of having to rely on your tax professional to answer all of your questions, you will never know if he truly understands the taxation of futures.

We hope the knowledge you gain from your time with our booklet will be useful to you.

Traders Accounting

April 2016 — Phoenix Arizona USA

II. ARE YOU A TRADER OR INVESTOR?

Calculating your taxes is not very simple. You can't just take your income, subtract your expenses, and multiply by a tax rate. That would be too simple, don't you think? The biggest problem, though, is that it would put all of us accountants out of business!

The first step to figuring out your tax situation, is to determine which class of taxpayers you fall within. As a trader, here are your options: You will file as a Dealer in Securities, Investor, or a Trader in Securities.

The Dealer in Securities:

A dealer is a professional middleman. Most likely this isn't your situation.

Let me give you an example of a dealer. You probably have heard of market makers. Market makers are considered Dealers in Securities. Market Makers are individuals and securities firms that use their own capital to buy and maintain an inventory in a specific company's stock. When a Market Maker receives an investor's order to buy shares in a particular stock, it sells those shares to the customer from its existing inventory.

You may also have heard of broker/dealers. These individuals/firms are registered with the Securities and Exchange Commission. Whether you are a market maker or a broker/dealer, to qualify as a dealer in securities in the eyes of the IRS, the bottom line with the IRS is that you must engage in transactions with customers.

Taxation of a Dealer: The timing and character of gains and losses on dealer securities futures contracts (and options on such contracts), is determined under section 1256. Dealer securities futures contracts are subject to mark-to-market treatment, and gains or losses are treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss.

The Investor

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, you pay your capital gains tax, and are lucky to realize even a small amount of associated investment 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.

Investor Limitations - Deductibility of Investment Expenses

There are many investment expenses, all of which fall into the miscellaneous itemized deduction category and are reported on Schedule A of form 1040—if you're trading as an investor. Unless you're trading as a business, investment expenses are limited, both in scope and to whatever exceeds 2% of your Adjusted Gross Income (AGI). The IRS' list of investment expenses follows:

Deductible expenses:

- Attorney and accounting fees
- Clerical help and office rent
- Cost of replacing missing securities
- Fees to collect income
- Investment council and advice
- Safe deposit box rental
- State and local transfer taxes
- Investment expenses from pass-through entities

Nondeductible expenses:

- Stockholder's meetings
- Investment related seminars
- Borrowing on insurance
- Tax-exempt income

The Trader in Securities:

Traders occupy an advantageous middle ground that falls in between the limited world of the investor and the highly regulated world of the dealer. On one hand, 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. On the other hand, you don't have to register your business with the government.

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 holding periods measured in only days and weeks. 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 Yaeger, 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 during one 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 Revenue Procedure 550, 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.

If you are concerned that you may not trade to the level defined by the court cases, you have the option of using a legal entity structure to lock the tax benefits into place. Read later sections covering the use of legal entities.

Conclusion: The dealer is well-defined and highly regulated. The investor is the default classification, and has very prescribed and limited tax breaks. The trader is most likely you - the individual entrepreneur, buying and selling securities for the purpose of making a livelihood. How exactly that looks in the eyes of the IRS is not clearly defined. The benefits however, of taking the initiative to trade as a business, are easily understood - independence, and financial freedom.

III. WASH SALES

The Wash Sale Rules for Traders

Generally, the wash sale rule applies to traders the same way it applies to investors. The difference is that traders have a much harder time keeping records relating to wash sales because they engage in so many transactions.

The wash sale rule basically states that if you sell a stock at a loss and buy replacement stock 30-days before, or 30- days after the sale of the same stock, you can't deduct the loss. This rule does not apply to gains, but only to losses. Naturally, the IRS wants to tax all of your gains. The best way to show the impact of the wash sale rule is through the following example:

AN EXAMPLE OF A WASH SALE TRANSACTION

On October 20, 2002 you purchase 1000 shares of Microsoft at $35 a share. On December 15, 2002 you sell the 1000 shares in Microsoft at $15 a share and recognize a 20,000 loss. On January 5, 2013 you buy back 1000 shares of Microsoft at $15 a share. Unfortunately, because of the wash sale rules, that $20,000 loss that the taxpayer thought they recognized in 2002 is disallowed.

