The Tax Intelligent Traders Manual

Building Your Wealth
Ensuring Your Future

THE TAX INTELLIGENT TRADER

(5th Edition 2012)
By Warren Black

Introduction

By now you have started your exciting journey to being a successful trader! Or I hope so ... (Or even better still, I hope you are already a successful trader making squillions of dollars!)

As an accountant and lawyer, I love seeing my trading clients become financially independent and living the life of their dreams through trading the world markets in the comfort of their own home.

What a wonderful way to make money! It is hard to imagine a business with lower staff and overheads, no office premises, virtually fixed costs, regardless of how much money you make, you name it.

But whether it is options, Forex, CFDs, futures, Eminis, shares, writing covered calls, warrants, or any other form of trading or instrument strategy, we all must face the taxman. Everyone has to pay tax, and unfortunately, in Australia, at high rates. And even worse, after you have made your trading profits, and paid your tax, someone (like a creditor, or lawsuit-hungry predator, or nasty ex spouse) turns up knocking at your door wanting their slice of the pie.

We live in a culture where greedy golddiggers are always seeking a slice of your hard earned wealth. ***"To reap where they have not sown …"***

And most people aren't prepared for when this happens and end up with a rude shock when it does.

Here's some shocking statistics:

- 69% is the average tax paid by Australians
- 48% of businesses go bankrupt indirectly because of government action, and the taxman is a major factor (ie. unpaid group tax, PAYG, GST, etc.)
- The average east coast Australian is sued THREE times in their lifetime, and New South Wales and Queensland, for example, are in the top 5 places in the world for lawsuits per head!
- 80% of small business fail in the first 5 years, a further 80% fail in the next 5 years
- 95% of people lose money in trading the markets. So the statistics aren't in your favour.

As a lawyer and accountant, I am always asked by my trading clients how to slash their tax, and how they can stop greedy golddiggers from getting to their assets.

Not only that but most traders get a rude shock if the ATO decides to audit them (and believe me, they often do). If the trader doesn't meet very strict criteria, the ATO can, and often do, say that you are not carrying on a legitimate business, and therefore, you can't claim all your expenses.

I decided to write this book to ensure this doesn't happen to you!

Intelligent tax planning is one of the best kept secrets of the rich. The rich know the importance of a good tax accountant or lawyer to keep their tax down to the bare minimum. The rich know that as their wealth grows, the golddiggers rub their hands with glee, seeing them as having "deep pockets" and an easy target for quick cash. They also know the ATO wants to maximise their slice of the pie.

So the rich know the importance of a tax and asset protection guru to not only slash their tax to the bare minimum 100% legally, but also, to secure their assets from greedy golddiggers.

As a trader, you will have many questions, such as:

- What is the best structure to trade in? Should I use a company? A trust? Why can't I just trade in my own name?
- Can I use my self managed superannuation fund to trade?
- How do I work out my tax as a trader?
- Can I claim the cost of my courses in learning how to trade?
- What about my software and all my subscriptions?
- What other expenses can I claim as a trader?
- What happens if I make losses in my trading? Can I offset them against my day job income? Can I offset them against future profits?

The good news is, the answers are all contained in this Manual.

Welcome to The Tax Intelligent Traders Manual; a ground breaking book that transforms you from a tax dummy into a tax intelligent trader, ensuring you keep the wealth that you make!

In this book, we look at a number of things. We introduce you to the different structures you can use to trade options or shares. We introduce you to the best way to work out your tax. We look at the expenses you can claim as tax deductions. We look at whether you can claim your losses as a trader. And we look at a whole number of other questions that you would never even have thought of.

Anything that my clients have ever asked me, I have covered in this book. If there is anything that you want to know that is not covered in this book, please email me at help@wealthsafe.com.au and me or one of my staff will gladly assist you.

This book is the only one of its kind in Australia at present. Nobody else has written a quality book on options (or any other) trading, and the tax and structuring impact of it.

This book is written in a Frequently Answered Question and Answer format. It is not intended to be an exhaustive guide to replace professional advice, however, so keep that in mind.

Finally, this book is only introductory. If you want a more in depth treatment of the subject matter, please contact us at Wealth Safe on the contact numbers at the end of this e-book or at the website www.wealthsafe.com.au (and sign up for your free book on the Tax Secrets of the Rich), and obtain your free 30 minute consultation with one of our staff.

Or alternatively, attend one of the author's specialist seminars by contacting us on 1300 669 336.

Disclaimer

Before you start, please read the following disclaimer.

This book is only intended to be an educational guide. It is designed to educate you and bring awareness of the tax issues that you face as an trader. That is all it is meant to do. It is not meant to give specific advice. Every case is different. If you are serious about trading, go and get professional advice from your tax specialist as to the best way to structure, and whether you can claim your expenses as a tax deduction in your specific circumstances. (You can contact us and arrange a specific consultation to go through your tax affairs; we are specialists and we understand the ins and outs of trading having done it ourselves!)

Bearing the above in mind, we trust you will find this guide sensational to help you move forward and become a tax intelligent trader!

About the Author

Warren Black, **B Com, LLB (1st Class Hons), Dip Fin Pl** is a qualified lawyer (with **First Class Honours**) and accountant and financial planner with nearly 20 years experience in taxation, asset protection and business law.

Warren is an experienced professional presenter who has presented across Australia and internationally at many seminars on tax and asset protection, including Money Masters, 21st Century Academy, Mal Emery Platinum, Universal Events, and many other events from time to time.

Warren worked for 10 years at the Australian Taxation Office (ATO). Since leaving the ATO, Warren has worked over 10 years in law and accounting. Warren has exceptional skill in tax planning, asset protection, commercial law, international tax and estate planning, among other things.

