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HOW TO SET UP A TRADING BUSINESS

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Robert A. Green's Passion And Focus Are On Traders

Job:

- Robert A. Green is a CPA and founder and CEO of GreenTraderTax.com, a publishing company, and Managing Member and Founder of Green, Neuschwander & Manning, LLC, a tax and accounting firm catering to traders and investment managers.

Why Focus On Traders?

- Because trading is a real profession and other tax professionals and solution providers underserve them. Caring for traders is an excellent mission.

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Robert Green’s Passion And Focus Are On Traders

Content:

- Mr. Green is the leading authority on trader tax. He is the author of Green’s 2017 Trader Tax Guide, which GreenTraderTax published as an annual tax guide every year since 1997. In 2004, McGraw-Hill published Mr. Green's hardcover book "The Tax Guide for Traders.” Mr. Green has been a contributor to Forbes.com since 2010. Mr. Green wrote the “Business of Trading” column for Active Trader magazine for 14 years until the magazine closed in 2015. Leading brokerage firms and other financial media feature Mr. Green's blog posts and Webinar content.

Robert Green's Passion And Focus Are On Traders

Media:

- Barron's recommended GreenTraderTax every year since 1999. Mr. Green is frequently interviewed and has appeared in the New York Times, Wall Street Journal, and several other media. Mr. Green has also appeared on CNBC, Bloomberg Television, and Forbes.com Video Network.

- Mr. Green is the chief tax speaker at Traders Expo and taught "Trader Tax 101" for CCH to tax professionals.

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- Robert A. Green and the Green companies are not affiliated with Interactive Brokers.
- This presentation is based on current tax law, and tax reform changes are expected in 2017.

Webinar Agenda

- Join trader tax expert Robert A. Green, CPA, as he explains how active traders may structure trading businesses to maximize tax benefits.

- Learn the advantages and challenges of sole proprietorships, general partnerships, LLCs and S-Corps.

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WHY TRADE AS A BUSINESS?

Starting with Why before addressing What and How is good.

Why Trade As A Business?

- If you are an active trader, you may qualify for trader tax status (TTS), which means you are in the business of trading.

- TTS allows business expenses versus more limited investment expenses. TTS traders may elect Section 475 ordinary loss treatment avoiding capital loss limitations and wash sale loss adjustments.

- Using an S-Corp structure, TTS traders may arrange employee benefit deductions including health insurance and retirement plan contributions.

Why Trade As A Business?

- Trading as a business for your account is not complicated: You don't need investors, customers, or employees.
- It's convenient to work from the comfort of your home, utilizing a portion of savings as trading capital.
- Overhead is low; you only need a personal computer, perhaps multiple monitors and a mobile device.
- Online brokers offer education, market data, resources, and low-cost commissions.

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TRADER TAX STATUS IS REQUIRED

A retail trader must qualify for trader tax status to enjoy business tax breaks.

Trader Tax Status Benefits

- Watch my recording available on the IB Website: Trader Tax Benefits – Part I, dated Nov 22, 2016.

- I briefly covered sole proprietorship vs. pass-through entities.

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SOLE PROPRIETOR (UNINCORPORATED) BUSINESS

Claim and report TTS on a Schedule C for 2016, and consider forming a pass-through entity for 2017.

Sole Proprietorship: Business Expenses & Section 475 Election

- Many active traders ramp up into qualification for TTS. They wind up filing an individual Schedule C (Profit or Loss from Business) as a sole proprietor business trader the first year. That’s fine.

- Deduct trading business expenses on Schedule C and report trading gains and losses on other tax forms.

- Consider filing a 2017 Section 475 MTM election by April 18, 2017, to use ordinary gain or loss treatment (generally recommended on securities only).