If you wind up with a wash sale, add your disallowed loss to the basis of your replacement security. Your new basis is the purchase price of the replacement, plus the loss you couldn't take, plus fees related to the security's purchase. This means that your loss is postponed; it's not gone forever. In the above example the taxpayers basis in the Microsoft stock he repurchased on January 5, 2013 would be $35 a share and not the $15 a share at which he purchased it.

The definition of replacement stock is not obvious either. The IRS says it can't be "substantially identical" to the security you sold. It's easier to differentiate stocks than it is mutual funds, as no stock is substantially identical to another, even within the same industry. After all, each company differs from others in numerous ways.

Options traders are particularly vulnerable to the Wash Sale Rules. Every single call option, as well as all puts in the money, are considered to be replacement stock for wash sale purposes.

With mutual funds though, replacement purchases get sticky. If two different funds track the same index and share virtually identical performance, they're considered substantially identical. Eliminate this problem by buying a mutual fund that moves in the same direction as the one you sold, but one that tracks off a different index.

When you sell the replacement security at a profit later, your basis will be higher, so your gain will lower. The end result? Less tax on a smaller gain. If you sell lower than your replacement security basis, your loss will be larger than it would be if based on the repurchase price alone, so you do get some recovery.

When you make a wash sale, your holding period for the replacement stock includes the period you held the stock you sold. This rule prevents you from converting a long-term loss into a short-term loss.

Most investors run into the wash sale rule only occasionally. If you're an active trader, you're likely to have a large number of wash sales each year. All is not lost; there are several ways to avoid having to deal with the wash sale rules that I will cover next.

TWO WAYS TO AVOID WASH SALES

If you make hundreds or thousands of trades each year, the record keeping required for compliance with the wash sale rule can be nearly impossible. There are several ways to eliminate the problem for active traders. The first way to avoid the wash sale rule is to simply wait for 31 days after you sold the stock or option before you buy it back. The second way (which is only available to traders and not investors) is to elect the mark-to-market accounting method.

Full details on the mark-to-market election are beyond the scope of this article at this point, but it's worth pointing out that a trader who makes this election isn't subject to the wash sale rule. There are some other important things you should know if you're thinking of making this election.

- If you make this election, all your trading gains and losses will be treated as ordinary income, not capital gain.
- If you make this election, any stock or other trading asset you hold at the end of the year is "marked to market." This means you report gain or loss as if you sold it at the close of business on the last trading day of the year for its fair market value.
- Once you make this election you're stuck with it. You can revoke it only with the consent of the IRS.

It's easy to see why the wash sale rule doesn't apply if you make this election. All your gains and losses are reported at the end of the year, whether you sell the stocks or not. There's no point in worrying about whether someone sold the stock and bought it back.

ADDITIONAL RULES ABOUT WASH SALES

Below are several different items you need to consider when you deal with the wash sale rules:

- If you bought identical shares within the previous 30 days that aren't replacement shares, it is not a wash sale.
- There are mechanical rules to handle the situation where you don't buy exactly the same number of shares you sold, or where you bought and sold multiple lots of shares.
- Your loss may be disallowed if a person who's related to you (or an entity related to you such as an IRA) buys replacement property.
- During the wash sale period, if you enter into a contract or option to acquire replacement stock, that will be considered a wash sale.
- If you don't sell the replacement stock in the same year, your loss will be postponed, possibly to a year when the deduction is of far less value.
- If you die before selling the replacement stock, neither you nor your heirs will benefit from the basis adjustment.
- You can also lose the benefit of the deduction permanently if you sell stock and arrange to have a related person - or your IRA - buy replacement stock.

IV. MARK-TO-MARKET ACCOUNTING

Beginning in 1997, the tax law has permitted active traders to elect a method of accounting called the mark-to-market method. Many active traders will find this election attractive as a way to make filing simpler — and possibly reduce their taxes.

This is one of the most important decisions you'll make as a trader and your decision will have great ramifications and should not be taken lightly. The rules are fairly complex and will be completely new to most traders. It is very important to read this article thoroughly, and then consult with a knowledgeable tax professional before making your decision.