Warren Black also won the Mallesons Stephen Jacques prize for his Honours thesis on Income Tax and Capital Gains Tax.

1. How do you tax the profits and losses of Traders?

In working out the tax on your profits or losses as a trader, and what expenses you can claim as tax deductions, your first question is whether you are a trader or speculator. The ATO is very strict on this issue, and has guidelines as to what they accept and don't accept.

A **trader** is someone who trades options, shares, forex, CFDs or futures for a living. They treat it as a proper business and not as a hobby.

A **speculator** by contrast treats their trading as a hobby. They trade the markets for speculative purposes, ie. sporadically, or occasionally, with no real system.

Traders are treated differently for tax purposes from speculators. It is far better for tax purposes to be classified as a trader than a speculator.

The ATO rewards you if take your business seriously. Let's take a simple example.

Example

John lives in Bondi in Sydney. John has 5 chooks in his backyard. He and his family live off the eggs and he sells a few eggs next door to his neighbour Mary. He keeps no records.

In no way is John carrying on a business. It is only a hobby. The money Mary gives him would not be taxable. But nor would the expenses that John pays on the maintenance or purchase of his chooks be tax deductible. There is no sense of commerciality or business-like system in what John is doing.

By contrast, let's take Farmer Joe who lives in Halls Creek. Farmer Joe has 2,000 chickens, a special incubator, special equipment and feedstuffs, top quality, business software systems to manage his chickens, you name it. He sells the eggs to supermarkets, wholesalers, etc. He keeps detailed records, uses MYOB, and has an accountant, and runs his farm through a unit trust structure.

Clearly Farmer Joe is carrying on a business. He would be taxed on his receipts. But he could also claim all his associated expenses with his chickens as a tax deduction.

Now that we have discussed, this, let's look at some general principles for traders. These principles are only general but will give you some excellent guidance.

A. SPECULATOR

If you trade as a hobby and do not carry on business as a trader (ie. you do it now and again with no regularity, no system and in an un-business-like manner), the capital gains tax (CGT) regime applies.

This is not the result you want.

Let me tell you what happens if you're a speculator.

1. *Trading profits*. Your trading profits will be taxed as capital gains at your FULL marginal tax rate, not as ordinary income. This is critical in what expenses you can claim as tax deductions (discussed below). The only way to avoid this result is if you can show that you have entered into a commercial transaction of a revenue nature, which you won't always be able to do. Note this can occasionally be of benefit as you can claim a 50% discount against your capital gains if you hold the asset (eg. share) more than 12 months, but traders do not hold shares for more than 12 months, and certainly not with options. This is for investors.

2. *Tax deductions*. Here's the critical issue. If you are treated as a speculator, you will have difficulties in claiming tax deductions for your trading expenses (such as attending seminars, educational courses, computer software, manuals, books, trading data, etc.). You will only be able to offset these costs against your capital gains. The problem with this is many of your costs cannot be offset against your capital gains, eg. seminar costs, software or subscription costs, computer costs, etc.

3. *Trading losses*. If you make losses from your trading, there are limits in claiming your trading losses against your other income (such as your day job income from your job as a manager at Coles, for example) as you pay CGT on your trading profits. In practical terms, this means if you make a net loss on your trading at the end of the year, you can only deduct your losses against capital gains from other activities (eg. buying and selling property, shares, etc.). If you do not have any other capital gains, you cannot deduct your losses against your other income, eg. such as salary and wages from your day job, or other business income. Yet if you make profits, you are fully taxable on them with only some reductions. Not very fair is it?! But that's tax in Australia for you!

But if you are a trader, life is much better, as you will see below. The key is to be classified as a trader by the ATO as the tax benefits are a lot better.

Let's look at the benefits of being a trader.

B. TRADER

If you are considered to be a trader by the ATO, the position is more favourable:

1. *Trading profits.* Profits are taxed as income (not capital gains). The practical effect is not greatly different from being taxed as a capital gain as a speculator (except in certain instances, such as options traders who buy long term options, or share traders who buy shares for buy and hold purposes, that is, for long term capital growth) but there is a great difference in relation to the tax deductions you can claim.

2. *Tax deductions.* Here's where the real differences arise. If you incur costs in becoming a trader, such as educational costs, subscriptions costs, computer software costs, data subscription costs, subject to another issue that I will discuss shortly, you can claim these costs as tax deductions against your trading profits. Even if you are not a trader (ie. your costs are learning to trade), you usually can claim a deduction for your costs over 5 years. Again this is explained below.

3. *Trading Losses.* Unlike speculators, if you make losses from trading, in some cases, you can deduct your losses against your other income (like your day job salary and wages or your business income), subject to the non-commercial loss rules, which are discussed later on.

Clearly you want to be classified as a trader. Not as a speculator.

2. How do I tax my trading profits as a Trader?

As a TRADER, your profits and losses are taxed under the income regime.

However an issue arises as to the TIMING of taxing your profits and losses.

That is, when do you claim your expenses and declare your income from specific transactions? Each transaction has a buying and selling point; do you look at net profits? Or do you examine individual transactions in isolation?

To explain further, let's take an example using options trading. Similar principles, however, can apply to futures trading, or other forms of trading.

Example

Assume that you buy a BHP CALL contract for $0.50, an outlay of $500, on 1 Feb, with the option expiring on 26 Feb. You also write an ANZ PUT for $0.60 on 1 Feb and receive $600. You sell the BHP CALL on 4 Feb for $0.80, receiving $800. You leave the ANZ PUT until expiry and keep your $600.

There are 2 methods for taxing this transaction:

1. **Individual transaction method**. You look at each transaction individually. In your tax records, you deduct $500 on 1 Feb, you include $600 as income on 1 Feb and you include $800 as income on 4 Feb (for simplicity I have avoided another timing issue on when the money is credited to your account).

