



Business traders form entities to achieve maximum tax breaks. Traders who do not conduct their trading through an entity can benefit from business-deduction treatment (and IRC 475 mark-to-market accounting), but they usually need an entity to deduct retirement-plan contributions and health-insurance premiums. Although an entity does not deliver business tax treatment (a trader still must qualify for trader tax status), it does reduce your chances of an IRS inquiry.

By Robert A. Green, CPA

Suppose you join millions of other Americans and leave your job to pursue your dreams of making a living in trading.

Inevitably, your friends and family will come to ask if you are just playing around in the markets. You will probably firmly object to that question and explain that you are actively trading, using sophisticated tools and services, to not only make a good living but eventually become wealthy from it.

It's at that point you may feel the urge to show the questioners your new business card; which might read something like "Joe Successful Trader, President of Successful Capital Management, LLC."

Having your own formal legal entity for your trading business may help appease your family and friends and make you feel better, but do you really need a separate legal structure for your trading business? Will an entity protect you and save you more in taxes?

The answers are yes, no and maybe.

You don't need a separate legal entity to start your trading business, since you can achieve trader tax status and elect IRC 475 as a sole proprietor. But most traders do need an entity to save more in taxes, with adjusted gross income (AGI) deductions for retirement plans and health-insurance premiums.

Plus, forming an entity can be simple and inexpensive.

The big question is which type of entity to form and how to use it properly to lower your tax bill as much as possible. Our review starts with the simplest way to conduct a trading business – without an entity as a sole proprietor.

Sole Proprietorships

Traders usually can start out with a sole proprietorship, or an unincorporated business filing a Schedule C (Profit or Loss from Business) included with their Form 1040 individual income tax returns.

Schedule C trading businesses can deduct every possible business expense (directly from gross income) in the same manner incorporated businesses such as LLCs, general partnerships and corporations can.

The only caveat is that a trader must first qualify for "trader tax status," which is a different topic beyond the scope of this article. You can learn more in my book "The Tax Guide for Traders," and there is free content available at www.greentradertax.com.

The main drawback of a Schedule C business is the tax laws do not permit it to pay a salary or fee to its owner. Why is that a problem?

It is because another huge tax benefit for traders is deducting retirement-plan contributions and health-insurance premiums from AGI. Very few traders can do this because they don't have earned income.

Other than trading, all other types of sole proprietorship businesses have earned income by default (when they are profitable) and they can contribute to retirement plans and deduct health insurance.

Trading gains are not reported on Schedule C (as revenues or other income); instead they are reported on Schedule D (Capital Gains and Losses) or Form 4797 Part II (if the business trader made a timely IRC 475 mark-to-market accounting election).

So a trader's Schedule C business – by design – must show a loss (because only expenses are reported on Schedule C).

Note that GreenTrader has special tax-reporting strategies for transferring some business trading gains to Schedule C to “zero it out” and unlock home-office and 100-percent depreciation deductions. This eliminates the red flag of a Schedule C loss.

There are a few types of traders who have earned income by default. Traders who are members of options or futures exchanges have earned income on all their trading gains and they can therefore contribute to retirement plans and have the health-insurance premium deductions.

But the majority of traders are not members of exchanges.

Whether you have trading gains or losses, a separately filed entity return may be a better alternative for you. Profitable traders save more with entity-driven AGI deductions and losing traders deflect IRS scrutiny.

Partnership tax returns

The best solution for the majority of traders is to file a separate partnership tax return for your trading business.

For starters, you help solve the problem of the IRS scrutinizing Schedule C businesses, especially for traders since they always have net losses or breakeven on their Schedule Cs.

Your trading gains and losses, business expenses, interest, dividends and other items of separate tax treatment are reported on a Schedule K-1 issued by the partnership tax return (Form 1065).

If you elect IRC 475 MTM on the partnership return and have gains, those gains absorb your business expenses; you wind up reporting a net ordinary gain on Schedule E of your Form 1040.

If you have MTM trading losses instead, or use cash accounting, you will have a Schedule E ordinary loss (from expenses only), but that usually draws less scrutiny than a Schedule C loss.

Just like with a Schedule C, you can also deduct home-office expenses in connection with the partnership, but it's done a little differently with a partnership.

Report your home-office expenses on your individual return (it can't be done directly on the partnership return) and then report these expenses as “UPE” (Unreimbursed Partnership Expenses) on Schedule E, right under where you report the other Schedule E income from the partnership.