Mark-to-Market Election

If you're a trader, you may choose whether or not to make the mark-to-market election. You don't automatically get mark-to-market treatment when you file as a trader. And you cannot elect this treatment if you aren't a trader. The election has to be filed by the return due date — without extensions — for the year *before* the year you want the election to be effective. For example, the last day to file the election for the year 2014 was April 15, 2014.

Consequences of the Election

Marking to market - The most obvious consequence of the election is that at the end of each year you must mark your securities to market. What this means is you treat any stocks you hold at the end of the day on December 31 as if you sold them on that day for the current market value. If the stock has gone down, you get to report a loss without actually selling it. If the stock has gone up, you have to report that gain. Your basis for the stock is adjusted to reflect the gain or loss you report, so that you don't report the same gain or loss again when you actually sell the stock.

No wash sales - The wash sale rule doesn't apply to a trader who has made the mark-to-market election. There's a simple logic to this: if all your gains and losses are going to be flushed out on December 31, there's no reason for the tax law to be concerned about wash sales that may occur during the year. For those of you that are investors and non-mark-to-market traders, the wash sale rule is a cumbersome accounting imperative, which says in a nutshell, that if you sell a security (or option) at a loss, and buy that same security (or option) within 30 days before or after the original sale date, then the loss you thought you incurred is disallowed.

Wash sales can be a significant headache for a trader even if they don't affect the amount of tax the trader has to pay. If you make hundreds of trades in the same stock, many of the trades are likely to result in wash sales. At some point, accounting for all the wash sales becomes nearly impossible. Eliminating this concern is a significant benefit of the mark-to-market election.

Ordinary income and loss - If you make the mark-to-market election, your trading gains and losses are converted to ordinary income and loss. You'll report the gains and losses on Form 4797 (sales of business property), not Schedule D (capital gains and losses).

This does *not* mean that your trading gains are now subject to self-employment tax. In a 1998 tax law, Congress clarified that although your trading income becomes ordinary income, it is not self-employment income. This also means you can't use this income to support a contribution to an IRA or other retirement plan.

Traders usually generate all, or nearly all, of their gains as short-term capital gains, which are taxed at the same rate as ordinary income. In most situations, changing to a system where the trader reports the gains as ordinary income will not have any tax cost. If the trader has capital losses from an investment that isn't part of the trading activity, the trader will lose the ability to offset those losses with capital gains from trading.

For many traders, the flip side will be more important. Even good traders sometimes have losing years. When they do, the capital loss limitation rears its ugly head. A trader who has not made the mark-to-market election can deduct only $3,000 of net capital loss, with the excess loss carrying forward only, not back to earlier, profitable years. If you make the election, your trading loss isn't subject to this limitation, and can carry back as well as forward. The difference can be *huge*.

One word of caution for futures and commodity traders is that by electing mark-to-market accounting you will lose the benefit of the 60% long-term capital gain or loss treatment you receive when you trade these types of securities.

You're Stuck With It

Once you make the election, you have to continue to use the mark-to-market method for all future years. You can change the election only with the consent of the IRS, and they generally won't grant this consent if your reason for changing is simply that the election didn't turn out to your advantage. Be sure you know what you're doing before making the election.

Identifying Holdings

Before you make the mark-to-market election, you need to think about identifying any stocks you hold as an investment. Failure to do so could be costly.

What's at Stake - Suppose you're a trader and you make the mark-to-market election. In addition to stocks you trade, you have some stocks you hold as investments. You've held some of these stocks for years, and they've gone up in value a great deal. If these stocks are considered part of your trading business, you'll report ordinary income, not capital gain, when you sell them. Even if you don't sell them, the gain will be treated as ordinary income when you mark to market on December 31. Depending on how much gain you have in your investment stocks, this could be a real disaster.

What You Can Do - The rules permit you to maintain investments that are not part of your trading business. To do this, though, you have to *identify* those investments. In other words, you have to make it clear, up front, which stocks are part of your trading business and which are not. You can't decide later to treat the losers as trading stocks (for ordinary losses) and the winners as investment stocks (to avoid marking to market and get capital gain treatment).

