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ACTIVE TRADER

Tax Tips for Traders

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Active trading can produce some tax headaches and pitfalls, but it also creates opportunities for special tax savings. It's best to understand the rules before organizing your tax affairs, making tax time an easier experience. However, it's never too late to improve your outcome.



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Accounting can be a snap

Securities (stocks, stock options, ETFs, mutual funds, bonds, and single-stock futures) require line-by-line tax reporting — each individual sale or redemption must be entered on the tax form. Manually entering all sales can be expensive and time consuming.

Accounting for securities transactions is more complex than it should be, with wash-sale rules, straddle-loss deferral rules, and numerous others to consider. Nonetheless, for stock traders, good trade accounting software may be the best solution. The key is to find software that will import all your transactions directly from your broker's Web site, match the trades properly, do adequate wash sale reporting, and more. Of course, no software package is going to handle every tax rule related to stock trades, particularly those involving related party transactions, wash sales involving substantially identical securities, (which is a partly subjective determination) and unusual types of securities or transactions.

Two companies that offer this kind of software are GTT TradeLog™ (Note: GTT Trade Log is affiliated with the author's company) and Gainskeeper.® These products are compatible with most leading brokerage, and the brokerages generally work closely with the software providers to ensure a smooth import feature.*

Traders vs. investors

The tax treatment of your investment-related income and expenses depends on whether you are considered by the IRS to be an investor, dealer, or trader. You are generally considered an investor if you buy and sell securities for long-term capital gains and to earn dividends and interest; and a dealer if you hold an inventory of securities to sell to others. The term "trader," however, is not defined in tax laws or regulations. So there is no clear-cut test to determine whether a person qualifies as a trader. IRS Publication 550 states that to be considered "engaged in business as a trader in securities, you must meet all the following conditions: 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."

Generally, the IRS may view you as a trader if you:

- Have established a pattern of buying and selling a number of securities almost every business day.
- Devote substantial periods of time to manage your own transactions and, preferably, don't work at a second job.
- Seek short-term gains rather than long-term appreciation.
- Derive little income from interest and dividends.
- Hold securities for relatively short periods of time.

From a tax perspective, trader status will generally provide greater opportunities to deduct investment related expenses because of the ability to claim ordinary business expenses. Investor status will only allow you claim certain investment related expenses as "miscellaneous itemized deductions," which are only deductible in excess of 2% of adjusted gross income (AGI).

Make the most of expenses

If you meet the requirements to be considered a trader, then just like other businessmen, you need to keep track of your business expenses for tax purposes. Trade-accounting software doesn't handle that, but programs such as Quicken or QuickBooks do, although there are other business accounting software packages as well.*

Business expenses include everything directly related to the business, such as books, training, data feeds, supplies, Internet, communications, depreciation, amortization, services, and more. Business expenses can generally be used to offset business income, but if the expenses exceed the income, there may be limitations on the losses you can claim. How your business is structured (sole proprietorship, partnership, corporation) will also play a role in how you need to report your business income and expenses as the tax reporting requirements for each can be quite different.

If you work from home, there are home-office expenses you may be able to claim, including real estate taxes, mortgage interest, and all indirect expenses attributable to your home — i.e., insurance, lawn care, repairs and maintenance, utilities, and more. The square footage of your exclusively used business area vs. the square footage of your entire home drives the allocation of the portion of these expenses that can be claimed as business expense. There are very specific IRS requirements to meet to claim home office expense and limitations may apply. You may find IRS Publication 587, *Business Use of Your Home*, helpful.

Itemized deductions, which may include unreimbursed employee business expenses, and investment interest and expenses are also deductible. However, they deliver much less punch on tax returns.

Configure your accounting program to separately account for cash, investment accounts, trading accounts, depreciable business assets, other depreciable and nondepreciable assets, liabilities, and net worth. It will make it a lot easier when it comes time to preparing your tax return.

The biggest mistake taxpayers make at tax time is not capturing their entire financial activity and leaving out numerous allowable tax deductions, which raises their tax bills. Show your entire financial activity to your accountant and give him the opportunity to consider ideas for tax deductions.

