



Forex taxation:

IRC 988 versus 1256 60/40 tax treatment,
trader tax status, forex funds and more!

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Items for discussion

- **Forex Tax:**

- **The tax code is uncertain and confusing regarding forex trading taxation.**
- **The tax problem is that some types of forex are treated as IRC 1256 contracts with lower 60/40 tax treatment, while other types of forex are treated as IRC 988 foreign currency transactions with ordinary gain or loss treatment.**
- **Green will simplify the rules and show you how to lower your tax rates on forex gains by up to 12% by electing out of IRC 988.**
- **He also will show you how to maximize your tax refunds from forex losses.**
- **Finally, he will show you how to report forex and currency futures and options on your income tax returns.**

Items for discussion (continued)

- **Trader Tax:**

- You will learn how to use important tax savings strategies in connection with trader tax status (business treatment) and how to qualify to claim that status. Business traders will learn how to deduct all business expenses safely, without having to form an entity.
- Since a trading entity is sometimes a good idea because it allows the deduction of health insurance premiums, retirement plan contributions, and other fringe benefit plans, this session also will cover the formation of trader entities.
- Learn how to get huge tax refunds from net operating losses (NOLs).
- We will show you how to avoid IRS exams and, if examined, how to win before the auditor even gets started.

- **Forex Funds:**

- Learn how easy it is to set up and operate your own forex hedge fund.

- **Questions & Answers**

Can forex traders have their (tax) cake and eat it too?

- Traders prefer the best of all tax-worlds with ordinary tax treatment for losses, so they are exempt from capital loss limitations.
- And capital gains (60/40) tax-treatment for gains, so they save up to 12% in tax rates (23% versus 35% at current tax rates).
- Traders should learn the complex rules for forex taxation before they start trading forex so they can make the necessary elections in-advance to ensure the best overall tax treatment.

Currency futures & options on U.S. exchanges are IRC 1256 contracts with 60/40 tax rate benefits:

- Currency futures and options listed on U.S. commodities and futures exchanges are by default treated as 1256 contracts.
 - They are reported on Form 6781, where they are split 60/40 before being moved over to Schedule D (Capital Gain or Losses).
 - Capital loss limitations of \$3,000 per year apply.
- Currency futures and options listed on foreign (not U.S.) exchanges are treated differently by default, but possibly in the same manner after doing some leg work.
- OTC forex options are IRC 1256 contracts, but if you want 60/40 treatment, you still have to elect it.

Forex spot & forward contracts are taxed differently.

- Forex spot and forward contracts are IRC 988 foreign currency transactions. They are reported in summary form as ordinary gains or losses on line 21 of Form 1040 (Other Income or Loss).
- Capital loss limitations do not apply since Schedule D is not used; so ordinary losses offset any type of income (including wages) without limitation.
- IRC 988 interbank forex includes spot forex, forward forex and other types of forex contracts.
- A trader or investor may elect out of IRC 988 for the more tax-beneficial IRC 1256 with 60/40 tax treatment.
- You need to make this election “internally” (within your own books and records) in advance of trading for the year. The election is not filed with the IRS.

A note of caution.

- You can have your cake and eat it too with ordinary loss treatment and 60/40 gain treatment by using internal elections wisely.
- But don't fool around with making these elections. If you wind up with 60/40 treatment on gains and ordinary loss treatment on losses from year-to-year, that will appear to be “cherry picking” after-the-fact, even though the elections must be made in advance of trading.
- Learn more about forex taxation at GreenTraderTax here <http://www.greencompany.com/EducationCenter/GTTRecCurrency.shtml>.

“Trader tax status” unlocks business expense deductions

- If you want to deduct your trading expenses as ordinary – just like forex trading losses – you need to qualify for “trader tax status” (business treatment vs. the default investment treatment).
- Business treatment gives full ordinary loss deductions (including home-office, education, start-up expenses, margin interest and much more), whereas investment expenses are very limited, only allowed in excess of 2 percent of Adjusted Gross Income (AGI), and not deductible at all against the nasty Alternative Minimum Tax (AMT).
- The average trader saves more than \$10,000 with trader tax status, and hedge funds save a fortune for all their investors.

Qualifying for Trader Tax Status

- A business trader meets most of the following qualifications:
 - Trades full-time or part-time, all day every day.
 - Hours spent: Spends more than three hours per day, every day with few sporadic lapses.
 - Number of trades: More than 750 round-turn trades per year, but there is no magic number in case law.
 - Holding periods: Mostly day trades or swing trades, and few positions are held for more than a few weeks. Investment positions are segregated.
 - Intention: To run a business and act accordingly with record keeping.
 - Business tools: Has significant tools and business expenses.
- If your trading activity is anything less than the current golden rules stated above, the IRS may scrutinize and challenge your qualification for trader tax status. In this case, it's wise to consider a consultation with a GreenTraderTax CPA to review your particular facts and circumstances. Sign up here <http://www.greencompany.com/Traders/TraderConsulting.shtml>.
- You can claim trader tax status after year-end; it doesn't need to be elected in advance.
- It's easier to qualify for trader tax status as a part-time forex trader than a part-time securities or futures trader. Forex trading is often done at night, after job and other market hours.

