TRADERS ACCOUNTING

The Business Decision Guide

Note to Reader

It was the last half of the 1990's, and online brokerage accounts were rapidly growing to keep up with the escalation of people day trading and people wanting to learn how to be day-traders. The very idea of being able to trade stocks on our own inspired the entrepreneurial spirit in us. The first few years of trading went pretty well. That is to say, more money was made than lost. While busy reveling in success, many of us never considered that the days of the dot.com boom were about to burst. Suddenly the markets changed and everything came crashing down. Not long into the bear market crash, it became obvious that the early success had been part of a strong bull market run and not the result of any trading expertise. It was painfully apparent help was needed.

The 1990's online trading boom brought with it a huge demand for education in trading and demanded inspired master traders to reach out to all of us newbie traders via websites and books. To say wisdom, training, and advice from these master traders was necessary would be an understatement. After completing several training courses from various master traders, it became clear there were a common set of messages that each of them shared. Despite the fact that each training course was different in content and style of trading, all mentioned the key element of successful trading - a disciplined approach. Some of them went so far as to call this disciplined approach, 'the psychology of trading' and others called it, 'the business of trading'. (After experiencing two profitable years trading and one miserable year losing money, the trainers were making a breakthrough; operate your trading as a business.)

Running a business requires a great deal of discipline in managing cash flow. Also, businesses get significantly more tax write-offs than individuals. As a business owner, we tend to make more carefully calculated decisions when it comes to spending money and entering new markets. We were not providing a service or a product for sale, but we were making critical business decisions that affected the everyday cash flow. By running a trading business we were creating the right environment for the disciplined or, if you prefer, the psychology of trading began to payoff. Tracking expenses, gains, and losses allowed us to see how we could trade more effectively, cut losses sooner, build better back testing models, etc.

Another lesson we learned, trading in the markets generates various taxation treatments based on the types of markets. By completing specialized training courses, profits for the trading business increased by adding more revenue streams (Forex, Futures, Securities, etc.). To paraphrase the statement above, each new revenue stream generates different tax consequences. While most of the taxation and regulations are complex and lengthy in description, they can be understood if you have enough time and patience to figure it out. But, who has the time or the desire to study and learn the IRS rules? Besides, running your own business and trying to do everything yourself is a recipe for failure.

For several decades, many authors and business consultants alike have suggested one of the best ways to succeed in business is to do something you enjoy. Most traders do not.

enjoy bookkeeping or tax preparation. However, many traders do enjoy the information gathered from a financial statement prepared by a professional bookkeeper. For example, statements from an accounting firm can make it possible to identify if trading in certain markets is consistently horrible. In one case, a trader found the financial statements clearly revealed that trading in the pharmaceutical markets had been horrendous. As a result, and to this day, that trader still champions a company policy, 'don't do drugs', and will not trade in the pharmaceutical markets.

The point here is twofold. First, in a trading business you need to spend your time doing what you do best – trading. Second, in a trading business you need to have specialized services to help you become a better trader such as education services, business coaches and mentors, tax, and accounting services.

Surprisingly the situation became even worse when trying to find a CPA to help the trading business. Most of the CPAs contacted stated a home based business may flag an IRS audit or benefiting from "trader in securities" was not possible for a home based business. The result was being classified as an investor. As such, all profits earned as an investor would be subject to capital gains tax laws. The thought of an IRS audit was more than a little alarming and, there just did not seem to be anyone who understood the business of trading.

In addition to the creation of online brokerage accounts, the dot.com boom inspired many new businesses to be created in the last half of the 1990's. The necessity for specialized services and specialized products continues to grow and in turn continues to inspire others to address those necessities. The need for a specialized accounting firm for traders was obvious. Jim Crimmins, the founder of Traders Accounting was one of the early entrepreneurs who saw the need back in 1998. Jim had the means to provide the professional tax services traders needed, and the knowledge to reconcile the many new rules and constant revisions established by brokers, the SEC, and the IRS. Today, even though Jim has since retired, Traders Accounting is still providing unparalleled specialized tax and accounting services for active traders.

