The Tax Treatment of Commodity Futures and Futures Options

Ted Tesser, CPA
Marc Sloane, CPA
Mark Press, Esq.

Center for Futures Education, Inc.

P.O. Box 309
Grove City, PA 16127
Tel.: (724) 458–5860
FAX: (724) 458–5962
e-mail: info@thectr.com
http://www.thectr.com

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Herbert Wool,
Arthur Wool,
Charles Tesser, and
Rose Balk

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I
INTRODUCTION

On March 12, 1912, the headline in *The New York Times* read, "Both Houses Likely to Pass Income Tax—Democratic Senators Unanimous for It and Are Confident of Progressive Support." This was the start of something far more pervasive and ubiquitous than anyone had ever thought or intended at the time. The article went on to state that the tax would be 1% of income over $5,000 per year, levied on both individuals and domestic corporations. The original reason for its passage was to replace the tariff that had previously been collected on sugar. There were those who questioned its constitutionality—but ultimately it was ruled in conformity with the Constitution, and it obviously passed. Over the past ninety some odd years of its existence it has taken on a somewhat different purpose, as well as a higher percentage.

Throughout history, the income tax has not only been used as a means for the government to raise revenue to subsidize its social programs, but also as a means to guide social policy; for example, if the government wants the population to increase, it will expand the deductions for dependents. If the government wants to encourage marriage, it will provide benefits for married couples. If the government wants to expand fuel conservation, it will give an energy credit for those who conform to its wishes. You get the idea.

The scope of the income tax and its enormity has varied through the last century, but the notion of a 1% income tax rate has come and gone in the same manner as the Edsel. To give you some idea of where we stand historically in regard to today's tax rates, a chart of the changes in maximum income tax levels for individuals throughout the past century or so is presented below.

Year	Top Marginal Tax Rate
1913	7.00%
1916	15.00%
1917	67.00%
1918	77.00%
1919	73.00%
1922	56.00%
1924	46.00%
1925	25.00%
1932	63.00%
1936	79.00%

Year (Continued)	Top Marginal Tax Rate (continued)
1940	81.10%
1941	81.00%
1942	88.00%
1944	94.00%
1946	86.45%
1948	82.13%
1950	91.00%
1952	92.00%
1954	91.00%
1964	77.00%
1965	70.00%
1968	75.25%
1969	77.00%
1970	71.25%
1971	70.00%
1981	69.13%
1982	50.00%
1987	38.50%
1988	28.00%
1990	31.00%
1993	39.60%
2001	38.60%
2003	37.60%
2005	35.00%

We currently live in a period of time in which we enjoy some of the lowest marginal tax rates in history, despite the fact that many taxpayers are still in the 50% tax category when you add in state and local taxes, Self Employment tax, FICA, Medicare, and all other miscellaneous taxes. In essence, that is like giving the government half of every dollar we earn. To put it another way, it is still like having a 50% draw-down on your trading account before the opening bell.

With this in mind, it is our hope that this booklet will give you some ideas and techniques for helping you to reduce your tax rate to a much lower marginal tax bracket; however, knowledge without action is worthless. It is the implementation of these strategies which counts. For traders, especially those with the proper knowledge of how to use this coveted status, this becomes even more of a possibility. We will now briefly discuss the most current and influential tax legislation over the past twenty years, and its effect on traders and investors.

The *Tax Reform Act of 1986* was sold to the American public as being "a tax simplification package." In reality, it turned out to be one of the most far-reaching, significant, and complicated pieces of tax legislation ever passed, especially for the American investor and trader. When you realize that it reduced the federal maximum tax bracket down from 50% in 1986 to 28% in 1988, you can see that this tax act truly was significant. There have been several pieces of tax legislation and one major tax act passed since then. The *Omnibus Budget Reconciliation Act (OBRA) of 1990*, and the *Revenue Reconciliation Act of 1993* were minor in comparison to the *Taxpayer Relief Act of 1997*. This can also be said of the *Economic Growth and Tax Relief Reconciliation Act of 2001*, the *Job Creation and Worker Assistance Act of 2002* and the *Jobs and Growth Tax Relief Reconciliation Act of 2003* (which we will cumulatively referred to as the "*Bush II Tax Acts*").

The 1997 tax act set a record for complicating the tax law and confusing both taxpayers and tax professionals alike. In fact, there are many parts of this law which were unclear, and still others which Congress finalized in HR2645. Nonetheless, it is possible to discern the impact of most of this tax law. We refer to this tax act as the "*Traders' Relief Act of 1997*," because traders were finally recognized by the new law and also officially given preferential tax treatment in the Tax Code. Of course, this treatment had existed through court precedent for many years prior to its being officially placed in the Code.

In this booklet, we will go into the major areas of change for investors and traders of commodity futures and futures options which have been effected by the *1997 Taxpayer Relief Act*, subsequent tax acts, and their interpretations. We will demonstrate how, in many ways, the *1997 Tax Act* has been a blessing to traders and investors alike. The *Technical Corrections Act* in 1998 has provided us with guidance as to the final interpretation of this significant tax act. The *Bush II Tax Acts* have had some minor impact on investors, but little on traders, as they are still very much a preferred tax class unto themselves.

This analysis is based on the best information available to date. Anytime there is a tax law change, there generally follows a propagation of litigation, regulations, rulings, and court decisions which can significantly affect the new law. Tax acts are complex and pervasive pieces of legislation. Regulations and rulings interpreting the law are continuously being issued, and these rulings will no doubt subsequently be challenged

in court as to their interpretation. Typically, there are many areas which are nebulous within any law, and they are subsequently clarified in the courts.

The information and views expressed in this booklet are believed to be reliable. Rulings, regulations, and tax court decisions may ultimately change the interpretation of some parts of this law. We encourage anyone reading this booklet to consult with a professional tax practitioner so the reader may evaluate his/her own circumstance as it relates to the new law.

II

A NEW BREED OF INVESTOR

There are many reasons people engage in commodities, futures, and options transactions. The manner in which these participants conduct business, and the reasons they do so, significantly influence the tax treatment of their transactions.

A. Dealer (Market Maker)

The law is quite clear on the definition of a dealer or a market maker. "A dealer in securities" is someone who engages in the purchase of securities for resale to customers with the intent of making a profit (Reg. Section 1.471-5). He is a merchant with an established place of business who regularly engages in this practice. Consequently, he may treat these securities as inventory, and, unlike investors, the securities held for sale to customers are treated as ordinary, not capital, assets, resulting in ordinary income, not capital gains/losses upon their sale.

What this section of the Code addresses is a very specific type of activity. It is describing a market maker: one who does business with the intent of facilitating trade for one or more of the major exchanges. A market maker is a legal definition and it is a matter of fact. It is a designation which is bestowed upon an individual upon the fulfillment of certain established criteria.

This distinction also grants certain privileges that go far beyond those of an investor. For one, dealers can deduct, dollar for dollar, any amount of any type of expense they incur in conducting the business of their profession. There is another huge difference. A market maker must consider a stock, option, or other investment vehicle he buys or sells as a "non-capital asset or an inventory item." This means that such a dealer is **not** limited to the $3,000 per year capital loss limitation to which other taxpayers are subject (including traders not electing Section 475 treatment, as discussed later on in this booklet); however, this income is also subject to ordinary treatment with regard to self-employment tax, retirement plan contributions, and, as of 1993, mark-to-market (Section 475) considerations (see page 20.)

