Trader Types & Expenses – The Basics

FAQs for the most prevalent questions received by the OptionsTaxGuy website

Questions:

- What types of traders are there?
- Do I need to trade inside an entity such as an LLC?
- What are deductible expenses as a Trader?

Answers:

- **What types of traders are there?**

There are three types of traders and we can define them as follows:

- ▶ Investor – which by definition is not a "trader" at all, as the word implies. The goal of the Investor is the long-term appreciation of their respective security holdings, supplemented by dividend and/or interest income. The Investor does not perform security transactions on a daily, weekly or perhaps even a monthly basis.
- ▶ Trader – termed in the Internal Revenue Code ("IRC") as a "Trader in Securities". This is also called by some tax pundits as having attained "Trader Tax Status" which is a term *nowhere found in the Internal Revenue Code, Regulations or Case law*. A Trader in Securities ("TIS") is an active trader with multiple trades on potentially a daily and/or weekly basis. The primary goal of a TIS is to profit on short-term swings in the market, or even day-trading the market, either to the upside or the downside. Those swings may last a few days or a few weeks and may entail multiple securities during the "swing". A TIS is considered to be in the trade or business of trading securities.
- ▶ Mark-to-Market Trader – is an active trader that engages in trading as a trade or business, according to the IRC, and is essentially electing to be taxed as a dealer in securities except that the Mark-to-Market Trader ("MTM" or "MTMT") does not consider the securities owned as "inventory" for sale to other traders. The MTMT seeks to profit from short-term movements in the market whereas the dealer profits both from the holdings in its account but also on the bid-ask spread.

If you consider yourself an **Investor**, then any investment expenses are deductible only as Miscellaneous Itemized Deductions on Schedule A of your Form 1040. [IRC Sec 212] Unfortunately, Miscellaneous Itemized Deductions, at this point (as of Mar 2021), no longer exist. However, they are scheduled to re-appear in tax year 2026.

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If you trade as a **Trader in Securities**, then you can deduct your trading expenses on Schedule C of Form 1040. Schedule C is the tax form for sole proprietors or single-member LLCs (more on the subject of LLCs later). [IRC Sec 162] It is important that you use the Business Code of <u>523110</u> and as a single-member LLC, you will also have a separate employer identification number ("EIN") obtained from IRS.

If you are a Trader in Securities who has made a **Mark-to-Market** election under IRC Sec 475, then you will report all trading expenses, on Schedule C of Form 1040 with the same Business Code and potentially a separate EIN from your social security number ("SSN"), but that is not necessary, unless you are trading inside an entity.

One important note would be that on Schedule C, *no items of income are reported*! Yes, that is correct. So where are they reported ...

As a TIS, you are still subject to the capital loss limit of $3000 and subject to wash sales and your gain or loss from trading is reported on Form 8949 which flows to Schedule D of Form 1040.

However, as a MTMT, you are no longer subject to either the capital loss limit noted above or the wash sale issue. Your reporting gains or losses are reported on Form 4797 Part II, thus, they are all taxed as short-term.

- **Do I need to set up an LLC? If not, what should I do?**

Essentially what this is asking is "Do I need an entity in which to trade?" and there are a number of issues with this determination that we will explore. I have heard it said by investors, with no actual knowledge of tax law, "just incorporate and deduct everything." Nothing could be further from the truth!

An LLC can be formed in any state and is, by default, a single-member LLC if only an individual owns and manages it and a partnership if owned and managed by two or more individuals. In fact, all LLCs are formed at the state level. An LLC can further elect to be taxed as either a C Corporation or an S Corporation. The principal difference between a C Corporation and an S Corporation is that a C Corporation pays its own income tax whereas an S Corporation flows its net income – or loss – through to its shareholder(s) and they pay the tax or receive the tax benefit, subject to several constraints, the discussion of which is outside the scope of this Q&A.

One of the big questions with forming an entity is whether there is *liability protection* with an entity. The answer to that is, for the most part, yes. The definition of LLC is "Limited Liability Company" — not "Limited Liability Corporation" as many people believe, even popular financial radio talk-show hosts.

However, no type of entity can protect one from personal negligence.

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So, if you place your assets (securities) into an entity in which to trade, the issue becomes, can a potential litigant reach those assets in the entity, or can the owner of the entity, on behalf of the entity itself be sued and the assets lost? Those are questions for an attorney in your state.

So what can an entity do for my trading?

Well, first off, it adds some legitimacy to your trading *business* because it is indeed a separate entity from you as an individual. From a strictly "trading" perspective, the TIS or MTMT will not trade any differently than if they were trading without an entity. That is the key point, since we are in the business of trading and an entity neither enhances nor detracts from our trading style.

As discussed above with regard to the deductibility of expenses and income reporting, an entity simplifies this because it captures all the income and expense and "flows it through" to the individual for inclusion on their tax return, typically on Schedule E page 2 of Form 1040.

The downside of an entity is that it costs money to form and there is compliance associated with it. Unless it is a single-member LLC, there is another federal tax return to file and typically another state income, business or franchise tax return to file. Some states, such as California, have a minimum tax per year, even if the LLC is dormant. So a California LLC could cost as much as $2500 to $3000 per year in compliance and tax costs. And I know what you are thinking, incorporate (form the LLC) in a no minimum tax state and just file there ... good thinking, you are well on your way to becoming a CPA ... oh no!! Unfortunately there is a concept called "nexus" which basically means that you file where you cast a shadow, or in the state in which you are domiciled.