Guaranteed payments vs. salaries

The partnership is the best solution for handling the earned-income requirement for your AGI deductions, retirement plan and health-insurance premiums.

Here's how to do it.

The partnership pays the owners a "guaranteed payment," which is earned income. In a sense you are just converting some trading gains into earned income and you have the flexibility to make it zero or any amount you want.

It's all about doing what-if calculations on self-employment (SE) tax cost vs. income tax savings.

A guaranteed payment has many tax advantages over a salary – its equivalent in the corporate world. Guaranteed payments don't need payroll tax return filings, whereas salaries do. Payroll tax filings are a costly burden, especially for traders who have no other employees.

Guaranteed payments are not subject to federal and state unemployment insurance costs and state workman's compensation insurance, whereas salaries are subject to all these types of added costs (and payroll tax costs are escalating).

Guaranteed payments can be declared after year-end during tax preparation time, when you can run "what-if" calculations for tax benefits; salaries must be declared and paid before year-end, so there is much less flexibility.

If a husband and wife are partners, both can receive guaranteed payments and enjoy retirement-plan benefits.

General partnerships vs. multi-member LLCs

Both general partnerships and multi-member LLCs (Limited Liability Companies) file partnership tax returns, so for tax purposes they are very similar. An LLC can also choose to be taxed as an S-Corp or C-Corp, but that's usually unwise for traders if they want the benefits of a partnership tax return.

General partnerships don't provide legal liability protection to their owners, but LLCs do have entity-level protection. Entity-level protection comes at a cost, though.

General partnerships are the most inexpensive entity to form and maintain on an annual basis. They don't have state filing fees on formation and (in almost all states) there are no minimum taxes.

Conversely, forming an LLC requires the payment of state filing fees and there are minimum taxes and/or annual reports, all of which vary by state.

Most traders can probably omit the need for entity-level protection and utilize the lower cost and more flexible general partnership. Unlike money managers, business traders are only trading their own funds.

General partnerships have other key advantages over LLCs in some circumstances. If you move from one state to another, your general partnership (a federal entity) is portable; if you formed an LLC in one state, you might want to close it when you move to another state (and form a new one in that home state).

De facto husband and wife general partnerships

Another huge advantage of general partnerships over LLCs is that general partnerships have a look back period and LLCs can only look forward.

Consider this example: If a husband and wife actively trade a joint account with joint trader tax status and they live in a non-community property state, the IRS compels them to file a (de facto) general partnership tax return since the IRS Schedule C instructions disallow a joint Schedule C filing.

Even in community property states, the husband and wife can verbally agree they are business partners and later form and file the partnership tax returns.

If a husband and wife were verbal business partners in 2006, they can wait until 2007 to form the partnership and file that 2006 partnership tax return.

This can have profound tax implications if the husband and wife are business partners and verbally elected IRC 475 ordinary loss treatment. That would convert restricted capital losses into unlimited ordinary loss treatment.

There are many nuances of de facto husband and wife general partnerships so you should not proceed without consulting a trader tax expert.

Limited Liability Companies

If the past is not an issue, an LLC may be your preference of entities. LLCs are inexpensive to form in most states (it varies by state). LLCs offer entity-level protection.

Your choice is either a single or multi-member LLC. A single-member LLC (SMLLC) is a “disregarded entity,” meaning for tax purposes it’s a “tax nothing,” with all taxable activity reported on the owner’s tax return.

For individually owned SMLLCs, the activity is reported on a Schedule C in the same manner as a sole proprietorship. Therefore, a SMLLC does not help solve the red flag issue caused by trading with a Schedule C business. And, the earned income (AGI deduction) tax strategies are more difficult to achieve with a SMLLC.

The first Schedule C (SMLLC) pays an administration fee to a second Schedule C. This is financial engineering used to create earned income subject to self-employment tax.

SE taxes are 15.3 percent of the SE income base (\$94,200 for 2007) and 2.9 percent (Medicare portion only) on unlimited income thereafter. The goal is to save more in income taxes from the AGI deductions (retirement plans and health insurance) than one needs to pay in SE tax.

It’s not just a trade-off; you also replace (bad) income taxes with (good) SE taxes, because SE taxes generate social security and Medicare benefits in retirement.

Single-member LLCs

It’s possible the IRS could challenge the fee payment strategy in an SMLLC.

Conversely, with guaranteed payment law (in a multi-member LLC situation), the IRS can’t challenge the earned-income strategy.

