TAX STRATEGIES FOR BUSINESS OWNERS AND TRADERS
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Introduction

This seminar is designed to provide basic tax (federal) and general business information. For additional information used in this seminar see "References and Websites" on the last page of your handout. Due to the attendees' range in income and circumstances comments made in this seminar may not apply to your specific case. If you feel you have specific questions please inquire after the seminar or make arrangements to meet with me to ensure you receive the proper information. Research may be needed to answer your specific question(s).

Tax Strategies

I. Capital assets - Almost everything you own and use for personal purposes, pleasure, or investment is a capital asset. (1)

II. Capital gains - not all long-term capital gains are taxed at 15%. In addition to the 15% rate, there is a 20% rate for upper-income investors and there are several additional long-term capital-gains rates, which can range from 0% to 28%. There's also a 3.8% Medicare surtax on gains exceeding the $250K/$500K home exclusion and/or AGI exceeding $200K/$250K. Which category your profit will fall into depends on your income-tax bracket, the type of asset you sold, how long you held it and when you sold it. Keep in mind, short-term gains (on assets held for one year or less) are taxed at your ordinary income rate, which can range from 10% to 39.6%. (2)

   A. You don't owe capital gains tax until you actually sell - That means you have control…you decide whether you want to keep your shares for longer than a year for lower tax rates, or whether you want to sell more quickly to take advantage of a market situation. The point here is: *you* have control over your financial destiny here. (3)

   B. Use losses to offset gains - If you sell some shares and make a good profit, see what you can dump at a loss to offset the taxes. If you own "dead" shares that are never going anywhere, now's the time to sell them, even if it's at a loss. At least that loss will help you out with your taxes by reducing the amount of profit you make overall, meaning you'll pay less capital gains taxes. (3)

III. A wash sale occurs when you sell or trade stock or securities at a loss and within 30 days before or after the sale you: (4)

   A Buy substantially identical stock or securities.

   B. Acquire substantially identical stock or securities in a fully taxable trade

   C. Acquire a contract or option to buy substantially identical stock or securities, or acquire substantially identical stock for your individual retirement account (IRA) or Roth IRA.

   D. If you sell stock and your spouse or a corporation you control buys substantially identical stock, you also have a wash sale.

      If your loss was disallowed because of the wash sale rules, add the disallowed loss to the cost of the new stock or securities (except in (4) above). The result is your basis in the new stock or securities. This adjustment postpones the loss deduction until the disposition of the new stock or securities. Your holding period for the new stock or securities includes the holding period of the stock or securities sold.

Options and futures contracts. The wash sale rules apply to losses from sales or trades of contracts and options to acquire or sell stock or securities. They do not apply to losses from sales or trades of commodity futures contracts and foreign currencies.

IV. A professional trader (aka trader in securities) is one who engages in investing as a business. As a consequence, all normal or necessary expenses are deductible, and the professional trader can set up qualified retirement accounts to take advantage of the tax benefits offered by such accounts. The professional trader can also deduct relevant educational seminars, including travel and lodging expenses, expenses that a casual investor cannot deduct at all. However, probably the greatest benefit to electing the professional trader status is that no Social Security or Medicare taxes have to be paid on the income, which is equal to about 14.1% of self-employment income, up to the Social Security income cap. The savings on any income above that limit will only be the 2.9%.

The following is a list of deductible trading expenses:

Accounting fees
Books, tapes and video courses on investing
Calculators or adding machines
Costs of collecting interest and dividends
Tax advice
Home computers and software
Data-retrieval services
Interest expenses
Legal fees
Salaries
Subscriptions
Home office deduction; simplified method $5/sq ft, max 300 sq ft
Travel expenses for business

Requirements for Professional Trader Status - According to the Taxpayer Relief Act of 1997, traders in securities engage in a trade or business involving active sales or exchanges of securities on the market, not by trading with customers. However, professional trader status is not defined by the tax code – it is defined by IRS guidelines and case law. Hence, there is a certain amount of risk in electing the professional trader status, especially since there are no bright lines in the IRS guidelines, or the court record, for that matter.

To treat trading as a business, the following requirements must be met:

the trader must seek to profit from changes in security prices — not from dividends, interest, or capital appreciation
the activity must be substantial, continuous, and regular; and
the trader must make the election to use the mark-to-market method of accounting under IRC §475(f).

Factors that the IRS considers when determining whether trading is actually being conducted as a business include the following:

typical holding periods for the securities — shorter holding periods indicates trading to profit from short-term price changes
frequency and dollar amount of trades, with greater frequency and amounts indicating a business
whether trading is pursued to earn income for a livelihood, and
the amount of time spent trading.

What does not matter is whether the trader calls himself a *trader* or a *day trader*.

The trading of securities is only considered a business for those securities that satisfy the trading requirements. Any other securities held by the investor are considered an investment rather than a business, and thus, subject to the investment rules. Records must be kept to distinguish between those securities that are traded as a business and those that are traded as an investment, since they are subject to different tax rules which is generally done by keeping them in separate accounts. If long-term investments are commingled with the short-term investments in the same account, then the owner's professional trading status may be in jeopardy, since the IRS regularly audits professional traders.