So now you know about the pros and cons of entities, do you even need one?

If you are a TIS or a MTMT, I think it is a great idea because it adds legitimacy to your trading business. Additionally, if you have some securities in your "trading" account that have sentimental value – left to you by a deceased relative – it provides the opportunity to segregate your accounts into an investing account, owned individually and the trading account owned by the entity. That can be done anyway, but it adds one level of separation in order to help you satisfy your TIS or MTM criteria.

However, keep in mind one critical point – having an entity will NOT qualify you as a TIS or MTMT if you do not satisfy the other criteria of regular and consistent trading.

So if you decide not to form an entity and trade in a regular and consistent manner a satisfactory volume of trades based on transactions or dollar volume, you may still qualify as a TIS or MTMT whereas the person with an entity that trades irregularly and without the requisite volume will not.

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- **How can I make sure that I'm eligible for "trader tax status"?**

As mentioned above, there is no such thing as "trader tax status". It is never mentioned in the Internal Revenue Code, Regulations or Tax Court decisions.

It is also a misnomer that somewhat implies there is a "status" which one can attain, conferred by IRS, for special tax consideration ... and that is simply not the case.

What is mentioned in the Code, Regs and court decisions is "Trader in Securities". And as a review, a Trader in Securities

> is an active trader with multiple trades on potentially a daily and/or weekly basis. The primary goal of a TIS is to profit on short-term swings in the market, or even day-trading the market, either to the upside or the downside.

Essentially, a TIS is a facts and circumstances determination based on court case decisions. Attached is a summary of the most prominent Trader vs Investor court cases. The main criteria, as you will note, is consistency of trading throughout the tax year and number of trades, measured in either actual number of trades, an open/close or buy/sell being two trades, or dollar volume.

With regard to the number of trades, as you will note, the absolute number decreases over the years but the consistency and regularity of trading seems to be the most deciding factor. A recent Tax Court decision (Poppe v Commissioner) designates 60 trades per month, that translates into less than 3 trades per trading day, assuming 20-22 trading days per month.

- **What are deductible expenses as a Trader?**

As mentioned previously, as a TIS you are considered to be in a trade or business so any expense incident to the production of that income is deductible. Some examples of specific expenses for traders may be found in IRS Publication 535 – Business Expenses and the Instructions for Form 1040 Schedule C.

Here is a list of the type of expenses a TIS can expect to have. These expenses may be taken in full or partially based on their applicability to the trading business on a percentage basis. There is a tax adage that goes – *Pigs get fat while hogs get slaughtered*. That is a warning against deducting everything including the kitchen sink.

- Computers and software already loaded
- Software purchased subsequent to the purchase of a trading computer
- Multiple monitors for trading
- Specific software for your trading
- Mobile information device – cell phone or hot spot (percentage use)

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- Trading research services – but not robo-trading, trade following automated trading or self-created trading systems (your time is not deductible)
- Office supplies
- Coaching and mentoring services
- Subscriptions to investment advisers, websites, periodicals
- Reference materials
- Seminars/webinars
- Travel to seminar – where the primary purpose is business not personal including meals where the travel is ordinary and necessary for trading purposes
- Continuing education – but not education that would qualify you for another trade or business
- Interest – credit cards used to purchase trading items
- Interest – margin interest charged by a brokerage
- Office furniture conducive to trading
- Home office – if used *regularly and exclusively* for your trading business; this represents a pro-rata share of you home costs or a flat rate of $5 per square foot up to 300 sf; If qualified business use for a month is less than 15 days then that month is *excluded*. There are typically 22 trading days in a month.
- Entity formation fees – from your secretary of state and the third-party fees for filing the formation documents with your state
- Brokerage data fees – typically for "professional" designated entities
- Accounting/legal fees – tax compliance and planning
- Franchise/business tax associated with the trading business – some states have a minimum tax just for having an entity
- Vehicle expense for business use – all trading business mileage must be substantiated with a mileage log or other method (not percentage estimates). Taxpayers lose on vehicle expense audits most of the time and it is because they do not have adequate substantiation (proof) for that mileage or a valid business purpose.

Advanced expenses

- Health insurance benefits for employees or self-employed (no entity and filing on Schedule C)
- Retirement benefits
- Employees are paid a salary and retirement benefits are typically based upon a percentage of that salary
    - Quarterly and annual employment tax filings – Federal
    - State unemployment tax filings

This does not represent an exhaustive list. However, as noted in the vehicle section, these expenses must be **substantiated** according to IRS rules and regulations and the home office must be used "regularly and exclusively" for the trading business.

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Substantiation cannot be emphasized enough!! If two businesses are run out of the same area, each must be allocated up to a maximum of 300 square feet for the safe-harbor/simplified method.

As a TIS and even a MTMT, all expenses are reported on Schedule C for the sole proprietor and on page 1 of the entity tax return, most being designated as "Other deductions" at the end of the expense section and then listed as an attachment to the tax return.

A MTMT with an entity and paying themselves a salary, with health benefits and a retirement plan will be looking at a substantial amount of trading profit going into Federal and State tax compliance.

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