Sole Proprietorship: Employee Benefit Plans Not Allowed

- A Schedule C trader may not pay himself compensation and the Schedule C does not generate self-employment income (SEI), either of which is required to deduct health insurance premiums and retirement plan contributions from gross income.
- The exception is a full-fledged dealer/member of an options or futures exchange trading Section 1256 contracts on that exchange; they have SEI per Section 1402i.
- The business trader needs an S-Corp for those employee-benefit plan deductions.

TRADING ENTITIES

Conducting your trading business in a entity unlocks several additional tax benefits.

Trading Entities

Forming an entity can save active traders significant taxes.

- Business traders solidify trader tax status (TTS),
- Unlock employee-benefit deductions,
- Gain flexibility with a Section 475 election and revocation, and
- Limit wash-sale losses with individual and IRA accounts.

An Entity Looks Better To The IRS

- An entity consolidates your trading activity on a pass-through entity tax return (partnership Form 1065 or S-Corp 1120-S), making life easier for you, your accountant and the IRS.

- It's important to segregate investments from business trading when claiming TTS, and an entity is most useful in that regard. That avoids the IRS playing havoc with Section 475 positions vs. investment positions.

- A trading entity is fairly simple and inexpensive to set up and operate.

Section 475 MTM Flexibility

- Entities help traders elect Section 475 MTM (ordinary-loss treatment) later in the tax year — within 75 days of inception — if they missed the individual MTM election deadline on April 15. (April 18, 2017 for 2017).

- It’s easier for an entity to elect Section 475 MTM than it is for a sole proprietor.

- An entity may adopt Section 475 MTM internally from inception at no cost. Conversely, an existing individual must prepare a complex Form 3115 (which costs accounting fees), after filing an external election statement with the IRS.

Pass-Through Entities Are Preferred

- A pass-through entity means the entity is a tax filer, but it's not a taxpayer. The owners are the taxpayers, most often on their individual tax returns.
- Consider marriage, state residence and state tax rules including annual reports, minimum taxes, franchise taxes and more when setting up your entity.
- There is no sense in forming your entity in a tax-free state if you pass the income to your individual state tax return.

Pass-Through Entities: Tax Reporting & Schedule K-1

- Report all entity trading gains, losses and expenses on the entity tax return - partnership Form 1065 or S-Corp Form 1120S - and issue a Schedule K-1 to each owner for their respective share of each item of income, or loss.

- For example, the entity can pass through capital gains to utilize individual capital loss carryovers.

- Or the entity can pass through Section 475 MTM ordinary losses to comprise an individual net operating loss (NOL) carryback for immediate refund.

CHOICE OF TRADING ENTITY

An S-Corp unlocks employee benefits; a partnership does not.

Limited Liability Company

- The default tax treatment for a spousal Limited Liability Company (LLC) is a partnership tax return.

- A single-member LLC (SMLLC) is a “disregarded entity,” a “tax nothing” in the eyes of the IRS. That means an individual-owned SMLLC, qualifying for TTS, is back to filing a Schedule C, which a business trader tries to avoid.

- A multi-member LLC and a SMLLC may elect S-Corp tax treatment within 75 days of inception, or by March 15 of the current tax year for existing entities.

S-Corp Election

- I recommend an S-Corp election (Form 2553) for traders with TTS that want employee-benefit plan deductions.

- C-Corps may also elect S-Corp status. In states that have some fees applicable to LLCs, I recommend a C-Corp to S-Corp route. (California has LLC user fees, and New York State has an LLC publishing requirement.)

- A general partnership does not have liability protection and it can also elect S-Corp status in every state except Connecticut, the District of Columbia, Michigan, New Hampshire, New Jersey and Tennessee.

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S-CORP TAX RETURNS FOR TRADERS

Traders need an S-Corp to arrange employee benefit plan deductions.

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S-Corp Federal & State Taxes

- *Federal tax*: S-Corps do not owe federal taxes on the entity level. (One exception: It was a C-Corp prior to electing S-Corp status, and it has undistributed C-Corp Earnings & Profits.)