Mark-to-Market Election

A distinct disadvantage to the professional trader status is that the trader must use mark to market accounting, which is more complex than recording sales and profits or losses. Furthermore, all capital gains and losses from trading securities are treated as short-term, so none of these trades in the professional trading account will qualify for the lower long-term capital gains rate. However, gains or losses from the trading of futures are treated as 60% long-term and 40% short-term, regardless of the holding period.

The mark-to-market election is made by attaching a statement with the following information:

that the election is being made under IRC §475(f);
the name of the business or some other designation that distinguishes the trading business from other activities by the taxpayer; and
the 1st tax year for which the election applies.

The election must be made before the non-extended due date of the previous tax year. So the deadline for making the election for 2013 is April 15, 2013.

Since the mark-to-market election requires a change of the accounting method for reporting gains and losses, the taxpayer must file Form 3115, Application for Change in Accounting Method. If the request conforms to Revenue Procedure 2011-14, then permission will be automatically granted. Once the election is made, the trader can only revoke the election by seeking permission from the IRS, by re-filing Form 3115 to change the accounting method and paying a fee to effect the change.

Warning! Professional Trader Status May Be Revoked

Judging by some court cases, the IRS seems to require day trading or at least very short-term trades. Trades must also be conducted on most of the trading days during the tax year. Additionally, most of the income must be earned from capital gains, not from interest or dividends.

Otherwise, the IRS may decide that the professional trader is actually an investor, thereby revoking the professional trader status, which will incur a hefty liability of back taxes, penalties, and fines. If the trader wants to make longer-term investments, or investments that pay interest or dividends, then it should be done in a segregated account, outside of the business. The risk is that there are no bright lines distinguishing the professional trader from an investor, so if the IRS disputes the professional trader status, it may be difficult to win in such a case, especially if the taxpayer is operating in a gray area. (5)

For IRS definitions see www.irs.gov/taxtopics/tc429tml - Topic 429-Traders in Securities (Information for Form 1040 Filers)

V. Active vs passive activities - Generally, losses from passive activities that exceed the income from passive activities are disallowed for the current year. You can carry forward disallowed passive losses to the next taxable year. A similar rule applies to credits from passive activities.
Passive activities include trade or business activities in which you do not materially participate. You materially participate in an activity if you are involved in the operation of the activity on a regular, continuous and substantial basis. In general, rental activities, including rental real estate activities, are also passive activities even if you do materially participate.

VI. Alternative minimum tax - the alternative minimum tax (AMT) is an additional tax that is calculated separately from a taxpayer's regular tax and if higher than the regular tax the difference is added to the regular tax. The rates are 26% and 28%.

VII. IRA's – Comparison between Roth vs Traditional IRA

	Roth IRA	Traditional IRA
Tax benefits	Tax-free growth Tax-free qualified[1] withdrawals	Tax-deferred growth Contributions may be tax-deductible
Eligibility: Age	Any age with employment compensation	Under age 70½ with employment compensation
Eligibility: Income	Phased out S $114K-$129K; M $181K-$191K Married separate $0-$10K	No income limits to make contributions
Taxation at withdrawal	Contributions are always withdrawn tax-free. Earnings are federally tax-free after the five-year aging requirement has been satisfied and certain conditions are met.	Withdrawals of pre-tax contributions and any earnings are taxable when distributed.
Penalties at	A non-qualified distribution is subject to	Withdrawals before 59½ may be

	Roth IRA	Traditional IRA
withdrawal	taxation of earnings and a 10% additional tax unless an exception applies.	subject to a 10% early withdrawal penalty unless an exception applies
Minimum required distributions (MRDs)	Not subject to minimum required distributions during the lifetime of the original owner	MRDs starting by April 1 of year following reaching age 70½.
Maximum contribution	For both 2014 and 2015: $5,500 ($6,500 if you are 50 or older) or 100% of employment compensation, whichever is less	
Catch-up contribution	Individuals age 50 or older (in the calendar year of their contribution) can contribute an additional $1,000 each year	

VIII. Estimated Tax

If you are filing as a sole proprietor, partner, S corporation shareholder, and/or a self-employed individual, you generally have to make estimated tax payments if you expect to owe tax of $1,000 or more when you file your return.

If you are filing as a corporation you generally have to make estimated tax payments for your corporation if you expect it to owe tax of $500 or more when you file its return.(7)

General Business Strategies

I. Type of entities – Sole Proprietorship, Partnership, C Corporation, S Corporation, Limited Liability Company

LLC's

provide liability protection for their members. This means your personal assets will be protected against debts, losses, and any court rulings against your business.

are "pass-through entities." This means that dealing with business taxes is much easier, though it also means you'll be paying those taxes on your personal 1040 tax return. That said, you can elect to be taxed as a corporation. This brings us to our next point: provides great flexibility. Corporate management structures are far more rigid than those of an LLC. In fact, with an LLC Operating Agreement, you can essentially create the management structure of your choosing.

have far less paperwork up front and in the long-term. This makes them easier to run and to keep compliant with state and local laws.