2. **Net profit method**. You look at each transaction as a whole. For the BHP CALL, you have $300 net profit ($800 - $500) derived on 4 Feb when you closed out the Option. For the ANZ PUT, you have a $600 net profit ($600 – nil) derived on 26 Feb, the date of expiry.

Both methods have their pros and cons. Method 1 means that transactions may lag over into the next year of income, i.e. if you bought BHP for $500 on 29 June and sold it for $800 on 3 July, the transactions are assessed in different income years. That is, you get the deduction BEFORE you have to declare your income. Likewise with writing options; you declare your income even though you have not as yet realized the profit as you may have to buy the option back if it goes against you.

Method 2 taxes the entire transaction in the next income year as that was when the transaction was finished (ie. you don't get the tax deduction until next year). There are slight differences but there is no universal rule as to which method is better.

So which method should you use?

The accepted view is that you use the **individual transaction method.**

Why is this?

Although the net profit method is in line with the ATO financial futures ruling released in 1998, the ASX has released a paper called "the Taxation Treatment of Options" by Patrick Broughan of Ernst & Young. This paper is on their website. On page 9 of the paper, he suggests that the individual transaction method is the better method for trading options. It gives the most "correct reflux" of ordinary income. The net profit method should only be used for ETOs other than LEPOs (Low Exercise Priced Options) and cash settled options (such as the Twenty Leaders Index Option).

The Australian Taxation Office have now accepted that this is the preferred method.

Do you need further guidance? Contact a Wealth Safe representative to arrange a specific consultation, or find out how you can attend a specialist seminar. You may know more than your accountant by the time you have consulted with us, or go to a specialist seminar!

3. How do I know if I am carrying on business as a trader for ATO purposes?

This is a very important question and not easy to answer.

Why is this issue important?

1. As stated earlier, if you are carrying on a business as a trader, your trading profits are taxed as ordinary income and your losses are revenue deductions. So if you make trading losses, you can offset these losses as deductions in your income tax return against your other income, provided you satisfy the non-commercial loss rules (these will be discussed later).

2. The point where you are considered to have started trading as a business (that is, regarded as a trader by the ATO) determines which of your expenses will be tax deductible, ie. education costs, subscription costs, etc. (This issue is discussed further below.) If you are not carrying on a business, you may not be able to claim many of these expenses. The ATO is very strict as to the point you are considered to be carrying on a business, and usually, you need to show some evidence of live trading (technically this is not essential but see my discussion at question 5 below).

So what makes me a trader?

Whether or not the ATO will treat you as a trader is a question of FACT not of law.

You must be able to show the ATO that you are carrying on a business and not engaging in a mere hobby or speculative activity.

The ATO looks at a number of criteria in deciding if you are carrying on a business, including:

- Your intention to carry on a business, ie. at what point did you develop an intention to carry on business as an options trader? Do you have written material or other evidence to show this?
- Do you have a written trading plan? When was this plan formulated?
- Do you have a clearly defined system of trading or is your trading system more speculation or guesswork?
- What is the size of your trading account?
- How much time do you spend on your trading each week?
- How often do you trade each month/year? If you had dormant trading periods, can these be explained in relation to your trading strategy?

- Is your overall behaviour consistent with that of the usual trader in the industry, ie. is it sufficiently commercial and in accordance with the industry standard?
- How sophisticated is your computer software and equipment?
- Have you set up a special office at home or elsewhere which is designated exclusively or mainly for trading?
- Do you subscribe to data providers or journals? Are you a member of any forums, technical bodies?
- What level of education do you have? Do you regularly do courses to improve your skills as a professional trader?
- Have you set up any structures, eg. company, discretionary trust
- Do you use a discount or full service broker?

Ultimately it is a question of fact whether you are a trader.

If you are in doubt, you can always apply to the ATO for a Private Ruling. It would be a wise idea to do this if in doubt, as the last thing you need is to miss out on claims you may be entitled to.

4. You mentioned about a 50% discount on capital gains. When does this apply? Can I get it as a Trader? If not, will I lose it for my investment assets?

As outlined in question 1 above, you cannot get the 50% CGT discount as a trader as your trading profits are income.

However, in any event, this is irrelevant, as most options traders will not hold the option or currency for more than 12 months.

This does raise an interesting question. Assume that John trades options on shares, and on commodities. John also holds shares (that are non-optionable) and gold interests for long term buy and hold. Will John miss out on his CGT discount if he sells the shares or gold bullion because he is a trader?

The answer is YES, he will lose his discount, UNLESS he is careful how he structures his arrangement.

To explain, if the ATO see that John is a trader, and he holds investment assets, the ATO will have difficulty in distinguishing what is a trading asset and what is an investment asset (remember the ATO are not commercially savvy most of the time!).

What John can do is this:

- John sets up a trust or company (I prefer a trust, as discussed later on) to trade options, CFDs, forex, futures, etc.

- John sets up a separate trust or company to hold his investment assets, ie. his long term buy and hold shares (if John is wanting the structure to hold investment assets, I wouldn't recommend a company in any circumstances, for reasons explained later on). Or at the very least, John has a minute in his trust to document the purchase and what it was for.

  By having a separate structure, the ATO can clearly distinguish John's business or trading trust/company, and his investment trust/company.

5. Can I claim my expenses as tax deductions as a trader? What are the issues that I need to watch out for?

I outline below a four stage process to help you work out if you can claim an expense as a tax deduction.

1. Are you carrying on business as a trader?

This is already discussed in question 3 above.

2. Assuming you are carrying on a business as a trader, at what point are you considered to be carrying on a business?

This is critical in relation to which expenses you can claim as tax deductions. This is a common question asked by people buying trading courses, and one I get asked all the time.

It is also the area which causes the most contention or dispute with the ATO.