Qualifying for Trader Tax Status

Statutory vs. Case Law

- Currently, the IRS does not provide “statutory law” with objective tests for how to qualify for trader tax status. Subjective “case law” applies, and it’s weak on guidance; case law has not caught up with the online business trading revolution. Our golden rules are based on years of experience.
- Subjective “case law” has a two-part test to qualify for trader tax status:
 - “Taxpayers’ trading activity must be substantial, regular, frequent and continuous.”
 - “The taxpayer seeks to catch the swings in the daily market movements and profit from these short-term changes rather than profiting from long-term holding of investments.”
- The above is too broad and subject to varying interpretation
- The IRS likes to challenge “sporadic lapses” in trading activity
- Do you need to trade every day, or is just managing your trading business on a daily basis enough to satisfy the IRS?
- How does the IRS treat automated trading?
- Forex trading is not a classic investment activity.

How do I claim trader tax status and prepare my tax returns?

- Trader tax status is NOT elected with the IRS; rather you claim it on your own.
- Assess your trader tax status before or after year-end. Since it's based on facts and circumstances, after year-end may be safer.
- If you qualify for trader tax status, and have not formed a separate legal entity, then you are classified as a "sole proprietor" or "unincorporated business." Report your trading business expenses on Form 1040 Schedule C (Profit or Loss from Business).
- Currency futures (IRC 1256) trading gains and losses are reported on Form 6781. Forex trading gains and losses are reported on Form 1040, line 21 Other Income (Loss), unless you elect out of IRC 988 for IRC 1256.
- Important GreenTraderTax strategy. Transfer business trading gains to Schedule C, to unlock home-office deductions and IRC 179 depreciation; but do not show a profit on Schedule C (it could invite IRS questions about SE tax).
- It's important to attach a good tax return footnote explaining your trader tax status and this special tax treatment on your tax return.
- You can even amend prior year tax returns to claim trader tax status.

Net operating losses (NOL) give huge immediate tax refunds

- NOLs may be carried back two tax years and/or forward 20 tax years.
- NOLs may offset any type of income in prior and future years, whether you were/are a business trader then or not.
- Conversely, securities trading capital losses may only be carried forward and applied against capital gains.
- Futures trading capital losses may be carried back three tax years, but only applied against futures trading gains in those years.
- NOL tax treatment requires “trader tax status” (business treatment). It converts ordinary forex trading losses (IRC 988) into an NOL.
- Watch out! If you have negative taxable income (perhaps from forex losses and no other income) and you don’t qualify for trader tax status, your forex trading losses are wasted tax-wise.
- Trader tax status also converts your trading expenses in business expenses; also added to your NOL.

Trade accounting can be challenging for forex traders

- Brokers are not supposed to report forex transactions on Form 1099s filed each year with the IRS, but some do.
- Most brokers provide useful online reports summarizing annual taxable trading gains and losses.
- Learn how to use the GreenTraderTax Worksheets and Formulas for annual trade accounting; it may be your last resort for forex and other accounting. It's a simple way to count the forest rather than each tree in the forest. See <http://www.greencompany.com/Traders/Guides.shtml>.

Entities, retirement and employee-benefit plans

- Entities are helpful for traders and are required for hedge funds. Traders don't need liability protection, but money managers do.
- One size doesn't fit all when it comes to entities. Don't go with canned solutions; work with a trader tax expert to pick the best entity for your special needs. It varies by state and there are other factors to consider, too.
- Learn the differences between in-state and out-of-state entities. Tax-free states market entities for "asset protection" and tax avoidance reasons, but both usually fail in practice. If you live and work in your home state, you need to register a foreign entity in that state. It's different for funds.
- Most traders don't have earned income from trading, so in order to contribute to a retirement plan they need to form a trading entity.
- Learn the self-employment (SE) tax rules for traders (see below page).
- Learn about different types of entities and retirement plans, and how to choose the best ones for your situation. Multi-member LLCs, general partnerships and S-Corps are good for traders. C-Corps are bad for traders (double taxation and losses are trapped in the entity).
- Mini 401(k) retirement plans can generate the most tax savings for traders. Defined-benefit plans, Roth IRAs and other employee-benefit plans (Health Savings Accounts, HRAs and more) are also good.

Self-Employment Tax

- By default, almost all traders are exempt from SE taxes, which are equivalent to payroll taxes in a job situation (FICA and Medicare). This can be a huge savings!
- SE taxes are 15.3 percent of the first \$90,000 and 2.9 percent (Medicare only) thereafter.
- Traders are exempt from SE tax because trading gains are not considered “earned income,” whether or not you have trader tax status. SE tax is assessed on earned income only.
- There are two exceptions:
 - Traders who are members of an options or futures exchange are deemed to have earned income on all their exchange-generated trading gains (IRC 1402i).
 - Proprietary traders who receive a Form 1099-Misc. for non-employee compensation are considered to have earned income.
- The GreenTraderTax entity/retirement plan strategies are designed to maximize income tax savings (with AGI deductions for retirement plans and health-insurance premiums) vs. SE tax costs. You almost always wind up with net tax dollars in your pocket, plus you replace bad (income) taxes with good (SE) taxes (which provide retirement benefits).

Trade other people's money in a hedge fund or managed accounts

- Successful traders are often asked to give investment advice or trade for others.
- Be cautious – if you get compensated for investment advice or trading for others, you may trigger your home state and/or federal investment adviser rules. You are also subject to “fiduciary care” rules.
- Forex trading is not regulated in the U.S. But your FCM (futures commission merchant or broker) is regulated.
- The SEC and states regulate securities trading and the CFTC and NFA regulate futures and commodities trading.
- Learn about the unique GreenTrader Incubator Hedge Fund strategy. It's a very low-cost way to get started in a hedge fund business.
- An incubator fund helps you generate a performance (track) record before you prepare your offering memoranda (and other legal paperwork). It breaks the development costs into two phases, saving you money to start. It can also serve as your trading business entity.

Questions and Answers

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