- *State tax*: Trading in an S-Corp tax structure means you don’t need a second entity; a management company. This is the best and most simple solution if there is no tax on S-Corps in your state, which is usually the case.

- Some states have minor taxes on S-Corps. Read my blog posts A Few States Tax S-Corps: Traders Can Reduce It, and Trader Tax Battle Of The States.

S-Corp Health Insurance

- Whether the S-Corp is profitable or not, plan to take the officer/owner health insurance deduction through officer W-2 wages.

- Add health insurance premiums, paid by the entity or individually during the entity period, to wages in box 1 on the officer/owner’s W-2.

- The health insurance amount in wages is exempt from payroll taxes, including FICA and Medicare, so it’s pure income tax savings.

S-Corp Health Insurance

- The officer deducts health insurance premiums as an adjusted gross income (AGI) deduction on his or her individual tax return, thereby offsetting wages.
- If you have non-owner employees, deduct their health insurance on the S-Corp tax return directly as “insurance expense.”
- Include health insurance during a short-year; not before entity commencement. Exclude employer-provided insurance including COBRA for both spouses.

Solo 401(k) Retirement Plan: Elective Deferral (100% Deductible)

- If you have sufficient trading profits by Q4, consider establishing a Solo 401(k) defined contribution retirement plan before year-end.

- Start with the 100% deductible elective deferral (ED; $18,000 for 2016 and 2017) and pay it by Jan. 31 through payroll since it's reported on the annual W-2.

- Add the ED to Social Security wages and Medicare wages on the W-2 but not taxable wages in box 1, as that is where the tax benefit (deduction) is. The gross wage ED component is subject to payroll taxes and the S-Corp tax return has a deduction for gross wages.

Solo 401(k) Retirement Plan: Profit Sharing Plan (25% Deductible)

- If you have large trading gains, consider increasing payroll in December for a performance-based bonus to unlock a 25% Solo 401(k) profit-sharing plan (PSP) contribution that you don’t have to fund until the due date of the tax return (including extensions by Sept. 15).
- The maximum PSP amount is $53,000 for 2016 and $54,000 for 2017. If age 50 or older, add a $6,000 ED catch-up for for 2016 and 2017. The total amount (ED and PSP) is $59,000 for 2016 and $60,000 for 2017.
- The S-Corp tax return deducts the profit sharing plan contribution.

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S-CORP PAYROLL TAX COMPLIANCE

An S-Corp needs payroll to unlock employee benefit deductions.

Payroll Tax Compliance

- Payroll is not complicated for a small trading or management company with spousal or single ownership.
- A payroll service usually includes quarterly payroll tax returns (Form 941), the annual payroll tax return (Form 940), state payroll tax returns and federal unemployment insurance with FUI tax of under $50 for the owner/trader.
- In most states, the trader/owner is exempt from state unemployment insurance and state workmen's compensation.

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ACCOUNTABLE PLAN FOR S-CORPS

An S-Corp needs to “use or lose” an accountable plan for reimbursing expenses before year end.

S-Corp Accountable Plan

- One formality of using an S-Corp is that it should have an accountable plan for reimbursing employee expenses, including the employee's home-office deduction.
- Without an accountable plan, employees report unreimbursed employee business expenses on Form 2106, which is part of miscellaneous itemized deductions only deductible in excess of 2% of AGI and not deductible for AMT.
- With proper usage of an accountable plan, the S-Corp reports the deductions on its tax return.

Unreimbursed Partnership Expenses

- Expense reporting is more relaxed with partnership tax returns.
- Partners may report unreimbursed partnership expenses (UPE) on their individual tax return Schedule E, including home office deductions on Form 8829.
- S-Corp shareholders generally cannot deduct unreimbursed business expenses on Schedule E because the shareholders are categorized as employees when performing services for the S-Corp.