Various objective factors indicate that one is a dealer. They include: maintaining an inventory of the physical commodity, employing a sales

force, maintaining customer accounts, licensing by appropriate regulatory bodies, and maintaining a regular place of business. The burden of proof of being a dealer is on the taxpayer, and the dealer designation applies to futures, options on futures, and index options, as well as securities and equity options.

B. Investor

In contrast, an investor, as defined by the tax law under Section 263A, is a person who buys or sells securities for **his own account**. Basically, investors are clearly defined as “investing” in securities for their own accounts as opposed to dealers in securities who buy and sell securities for resale to customers.

All expenses incurred in the activity of investing are considered to be investment expenses. These expenses are deducted as miscellaneous, itemized deductions on Schedule A of an investor’s tax return, and are subject to significant limitations and phase-outs.

Also, all income is considered to be capital gain income not subject to the self-employment tax, not eligible for retirement plan contributions, home office deductions, seminar expense, Section 179 depreciation, and other various deductions, and hence are reported on Schedule D. Furthermore, an investor is limited to a $3,000 per year net capital loss deduction, which can be carried forward (or back, in cases involving futures contracts and certain options, to be discussed later in this booklet).

C. Trader

There is no election on a taxpayer’s return to be classified as a trader. The case law decided in tax court, the various district courts, and the Supreme Court, has recognized a distinct group of market participants as follows: **Traders are investors who engage in the purchase and sale of securities for their own accounts; however, they do so to such a high level of activity that it becomes a business to them.** There are no fixed requirements in the Tax Code to qualify a person as a trader, and up until the *Taxpayer Relief Act of 1997* the distinction was not acknowledged in the Code. It was agreed that the taxpayer must trade in stocks, securities, futures contracts, or options on a relatively short-term basis. Nonetheless, this classification was **purely subjective** and the burden of proof has always been with the taxpayer.

Unless you can prove otherwise, you are considered to be an investor. In Paragraph 341 of the 1997 tax bill, Congress defined a trader as follows:

"Traders are taxpayers who are in the business of actively buying, selling or exchanging securities or commodities in the market. On the other hand, dealers deal directly with their own customers when they regularly buy or sell securities in the course of their business . . . Traders of securities or commodities are now permitted to make an election to use the mark-to-market accounting method. Previously, the mark-to-market rules only applied to securities dealers."

It is significant for Congress to acknowledge in the text of the tax law that traders do exist. Prior to this, the distinction was only handed down through a series of tax court cases (see Appendix I). These cases still define the criteria which separate an investor from a trader.

Here is a brief summary of some of the major advantages that a trader has over an investor:

1. Expenses are not subject to the 2% floor and phase-outs on Schedule A that investment expenses are. They are deducted on Schedule C on a dollar for dollar basis.
2. Itemizing deductions is not necessary to deduct "trading expenses." You can take a standard deduction and still deduct your trading expenses in addition to the standard deduction (on Schedule C).
3. Investment seminars which were ruled to be non-deductible in the *1986 Tax Act* are now fully deductible, as are trading seminars and the expenses associated with them, such as travel, hotel, etc.
4. Investment interest expense which was strictly limited under the 1986 Act now becomes trading interest (business interest) expense and is 100% deductible—even without profit in your trading account.
5. Section 179 depreciation, which is not allowed to investors, is now available to traders.
6. The home office expense, which cannot be deducted by investors, is now deductible for traders and, in fact, becomes one of the criteria in establishing "Trader Status" (see Appendix—Top Trader Court Cases).
7. Traders have the option of electing Section 475, and taking all of their losses as ordinary losses, not subject to the $3,000 per year limitation for investors.

To sum up, traders can receive capital gain or loss treatment of a purchase and sale of their transactions; however, the related expenses may be deducted from ordinary income as necessary business expenses. This is a huge benefit.

Although the non-Section 475 Trader is still subject to a $3,000 per year net capital loss limitation for trading losses, he may deduct 100% of his business expenses as ordinary (with the exception of meals and entertainment, which are 50% deductible). With the passage of the *Taxpayer Relief Act of 1997,* this $3,000 trading loss limitation can be increased without limitation if he elects to mark-to-market under Code Section 475 (See page 20).

Who qualifies?

The question of "Who qualifies as a trader?" is still a relatively subjective one. Although the Tax Code has now acknowledged the existence of "Trader" status, it has not outlined the specific criteria which an investor must meet to qualify as such. For these criteria, we must still look to the various court cases which have been settled over the past 70 years. Again, see the Appendix for a summary of what we consider to be 15 of the most significant court cases which have influenced the determination of Trader status.

There are Seven Major Factors—five subjective and two somewhat objective—which the courts will consider:

1. **Short-term holding period of the security traded**—The question of what constitutes short-term is still a subjective one. Is it less than a year, less than three months, less than a month, a week, or a day? The courts have stated that they reserve the right to make this determination on a case-by-case basis.
2. **Substantial number of trades in any given year**—What is considered to be "a large number" is also subjective. In some cases, the courts have allowed smaller numbers of trades to qualify one as a trader and in others they have required a larger number of trades. See Appendix, *Steffler v. the Commissioner.*
3. **Trading on a frequent, regular, and continuous basis**—The question of what constitutes frequent, regular, and continuous is, again, open to interpretation. Recently, the courts have been harsh on taxpayers who have tried to qualify as a trader but have not traded consistently. A trading diary is highly recommended for those who wish to qualify. See Appendix, *Paoli v. the Commissioner.*

4. **No intent to derive significant dividends or interest from holding of positions**. Again, what constitutes intent? The courts have generally construed that, if there are significant dividends from positions, then those positions were held with the intention of generating that type of income. There is no clear guidance as to what the terms "significant" or "material" mean, as they relate to other income.
5. **Commodities and options are considered better than trading stocks for Trader status**. In the case of *Marlowe King v. the Commissioner* and *Reinach v. the Commissioner,* preference was given to those trading commodities and options. See Appendix.
6. **The existence of a Schedule C indicating that business is being conducted**. This is the first entirely objective criterion which has come out of court. In *Purvis v. the Commissioner,* the taxpayer was denied Trader Status because he did not indicate on his tax return that he had a business by filing a Schedule C. See Appendix.
7. **The existence of an office**. A home office is okay, but again, this is a subjective criterion where the courts have said that if you are in business, you must have a place from which to conduct it.

Trader Status: Conclusion

Because Trader Status is a highly subjective classification, and because it involves the specific evaluation of one's activities as they relate to legal precedent, it is not advised that the investor make this determination without seeking a professional opinion. It is strongly recommended that those who believe they qualify seek the advice of a competent tax practitioner in evaluating their own situation.

As a special service, Tesser Horowitz & Ullmann, Inc. will provide a free Trader Evaluation to readers of this booklet. Call either 212-949-6979 or 800-556-9829 to obtain a free *Trader Status Evaluation* or visit www.TaxTrader.com. There is no cost or further obligation for being evaluated.

D. Hedger

We do not discuss this category in this booklet.

III
THE NEW TAX LAWS: CHANGES AND NON-CHANGES

A. Capital Gain or Loss Rules

Prior tax law

Throughout recent years, gains and losses on disposition of capital assets have been treated differently from other items of income or expense. Capital assets are defined in the Internal Revenue Code (IRC) as property which is held by a taxpayer for the purpose of making a profit or loss with the following exceptions:

1. inventory;
2. property held for sale to customers in the ordinary course of a taxpayer's trade or business;
3. depreciable business property;
4. real estate used in a trade or business;
5. copyrights and similar property held by their creator; and
6. accounts or notes receivable or received in the ordinary course of business.