In our interpretation of the law, a newly-formed SMLLC is entitled to file an “internal” IRC 475 MTM election within 75-days of inception, under the “new taxpayer exception.”

However, to play it safe (and when possible), we advise an SMLLC to also file a timely “external” IRC 475 MTM election in the same manner as a sole proprietorship - by attaching the IRC 475 MTM election statement to their tax return or extension for the prior tax year (by the original due date not including extensions).

We prefer a multi-member LLC, which files a partnership tax return. If necessary, try to find a person to be your second member in your LLC, creating a partnership return. The second person can receive a tiny share of profits and losses and not own any of your capital shares.

If your partner is a non-family member, an LLC is preferred over a general partnership. One general partner can bind the other to debts incurred in the name of the partnership, so the LLC entity-level protection is preferred in non-family member situations.

Corporations

Corporations are similar to LLCs in that you incorporate as a separate legal entity in a state of your choosing.

We recommend your home state for business traders, but a tax-free state for hedge funds (which may have investors all around the country).

You trade, live and work in your home state, so even if you form your trading business in a tax-free state, your home state will eventually catch up with you.

Registration costs are minimal. Plus, pass-through entities are best, so out-of-state entity results pass through to your home state individual tax returns.

By default, corporations start out as C-Corps, which mean they owe taxes on the corporation level, and a second time (double taxation) when the corporation pays dividends to the owners (15-percent dividends tax on the individual tax return in 2007).

Many C-Corps try to prevent double taxation by paying out salaries to the owners (so the entity profits are lower), but that causes those added payroll taxes (which are otherwise not due on trading gains).

There are other tax problems with C-Corps. Trading losses are trapped in the C-Corp, providing no immediate tax benefit to the owners.

You also can't get lower futures tax rates (60/40 treatment) in a C-Corp.

S-Corporations

There is a much better version of a corporation and that's an S-Corp.

C-Corps may elect S-Corp status within 75 days of inception (or any taxable year, providing they pay conversion tax on their retained earnings).

Like the benefit of a partnership tax return, an S-Corp passes through entity-level income and expense to the owners, so there is no double taxation.

But there are some tax drawbacks with S-Corps. To create the earned income strategies for the AGI deductions (retirement plans and health-insurance premiums), the S-Corp needs to pay salaries to the owners.

Salary is a burden (payroll tax return filings) with added costs (federal and state unemployment insurance and workman's compensation).

Guaranteed payments in partnerships are more flexible and have none of these burdens or added costs.

Plus, many states have a small franchise tax on S-Corps that can cost several hundred dollars per year or more (it varies by state).

The IRS announced a new enforcement action to force S-Corps to pay “reasonable salaries” to its owners, defined as 30 percent to 40 percent of net profits.

Service businesses use S-Corps to avoid payroll tax costs, since when they use LLCs, all the income is subject to SE tax. But again, traders are very different; their underlying income is not subject to SE tax.

Multiple-entity solutions

Some traders are intrigued with multi-entity schemes marketed by some professional firms, like a C-Corp being the manager of a family LLC trading business. But be careful; there can be some pitfalls here, too.

If the C-Corp is the trading manager and not an owner of the LLC trading business, the trading business will fail trader tax status; this has the consequence of denying business expense treatment and related tax-loss insurance (IRC 475 MTM).

And, your C-Corp needs to be registered in your home state.

So double (federal and state) taxation usually ends up defeating the perceived tax benefits here. The firms who sell these schemes count on no state taxation and they are very wrong, at great risk to you.

Multiple entities also call for multiple fees paid to the promoters, plus multiple other costs (two sets of formation and maintenance costs and taxes).

We believe it’s very inappropriate for promoters to push these schemes on new traders, who may never even qualify for trader tax status or remain in the activity for long.

Some of the education sites are paid commissions by these firms to sell these schemes, which is unethical by CPA firm standards.

When it comes to entities, keep it simple and effective and customized for your individual situation. Don’t buy cookie-cutter multi-entity schemes out of the gate.

Bottom line

Entities are generally very helpful for business traders; they help deflect IRS questions about trader tax status and they provide retirement plan and health-insurance deductions. But it’s important to choose the right type of entity and register it in your home state. Entities may raise your tax-filing complications, but at the same time they deliver better and safer tax results with low costs. It’s wise to consult with a trader tax expert who knows how traders can best use entities.

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