This Trading Business Decision Guide was written to give market traders an edge in the market place. Running a trading business not only creates the right mind set (the discipline and the psychology) necessary for successful trading, which is fantastic in itself, the methods of operating a trading business and the services discussed in this guide also give a trader maximum cash flow control.

There is one undeniable fact in trading. No matter what markets you trade in, no matter what style of trading, and neither technical analysis nor fundamental analysis will prove otherwise: it is easier to successfully trade with more money than it is with less. This guide will give you the information necessary to take the next step to improve your cash flow.

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***IRS CIRCULAR 230 DISCLOSURE:*
Pursuant to requirements imposed by the Internal Revenue Service, any tax advice contained in this booklet is not intended to be used for purposes of avoiding penalties imposed under the United States Internal Revenue Code or promoting, marketing or recommending to another person any tax-related matter.

The Basics of a Trading Business

A Sole Proprietorship and a General Partnership are the simplest and least expensive forms of trading businesses.

If you currently operate a small business on your own and report your business income on Schedule C, then you are a sole proprietorship – it's that easy. A general partnership is automatically created when two or more people go into business together. Because of this simplicity, most businesses are sole proprietorships or general partnerships.

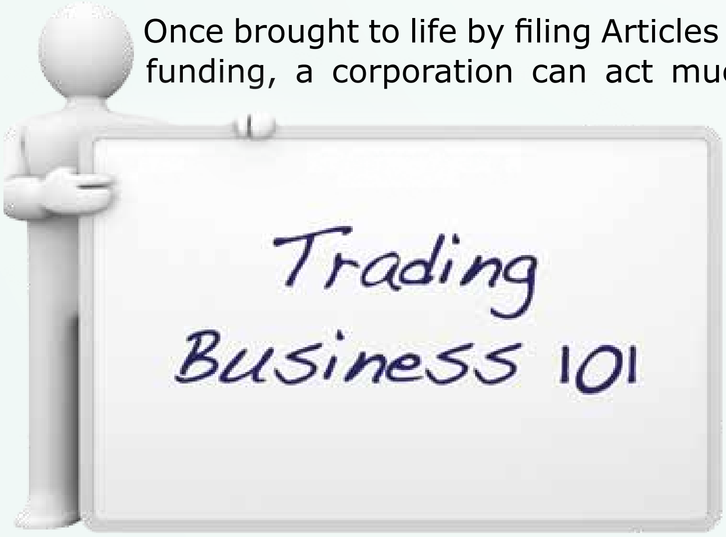
> *"A sole proprietorship can be the most expensive business structure in the long run."*

However, even with low start-up costs and ease of operation, other factors can make these the most expensive forms of business. First, your liability for business debts is unlimited. These entities cannot shield you, as the owner, from liabilities that could literally cost you, your family and your business everything. For instance, if you have significant business or margin losses, or an adverse legal judgment, creditors can force you to sell your home, your business assets and personal property to cover the claim.

Additionally, you may be hurting yourself tax-wise since other business entities have a variety of tax advantages, such as the ability to reduce self-employment taxes. Furthermore, sole proprietors are highly scrutinized by the IRS. Finally, when it comes time to sell or pass on your sole proprietorship, it can be problematic.

> *"You are not personally liable for the debts and liabilities of the corporation."*

The primary advantage of a Corporation is that its owners, known as stockholders or shareholders, are not personally liable for the debts and liabilities of the corporation.



Once brought to life by filing Articles of Incorporation with the state and properly funding, a corporation can act much like a person. It can own and operate a business, hire employees, buy and sell goods and services, enter into contracts, lease or buy real estate, maintain its own checking and savings accounts, sue, and be sued. A corporation is not affected by the death or bankruptcy of any shareholder, officer or director. Instead, it continues to exist as long as it complies with the state requirements and corporate formalities.