This was established in Code Section 1221. This definition appears to make everything *not* listed a capital asset; however, *this is not the case.* The Supreme Court restricted the definition of capital assets in the *Corn Products* decision in which capital gain treatment was not afforded to a hedger. Generally, speculative positions taken in a futures market are accorded capital gain treatment or Section 1256 treatment (see page 17). Positions in these markets are *not* considered capital transactions when they qualify as hedge transactions.

The Taxpayer Relief Act of 1997

A practical effect of the change in the new law was that another exception to the capital gain rules now exists. Although not codified as an exception, but nonetheless contained in the IRC, traders can now classify their income or loss as ordinary, under Section 475.

The Bush II Tax Acts

As of 2005, capital assets should be separated into short-term and long-term categories. Assets held for a year or less are in the short-term category, and assets held for more than one year are in the long-term cat-

egory. You should follow the line by line instructions in the computations on Schedule D (Form 1040) to report your sales and obtain the benefit of the lower rates on long-term capital gains.

Gains and losses on sales of capital assets held for more than a year are long-term. They should be reported on Part II of the Schedule D, where long-term gains and losses are netted. A net long-term loss offsets a net short-term gain from Part I of the Schedule D. If you have a net long-term gain and also a short-term loss from Part I of Schedule D, the excess loss is deductible up to the $3,000 capital loss limitation against ordinary income (except if Section 475 is elected).

If you have a net long-term gain in excess of a net short-term capital loss, the excess is called a net capital gain. Net long-term capital gains are taxed as follows: if your top tax bracket is 10% or 15%, your capital gain rate is generally 5%. This means that net capital gains that would otherwise be taxed at 10% or 15% are instead taxed at 5%.

If your top tax bracket is 15% to 35%, your long term capital gain rate is generally 15%, except for collectibles, which are taxed at a 28% tax rate.

Capital Losses and Carry-overs

Capital losses are fully deductible against capital gains on Schedule D, and if losses exceed capital gains, you may deduct the excess of up to $3,000 against ordinary income on Form 1040. Net losses over $3,000 are carried over to future years (with an unlimited time for individuals to carry the loss forward). The $3,000 capital loss deduction is reduced to $1,500 for married couples filing separately.

B. Determining Net Capital Gain or Loss

To determine the appropriate tax treatment for individuals, capital gains and losses must be combined on a joint return, with both spouses being treated as one taxpayer for the purpose of combining capital gains and losses. First, all capital gains and losses must be separated into short-term and long-term components. Second, all short-term components are combined, resulting in a net short-term capital gain or loss. Then the two are netted against each other, with any excess up to $3,000 per year being deductible against ordinary income.

C. Tax Treatment of Capital Losses

When combining capital gain and loss results in a net capital loss, capital loss limitation rules apply. Capital losses are deductible in full against capital gains, and may be deducted from other income—subject to a limitation of net $3,000 in any one year.

This rule is applied to investors and traders alike (unless Section 475 is elected), even though traders have been allowed to consider their expenses as ordinary.

Tax treatment of capital losses remains essentially the same under the *Bush II Tax Acts*, subject to a $3,000 per year capital loss limitation except as modified by Section 475 (mark-to-market rules, see page 20).

D. Capital Loss Carry-Overs

Prior tax law

Capital losses in excess of those used to offset ordinary income were allowed to be carried over to other tax years. In general, capital losses may be carried over to subsequent tax years to fully offset capital gains in those years, and additionally a current $3,000 loss in any one year against ordinary income, until the loss is used up. Amounts in excess of these capital loss carry-overs may once again be used in future years to offset future capital gains. There is no limit to the number of years to which capital losses may be carried forward for an individual, nor limitation as to the amount of capital gain a prior loss may offset.

When these capital losses are carried forward, they retain the same character of short-term or long-term in years to which they are carried. The deduction of $3,000 against ordinary income is applied first against short-term capital losses until they are used up and then against long-term capital losses.

The Taxpayer Relief Act of 1997

This did not change, except for a new twist. In the *Taxpayer Relief Act of 1997*, it was determined that all carry-forward capital losses from prior years shall be applied first against the maximum taxable long-term capital losses and then to short-term capital losses until they are used up. This was addressed in the *Technical Corrections Bill* HR 2465.

The Bush II Tax Acts

The treatment of capital loss carry-overs is the same under current law.

E. Dividends

Under the prior law, there was a $400 exemption for most dividends, and the rest were taxed as ordinary income. This has changed significantly.

The Bush II Tax Acts

Taxable dividends paid out of accumulated earnings of a corporation are taxable. Stock dividends paid on common stock are generally not taxable. Dividends paid to individuals from most domestic corporations and many foreign companies are taxed at 15% (or 5% for taxpayers whose top bracket is either 10% or 15%). These are the same rates as long-term capital gains. "Qualified Dividends" must be grouped together to get the reduced rate.

Generally dividends on preferred stock do not qualify for the preferential rate. Distributions that are called dividends, but are really interest, do not qualify for the preferred rate. The most common dividends that are taxable are:

Preferred stock dividends;

Stock dividends elected by the stockholder of common stock who had the choice of taking stock instead of dividends;

Stock dividends paid in a distribution where some shareholders receive property or cash;

Distributions of convertible stock to holders of common stock.

Dividends are reported on Schedule B. You will receive a 1099-DIV. If you fail to report dividends, you will get a notice asking for an explanation and a bill for the tax deficiency. If you receive a 1099-DIV that you believe is incorrect, first notify the payer to get a corrected 1099. Do not attach copies of the 1099 to your tax return. These rules apply to traders as well as investors.

F. Section 1256 Contracts

Prior tax law

Special treatment under the old law applied to commodities, futures contracts, and certain non-equity options contracts. Any gain or loss with respect to Section 1256 was treated partly as a long-term capital gain or loss. The long-term portion was (and still is) 60% of the gain or loss, and the short-term portion was (and still is) 40%, without regard to the

holding period or whether the position was a contract to buy or a contract to sell.

Section 1256 transactions are enumerated in, and derived their name from, Code Section 1256 of the IRS Code. The term applies to any U.S.-exchange-regulated futures contract, any foreign currency contract, most non-equity options, and any dealer equity options. Regulated futures contracts are defined as contracts subject to mark-to-market treatment and traded on or subject to the rules of a qualified board or exchange. Thus, virtually all of the futures contracts traded on exchanges in the United States are regulated futures contracts by agreement with the IRS.

Prior to the *Economic Recovery Tax Act of 1981 (ERTA)*, futures contracts were taxed only on realized gains and losses; i.e., on positions which were closed. Thus, when a taxpayer took a position in one year and did not liquidate the position until a subsequent year, the resulting gain or loss was **not recognized** until the subsequent tax year when the position was liquidated. Taxpayers could, with a sharp eye on tax planning, control when gains or losses were recognized. This benefit was ended in 1981. Under *ERTA* and subsequent provisions, gains or losses on futures positions *open at year-end* are taxed as if they had been liquidated on the last day of the year. The mark-to-market rules also apply to options on futures contracts and index options on broad-based indexes. The price used for tax purposes is a settlement price established by the exchange on the last day of trading for the year.

To avoid taxing the same gain twice, the settlement price at year-end becomes the starting point for determining the gain or loss in a subsequent year.

For example; a taxpayer entered into a long jelly bean futures position in 2005 at $5.00 per pound. At year-end the position was still open and a settlement price of $6.09 was established by the exchange. For tax purposes, the gain of $1.09 per pound is taxed in 2005. This gain adjusts the taxpayer's basis to $6.09 for 2006 so that the gain will not be taxed twice. If the position is closed in 2006 at $7.26, the gain to be reported in 2006 is $1.17 per pound; conversely, if the position were to be closed in 2006 at $6.03 the result would be a $.06 per pound loss.