When to Identify - The proposed regulations provide that if you want to identify securities as not being part of your trading business, you must do so on the same day you acquire the security (or enter into or originate your position in the security, in the case of short positions or options). If you hold any investment securities at the time the mark-to-market election becomes effective, presumably you can identify them at that time.

How to Identify - Regulations developed for securities *dealers* provide two ways to identify securities for purposes of these rules. One is to establish a separate account for investment securities, and the other is to clearly indicate on your own records which securities are not part of your trading business.

These rules also apparently apply to securities traders. There's some question in my mind, however, whether the procedure of identifying shares on internal records makes sense for an individual trader. It will be difficult to establish factually that the identification occurred at the proper time, rather than being made up later. *For this reason, I recommend that anyone who makes the mark-to-market election and holds some securities for investment should establish separate* *accounts for trading and investment activities, taking care never to mix the activities of the two accounts.*

No Connection to Trading Business - Even if you identify securities as investment securities, the IRS can disregard your identification unless you demonstrate by "clear and convincing evidence" that the security has "no connection" to your trading activity. If the IRS rejects your identification, you'll be required to mark the securities to market at the end of the year, and report any gain as ordinary income. It isn't clear what is meant by "no connection" to the trading business. In particular, it isn't clear whether investment securities can be used as collateral for trading margin without being drawn into the mark-to-market regime.

Making the Mark-to-Market Election
Many elections under the Internal Revenue Code are as simple as putting a checkmark in the proper box. That isn't the case for the mark-to-market election. In fact, making the election is a royal pain.

Deadline - The IRS chose an unusual deadline for this election. Most elections are due at the end of the year, when you file your return. This election has to be made by the due date — without extensions — for the *previous* year's tax return. The last day to make the mark-to-market election for the year 2013 was April 15, 2013.

I believe the main reason for this is to prevent taxpayers from choosing the election at a time when they already know whether their trading activity will generate a profit or a loss. Many traders would wait until they have a year with significant trading losses, then file the election for that year to avoid the capital loss limitation. Of course you're stuck with the election for all future years once you make it, but until then you get the benefit of capital gain treatment in profitable years without worrying about the capital loss limitation in a year with poor results.

There's a rule that says a "new taxpayer" (a taxpayer for which no federal income tax return was required for the preceding year) can make the mark-to-market election during the first two months and 15 days of the election year. They make the election by recording it in their books and records rather than by filing an election with the IRS. It appears that this rule was designed for newly formed entities (such as corporations and partnerships). Individuals who start trading after April 15 without forming an entity will apparently have to wait until the following year to make the mark-to-market election.

V. SETTING UP LEGAL ENTITIES FOR YOUR TRADING BUSINESS

What is a Legal Entity?

A legal entity is an organization recognized by the IRS, that has a corresponding Employer Identification Number (whether it has employees or not). There are four structures to choose from: the sole proprietorship, a C-Corporation, a flow-through entity such as a limited liability company (LLC) or limited partnership, and a C-Corporation that manages a flow-through entity. Which is best? Read on, and find out.

Sole Proprietorships

We'll tell you straight out, setting up a sole proprietorship for your trading business is a bad idea, with the biggest disadvantage being your election of trader status. As we've mentioned, proving trader status is not a well-defined area, and the defining characteristics change all the time. The IRS uses everyday taxpayers (read: sole proprietor traders) to test their theories on how rules will be applied. Selecting a sole proprietorship means that the probability of an audit increases, and the next new tax ruling could change your trader status. That's not a good way to run any business.

There's more bad news regarding sole proprietorships. Personal assets aren't separated from your business assets, so you'll have zero liability protection. Should something go wrong, you could lose your home, and any other personal assets. Tax deductions for your trading business are extremely limited too. As a sole proprietor business owner, you can't make retirement contributions since the income from your trading is not considered self-employment income.

And speaking of income, if you forego the Mark-to-Market accounting election, your income is accounted for as a capital gain on Schedule D, but your expenses are reported on Schedule C. Your income is deemed capital, yet expenses are treated as ordinary. This creates an enormous conflict, and appears odd to the average IRS agent that may review your return.