You may have heard of the terms

‘S-Corporation’ and ‘C-Corporation’. They are similar, but an S-Corporation has made a special IRS election to be treated as a pass-through entity for tax purposes. In other words, corporate profits ‘pass through’ to the owners, who pay taxes on the profits at their individual tax rates.

C-Corporations, on the other hand, are traditional corporations with two potential levels of tax. The C-Corporation pays tax on its corporate income (the first tax). Then, if a C-Corporation distributes profits to its stockholders, the stockholders pay personal income tax on those dividends (the second tax). Although this may seem like a significant disadvantage, C-Corporations can have greater tax flexibility for profit distribution than S-Corporations and can minimize any ‘double taxation’ problems.

“C-Corporations offer greater tax flexibility than S-Corporations and can easily minimize any ‘double taxation’ problems.”

The Benefits

Corporations enjoy many tax advantages that are unavailable to a sole proprietorship or general partnership.

Reduction in Self-Employment Tax: When you operate as a sole proprietorship, your first $128,400 of earnings for tax year 2021 is subject to self-employment taxes (Social Security and Medicare, which is currently a combined 15.3%. With a corporation, only salaries are subject to such taxes. By allocating a corporation’s earnings between a reasonable salary and profit, you can generate significant tax savings. For example, if you earn $80,000 as a sole proprietor, you would pay self-employment on all $80,000. However, if instead, you are incorporated and took $35,000 in salary, the remaining $45,000 in profit would NOT be subject to the self-employment tax.

Medical Expense: C-Corporations can offer a medical reimbursement plan to their officers, employees, and owners. This allows you to deduct medical costs not covered by insurance, such as: co-payments, deductibles, prescriptions, and other out-of-pocket medical expenses. With a sole proprietorship, medical reimbursement plans may cover employees, but not the owner.

Retirement Plans and Fringe Benefits: There are a number of fringe tax benefits which favor corporations over sole proprietorships. For example, corporate tax-deferred retirement plans, such as defined contribution and defined benefit plans can be more flexible and can have higher contribution limits. Corporations are also allowed to pay for and deduct certain childcare expenses, group term life insurance premiums, group disability insurance premiums, and certain travel expenses associated with directors’ and shareholders’ meetings.

Sole Proprietors and General Partnerships risk everything they personally own when they operate a business.

If a judgment is awarded against the business, the owner's personal assets can be used to satisfy payment.

Your home, car, savings, and investments could all be taken from you should your business be sued or go into debt such as over extended margins. When you have a general partnership, each partner can solely make decisions that have joint consequences for the partnership. So, even if one partner makes a bad decision, all partners are liable for the entire amount of any damages.

> *"IRS to Step up Audits of Sole Proprietors." Source Treasury Inspector General for Tax Administration, April 12th, 2010*

Unlike a sole proprietorship or general partnership, a corporation is a separate legal entity apart from the individuals who own or operate it. Because of this, the personal assets of the shareholders, directors and officers of a corporation are generally not at risk when the corporation is sued or goes bankrupt. If you own property or other significant assets, forming a corporation is one way to protect them. If you plan to hire employees, a corporate entity can protect you personally from employee lawsuits.

An individual can be liable for corporate debts through a legal action commonly referred to as 'piercing the corporate veil'. This occurs when a court looks at the corporation not as a separate entity, but as an extension of the individual. Generally, it occurs through fraud, failure to document business activities, or failure to treat the corporation as a separate entity. Properly maintaining your corporation usually prevents a piercing of the corporate veil.

Trading Business Compliance

In order to properly maintain your corporation and ensure personal liability protection, you will have to comply with certain corporate formalities. Some of the most important ones are described below.