In determining the year-end price for mark-to-market purposes, the taxpayer is not permitted to adjust the settlement price by the amount of commissions which would have been paid if the position had been closed.

Taxpayer Relief Act of 1997

Under the *Taxpayer Relief Act of 1997*, Section 1256 transactions were still given preferential treatment. In fact, amazingly, the 60% part which is considered to be long-term capital gains, will now be taxed at the newest, lowest rate, the 15% maximum tax rate (as of "*Bush II*"). That means that 15% is the maximum rate at which the 60% long-term capital gains portion can be taxed. If, in fact, the taxpayer is in a maximum 35% tax bracket (2005 under *Bush II*), he will be taxed on 60% of the commodity at a maximum 15% tax rate, regardless of how long that commodity was held. This position was detailed in the *Technical Corrections Act*, HR 2645, although the rates were different then.

The Bush II Tax Acts

There has been no significant change from the prior law regarding Section 1256 transactions, except for the tax rates. The income is still reported as 60% long-term, 40% short-term. If, however, you elect Section 475, you give up the preferential tax treatment, and all the income is reported as ordinary. This is a significant consideration in whether or not to make the election.

G. Carry-Over of Section 1256 Losses

The general capital loss carry-over rules apply to Section 1256 contracts in the same way as any other capital loss transaction, with one exception. A taxpayer may elect a special provision to enable the carry-back of losses from Section 1256 contracts to offset prior year gains. This provision allows taxpayers who have recognized gains in prior years, which were subject to mark-to-market rules, to offset them with losses that are carried back.

The amount of loss which may be carried back is called the net Section 1256 loss. This is a net loss from 1256 transactions which is reduced by any gain from transactions in other capital categories. Losses can be carried back three years, against *other gains from Section 1256 transactions*, and, if not used up in those three years, can then be carried forward to subsequent years like any other capital loss. When carried forward, the loss is treated as a Section 1256 loss in subsequent years.

When Section 1256 losses are carried back, they *must* be carried back to the farthest year available, which is three years prior to the date of the current tax return. They may only be used to offset gains from Section 1256 contracts in years to which they are carried back. Gains from other capital assets may not be offset by carried back losses from

1256 transactions. Also, the capital loss carry-back from 1256 transactions to a prior year cannot generate or increase a net operating loss (NOL) in a carry-back year.

The election to carry back a net loss from a Section 1256 contract is made on the tax return of the loss year. The carry back is accomplished by filing an amended return for the year or years to which the loss is carried back.

H. Characterization of Carry-Back Losses

When the election to carry back losses is made, the characterization of losses from futures trading is applied differently from when no election is made, or when it is carried forward. If no election is made, the 60/40 split between long-term and short-term is made in the loss year; the amount and character of other capital gains or losses determine the composition of the long-term and short-term carried forward loss. If the 1256 loss carry-back election is made, the split between long-term and short-term is made in the carry-back year.

The only major change that occurred under the *Taxpayer Relief Act of 1997* and continued in the *Bush II Tax Acts* is in the Net Operating Loss (NOL) carry-back of ordinary mark-to-market positions under Section 475. The three-year period for a NOL carry back has been changed from three to two years **only** for those positions of a trader marked-to-market and **taken as ordinary**. See next section.

I. Mark-to-Market Provisions—(Section 475 Transactions)

Prior tax law

Under the tax changes in the 1993 legislation, specifically Section 475, a dealer must value his inventory at market value and mark it to market at year-end if the security is considered to be inventory to him. Thus, any securities dealer is now taxed on unrealized appreciation in his inventory account at year-end.

The securities which are identified by him as investments are not subject to the tax on unrealized gains or losses, and they need not be marked-to-market at year-end. When a securities dealer initiates a position as a dealer, he must decide whether to put the security into his inventory account or his investment account. Securities which are held for investment by dealers must be identified in the dealer's records by the close of business on the day of acquisition to qualify for capital gains treatment. Losses from the sale of investment securities are capital losses where the security was identified as being held for investment

purposes. As mentioned previously, “security” is a generic term, and it applies to all investment vehicles.

The Taxpayer Relief Act of 1997

There were several major revisions to Section 475 and related sections. *The 1997 Tax Act* allows security traders and futures traders to elect mark-to-market accounting similar to the requirement that previously existed only for securities dealers. The election applies to tax years ending after August 5, 1997.

Under the *Bush II Laws*, the category of taxpayer being considered is extremely important. Securities dealers and traders of futures contracts are still required to use mark-to-market, Section 475, but other securities traders and dealers of futures contracts may *elect* to use mark-to-market methods. The trader-versus-dealer distinction, hence, is extremely important in this sense.

Similarly, investors are not permitted to mark their positions to market and traders are. You may wish to review Section II where the distinction among the four categories of taxpayer is made.

Futures dealers and traders are required to value their inventory of futures contracts at fair market value each day. Generally, any non-inventory commodity or commodity-based derivative held at year end will be treated as if it were sold for fair market value. The definition of a futures contract has also been expanded to include futures options and options on most indexes for the purpose of Section 475. **The difference is that by marking the position to market, any gain or loss will be considered ordinary and not qualify for Section 1256 treatment, which is 60% long term, 40% short term. Any loss would also be considered ordinary and not subject to the $3,000 per year net limitation.**

The election does not require the consent of the IRS as long as it was made for the first tax year ending after August 5, 1997; however, once an election is made, it cannot be revoked without permission of the IRS. Adjustments are made to the actual gain or loss when property is ultimately sold after having been marked-to-market under this election. Needing the approval of the IRS to rescind the election is one of the primary reasons for making the election in an entity, as opposed to on an individual return (see Section IV).

Securities or futures contracts held for investment are excluded. Only securities or futures contracts used in the business of traders and futures dealers can be marked-to-market for the purpose of deducting greater than $3,000 of net loss in any one year. Investment securities

must be identified as not subject to the election. This identification must be made in the books and records. Taxpayers must be able to demonstrate by clear and convincing evidence to the satisfaction of the IRS that the identified property has no connection to the business activities of the trader or dealer.

If the election is made, the character of income or loss will be considered ordinary; therefore, making this election should not be done without careful planning and decision making. Under the *Technical Corrections Act of 1998* (HR2645), it was mandated that the income, although ordinary, will *not* be considered self-employment income. This is a big bonus for traders who elect section 475; however, you should consult with a competent tax professional before you make this decision.

Historically, traders have received capital gain and loss treatment on their income. Because the election results in ordinary income or loss, **the capital loss limitation rules**, as well as 60%/40% treatment (IRC 1256), short-sale rules (IRC 1233), and wash sale rules (IRC 1091), will not apply to mark-to-market properties. Nothing significant relating to these matters was changed by *Bush II*.

J. Wash Sale Rules

The wash sale rule defers recognition of losses arising from the sale of securities where substantially identical property is acquired within a period of thirty days prior or thirty days subsequent to the sale. This prevents a taxpayer from recognizing a sale in one year and re-instituting the identical position immediately in the next. The disallowed loss is carried over to subsequent years.

K. Short Sale Rules

A short stock sale occurs when an individual contracts to sell a security he does not own, or does not wish to deliver, at the time of the sale. A short-sale seller usually borrows the security for delivery to the buyer. At a later date, the short seller repays the borrowed shares by purchasing the shares, or by relinquishing the shares he already held but did not want to give up at the time the short sale was made. He usually pays interest for the privilege of borrowing the stock to sell short. This is treated as investment interest expense or trading interest expense for tax purposes.