Ultimately the expenses you are allowed to claim will depend on the facts of your situation. As a general principle, you cannot claim expenses which you incur before starting your business as a trader.

Expenses in learning to trade (seminar or educational costs).

The ATO has stated that if you incur expenses in learning how to become a successful trader as a new profession, these expenses are not deductible. However, if you are already committed to carrying on business as a trader, and you incur educational expenses to enhance and improve your ability to trade while already carrying on business, the expenses are fully deductible in the year that you pay them.

That is:

- If you incur educational expenses to learn how to trade and you have never traded before (eg. you attend an ASX course on share trading, or a private course on options or futures trading), it is unlikely that you can claim these expenses as a tax deduction. The ATO view is that you are learning a new vocation. It is well established law that expenses in learning a new vocation are not tax deductible. The ATO also say that you will have difficulty showing that you had made a serious commitment to being a trader when you have never done it before and have simply attended a course (unless you have a trading plan, some prior history and other unusual factors to indicate a commitment out of the ordinary, but as discussed below, the ATO will rarely accept that you are carrying on a business if you haven't live traded).

- By contrast, if you incur expenses after you have established an intention and commitment to carry on business as a trader, it is highly likely that you can claim the expenses as a tax deduction. So for example, if you were already a share trader who did a course to learn how to trade options and CFDs, or a Forex trader who did a course to improve his or her trading skills/profits, the cost of that particular course would be tax deductible.

That said, ultimately, it does depend upon your specific circumstances and you should seek professional advice on these issues.

As stated earlier, even if you cannot claim the expenses because you have not traded before, and you have not earned any income, you may still be able to claim the expenses as a deduction over 5 years.

Is it essential that you are live trading to be regarded as carrying on a business?

Although it is technically possible to be carrying on a business of trading before you start live trading (ie. when you are paper trading) the ATO rarely accepts that you are a trader if you haven't done it before. The ATO view is that you cannot be a trader until you have started live trading.

So if you claim to be carrying on a business as a trader during your paper trading period, and the ATO investigates you, the ATO will look far more strictly at your activities than when you are live trading, and you will need substantial evidence to justify your position.

That said, in theory, if you can show from your paper trading activities and businesslike records and other factors that you were carrying on a business at the time you incurred the expenses, the fact that you haven't live traded may not stop you from claiming your deductions (subject to the non-commercial loss rules which are discussed in detail below). This is clear from *FCT v Walker*, a case where the courts held that a man who owned one goat was carrying on a business because of the business like manner in which he looked after that goat!

Again it depends on your specific situation. I cannot stress this strongly enough.

Summary

You can claim your expenses for your trading if you are carrying on a business as a trader (especially if you are living trading).

If you are paper trading, and not live trading, you will need strong evidence to justify any claims to be carrying on business as a trader. Indeed it is highly unlikely you will be regarded as a trader by the ATO or the courts. You will especially need strong evidence to claim expenses to learn how to become a trader when you have never traded before and have no serious trading plan.

You should speak with your accountant or your tax lawyer to see at what point you would be considered to be carrying on a business as a trader if you have just started trading (or if you are considering starting paper trading or live trading).

3. Assuming I am carrying on a business as a trader and I know when I started my business, what expenses can I claim?

This is discussed in question 6 below.

4. What happens if I make trading losses?

That is, assuming you are carrying on a business as a trader and you know at what point you started your business, and what expenses you can claim, what happens if you make trading losses? Can you claim them as a tax deduction against your other income (eg. salary and wage income, or other business income)?

This is discussed in question 7 below.

5. Summary

In summary you need to determine:

1. Are you carrying on business as a trader?
2. At what point are you carrying on the business? In particular, are the expenses deductible or were they incurred before starting my business?
3. What expenses can I claim?
4. What happens if I make trading losses?

6. What expenses can I claim as a Trader?

You can claim expenses which are necessarily incurred in gaining your assessable income as a trader. By contrast, you cannot claim expenses which are private or capital in nature. This is the ATO statutory test, and is backed up by the courts.

By capital in nature, I mean capital costs of running your trading business, ie. set-up costs, buying capital equipment which have a long term life expectancy beyond the current year. For example, such expenses include computers and printers (although some of these items are subject to depreciation).

By private expenses, I mean expenses which are essentially private in nature.

Without being exhaustive, in consultation with your accountant or professional adviser, there are a number of expenses you may be able to claim:

- Courses in learning to trade and associated travel and accommodation costs (subject to Question 4 above)
- Cost of courses in upgrading your knowledge and associated travel, meal and accommodation costs
- Subscriptions (eg. Bourse or Pulse data)
- Charting software
- Telephone calls to your broker, ASX, etc.
- Certain travel expenses
- Home Office expenses (ie. part of furniture, heating, lighting, etc. can usually be claimed and even rates, taxes and interest if your trading office is physically separate from the house)

This list is not exhaustive and should be discussed with your accountant.

More importantly, although your expenses may be tax deductible, they are still subject to the non-commercial loss rules discussed below in Question 6. That is although the expenses may be claimed as tax deductions, if your expenses exceed your income from trading, you may have to carry the losses forward to the next tax year (ie. you may not be able to claim the losses as a tax deduction against your day job income in the current tax year).

7. What about my trading losses as a trader? Can I claim them as a tax deduction against my other income (i.e. salary and wages income or other business income)?

Please note that this section is only relevant in relation to trading losses which you have incurred while trading in your own name. Once you start trading through a family trust, the rules on trading losses change, and are discussed further below.

