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August 19, 2008

LBR Group and Roy F. Glassberg, CPA presents a Tax Summary for Traders

Roy F. Glassberg, CPA is a partner in a NY and Florida Based CPA Firm Glassberg & Mermer, CPAs since 1984. The firm was established in 1966 by Herbert Glassberg, LPA to provide advice and tax preparation services for individuals and businesses with the goals of maximizing a taxpayers net after tax return and minimizes the taxpayers risk to negative audit results.

Taxes for Traders (a/k/a day traders, active traders, trader businesses, etc.) is a special area of taxation and for myself an almost exciting (if taxes can ever be exciting) area of practice as the IRS has, in my opinion, given traders the best of both worlds; they allow a trader to deduct any and all business expenses against their trading income and yet do not consider net trading income to be subject to social security and medicare taxes.

Additionally if you are a trader of 'Section 1256 Contracts' 60% of your trading gains are taxed at long term capital gains rates, which for most taxpayers is currently 15% (state taxes are additional)

- I. Trader Deductible Expenses
- II. Trading Entities
- III. Section 1256 Contracts
- IV. Mark to Market Election
- V. The Best of The Best
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I. Trader Deductible Expenses

The following expenses are typical for a trader but are not the only allowable per The IRS. As with any business, such as a corner candy store, pizza parlor, doctor's office, etc., a trader may deduct any and all expenses that are necessary to help you "operate" your business. This includes:

- trading chat room fees
- computer (hardware and software) and internet and costs
- education classes and related education materials and travel and lodging costs
- trading data, charting fees, news subscription services
- office in home expenses
- tax preparation fees
- 50% of meals where the business of trading is discussed

As with all businesses if requested by The IRS you need to have both proof of expense (bill) and proof of payment (credit card statement, canceled check)

II. Should One Form a Trading Entity?

If you are trading money for others, as opposed to trading for yourself alone, than the simple answer is Yes. Setup either a General Partnership (usually zero or minimal State setup and annual fees) or a LLC taxed as a partnership.

In determining the best structure from a tax point of view (legal protection should be reviewed with an attorney) if you are solely trading your own money, for most people the formation of a business entity to trade is mostly unnecessary, except for one main situation, whereby you desire to pay social security and medicare taxes on your income, thus allowing you to fund a pension plan.

Other than trading via a Regular "C" corporation (which we feel has many more negatives than positives) you can deduct the exact same trading expenses individually as you can with any other trading entity. You do not pay social security or medicare tax and you get the 60/40 benefits of trading Section 1256 contracts (see Section 1256 Contracts below).

If you have the desire to fund a pension plan and thus defer the income taxes on a portion of your trading income we have seen traders setup a Sub Chapter S Corporation, pay themselves a salary (which causes the imposition of social security, medicare and federal and state unemployment insurance taxes) and than fund a pension plan.

Note that you can NOT fund a pension plan if you do not have social security or self employment income. Take note that I have clients that get paid a salary of \$170,000 to \$220,000 salary from a Sub Chapter S Corporation and the Corporation can fund and get a deduction for a pension contribution from anywhere between \$45,000 and \$200,000 (yes a \$200,000 pension deduction). See Example in Index at end of document

III. Section 1256 Contracts

Section 1256 Contracts have the potential disadvantage of having the taxpayer mark-to-market (treat open positions at December 31 as if they were sold) but this is countered with the favorable treatment of taxing 60% of your gains as a long term capital gain sale, vs. short term capital gain sale.