The act of delivering the security to the lender (repaying) is called "closing the short sale."

When a security is sold short and the transaction is closed, a seller realizes a gain on the transaction if the price he pays for the borrowed shares is lower than the price for which he sold them. If he covers at a higher price, he realizes a capital loss. The nature of this is slightly different with regard to futures contracts because the shorting of a futures contract means you are selling someone the right to buy the commodity at a fixed price.

It was previously possible for a trader or investor to simultaneously carry both a long and short position in the same security without recognizing the closing out of the short side of the position. This has now changed, and the trader or investor can no longer do this. The position is now considered closed out. This technique was referred to as "shorting against the box."

In other words, it was possible for an investor to short a stock, even though he owned it at the time. This used to allow the owner to lock in gains on a stock without actually selling the stock. In this way, an investor was able to postpone the realization of capital gains which were then incurred and reported at the time of the outright sale of the stock.

L. Short Sales of Property which Becomes Substantially Worthless—Section 1233

When a taxpayer entered into a short sale, no taxable event was considered to have occurred until the short sale was closed and completed. If property became worthless after the short sale was initiated and the short sale was never closed, there was never a taxable event, and any economic gain realized may have gone untaxed.

Now, if a taxpayer enters into a short sale of property and that property becomes substantially worthless, the taxpayer must recognize the gain as if the short sale were closed. The statute of limitations provisions were also changed for this purpose. If the short sale remains open when the property becomes substantially worthless, the statute of limitations will not expire until the earlier of:

1. three years after notification to the IRS of substantial worthlessness of the property or;

2. six years from the date the return is filed for the year the property becomes substantially worthless.

Trading firms used to take short positions in stock of targeted companies. Sometimes the short sales would be “boxed,” which means they took an offsetting long position in the same security at a later date, thereby locking in profits without ever incurring a tax liability. In other cases, short sales were never closed even after the property became substantially worthless. This practice has been eliminated through the revision of Section 1233.

There are still some open areas to be considered, including the meaning of substantially worthless securities, and whether this rule should be extended to other financial products (for example, put options on property that becomes substantially worthless).

IV

THE TRIPLE CROWN: THE ULTIMATE STRATEGY FOR TAX REDUCTION

In baseball, as well as horse racing, there is a special significance to the term "Triple Crown." In taxes there is a strategy which is so formidable that we have also named it the Triple Crown. It is the Ginsu™ knife of tax reduction (for those of you old enough to remember the Ginsu™ knife). It will slice and dice your taxes, and still be able to cut through any thing else—even the IRS. That's how powerful it is.

A. The Business

Most people don't realize that having a business is truly the last great tax reduction opportunity left in America today. In fact, there are really two tax systems in existence for U.S. citizens. One is for employees; the second is for employers—the owners of the business.

If you're an employee, you can deduct itemized deductions from your adjusted gross income, such as mortgage interest, real estate taxes, charitable contributions, and other miscellaneous itemized deductions. Only IRA contributions can be deducted to arrive at your adjusted gross income; however, if you're a business owner, you get all sorts of deductions in addition to the ones that employees get. And these deductions are not only greater in magnitude than the ones afforded employees, but are also deducted in a much more advantageous manner—before arriving at adjusted gross income, rather than deducting it from your adjusted gross income.

Establish a Business

This is Step 1 of our three-pronged approach. People already in business have the structure through which they can enact the second and third parts of our strategy. For those of you not already in a business, let us say that a business is like money in the bank—it is something everyone should have.

For those of you who have no business, let me suggest one—the business of trading. With a trading business, you become a trader.

In order to understand the exact nature of what a trader does and the advantages associated with this preferred tax status, you must understand the other types of participants in the market. As mentioned in Section II of this publication, there are four types of market participants. First, there is the broker-dealer/market maker. Second, there is the investor. Third is the hybrid category—the trader. The trader is allowed to treat his activity as a business. Fourth is hedgers, who are not addressed here.

B. The Entity

How to Choose the Proper Entity

The second step to our three-tiered approach is to put your business in the entity which is most advantageous to you. The preferred choice for most traders (and of course this varies with each situation) is the establishment of a corporation as the managing member of a limited liability company(LLC), as a general partner in a limited partnership (LP), or as a general partner in a family limited partnership (FLP). Again, we stress that there is no cookie-cutter mold for this and circumstances vary depending on each trader's needs.

The corporation should be, in most cases, an S Corporation (S-Corp) so income flows through to the owner(s). The corporation becomes a percentage owner in either the LP or the LLC. The S-Corp then becomes the trading arm of the LP or LLC which holds the trading accounts. The S-Corp generally owns a small percentage of the LP or LLC, and a management fee is paid to the S-Corp for trading and managing the accounts of the LP, FLP, or LLC.

It is in the S-Corp that you establish the third component of this strategy—vehicles for both deferring and deducting income; i.e., retirement plans, employee benefit programs, etc. A management fee is paid to the S-Corp, and a salary is paid to the individual trading the entity. His/her pay must be based on the parameters of reasonable compensation for services rendered. The concept of reasonable compensation, however, is a subjective one, and there is a somewhat wide range within which reasonable compensation can fall.

Advantages to the Triple Crown Strategy

A trader who trades as a business can do so in several ways. He can initially set up a Schedule C (Sch C) and file this as part of his/her individual tax return (Form 1040). This is a fine way to start; however, as one's business becomes more involved, and hopefully more profitable,

it is clear that the formation of a separate business structure is, by far, the preferred way to go.

The creation of an S-Corp and an LP, FLP, or LLC is ultimately the best way to add both flexibility and other advantages to your trading business, as well as to insulate your assets from any potential liability. A Sch C trader, unless he elects Section 475 (mark-to-market), reports all the income on Schedule D, and all expenses as ordinary on the Sch C. Although all of the expenses are ordinary, the income retains the character of capital gain income. Because of this, in most cases, it is not subject to self-employment tax, does not qualify for retirement plan contributions, and does not allow the trader the opportunity to deduct self-employed health deductions (other than on Schedule A).

The real problem occurs with retirement plan contributions and other employee benefit programs because there is no self-employment income (again, in most cases). The best way to establish these programs is to allow them to be deducted against salary, which is paid through the S-Corp.

As I mentioned before, an S-Corp is a corporation which is not a taxable entity unto itself. It does not pay federal and most state corporate income tax, and the profit or loss passes through to the individual's tax return. A "C"-Corporation may, in fact, be subject to a personal holding company surtax on the income, from which an S-Corp is exempt. As mentioned previously, it is our opinion that if the trader elects mark-to-market, Section 475, it is far better to do so in an entity than on a personal return.

The reason for this is that, once you make the election on your personal income tax return (Form 1040), it is very difficult to rescind that election. If it is made in an entity and if the request to revert back to a non-Section 475 taxpayer is not accepted by the IRS, it is not a permanent situation. All one would have to do is to form a new entity and start off fresh without electing Section 475.

LLCs are, for the most part, hybrids between corporations and limited partnerships. The taxpayer decides whether to file the LLC tax return as either a corporation or a partnership. There are advantages associated with either one and it does add some degree of flexibility to the entity's structure. The LP, FLP, and LLC are discussed further in the following section.

There are many reasons for forming a dual-entity structure, with one of the largest advantages being that an entity will make you a "small fish in a large pool" for audit purposes. We believe that, as a trader in an entity, you are far less likely to be audited than as a Schedule C trader.

This is especially true in light of the fact that a trader generally has a large number of transactions throughout the year and hence, a large amount of gross proceeds. This huge gross proceeds figure, often times in the millions, is more susceptible to audit on an individual's tax return than on that of an entity.