Taking advantage of tax-losses

Individual investors can use capital losses to offset capital gains, however, to the extent the losses exceed the gains, they are limited to a puny \$3,000 net capital loss each tax year to offset against ordinary income such as wages. For example, if you have net losses of \$50,000 from trading, you may only offset \$3,000 of that against other income.

Individuals may carry forward their unused capital losses to the subsequent tax years; but generally carry backs of securities capital losses are not allowed. You may use the entire capital loss carryover in the subsequent tax year, provided you have sufficient capital gains in that year; however, use of the annual

net capital loss is limited to \$3,000.

One of the potentially biggest pitfalls for active traders is getting stuck with large capital loss carryovers for which they have no capital gains to offset them. This can be a widespread problem during long-term bear markets. Some quit trading entirely and see little chance of ever using up all their net capital losses on their future tax returns.

However, if you can claim trader status, one way to potentially solve this problem is to elect Mark-to Market (MTM) accounting known as a 475(f) election. Under the MTM accounting rules, you report gains or losses you had on closed transactions, as ordinary income or losses, plus unrealized gains and losses on your trader business securities (but not your personal investment positions) you still hold at the end of your taxable year. MTM essentially converts capital gains and losses into ordinary gains and losses, and ordinary losses can offset income of almost any kind (wages, interest, dividends, capital gains, etc.).

With MTM, you are also not subject to the wash-sale rules, which can be time-consuming for active traders to track. A wash sale occurs when a security is sold at a loss and the same or a substantially identical security is purchased, within the same or a different account, within the 61-day period that starts 30 days before the sale and ends 30 days after it. If you have personal investments in addition to the investments you hold as a trader, it's a good idea to hold them in separate accounts as you must clearly distinguish between them for MTM purposes (MTM only applies to business positions and not to segregated personal investment positions).

Claiming trader tax status and electing MTM may save many securities traders significant taxes, but it requires a lot of careful analysis before making the election because an MTM election may not be changed in later years without IRS permission. Note if you exit a trading business, you may no longer use MTM and no IRS permission is required. Also the requirement to report unrealized gains and losses at the end of each year could create a tax liability even when you have no actual (realized) income. In making your decision, you will need to consider whether you have the resources to cover such a potential liability.

An MTM election also may not be suitable for some profitable Section 1256 contracts traders (commodities and index options, for example) who want to retain their beneficial "60/40" capital gains rate treatment. Note that 1256 contracts are generally required to be reported under MTM rules using the special 60/40 capital gain treatment even if you don't elect MTM accounting. You may also be able to elect out of MTM rules for certain straddle transactions. IRS Publication 550, *Investment Income and Expenses*, provides some helpful information on reporting these 1256 contracts.

Unlike trader tax status, which can be declared at anytime, for use in the current tax year, MTM must be elected by the tax filing deadline (without extensions) for the prior tax year. So for use in the 2007 tax year, MTM must be elected by April 17, 2007. Next, because MTM usually results in a change to your accounting method, in order to "perfect" your MTM election, you need to file a Form 3115 (Change of Accounting Method) for the year elected. So if you elect MTM for the 2007 tax year, a Form 3115 should be included with your 2007 tax return filing in 2008.

MTM can be a gamble

While MTM can often be very helpful to securities traders, those with large capital loss carryovers face an important decision in considering an MTM election for the subsequent tax year. Capital loss carryover from years prior to the MTM election cannot be used to offset MTM ordinary trading gains, so the election becomes a gamble for many traders.

For many traders, however, having ordinary trading losses may be better than adding to capital-loss carryovers that they have determined they are unlikely to ever use in the future.

Bottom line

Tax filing can be time-consuming, but it can be easier by following three simple steps:

- 1 purchase good accounting software for your trading activity;
- 2 determine if you qualify for trader tax status, and
- 3 if you already know you qualify for trader status, determine if MTM accounting would be a good election for you.

Robert A. Green, CPA, is author of the Tax Guide for Traders (McGraw-Hill, 2004) and a leading authority and content writer on trader tax.

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