Corporate shareholders must typically meet annually to elect corporate directors. It's the job of the directors to meet at least annually to elect corporate officers. You may also need to hold meetings to approve special actions like purchasing another company, amending charter documents, adding a new shareholder, and approving actions that fall outside of the normal course of business.

Written minutes should be kept which record the actions taken at all meetings. While it may sound daunting, this doesn't have to be a hassle. Traders Accounting offers a maintenance service for easily recording corporate minutes and meetings. You can hold a meeting in your trading company's office or anywhere else.

> *"Traders Accounting offers a maintenance service for easily recording corporate minutes and meetings."*

Since a corporation is a separate legal entity, corporate finances must be kept separate from your own personal finances. It's essential to have a corporate bank account, and you will need a separate federal tax ID number. When you incorporate with Traders Accounting we obtain a state charter and your federal tax ID number for you. We can provide the back office support to keep your bookkeeping records and accounts in compliance with IRS guidelines.

After the initial government filings, most states require an annual report which lists the corporation's business address and the names of the directors and officers. Typically, the state requires a filing fee with the annual report.

Furthermore, corporations must file a separate federal corporate tax return, either on Form 1120S for S-Corporations or Form 1120 for C-Corporations. Traders Accounting's tax preparation services can confirm that your deductions are documented properly for a trading business, and complete all the necessary forms.

What Is and Is Not the Best Business Structure for Trading

As previously mentioned, a corporation that elects to be treated as a pass-through entity for tax purposes is known as an 'S-corporation'.

In an S-Corporation, profits pass through to the shareholders who then report the income on their individual tax returns. This can simplify a corporation's tax reporting. In addition, it allows you to write off any losses against ordinary income. S-Corporations make sense for small business owners who want the protection and tax advantages of a corporation, but have no intent of raising significant capital or going public in the future.

The huge draw back to owning an S-Corporations is that you must pay employees a consistent salary over the course of a year. A trading business owner(s) will work for the S-corporation, and the S-Corporation, according to the IRS must pay owner-employees a reasonable salary. Paying zero wages to an owner-employee is unreasonable. (Would you take a job that pays nothing?) Paying wages less than the minimum wage are also unreasonable. (Would you take such a job?) The bottom line: if you decide to go with an S-Corporation, the business absolutely must pay wages to owner-employees.

What's the big deal, you ask? The IRS has been auditing S-Corporations that pay owner-employees less than reasonable salaries. The IRS is looking to recover underpaid payroll taxes. The penalty on unpaid payroll taxes is a stiff 100%.

Headliner

"An S-Corporation must pay reasonable compensation (subject to employment taxes) to shareholder-employee(s) in return for the services that the employee provides to the corporation, before a non-wage distribution may be made to that shareholder-employee."

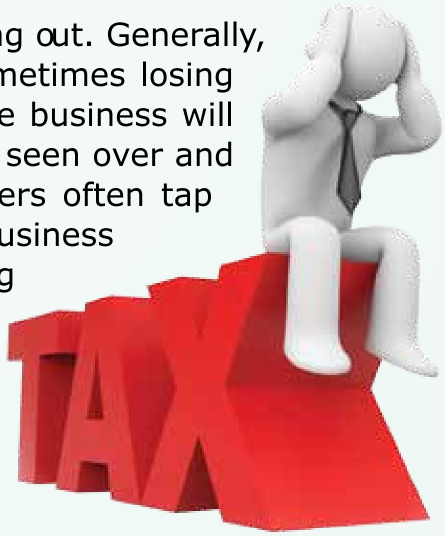
Source: IRS

Why is the IRS targeting S-Corporations? The motivation is simple. S-Corporations, unlike the regular C-Corporation, pass through all profits and losses to the shareholders. In a regular corporation, profits are distributed in the form of a dividend, which is taxed once at the corporate level as profits and is taxed again on shareholders' tax returns as dividend income. S-Corporations don't pay taxes, instead all the profits are considered distributed to the shareholders, and the income is taxed only once on the shareholder's Form 1040 at their personal rate.