There are two pools of tax returns for audit—the individual pool and the entity pool. An individual is put in a mix with other individuals, most of whom have smaller gross proceeds figures than will a trader. An entity, on the other hand, is in the same pool as corporations such as Exxon-Mobil, IBM, Coca-Cola, and other Fortune 500 companies. For this reason, tax returns with gross proceeds even in the millions of dollars do not raise an IRS eyebrow when compared to the billion dollar numbers on the large corporate tax returns.

There is also what is known as a DIF audit, which is really a comparison of the previous year's figures to the current year's figures, for audit selection. If you decide to become a trader one year, and start generating large numbers of gross proceeds from trades on your tax return, a computer might kick out the return due to the comparison to last year's tax return.

If, instead, you switch to an entity, and trade within the entity, there is no discrepancy in a year-to-year comparison. Because the gross proceeds figures do not show up on your individual tax return, there is no problem with that. Further, since this is your first year filing as an entity, there is no comparison to be made in the entity.

Moreover, the flexibility in electing Section 475 (mark-to-market) is much greater in the first year of an entity's formation. An individual must make the election for the current year by the earlier of the filing date of the prior year's tax return or April 15 for the current year. A new entity, however, must make the election in the first year, within 75 days of formation. The big difference is that, with an individual, it is a formal election which is filed with the IRS, and therefore set in stone. With an entity, though, it is an internal election which must be made by the Board of Directors.

Implementation

As an entity, it is easy to deduct ordinary, normal, and reasonable business expenses associated with doing business in the entity. Also, entities are presumed to be businesses, so that the question of Trader Status oftentimes becomes moot; therefore, there should be less of a question as to the business nature of the entity and hence, the ordinary deductions of such expenses as:

- Retirement plan expenses
- Single employer trusts (an area of huge advantage which we will talk about later on in this booklet—Section 419A expenses)
- Accounting fees
- Automobile expenses
- Books, audio tapes, video tapes on trading or taxes
- Courses on trading and seminars
- Expenses associated with such seminars
- Trading account management fees
- Calculators, adding machines, cassette tape recorders, computers
- Financial services such as trading services
- Trading software
- Data retrieval service
- Business interest expense (as an investor, margin expenses may be non-deductible.)
- Legal fees, and the cost of establishing entities
- Entertainment and meals during which business is conducted (limited to 50%)
- Safe deposit box rental and storage space for trading documents
- The salary of bookkeepers, accountants, or others who keep your trading records
- Tax return preparation and planning for your trading business
- Subscriptions to trading publications
- Trips to look after your trading account and conferences with trading advisors
- The portion of your home expenses that qualify as home office deductions

You will need to choose a state of origin to be the home of your entities. Keep in mind, however, that the entity's profits will be taxed in the state in which you do business, not the state in which it was formed; hence, setting up corporations in non-taxable states such as Nevada may not provide a tax benefit and are not recommended.

If you are lucky enough, however, to reside in Nevada, or any of the other states with no individual income tax and you do business there, your income will not be subject to state income tax. This information is crucial, and there are other CPA firms and practitioners recommending that the establishment of an entity in a non-income tax state will eliminate state taxation. This is not only incorrect, but illegal as well. Remember, the state in which you do business is the key to its taxation.

The Limited Partnership (LP), Family Limited Partnership (FLP), and Limited Liability Company (LLC)

An FLP is nothing more than an LP which includes only family members. It is a very useful tool to reduce or avoid taxation, both currently and in the future. Through the use of an FLP you can reduce or totally eliminate the estate tax (informally re-named to the "Death Tax" by President Bush). Many people think that Bush eliminated the Death Tax, however, it has just been temporarily reduced. After 2010, it goes right back to 55%.

Stephan Liemberg, J.D., C.L.U., one of the nation's foremost authorities on FLPs, uses this analogy. He states that, if you have ever been to a magic show, you have probably seen this staple of any good magic act: the magician takes a hat, puts something into the hat, waves his magic wand over the hat, and reaches in and pulls out a rabbit. This next section teaches you how to do a similar magic trick. It will allow you to take whatever assets you have in your possession and put them all into the magic hat called the LP or FLP. When you put your property into this magic hat, you will be making a contribution to the partnership, and in return getting back units of whatever comes out of the hat. You or others, at some later date, can put additional assets into the hat, such as cash or insurance on your life, the deed to your real estate, or even a business. The hat works just the way the magician's did on stage because it enables one or some of its owners (called partners) to invest or safeguard and manage the assets. It is a magic hat because if things go as planned, more assets will come out than were placed in, and the wealth can change hands from one party to the next—to ultimately end up in the hands of whomever you would like.

Through the magic of gifting discounted valuations to family members of subsequent generations, you can transfer wealth at wholesalers' prices. You can still, however, maintain control of the assets, even though you do not have ownership. And, the key to savvy tax planning is to have control, but not ownership. Ownership equates to taxation, and taxation to someone in a lower tax bracket (such as your son or daughter, or grandson or granddaughter) means lower tax.

Imagine that the hat's assets are managed according to the terms of a special document. That document is called a partnership agreement. It spells out how the assets in the hat are to be managed or invested, or how the business is to be run. The partnership agreement also spells out who receives the income and the assets, and under what conditions they will do so. The key is that you can have control over the entity and

administer and manage all of its assets. You control the magic wand that you wave over the hat. You can tap three times and determine which owners will have what assets, and who will share what assets with each other.

If you look at a partnership as a magic hat, you see that it comes in many different shapes and sizes to meet varying needs and objectives. Once you determine the hat you will be using, you can hold the ownership of the hat, yet have the assets in the hat not be taxed to you. This is also true of an LLC.

You can also, over time, change the shape and size of the hat that is holding more or fewer assets in it. You can shape the hat to meet the needs or objectives, or even the circumstances, of the owners or prospective owners, of the assets in the hat. This is the second part of the magic act.

If knowledge is power, knowing about LPs, FLPs, and LLCs makes you a very powerful and wise magician in meeting your financial goals, income, and estate plan. "Why is this?" you may ask. Because FLPs and LLCs are truly magic. They are one of the cutting edge estate and income tax planning tools of the twenty-first century. Understanding the advantages of the LP, FLP, and LLC is essential for those who would like to have their wealth preserved for their own use, and even passed down to their heirs, tax-free.

There are a number of reasons why you need to have more than a cursory understanding of LPs, FLPs, and LLCs. First, they are the centerpiece of tax planning for some of the wealthiest people in our country at this time. Why is this? LPs, FLPs and LLCs allow participation without taxation.

Secondly, as I mentioned, FLPs and LLCs avoid death tax inclusion of life insurance contracts, just as they would in an irrevocable insurance trust, but without the Crummey power issues of irrevocable insurance trusts. The implementation of Crummey powers is an arduous task.

And third, a properly structured LP, FLP, and/or LLC can add a significant layer of creditor protection to your assets. These three reasons should be enough, by themselves, but I'd like to add one more. Your knowledge of LPs, FLPs, and LLCs will distinguish you from most of the people in tax and estate planning.