1. In claiming your trading losses against your income, the rule is if you are carrying on a trading business, your trading profits are taxed as ordinary income and your losses are revenue deductions. That is, you can offset your losses as revenue deductions in your income tax return against your other income. So for example, if you earned $50,000 salary, and you had a business loss of $10,000 for a year of income, your taxable income for that year of income is $40,000 ($50,000 – 10,000). On the other hand, if you are a speculator, or were not carrying on a business as a trader at the time of incurring the expenses, it is unlikely that you can claim the deductions (except for the blackhole 5 year rules in certain circumstances).

2. This is subject, however, to the non-commercial losses rules. These rules are contained in Division 35 of the *Income Tax Assessment Act 1997*. Under these rules, among other exceptions, unless you satisfy one of four tests, you cannot claim your losses against your other income. Rather you must defer your losses until the following year of income. If in the next year, you make net profits from your trading to offset the losses, they are offset and if not, the non-commercial losses are applied to see if you qualify. If in that year you meet one of the four tests, then the losses can be so offset.

3. The main test for traders is whether you generated over $20,000 in assessable income from your trading. If you fail this test, all is not lost. You may still qualify, under a few additional exceptions:

   (a) If you only carried on business for part of the year, if a reasonable estimate shows that you would have been expected to have generated over $20,000 had you carried on business for the entire year, you can still claim your losses. So for example, if you started trading on 1 January and only generated $12,000 in assessable income, you can project that $12,000 over the course of the year as to what you would have earned as a reasonable estimate if you had traded for the whole year, ie. $24,000. (Note it is *assessable income*, not *taxable income* or *net profit*. This is far easier to satisfy. The test looks at the volume of transactions bringing in revenue, ie. sale of options as a buy-write, or naked call, or sale of an existing call/put.)

(b) If you can show that it was usual in the trading business to generate over $20,000 of assessable income, and exceptional circumstances prevented you from doing so, you can still claim your losses. This alternative, however, is less certain in how it applies.

4. In summary, the effect of the $20,000 assessable income test is:

   (a) If you do not live trade at all in the year of income, you cannot claim your losses as a tax deduction against your other income. The only exception is if you can convince the ATO to exercise their discretion on the basis of special circumstances (which is not usually done). In this situation, you must carry your losses forward to the following year of income to claim against future profits.

   (b) If you do live trade and generate over $20,000 in assessable income, you can claim your losses as a tax deduction in the year of income.

   (c) If you generate less than $20,000 in assessable income, you will still be able to claim your losses as a tax deduction against your other income if you only traded for part of the year and a reasonable estimate shows that you would have generated over $20,000 if you had traded for the whole year. For example, assume you live traded from 1 January 2008 to 31 March 2008. Your trading records shows that you generated $10,000 from selling options and your cost of buying the options was $16,000. This gives you a total net loss of $6,000. A reasonable estimate shows that if you had traded for the full year, you would have generated $40,000 from selling options ($10,000 x 12 months / 3 months). You would be deemed to satisfy the test, and therefore could claim your losses as a tax deduction against your other income. Or alternatively, if you met the special circumstances test.

5. So therefore, you must look at the non-commercial loss rules carefully in deciding whether you can claim a tax deduction for your losses.

8. Is it better to trade in my own personal name, in a partnership, in a company or family trust?

This is a difficult question and you need professional advice before setting up a structure to conduct your trading. Especially as there are strict anti-avoidance rules in the tax law.

I provide some general principles below.

In most circumstances, if you are a trader committed to long term success, it is better to trade through a company or trust. This is especially the case if you have a family with children, run another business through a further company or trust or give to charity on a regular basis. A trust or company not only saves you a lot of tax (in many situations) but gives tremendous asset protection for the person in business who is daily at risk of being sued in their business.

To anyone who wants to trade options, futures, CFDs, Forex, shares, or anything else, and intends to treat it as a serious business, I cannot emphasise strongly enough the importance of setting up correctly.

In saying that, your personal circumstances must always be considered. If you have a small trading capital, for example, and you have a day job, you are at minimal risk of being sued, and you will get minimal tax saving from a structure. So you may be better off in that situation to trade in your own name, especially if you are still in feasibility mode, and not 100% confident of your ability to make it profitable. However, as soon as you are a serious trader, you definitely need to set yourself up in a company or trust, and give yourself a solid foundation to move forward with.

Ideally I prefer people to do it in the beginning as from experience, once people start trading in their own name, it is too much of an administrative hassle to change it. If, however, you decide to start in your own name, and intend to switch to a trust later on, make sure you keep an eye on it, and do it, as soon as you start making profit! Otherwise the tax consequences could be too painful for you.

A true story …

I have a good friend who traded options in his company, not using a trust. He resisted my efforts to move into a trust.

One day he made $1.8 million in trading in a month. Yes, that is absolutely serious. He bought a whole stack of out of the money CALL options on BHP and CBA (2 cents each for memory) and the stocks had a BULL run and spiked up.

His decision not to set up in a trust cost him $50,000 minimum. Why? Because he gave over $100,000 to charity. If he had used a trust, he could have distributed the profits from his PRE-TAX income to the charity. By using a company, he PAID TAX FIRST and then paid the charity.

A hard lesson. I trust you will learn from his mistakes …

So tell me more about Companies and Trusts?

As an introduction for the beginner, here are some basics of the tax treatment of companies and trusts.

Companies

Companies are taxed at 30%. They are regulated by ASIC and are fairly expensive to set up and maintain on a regular basis.

The advantage with companies is they give you asset protection for assets held in the company. So for example, if you are running another business in a different entity (or in your own name) and a business creditor wants to sue you for that business, assets held in a company are protected as a general rule.

Companies can also protect you from being personally liable in relation to a business being carried on through a company. Directors have limited personal liability apart from situations when you are trading insolvent or have breached fundamental duties as a director. Admittedly it is unlikely that anyone would sue you in relation to your trading business so this is less of an issue here. However, it is still important because say, for example, you run another business, as well as your trading business, you want to ensure that your trading income and business income are held in two separate structures to protect your trading income from a lawsuit against your business.