Consequently, a shareholder who is also an employee of an S-Corporation is tempted to pay themselves less wages and more profits. The math speaks for itself: wages are subject to FICA payroll taxes (the employer pays half and the employee pays the other half for Medicare and Social Security taxes). Profits are not subject to FICA taxes, so paying more profits and fewer wages saves everyone a little over 15.3% in taxes.

The IRS obviously knows this, and is hoping to recover some unpaid payroll taxes.

The real difficulty comes when a trading business is just starting out. Generally, trading businesses go through two or three lean years, sometimes losing money and sometimes breaking even. After a few years the business will either close or begin making profits. This is a cycle we have seen over and over again with our clients. In the startup years, the owners often tap their own savings and investments to keep the trading business afloat. Most people strenuously object to the idea of taking their own money out of their savings account, putting it into their business, and then being forced to pay themselves a salary, plus all those taxes.



For this reason, Traders Accounting discourages traders from using S-Corporations in an effort to maintain maximum cash-flow. An honest examination of the cash-flow projections for the trading business will point to other business tax structures (C-Corporation and/or LLC) that will be the more advantageous.

In a C-Corporation, profits are taxed at the corporate rate. If the corporation pays stockholder dividends, the individual stockholders will be responsible for this income on their individual income tax returns.

"Corporate profit can be reduced by paying a bonus to corporate officers."

Although C-Corporations are subject to this double taxation, proper financial management can solve this problem. Most importantly, any corporate profit can be reduced by paying a bonus to corporate officers (including yourself).

In addition, this two-part tax mechanism actually creates an opportunity for even greater tax flexibility. With a C-corporation, you can use income shifting to take advantage of lower tax brackets. To illustrate, let's take the example of a business that earns $100,000. With a sole proprietorship, an owner who is married filing jointly would be in the 22% income tax bracket. If the business was a C-corporation, the business owner could take $50,000 in salary and leave $50,000 in the corporation as corporate profit. The federal corporate tax rate on the $50,000 profit is 21%. Furthermore, the business owner is now in a lower tax bracket for his or her personal income tax. This can reduce your overall tax liability by over $8,000.

Take a look at another example of the tax benefits. Two traders both have made $40,000 trading. Additionally, each made an additional $100,000 of W-2 income. John is trading as an investor without benefit of a C-Corporation or LLC. Susan sought out, with guidance from tax professionals like Traders Accounting, to set up a business in which to trade. Their trading expenses look like this:

Annual Business Expenses		***Deductions Taken:***	
		John	Susan
Telephone	$480	×	✓
Brokerage Feed	$1,200	×	✓
Seminars	$3,500	×	✓
Travel	$650	×	✓
Cable	$360	×	✓
Phone	$240	×	✓
Margin Interest	$6,000	×	✓
Total Deductible Expenses	$12,430	$0	$12,430

Out of the total expenses of $12,430, John can only claim $0 in deductions. He cannot claim any of the items above since he is classified as an investor. Due to the new tax law that went into effect for the 2018 tax year miscellaneous deductions are eliminated from 2018-2025.

Susan, however, is able to deduct the complete $12,430 as they are 'ordinary and necessary business expenses'. Susan is also in the 30% effective tax rate and is able to save $3,729 on her taxes

The difference is Susan will have $2,229 more in her trading account at the end of the year that John missed out on!

Like a corporation, a Limited Liability Company is a separate business entity.

LLCs have become quite popular because they combine the personal liability protection of a corporation with the tax simplicity of a partnership. The owners, (or "members") of an LLC are not personally liable for its debts and liabilities, and there is only one level of taxation. Moreover, LLCs are more flexible and often require less ongoing paperwork than a corporation.

"Protection of a corporation with the tax simplicity of a sole proprietorship."

LLCs Compared to Corporations:

Simpler management structure. LLCs are not required to have a formal Board of Directors (known as 'Managers' in an LLC). The owners and officers of an LLC can make all important company decisions directly.