Just to sum up, the advantages of using LPs, FLPs, and LLCs for a trading business are as follows:

- Excellent wealth shifting tool
- Easy division of difficult assets
- Flexibility in electing Section 475 treatment

- Reduction in the risk of being audited
- Pass-through net operating losses (ordinary trading losses as well, if Section 475 is elected)
- Structural flexibility
- Wide array of potential partners and owners
- Ease of placing property in and taking property out without tax significance
- Shift of responsibility for investment and operating decisions
- Means to vary levels of income and compensations to partners/ members
- Flexibility in investing or trading
- Privacy in public disputes
- Ability to use an arbitrator instead of a judge in disputes
- High level of certainty in FLP/LLC treatment
- Simplicity and ease of maintenance
- Reduction of costs for preparation of individual tax returns (Form 1040)
- Excellent creditor protection
- Ease of establishment within different states
- Unifying the investment and administration decisions
- Ability to diversify assets

C. Structures To Reduce, Defer, and Avoid Payment of Taxes

This section explains the third step of our "Triple Crown" approach, which is structures to reduce, defer, and avoid the payment of current and future income tax. There are more than a few types of vehicles, to say the least, for achieving this goal. The purpose of this section is just to acquaint you with the various types of programs which can be established in the entity structure.

There are two basic types of programs which can be established in an entity structure.

1) Tax Deferred Programs: money can be contributed, but not deducted, from current taxable income; however, the money can grow exponentially in these plans because there is no payment of current income tax due on your profits.

2) Tax Deductible Programs: money contributed not only can grow without paying current income tax on profits, but you also receive a current tax deduction on your income tax returns for the amount of money contributed.

1. *Tax Deferred Programs*

Roth IRA

- The limitation for 2005 is $4,000 plus a $500 catchup provision for those 50 years of age or older, or

- The lesser of this figure or earned income

- You can contribute after the age of 70½

- It can be set up by April 15 of the subsequent year for the previous year (in essence, doing post-year-end tax planning)

- Withdrawals are non-taxable if the contribution remains in the plan for five years or more and you have attained age 59½ or greater

- There are income phase-outs at the following levels (in 2005):

  Single—income of $95,000 to $110,000

  Married Filing Jointly—income of $150,000 to $160,000

  Married Filing Separately—income of $0 to $10,000

- You can participate even with the establishment of any other employer-sponsored plans

- There are exceptions whereby you can withdraw money without penalty. These include:

  Disability, death, and unreimbursed medical expenses

  Qualified higher education expenses

  First time home buyers (up to $10,000)

  The receipt of substantial periodical payments

Variable Annuity

- Insurance companies sponsor these programs (we work with various insurance companies and are capable of assisting you in finding the best companies for your needs—for more information, call 1-800-556-9829).

- They are very similar to mutual funds in that there are all types of variable annuities:

Small Cap Funds

Large Cap Funds

Sector Funds

Mid Cap Funds

Foreign Funds

Metals, etc.

- You can trade in and out of funds, or even go to cash, without penalty, and sometimes in an unlimited fashion.

- You can contribute an unlimited amount of money each year as a contribution.

- You can either withdraw your money in a lump sum payment or annuitize the withdrawal and get income for the rest of your life.

- No premature withdrawal penalty if contributions are not deducted.

- Gains go untaxed until withdrawal, thereby allowing you to take advantage of what Einstein called the eighth wonder of the world —compound growth.

- Your contribution withdrawal is tax-free unless you use a tax-deductible variable annuity.

2. *Deductible Plans*

Traditional IRA:

- The limits are the same as the Roth IRA. In 2005, those limits are:

  $4,000 per person plus a $500 catchup provision if you are age 50 or older, or

  The lesser of this figure or earned income

- You cannot contribute after you are 70½ years of age

- You must start to withdraw from the plan when you attain the age of 70½

- A 10% premature withdrawal penalty will apply if you withdraw funds prior to age 59½.

- It can be set up by April 15 of the subsequent year for the previous year (in essence, doing post-year-end tax planning)

- Withdrawals are fully taxable

- Generally, if withdrawal is made prior to age 59½, there is a 10% tax penalty

- Income phase-outs take effect if your spouse participates in another employer sponsored plan (limitations in 2005):

    Single—$50,000 to $60,000

    Married—$70,000 to $80,000

- There are exceptions whereby you can withdraw money without penalty if the following conditions apply:

    Disability, death, and unreimbursed medical expenses

    Qualified higher education expenses

First time home buyers (up to $10,000)

Deductible Variable Annuities

- Insurance companies sponsor these programs

- They are very similar to mutual funds in that there are all types of variable annuities

    Small Cap Funds

    Large Cap Funds

    Sector Funds

    Mid Cap Funds

    Foreign Funds

    Metals, etc.

- You can trade in and out of funds, or even go to cash, without penalty, and sometimes in an unlimited fashion.

- There are limitations on the amount of money each year as a contribution.

- You can either withdraw your money in a lump sum payment or annuitize the withdrawal and get income for the rest of your life.

- There is a premature withdrawal penalty if under age 59½.

- Gains go untaxed until withdrawal—compound growth.

- Your contribution withdrawal is fully taxable.

Simple IRA:

- The employer sets this up for the employee. If you establish a series of entities you can be both employer and employee.

- You are limited to a $10,000 contribution (plus a $4,000 catch-up amount) in 2005for those 50 years or older

-The employer may not maintain another qualified plan

- Similar withdrawal rules to a tax-deductible IRA

401K:

- The employer sets this up for the employee. If you establish a series of entities you can be both employer and employee.

- You are limited to a $14,000 contribution (plus a $4,000 catch-up amount) in 2005 for those 50 years of older

- Similar withdrawal rules to a tax-deductible IRA

- You can roll over the amount in a 401K to a self-directed IRA once your employment with the company is terminated.

Simplified Employee Plan (SEP):

- You can contribute the lesser of 25% of income or $42,000 in 2005.

- It can be set up by October 15 of the subsequent year for the previous year (in essence, doing post-year-end tax planning), as long as proper tax return extensions are filed.

Keogh Plans:

<u>1) Defined Contribution Plans</u>

- Contributions are based on income
- You can contribute up to the lesser of 25% of income or $42,000 in 2005

<u>2) Defined Benefit/Section 412 (i) Plans</u>
- The contribution is based upon age and the benefits desired upon retirement rather than on a percentage of income

- In 2005, there is a $170,000 per year post-retirement annual benefit limitation. Benefits to be paid must be determined upon the adoption of the plan.

- Specific contribution amount is determined by actuaries based on factors such as age, desired benefit, and projected rate of return on contributions.

Single Employer (Section 419A) Trusts:
- One of the best kept tax avoidance secrets in place today.

- You can fund to build up large amounts of cash either upon retirement or even before retirement.

- You can trade the markets with your contribution—limited to $42,000 in 2005.

- Full control over how and where the funds are traded.

- There is asset protection and limited liability pertaining to the funds in a single employer trust.

- You can establish to pay for post-retirement medical benefits with your funds, or life insurance benefits to either protect or build a large estate, if you have none.

- You can withdraw money prior to retirement without penalty by terminating the program.

- If disabled, you can withdraw money from the trust.

- Complies with current law which has disallowed the use of the VEBA, which was the best vehicle prior to 2004.

- You can establish it in such a manner as to avoid the death tax.

V
SUMMARY AND CONCLUSION

Because of the continual shifting of legal and regulatory precedents, taxpayers should seek competent professional advice regarding investment, trading, and hedging transactions on an on-going basis. This booklet is by no means an exhaustive work on the tax consequences of futures and futures options transactions. It should not be used in lieu of competent legal and/or accounting advice, but will hopefully provide some insight into the tax issues and complications involved in the futures industry.

GLOSSARY

Appreciation—An increase in property value for the purpose of tax assessment, resale, insurance, and so on.

Asset—Any property, physical or intangible, that has monetary value.

Basis—The cost of any property for tax purposes.

Business Expense—Any expense incurred in the process of trying to generate business income.