Companies do have their problems:

1. They can be more costly to run

2. The tax cap of 30% doesn't work if you want to draw money out of the company. You get taxed at your full tax rate. Even loaning the money to you from the company doesn't help because of strict tax rules about loaning money out of your company. By giving yourself a loan from your company or a drawing without a proper loan or legal agreement, you can end up paying tax as high as 76.5%! Yes that is absolutely serious.

3. When compared to a discretionary trust, companies are inflexible when it comes to distributing profits. As a general rule, the most effective use of companies is as a corporate trustee for a

discretionary trust or to accumulate profits in relation to a trust when the trader is on a high marginal tax rate (discussed below).

Trusts

A family discretionary trust is an excellent vehicle for running any type of business venture especially trading the markets.

Who are the Players in a Trust?

A trust has a Settlor, Trustee, Beneficiaries, Appointor and Guardian.

The **Settlor** creates the trust and has no further involvement.

The **Trustee** manages the trust and determines who gets distributions of trust profits and capital each financial year. They are the legal entity controlling the trust.

The **Beneficiaries** are those who are entitled to receive distributions of capital.

The **Appointor** protects the trust and has the power to hire and fire the trustee.

The **Guardian** is similar to the Appointor. The Guardian protects the trust; and in certain situations has the power to fire the Appointor.

I call the Trustee the "Puppet" and the Appointor the "Puppet Master". (The Guardian is the owner of the puppet booth who employs the Puppet Master.)

The Puppet Master can remove the Puppet at any time and get a new one. Similarly, the owner of the puppet booth can sack the Puppet Master and get a new one any time.

How does a discretionary trust work?

In a discretionary trust, the trustee can distribute to any one of a number of beneficiaries at their discretion.

For example, the Smith Family may set up the Smith Family Trust. The beneficiaries include mum, dad, the 3 children, their family companies, all other trusts and all registered charities or churches anywhere in the world. If the trust makes $50,000 profits from trading, it can distribute to any one of the beneficiaries.

The beauty is unlike companies, a trust is taxed at the beneficiary level. So in the Smith Family example, $10,000 each may be distributed to mum and dad, $20,000 to the family company, $1,000 to each of the children and the remaining $7,000 to their local church. Each beneficiary will be taxed on the income at

their marginal rates. Obviously churches pay no tax (yet normally if you gave money to your church, it would be from AFTER-TAX income). The family company pays tax at 30%. And mum, dad and the children pay tax at their marginal tax rates.

In one example I use in my seminars, where Mr Smith earns $100,000 and his wife earns nothing, and he has 3 children, if Mr Smith makes $40,000 trading profits, the difference in tax between Mr Smith trading in his own name and through a trust is $4,891 compared to $16,600!!!

This is a substantial difference.

So as you can see there can be some great tax savings in a trust. And trusts are much more flexible than a company.

That said, the above information is only general in nature, and it is VERY important that you seek specific advice if you intend to run a trading business. Indeed there are situations where setting up in a trust may not be the best way for you to go. In particular, many people make the mistake of using their trust to trade and to buy their investments (such as property). This is fraught with danger as it can substantially compromise your asset protection strategies.

Partnerships

Partnerships are not usually a good idea. The reason is you become jointly and severally liable for the debts of your partners.

So if one of the partners runs off with the money, all the other partners are liable. Not only that but they are not very useful for tax planning purposes.

However, a partnership can be an excellent structure if each partner operates through a family trust. This not only enables the partners to tax plan but enables the partners to protect their assets from personal liability if structured properly.

Asset Protection

Finally I will make some comments on asset protection.

As a general rule, as alluded to earlier, it is better to have your different businesses, your options trading business, and investment properties held in separate trusts. You should never buy real estate in the same trust as your business trust or trading trust.

Why? If someone sues you in your business, and you are trading in your business trust, all your trading profits are at risk of being seized. Or if a tenant of an investment property sues you and your trading capital is sitting in your property trust, again, it is totally at risk of being seized.

For example, assume you trade commodities, own two investment properties, and run a chemical manufacturing business. Obviously you have a strong risk of being sued in the manufacturing business, a low to medium risk of being sued by a tenant with respect to your investment properties, and minimal risk with your commodities trading. In this situation, your manufacturing business, investment properties and commodities trading should be held in separate companies/trusts. This ensures any lawsuit against your manufacturing business won't affect your options trading.

Furthermore, as an aside, if you do buy real estate through a trust, be aware that you cannot put the name of the trust on the title. You should therefore lodge a caveat over the property (or lodge a declaration of trust if you are in Western Australia) to mark the interest of the trust in the property on the title. Otherwise the benefit of holding a property in a trust for asset protection may be lost.

There are other techniques to protect your assets, including creating "firewall" structures, and if you are in a relationship with someone, how you can shelter your assets in your partner's name. This is beyond the scope of this book, and you should read my asset protection book. I do have a brochure and a good guide on asset protection if you are interested in further information.

This area is very complicated, however, and you should get professional advice before engaging in any type of asset protection strategy.

9. Ok. Let's assume I am trading through my company or family trust and make trading losses. Can I claim my losses as a tax deduction against my other income (i.e. salary and wages income or other business income)?

Unfortunately the short answer is no. This section provides a brief explanation why.

Companies

1. If you carry on your trading through a company, if you make trading losses, unless your company is generating income from other sources, you cannot claim the losses against your own personal income from other sources. The losses stay in the company. They can only be carried forward to offset against company income in future years. Even then, there are certain strict tests to be satisfied each year to ensure that the company can continue to claim losses.