No ownership restrictions. Contrast this with S-Corporations, which cannot have more than 100 stockholders, and each stockholder must be a resident or citizen of the United States. There are no ownership restrictions placed on an LLC.

Huge Tax Advantage. Generally, LLCs are treated as a pass-through entity for tax purposes. However, profits from a multi-member LLC, in the business of trading, are not subject to self-employment tax. Although an LLC can, make an election with the IRS to be treated like a corporation for tax purposes, whether as a C-Corporation or an S-Corporation.

> *"Single Member LLC's will continue to be disregarded for other federal tax purposes."*

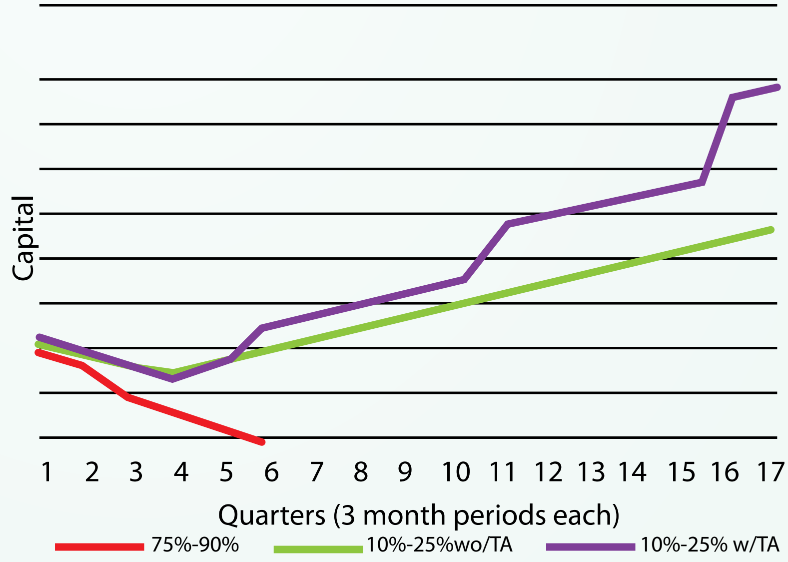
Year-over-year advantages of the proper formation of a trading business.

We have included the graph below for illustrative purposes, representing how the cash flow of a trading business develops over time. In this example, we have the same amount of capital at the opening of the trading accounts and show year-over-year advantages with and without the proper formation of a trading business:

RED: Research has shown that 75%-90% of traders fail in the first 16-24 months of trading.

GREEN: 10%-25% of traders begin to realize some success after an initial period and then will consistently grow their capital over time.

PURPLE: This graph illustrates the success traders have using Traders Accounting's recommendations and business services.



The Bottom Line

At Traders Accounting, our services assist in finding $15,000-$25,000 per year in deductible expenses for most of our clients.

The use of a legal entity is truly powerful. It provides preferential tax treatment and can provide asset protection from lawsuits. There really isn't any other option available that covers these areas for a trading business.

Some of our clients feel hesitant to run their affairs in a legal entity structure. We always encourage these individuals to take the time to determine their financial goals. We also encourage them to educate themselves through books, audio sources and/or seminars on others who have felt the same and then found success. What they find, is that most successful individuals started their own business using a legal entity.

We encourage you to establish a business entity for your future business endeavors, and to establish the discipline that is vital to successful, profitable trading.

Your Next Step is to Take Action

You will need to decide which option makes the most sense for you: filing your tax returns as a Sole Proprietor or establishing a Legal Entity for your trading business.

The best way to reach this decision is to call **Traders Accounting at 800-938-9513** and set up a consultation**.** We offer a FREE 30 minute consultation to help you decide if an entity is right for you and if so which one!

We've helped thousands of other traders like yourself understand their options and make more informed decisions. Let us help you too!

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