What types of transactions are considered Section 1256 contracts for US income tax purposes

- Commodities
- Currency Regulated Futures Transactions
- Foreign Currency Contracts
- Non-Equity Options
- Dealer Equity Options
- Dealer Securities Futures Contract
- certain options are 1256 contracts and certain are NOT
 - ① a 1256 contract has to be listed on an exchange
 - ① a 1256 contract can NOT be an option of a single equity
 - ① If an option is of an index or group of stocks it can NOT be of a narrow-based index(see index for definition of narrow-based)
 - ① options on ETF's such as the QQQ, SPDR, Ishares are NOT section 1256 contracts
 - ① options such as MNX and OEX are section 1256 contracts; for a list of other 1256 options contracts go to <http://www.cboe.com/Products/Cash-SettledIndexOptions.aspx#broadbased>

IV. MARK TO MARKET ELECTION FOR EQUITY TRADERS **WHY AND WHY NOT**

The IRS allows traders that do not trade Section 1256 contracts to make a Mark to Market election for their trading business. One needs to make this election by April 15th of the current business year. i.e to make a Mark to Market election for 2009 you need to make the election by April 15, 2009.

The benefit of making this election for equity traders is if you have a negative trading year you can reduce any other taxable income you have that year by the full loss (if you do not mark to market you may only use \$3,000 of your trading loss to reduce other taxable income). And any excess trading loss you can elect to either carry it forward or go backwards, and obtain a refund of taxes paid in prior years.

The negative of making a mark to market election is if you keep open trading positions from December 31st of one year into the next year (most of my equity clients close out positions at December 31) you have to pay tax on unrealized gains.

Who should NOT elect mark to market their trader business.

- Section 1256 contract traders as they will lose their 60% of gains being taxed at long term capital tax rates
- A trader that has large long term capital loss carryforwards as their trading income will not net against these loss carryforwards


V. THE BEST OF THE BEST

You have proven that you can consistently earn a good or great living as a trader and you do not like paying the taxes that your government insist that you pay; you are The Best of the Best and you deserve to have the Best of the Best tax setup.

Enter the Roth IRA. If you have a traditional IRA or pension plan from a former occupation you can make a decision to pay tax on those monies (a pension will have to be transferred to a traditional IRA prior to converting to a Roth IRA) today by transferring the monies to a Roth IRA and than trade in The Roth IRA account (an important step prior to doing this is to find a trustee that will allow the type of trading you do in The Roth IRA account). **Any and all profits in this account will NEVER be taxed.**

Is there a situation where this cannot work. Yes. Unfortunately if your total income (NOT including the traditional IRA to Roth IRA conversion income) is greater than \$100,000 than you cannot do a Roth conversion.....EXCEPT, as of today, in 2010 The IRS will allow any taxpayer to do a conversion, even if their total income is greater than \$100,000.

Thus the question; should you setup a Sub Chapter S Corporation today so you can fund a pension and than convert that pension in 2010 to a Roth IRA? The only possible problem here, is if The IRS changes this 2010 exemption between now and than.



VI. INDEX

Sub S Corporation and Pension example:

A. Trader individually earns after expenses \$500,000 trading and pays income tax on \$500,000

B. Sub S Corporation earns after ordinary expenses \$500,000

Sub S Corporation pays trader a \$200,000 salary

Sub S Corporation contributes into a pension plan \$170,000

Sub S Corporation pays social security and unemployment taxes of approximately \$9,000

Net Result is the trader pays income tax on \$200,000 salary and Net profit from Sub S Corporation of $(500,000 - 200,000 - 170,000 - 9,000)$ \$121,000 and the net cash you received is net salary of \$191,211, profit from Corporation of \$121,000 and you have \$170,000 in a retirement account.

- An index is generally narrow-based if:
 - It has 9 or fewer component securities;
 - One security comprises more than 30% of the index's weighting;
 - The 5 highest weighted component securities in the aggregate comprise more than 60% of the index's weighting; or
 - Any one or combination of securities, in the aggregate, has a dollar value of average daily trading volume of less than \$50 million (or in the case of an index with 15 or more component securities, \$30 million) and has an aggregate index weight in excess of 25%.
- However, an index that meets one of the above criteria will *not* be narrow-based, if:
 - It has at least 9 component securities;
 - No component security comprises more than 30% of the index's weighting; and
 - Each component security is registered pursuant to section 12 of the Exchange Act; is one of the 750 securities with the largest market capitalization; and is one of the 675 securities with the largest dollar value of average daily trading volume.

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