2. Let's take an example. Your company makes a $50,000 loss from trading. It makes $20,000 of income from other sources. Its net loss will be $30,000. This will stay in the company and be available to offset against trading profits in future years. You cannot claim it in your own name.

Family Trusts

1. Likewise, if you carry on your trading through your family trust, if you make trading losses, unless your family trust is generating income from other sources, the trustee cannot distribute the losses through to the beneficiaries to offset against other income. The loss can only be carried forward to offset against trust income in future years. Even then, there are certain strict tests to be satisfied each year to ensure that the trust can continue to claim losses.

2. However, one difference between a family trust and a company is you may be able to salvage this situation. Say for example that you are trading through a family trust and that you run a business through ANOTHER family trust (or even the same family trust) or have property rent income in a separate property trust (ie. the property is positive cashflow, not negative geared). If you make profits through your other business or property trust, when it comes time to distribute your profits in those trusts, you can distribute this income into the trading trust in a loss year to offset your losses. (This is provided your trust deed allows you to do this, and the vesting date complies with certain rules, so seek professional advice in this regard from your accountant, or contact us on 08 6212 0900 for a consultation.)

3. For example, say you have a $20,000 loss from trading in your trading trust. However, you made a $50,000 profit in your business trust. You simply distribute $20,000 from your business trust to your trading trust to offset the losses. The remaining $30,000 is then distributed as per normal in your business trust.

It is therefore important to be aware of this weakness with family trusts and companies. Although trading through them can bring some great tax savings and asset protection, there is the problem of losses. If you make losses, they may end up being trapped in the trust or company, that is, you cannot offset the losses against income in your own personal name.

But the benefits of a trust, in my view, generally far outweigh this one disadvantage.

Finally, as stated in Question 6 above, if you decide to carry on your trading business in your personal name, the non-commercial loss rules in Division 35 will apply. You need to get separate advice here.

10. What are the practicalities for using a family trust to trade?

Your Trading Trust needs a tax file number and an ABN. And you may want to get registered for PAYG so you can pay wages and get some of the wonderful business benefits for a trust (such as novated leases, double deductions, and other things – we can give you more information on this if you are interested).

To get a tax file number and ABN for your trust, you can apply online at the Business Entry website www.abr.business.gov.au. (More detail is given on this at Question 11.) You can also apply for PAYG registration if you are intending to pay yourself a salary through your options trading business (which you may do if you are the individual trustee of your options trading trust).

Be VERY careful to properly complete the ABN application. Otherwise your trustee company for your trading trust may not properly show up on the ABN listing.

(By the way if you purchase a trading trust through our company, we apply for the ABN automatically for you as part of the cost.)

You should also ensure that your accountant gives you advice on creating and maintaining minutes of all activities relating to the Trust, and ensuring that your administration system is meticulously correct.

11. What about a self managed superannuation fund? Can I trade my superannuation in my fund?

Again this is a difficult question and you do need professional advice before trading your superannuation monies as the superannuation legislation is very strict. This is for a number of reasons:

- Superannuation has very strict rules. If you are under 60, you cannot use the monies for personal use, ie. pay yourself management fees, withdraw funds, etc. The superannuation fund must be for the sole purpose of providing for your retirement and no other purpose.
- Superannuation has a number of other rules which are beyond the scope of this book, ie. you can't lend to yourself from your superannuation fund, you can't borrow in your superannuation fund, etc. So you need to be very careful.
- Because you can't borrow in your superannuation fund, you have to be very careful as to what you trade in your superannuation fund.

- ASIC have very strict rules about when you should be setting up a self managed superannuation fund due to the costs and other responsibilities involved.

So … can you trade in your superannuation fund? The short answer is YES, depending on the certain situation. You can trade anything in your superannuation fund, provided it meets certain rules:

- You do not borrow or put your fund into the position where it may have to borrow, eg. write naked calls or puts which can wipe out the fund balance and more, open margin accounts, etc.
- You can trade options for certain strategies (general trading, buy writes without margin lends, etc.)
- You can trade Forex and CFDs in your superannuation fund subject to certain strict rules (in the past the ATO said you couldn't trade Forex or CFDs but now they say you can)
- You can trade shares in your superannuation fund (provided you don't borrow through margin or otherwise)
- You cannot trade futures in your superannuation fund
- You are careful what expenses you cover from your superannuation fund, ie. the expenses must be for courses or other expenses to do with your trading for the sole purpose of benefiting your superannuation fund, and in most cases, this is unlikely to occur
- Your **trust deed** and **investment strategy** for your fund **must allow you to do it. <u>This is VERY IMPORTANT</u>.** Get your Deed and investment strategy carefully checked by a professional advisor before trading options. Otherwise you could suffer severe penalties.

If you don't have a self managed superannuation fund, and want to trade, you can set one up online, however, make sure that the fund allows you to do your particular trading strategy.

Once you set up your fund, you need to set up a bank account and rollover your superannuation monies.

Alternatively, contact us at 08 9228 2111 and we can set you up with a self managed superannuation fund that is fully compliant to for your trading strategy.

If you do have a self managed superannuation fund, make sure that you seek professional advice before trading through your self managed superannuation fund. The penalties are severe if you get it wrong.

12. What about the cost of borrowing monies for trading?

Again get specific advice from your legal adviser or accountant for your individual circumstances. However, I provide some comments on borrowing monies for your trading as many people draw their trading capital from their line of credit on their home mortgage (or investment properties).

If you draw monies from a line of credit or through a personal loan for the purposes of trading, and you have to pay interest on that loan, you may be able to claim a deduction for the interest costs of the monies.

Whether you can claim a tax deduction for interest depends on the purpose of the funds. That is, whether you draw the funds from your line of credit to buy a new private car (or acquire investment assets for long term growth, such as a buy and hold property), or to fund your trading account to trade Forex, or commodities or options, will determine what portion of your interest costs you can claim.