Call—An option contract which gives the buyer the right to purchase something for a certain price within a specific period of time. In the case of calls on an index, such as the OEX, which are settled in cash, it is the right to receive an amount of money based on the call strike price and the index closing price at the date of expiration.

Futures Contract—A contract calling for the delivery of a commodity, financial instrument, or cash at a specific future time for a specified price. Futures contracts, for the most part, are marked-to-market at year end and treated as if sold, for tax purposes, even if they are not.

Index—A measure of relative value compared with a base quantity for the same series. Stock indexes, such as the OEX, are frequently weighted to reflect the prices and number of shares outstanding. The Dow Jones Industrial Average is another example of an index.

Leverage—The use of small amounts of capital to control larger amounts of capital in an attempt to increase earnings.

Liquidity—The ability to turn an investment into cash without its losing any significant value as a penalty for haste.

Mark-to-Market—The adjustment in the value of a brokerage account to make it conform to a new market price. The convention of computing, for tax purposes, a gain or loss on futures positions at the year-end closing value, regardless of whether or not the position is sold at that point.

Option—A contract for the right to buy (or call away from the owner) or the right to sell (or put to the buyer) a certain quantity of a commodity, security, or futures contract at a set price (strike price) by a certain time (expiration date). Index options are settled for cash on expiration and for tax purposes are generally treated as futures contracts.

Put—An option contract which gives the buyer the right to sell (or "put to the buyer") a certain quantity of a commodity, security, or futures contract at a set price (strike price) by a certain time (expiration date). Index puts, such as those on the OEX, are settled for cash upon expiration and for tax purposes are treated as futures contracts.

APPENDIX

Top Trader Court Cases

TOP 10 COURT CASES WHERE TRADER STATUS WAS ALLOWED:

1) *Snyder v. Commissioner*—1935—Court stated that a taxpayer can be in the "business' of trading securities.

2) *Higgins v. Commissioner*—1941—Court ruled that whether or not the trading activities of a taxpayer constitute carrying on a business was determined by the examination of the facts and circumstances of each particular case—lead ground work for subjectivity

3) *Fuld v. Commissioner*—1943—Taxpayers were held to be traders because of the large number of trades, none of which were held as long as two years.

4) *Nubar v. Commissioner*—1951—It was held that extensive trading of stocks and futures constituted engaging in a trade or business.

5) *Kemon v. Commissioner*—1953—Court determined that Traders are sellers who take advantage of short term price swings to sell at a gain over cost.

6) *Liang v. Commissioner*—1955—Relevant consideration to Trader Status is the intent to derive profits from frequent trading.

7) *Reinach v. Commissioner*—1967—Option writer did not have to prove that his activity was a trade or business due to the nature of the instrument traded (options).

8) *Marlowe King v. Commissioner*—1978—Futures Trader was allowed to deduct all expenses incurred in his business of trading futures as ordinary expenses, even though some futures transactions were long-term. Trading business was upheld because of the nature of instrument traded (futures contracts).

9) *Levin v. Commissioner*—1979—Trader is an active investor because he or she does not passively collect income through dividends or other means, but rather actively manipulates his or her holdings. A Trader's profits are derived through actively trading.

10) *Ropfogel v. US District Court of Kansas*—1992—Determined that the criteria for Trader Status is comprised of six factors:

1) Frequent trading
2) Regular trading
3) Continuous trading
4) Substantial number of trades
5) Trading to capture short-term swings in the market
6) A systematic approach to trading activities

TOP 5 COURT CASES WHERE TRADER STATUS WAS DISALLOWED BUT FAVORABLE GUIDELINES WERE ESTABLISHED FOR TRADER STATUS:

1) *Purvis v. Commissioner*—1976—An attorney was denied trader status because he failed to file a Schedule C.

2) *Moeller v. Commissioner*—1983—Despite full-time management of securities and large investments, taxpayer was not granted trader status because his/her investments were all long-term.

3) *Stephen A. Paoli v. Commissioner*—1991—Trading was deemed not to be frequent, regular, and continuous. Credibility of the taxpayer was at issue (said he was trading for many months without making one single trade).

4) *Frederick R. Mayer v. Commissioner*—1994—Trading advisors which he managed full-time were objected to by the IRS in the determination of Trader Status. The issue of managing the trading advisors full-time as a determinant of trader status was never addressed because the "trading" advisors were actually engaging in investment rather than trading activities.

5) *Rudolph Steffler v. Commissioner*—1995—Distinction was made between a business and an activity entered into for profit. Substantial number of trades was the issue.

ABOUT THE AUTHORS

Ted Tesser, CPA

Ted Tesser is a CPA and a member of the New York State Society of Certified Public Accountants. He has a Masters Degree in Accounting from New York University, with a specialty in investment related taxation, and is an active investor and trader, as well as a CPA. Ted has been involved in the financial markets for the past 30 years and counsels traders and investors on issues regarding tax, retirement, estate, and entity planning. He founded Waterside Financial Services, Inc., a company dedicated exclusively to traders and investors, in 1986. In 2001, he merged this company into Tesser Horowitz & Ullmann, Inc.

Ted is the author of *The Serious Investor's Tax Survival Guide, The Trader's Tax Survival Guide, The New Trader's Tax Solution,* and is a contributor to *Day Trading on the Edge*. He has recorded seven video-taped seminars, including his latest work, *Bulletproof Your Trading Taxes* (DVD), as well as *The Ultimate Tax Shelter, Million Dollar Tax Tips, Traders—Cut Your Taxes in Half This Year,* and *Cut Your Trading Taxes in Half* (available through Traders' Library (800) 272-2855). He has been a featured speaker at many prominent trading conferences, and has appeared on CNBC and KWHY television on numerous occasions.

Ted has also written for and contributed to most current trading publications, as well as many which have come and gone, including *Futures Magazine, Technical Analysis of Stocks and Commodities, Active Trader Magazine, Traders World, The Journal of Medical Economics, Forbes,* and many others. He has been favorably reviewed in these magazines, as well as in *The Wall Street Journal.*

Marc Sloane, CPA

Marc Sloane is a CPA, a member of the New York State Society of Certified Public Accountants, and a member of the American Institute of Certified Public Accountants. He has a Masters Degree in Accounting from Long Island University with a specialty in investment-related taxation. Marc has been a principal of Horowitz & Ullmann, P.C., which is an affiliate of Tesser Horowitz & Ullmann, Inc., since 1977. Marc has had a professional relationship with Ted Tesser since 1990. He now works extensively with traders and investors, and is both a partner in Tesser Horowitz & Ullmann, and manager of their tax department.

Mark Press, Esq.

Mark Press is a tax attorney, a member of the New York State Bar Association, and a member of the American Bar Association. He has a Masters Degree in Accounting from New York University with a specialty in retirement and estate planning, entity formation, and various investment related issues. Ted Tesser and Mark Press attended New York University as classmates in the early 1970s and have been working together to assist their clients ever since. Mark received his law degree from St. John's University School of Law.

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In 2001, **Ted Tesser**, CPA, formed **Tesser Horowitz & Ullmann, Inc.** along with his partners, **Marc Sloane**, CPA, **Stewart Hung**, CPA, and **Michael Winicki**, CPA. Each partner, along with most of their professional staff, is an expert in trader- and investor-related issues and specializes in savvy tax planning and tax preparation for domestic and international clients. **Tesser Horowitz & Ullmann, Inc.** is an outgrowth of the affiliation of **Waterside Financial Services, Inc.** (founded by Ted Tesser in 1986) and **Horowitz and Ullmann. P.C.** (founded in 1973), with roots going back as far as 1953.

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