Why is a Legal Entity More Beneficial Than Filing as a Sole Proprietor?

The number one reason you should conduct your trading business within a legal entity is that it solidifies your business activities and expense deductions. If you're like most traders, you'll easily find deductions totaling from $10,000 to $20,000—without even breaking a sweat. And, if you're a trader with substantial losses, and you're filing under the mark-to-market accounting method, the $3,000 capital loss limitation waiver could be worth tens of thousands of dollars.

If you're not operating under a legal entity, your tax savings are continually in jeopardy. At any moment, a new tax court ruling could re-define the definition of a trader, and throw your entire tax plan into the garbage, with no recourse.

Also, establishing a legal entity for your trading business brings you sound peace of mind. You'll lock in the benefits of the trading business, rather than being at the whim of the IRS. Legal entities, unlike securities traders, are well defined, so you'll be sure of the status conferred upon your business activities and expenses.

Flow-Through Entity: Limited Liability Company

A limited liability company (LLC) is a relatively new entity that affords two key benefits: asset protection for members, and loss deductibility. When you run your trading business under an LLC, your potential loss extends to the capital you paid into the business. And, your assets are protected. An LLC's income, losses, tax deductions and tax credits are passed through to you, the taxpayer. You may fully deduct losses against ordinary income, which again, helps any business just starting out. And as an added benefit, you may set up retirement plans, which are deductible to the business and are not taxed at the individual level. You'll find more on retirement accounts in our bonus materials.

Flow-Through Entity: Limited Partnership

Until the advent of the limited liability company, limited partnerships were the way to go. The benefits of both entities are the same. Your potential loss extends only to the capital you pay into the business, and your assets are protected. The partnership itself is not taxed. As a flow-through entity, income, losses, deductions, and credits are all passed through to you, the taxpayer. And, you don't have to pay self-employment taxes on your income.

Who Should Use Flow-Through Entities for Their Trading Business?

The LLC and limited partnership are perfect for traders who are active, completing more than 15-20 trades per month, who want to write-off their business expenses, and who may want to use a portion of earnings to pay for personal expenses.

The IRS allows both to be regarded as a "pass through" type of tax entity. That is, the profits or losses pass through the business and are reflected and taxed on the individual owners' tax returns, rather than being reported and taxed at a separate business level (as with a regular Corporation). The members (partners) of flow-through entities pay tax on their individual share of income, and generally use any losses to offset other personal income.

C-Corporation

A C-Corporation may be a great choice if you're doing business as a trader. Since a corporation is a legal entity in its own right, with the right to sue and be sued, and the right to enter into contractual agreements, it, like any other "individual," pays its own taxes. Even better, a C-Corporation gives you and other shareholders personal asset protection.

A C-Corporation brings you many other benefits as well, such as the ability to amortize pre-existing and start-up expenses, depreciate business assets, and maximize allowable write-offs. In fact, corporate deductions are so wide reaching that frankly, if your expense is ordinary and necessary, it's deductible.

For those who think starting a corporation means starting a company like Microsoft, you'll be pleased to learn that your corporation can be any size. In fact, you need only one person, yourself, to fill the roles of officer, director and shareholder. You can be your own corporation! Your family members may participate in the corporation as well, as you'll soon see.

Of course, corporations have their downsides too, the major one being double taxation. If you form a corporation, its profit is taxed on the corporate level. And when you pay those once-taxed profits out by way of shareholder dividends, the recipient shareholders, i.e. you, must report the payment as dividend income, creating two taxes on the same profit. However, you can easily avoid double taxation if you're a sole owner corporation. Simply use extra funds to invest in another LLC trading vehicle rather than paying out dividends.

Who Should Use the C-Corporation for Their Trading Business?

The C-Corporation, by itself, works well if you're looking to grow your wealth by long-term investing rather than using profits for short-term needs. One of the main advantages is that the C-Corporation has its own tax brackets. For example, instead of your trading gains being taxed at your personal tax rates, the first $50,000 of profits in your C-Corporation are taxed at just 15%. In addition, the C-Corporation is unique in that it gives you the ability to write-off 100% of all medical expenses, including long-term care and other related expenditures. If you're in this situation, the C-Corporation may be right for you. (See our later discussion on writing off medical expenses for more information.)