PARTNERSHIP TAX RETURNS FOR TRADERS

One tax advantage is "special allocations," but it's difficult to arrange employee benefit plan deductions with partnerships.

Partnerships: Difficult To Arrange Employee Benefit Plans

- If you trade in a general partnership or multi-member LLC filing a partnership return, it’s difficult to achieve targeted SEI for health insurance and retirement plan deductions because a partnership passes through negative SEI, whereas an S-Corp does not.

- Perhaps you have retirement and health insurance arranged in another business or job or through your spouse.

- If you don’t need retirement and health insurance AGI deductions, the partnership tax structure works fine.

Partnerships Have Some Tax Advantages: Special Allocations

- In most states, a general partnership or LLC can elect S-Corp status at a later day, generally by March 15 of a current tax year. So consider an S-Corp election by March 15, 2017 if you want to add health insurance and or retirement deductions for 2017.

- Special allocations are useful when one family member wants a profit allocation or carried interest based on performance. S-Corps can't do special allocations.

- The IRS does not allow partnerships to pay wages to partners; guaranteed payments are used instead.

C-CORPS

Are the wrong choice of entity for a trading business, but okay for a management company.

C-Corps

- Selecting a C-Corp structure for your trading business is the wrong move. It’s okay for a second entity, like a management company.
- On the trading education and seminar circuit, some tax service providers recommend a C-Corp as a vehicle, even though the trader doesn’t qualify for TTS.
- In this case, the C-Corp is an investment company. Contrary to what others may say, the IRS doesn’t allow investment expenses in a C-Corp used entirely for investing and that means no deductions at all.

Be Wary Of C-Corp Schemes

- In another twist, tax service providers recommend two entities: an LLC investment company and C-Corp management company.
- Again, it doesn't work without TTS since the LLC investment company has investment expense treatment on fees paid to the C-Corp.
- Back to square one: there's no business expense benefits without qualifying for TTS.

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FORM THE ENTITY IN YOUR HOME STATE

Forming a pass-through entity in a tax-free state doesn't avoid individual taxes in your home state.

Register A Trading Entity In Your Home State

- Tax-free states market entities for asset protection and tax-avoidance reasons, but both often fail in practice.
- If you live and work in your home state, you need to register a foreign entity in that state.
- Registering is a must: Asset protection won’t work in your home state if you have not registered your company there. If another party sues you, it’s generally in your home state, too.

INVESTMENT MANAGEMENT

An entity for your retail trading business should not admit outside investors as that brings up investment management issues.

Investment Management

- Investment management is when you trade money belonging to investors and they pay compensation for that investment advice.

- As you can imagine, handling other people's money is serious business, therefore there is a huge body of investor-protection law and regulation on securities, commodities and forex.

- The investment manager may need various licenses and to register with the regulator in charge: SEC or state for securities, and NFA for futures and forex.

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COSTS FOR SETTING UP A TRADING BUSINESS

There are a few reasonable costs and or taxes for setting up a trading business, and it takes about a week.

Costs For Setting Up A Trading Business

- Sole proprietorship or general partnership (GP): There are no state filing fees, annual reports or minimum taxes.

- LLCs and C-Corps: Entity filing fees vary by state ($50 to $500). S-Corp minimum taxes, annual reports or franchise taxes vary by state. See my blog series on states.

- Engage an attorney to prepare a partnership or LLC operating agreement, or corporate bylaws, and related entity paperwork (accountable plan, resolutions, S-Corp election, elections).

- We offer an Entity Formation Service.

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CLOSING REMARKS, QUESTIONS & ANSWERS

If your passion is trading, then consider a trading business structure with maximum tax advantages customized for your needs.

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Closing Remarks

- Questions & Answers
- Thank you for attending this Webinar or watching the recording at IB.
- Visit www.GreenTraderTax.com for additional information.
- Call us toll free at 888.558.5257 or 203.456.1537
- Chat with us.
- Email us at info@greentradertax.com .