If part of the line of credit funds is used to fund your trading account, and part is for private purposes, for example, you will need to apportion the interest costs between the respective purposes of the loan monies. This can be fun, especially if you have used the one line credit for personal and business/trading purposes. You will have to go through each withdrawal and work out which is which and calculate the interest that you can claim as a tax deduction.

Example

Assume you draw funds from your home line of credit to trade options (say write covered and naked calls, or buy and sell options). You need to calculate the interest on this portion of the loan and claim that as a tax deduction as your options trading profits are assessable income.

On the other hand, if you also drew funds to buy shares purely for capital growth which have no dividends (and are not used for covered calls), the interest relating to this portion of the loan would not be deductible. Furthermore, you could not claim the interest relating to the mortgage on your family home (which is a private activity).

You would therefore need to calculate each withdrawal separately.

You do need to be careful how you do this though. There was a High Court decision *Hart v FCT* (2004) where the High Court if you set up certain loan arrangements which are mainly to avoid tax, the ATO can strike out the arrangement.

Make sure you get advice before determining which loan product you use.

13. What about practical issues such as an ABN, TFN, GST?

GST

Traders do NOT have to register for GST. That is the good news.

Please note that if you trade through a company or trust that carries on another registered business (which we do NOT recommend but strongly discourage, for reasons above) it does NOT MEAN that you are liable for GST on your trades or you can claim GST tax credits. Each business is treated separately for GST purposes, eg. if you are a GST-registered car mechanic in your company and you also trade in your company, you charge GST on your car repair work but not on your trades.

Buying and selling options or Forex or futures, for example, is treated as a financial supply. This is input taxed.

"Input taxed" means that although you don't charge GST on any trades you do, nor can you claim any input tax credits on GST payable on your expenses. So for example, you cannot claim back the GST you have to pay on your brokerage commissions, or on your computer hardware or software items.

If possible you are best to buy your computer through other means, eg. if you also need your computer for business or work purposes, your employer may be willing to buy your computer on salary sacrifice.

Tax File Number (TFN) and Australian Business Number (ABN)

You will need a TFN and an ABN if you trade as a business.

As stated above, you can apply online for a TFN and ABN for your trading business at the Business Entry website www.abr.business.gov.au.

You can also apply for PAYG registration if you are intending to pay yourself a salary through your trading business. The site is self explanatory and it takes about 30 minutes to answer all the questions. You receive your ABN and your TFN usually within 2 weeks. Sometimes you get it instantly.

PAYG

PAYG is necessary if you pay yourself a salary from your trading trust.

You should see your accountant or lawyer for specific advice; however, when trading, you may decide to pay yourself a salary or at least a percentage of the profits (perhaps 25-50%) and pay the balance to the beneficiaries.

14. I have set up a trust (or company) to trade. How do I open up a Bank Account for my company/trust? What about a Self Managed Superannuation Fund?

Just go into the bank with the Company Trustee documents and the original Trust documents and any Deeds of Variation or trust Minutes. The bank manager will handle it for you from there.

If you have a self managed superannuation fund, take in your trust deed and certificate from the ATO which your accountant should have given you when they set up your self managed superannuation fund.

15. Are there any other things to consider?

Not really. Just make sure you get specific advice before you do anything,

Most people tend to just jump in and start trading. This is not a wise move. While learning to trade properly, make sure you set yourself up properly. If you don't do it there is an ancient proverb in the Bible which compares it to a wise man who built his house upon a rock, and a foolish man who built his house upon the sand. When the storms of economic uncertainty hit, the house of the wise man stood firm. The house of the foolish man collapsed, and great was the fall of his house.

Nobody in their right mind would build a house and cut costs on the foundation. Similarly with respect nobody in their right mind would start trading and cut costs on their structuring. A wise person would always ensure they are properly structured before they proceed to trade on the markets.

16. How can I get further assistance?

If you are still unsure of what to do, or have queries to be answered, we would be very glad to assist you. (Or see your accountant.)

You can contact us on 1300 669 336 or at help@wealthsafe.com.au and arrange a consultation. Ask to speak to one of our representatives who will be glad to help you set yourself up to trade.

The author of this book, Warren Black, is also available for one on one consultations. Please contact the above number to arrange a consultation.

Summary

When becoming a trader, there are a few issues to consider in your trading and in working out your tax.

1. Are you carrying on a business as a trader? Or are you a speculator (ie. dabbling in the market without making it a serious commercial venture)?

2. At what point did you start carrying on a business? This is important for working out which expenses you can claim as tax deductions. Most expenses incurred before you start carrying on a business cannot be claimed as tax deductions. This can pose real problems if you spend a lot of money in learning to become a trader and only decide later on to make it a serious business. However you do have the blackhole rules that may allow you to claim over 5 years.

3. What expenses can you claim as a trader? Although you cannot claim all your trading expenses as a tax deduction, there are many expenses that you can claim (such as computers, trading software, among other things).

4. How do you deal with trading losses? All traders make losses from time to time. This book has looked at whether you can claim your losses, and in particular, whether you can claim your losses against your day job income (as many traders still have a day job!). Be aware of the non-commercial loss rules though when it comes to offsetting your losses against your income.

5. What are the different structures you can trade through and what are the different issues that arise with each structure? Many traders simply start trading in their own name. Yet this is fraught with difficulties. And to start off in your own name with the idea that you can change over later on can prove very costly. Using a trust, company or self managed superannuation when trading can make all the difference to the tax you pay, and the wealth you create.

I trust you found this book useful.

I welcome any feedback for future editions of the book. Any feedback, please email to help@wealthsafe.com.au.

Warren Black
Chief Executive Officer
Wealth Safe, Eternal Lawyers