S Corporations

provide liability protection for their shareholders. Only the money invested in the S Corporation by its shareholders is at risk, barring extreme circumstances. Personal assets are usually protected, as they are with LLCs.

S Corps are not taxed, but shareholders are. In other words, if you have four partners and your S-Corp made $40,000 this past year, you'll each claim $10,000 in taxable income from your S-Corp. While your S-Corp will need to

file an IRS 1120 S form, S-Corps are “pass-through” entities, much like LLCs are, and are not taxed, in and of themselves.
appear more legitimate. Investors often view the corporate structure as more permanent than that of an LLC.
have a more rigid management structure. All S-Corps have hard and fast rules for how to remain compliant, who can vote on corporate practices, etc. These rules give shareholders and owners a real, clear path to follow, and that path is familiar to investors.
require more paperwork. This may seem like a disadvantage, but the additional paperwork actually gives you a concrete record of your decisions and proof that you acted in the best interest of your company. While this can feel tedious, having these documents can be very valuable for tax and liability purposes.
can sell stock to raise capital, corporations often sell stocks. LLCs can only sell interests in their company.

II. Recordkeeping

A. Organized

Keep calendar of events

Who, what, when and where

Mileage log, odometer reading 1/1/XX & 12/31/XX and business miles driven. Miles usually better than itemized expenses

B. Record retention

Keep records for 3 years if situations (4), (5), and (6) below do not apply to you.
Keep records for 3 years from the date you filed your original return or 2 years from the date you paid the tax, whichever is later, if you file a claim for credit or refund after you file your return.
Keep records for 7 years if you file a claim for a loss from worthless securities or bad debt deduction.
Keep records for 6 years if you do not report income that you should report, and it is more than 25% of the gross income shown on your return.
Keep records indefinitely if you do not file a return.
Keep records indefinitely if you file a fraudulent return.
Keep employment tax records for at least 4 years after the date that the tax becomes due or is paid, whichever is later.

III. Starting a small business - assuming LLC

Decide on type of business
Go to DCCA and register name
File articles of organization, make sure to check not responsible for liabilities
Draft operating agreement
File state of Hawaii Form BB-1 for GET license & UC number, if applicable
Open bank account, cannot open without GET license, articles of organization and operating agreement
Get separate credit card for business
Find help to set up your books correctly. IRS rules state you must keep books. Excel spreadsheet does not qualify as books. Must be a general ledger.
Keep a calendar preferably not your phone

IV. How can you get the most value from a CPA’s services?

Be prepared to discuss your plans and objectives. CPAs are in the best position to advise you and serve your interests when they understand the goals you have set.
Gather information about business or personal financial decisions under consideration so you can ask the CPA specific questions.
Clearly explain what you expect from the CPA's services.
Save yourself unnecessary fees by keeping good records and not using professional time for routine work.
Keep your CPA informed of changes in your personal and professional life. A recent marriage or divorce, the birth of a child, a career change, or an especially generous bonus all can have a significant impact on your tax liability and personal financial goals.

References

(1) IRS Publication 554
(2) Capital gains: At what rate will your long-term sales be taxed? Published: Feb 23, 2015
(3) Capital Gains Tax 2013, 2014, 2015; August 5, 2014, Capital Gains Tax.org Also see IRS Publication 550
(4) IRS Publication 550 Investment Income and Expenses
(5) thismatter.com/money/tax/securities-trading-business-taxation.htm
(6) IRS How long should I keep records
(7) IRS Estimated Taxes

Websites

irs.gov – Internal Revenue Service
thismatter.com/money/tax/securities-trading-business-taxation.htm
the street.com/story/716334/1/how-to-file-a-return-that-tells-the-irs-youre-a trader.html
irs.gov/taxtopics/tc429.html

Table 1. 2015 Taxable Income Brackets and Rates

Rate	Single Filers	Married Joint Filers	Head of Household Filers
10%	$0 to $9,225	$0 to $18,450	$0 to $13,150
15%	$9,225 to $37,450	$18,450 to $74,900	$13,150 to $50,200
25%	$37,450 to $90,750	$74,900 to $151,200	$50,200 to $129,600
28%	$90,750 to $189,300	$151,200 to $230,450	$129,600 to $209,850
33%	$189,300 to $411,500	$230,450 to $411,500	$209,850 to $411,500
35%	$411,500 to $413,200	$411,500 to $464,850	$411,500 to $439,000
39.6%	$413,200+	$464,850+	$439,000+

Table 2. 2015 Standard Deduction and Personal Exemption

Filing Status	Deduction Amount
Single	$ 6,300.00
Married Filing Jointly	$ 12,600.00
Head of Household	$ 9,250.00
Personal Exemption	$ 4,000.00