Corporations with a Flow Through Entity:

Limited Liability Company with a C-Corporation as Management

You'll enjoy all the benefits of a C-Corporation, including:

- Fully deductible fringe benefits
- No self-employment taxes
- Personal asset protection
- Clear tax laws, with few gray areas

The C-Corporation acts as management. It pays your bills, and enters into agreements for itself and for your LLC. You, and your family members, hold the C-Corporations' stock.

The LLC, on the other hand, acts as the trading company, and is the owner of securities traded by your C-Corporation. LLC members include you, your family members, and your C-Corporation. Because the C-Corporation manages the LLC's activity, the only expenses the LLC incurs are commissions, margin and management expenses. And, LLC members may take distributions versus a salary, and avoid payroll taxes. Of course since the LLC is a pass through entity, you'll still pay tax—but later.

The LLC holds your brokerage account, and the LLC's personal asset protection means it can't be seized in the event of a dispute since you personally do not own it—the LLC does.

Even better, since your corporation handles your trading and deducts all trading expenses from its management income, the bulk of your profit is taxed at the lower corporate rate. (For example, the first $50,000 of income to the C-Corp is taxed at 15%.) Now you'll still have to pay tax on dividends (if you issue them), but the only income that passes through to you, as the LLC owner, is income the LLC creates itself.

Who Benefits from Using the C-Corporation in Combination with a Flow-Through Entity?

If you want to use a legal entity for your trading, and you want to take money out of your trading business without paying payroll taxes, and you will be trading less than 350 trades per year and dedicating 500 hours or more to trading or trading related activity, the C-Corporation/LLC combination may be right for you. The C-Corporation acts as the manager of the LLC trading business, making all of the trading and business decisions. As such, all of the expenses are run through the corporation. The LLC is used strictly for holding the brokerage account.

Where Should You Locate Your Entity?

Any entity that carries on an active business must be registered with the state where the business is conducted. As a general rule, when an entity has revenue and/or takes business deductions, it's carrying on an active business, and needs to be registered in that state. If you pay payroll to fund your retirement account or medical insurance, you must register your business within the state where you live. In many cases, it's best to set up the entity in the state where you live. In some cases, however, you might want to consider a state that does not tax income (e.g., Nevada).

Which Entity Should You Use for Your Trading Business?

We do not believe that there is any one perfect entity, or entity structure. However, in our experience, the three simplest, most beneficial structures for active traders are a standalone LLC, a standalone C-Corporation, or a combination of the C-Corporation and the LLC.

As you may be beginning to see (and as you'll see even more later when we discuss deductions), it's important that you trade under the protection of a legal entity in order to convert what are now personal expenses into deductible business expenses.

Which entity is right for you, and will work best with your lifestyle, trading habits and goals? It's a big decision. We at Traders Accounting invite you to leverage our years of trader and entity tax experience. Email us at learn@tradersaccounting.com, or call us at 1-800-938-9513. We'll review your situation and help you determine which entity is right for you. On top of that, we're pros at setting up entities quickly and cost-effectively, and will get your new entity started soon so you can begin realizing the savings.

Notes

ARE YOU A TRADER OR INVESTOR?

Calculating your taxes is not very simple. You can't just take your income, subtract your expenses, and multiply by a tax rate.

That would be too simple, don't you think?

Want to find out what your deductable expenses really are?

Want to avoid claiming non-deductable expenses?

Did you know that there is no real definition of a "trader" in the tax code? Find out how to setup your trading entity correctly!

A Trader's tax situation is very unique, this guide will inform and educate the trader on these extremely important tax situations.

Don't start, or continue running, your trading business without reading this extremely important guide.

About the Author:

Jim Crimmins is the founder and President of Traders Accounting, a firm dedicated to those engaged in active trader business. Jim, a day trading accounting expert, has become the voice of 'tax efficient trading' for the fast growing market of day traders. He delivers webinars and participates in several chat rooms each month as well as creating classes, lectures, and home study courses for small business entrepreneurs.

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