CHAPTER 4

Retirement Plans

Even traders will retire someday, and it's never too early to consider a retirement plan. Every consistently profitable trader should have a retirement plan. Recent tax law changes increased the deductible contributions dramatically.

Remember, you need to first form an entity to pay yourself an administration fee so that you have earned income, which is the basis for a tax-deductible retirement plan contribution. Part-time traders may have other sources of earned income or be covered in their employers' retirement plans, so they may not need an entity.

The two most basic retirement plans are the traditional individual retirement account (IRA) and the Roth IRA. A traditional IRA is tax-deferred (i.e., you will not be taxed on income in your account until you eventually tap into those funds). Annual contributions are tax-deductible.

Roth IRAs are the opposite: Annual contributions are not tax-deductible, but you also are not taxed when you withdraw funds. This option can result in significant tax savings if the IRA has gained substantially over the years. It's especially attractive to traders.

MINI 401(K) PLANS

For traders, though, a Mini 401(k) plan (also known as solo or individual 401(k) plan) is the plan of choice. You get both an elective deferral from a traditional 401(k) plan plus a maximum defined contribution profit-sharing plan, all in one. Many other advantages include consolidation of all retirement plans into one and plan loans. The main tax benefit for traders is that you can save self-employment taxes by paying yourself a lower fee from your entity in reaching the plan contribution limits versus just having a defined contribution plan like a SEP IRA, or profit sharing plan.

Here is an example of how a Mini 401(k) can save you $4,929, based on a 2003 tax return. Assume the trader has adjusted gross income (AGI) deductions in the amount of $17,499, comprised of the following:

- $14,132 tax-deductible contribution to your Mini 401(k) plan; the maximum 401(k) elective deferral amount of $12,000 for 2003, and $13,000 for 2004. In addition, you are entitled to a profit-sharing contribution of 20 percent of your net fee income (after deducting 50 percent of your self-employment tax).
- $2,130 of deductible health insurance premiums. For 2003, you may deduct 100 percent of your health insurance premiums (up to your earned income).
- $1,237, or one-half your SE taxes of $2,473 due on your $17,500 fee income. Notice the AGI deduction is 100 percent of the fee amount.

You save $7,402 in income tax, assuming a combined federal and state marginal income tax rate of 42.3 percent. You owe SE taxes of $2,473 ($17,500 fee income multiplied by 92.35 percent multiplied by 15.3 percent SE tax rate).

Plus, you replaced bad income taxes with good SE taxes. Paying SE taxes increases your retirement benefits (social security and Medicare insurance); income taxes never benefit you in the future.

Your cost of forming the entity (needed for a trader retirement plan) is around $750 (varies by state). In future years, you don't have this one-time cost.

If you have a successful year and can afford to contribute more to your retirement plan, we recommend you contribute the maximum allowed—$41,000 (2004 maximum) to a Mini 401(k) plan or other type of defined contribution plan.

In that case, you can expect even greater net savings, and you'll be able to grow more money in a tax-deferred account.

The major tax reason why the Mini 401(k) profit-sharing plan is the most attractive retirement plan for traders is that you can contribute the maximum $41,000 on a lower fee income. With other profit-sharing retirement plans, you must use the maximum fee compensation allowed of $205,000 to reach the $41,000 contribution limit. With the Mini 401(k) plan, you save a few thousand dollars of SE taxes—you pay SE taxes on under $150,000 instead of $205,000.

Be Flexible

The cardinal rule for retirement planning tax strategies for small business owners is to figure out:

- How much they can contribute on a before-tax basis to a retirement plan
- How much salary or fees are required to make that contribution
- How much income taxes will be saved with that retirement plan tax-deductible contribution versus the extra cost of paying payroll taxes due on the compensation amount

Not One Size Fits All

Several different types of retirement plans are eligible for the tax advantages of a qualified plan. The owner gets a tax deduction from income for contributions and the plan has a tax-free buildup of plan investments providing deferral of income until periodic distribution of the funds at retirement age.

The type of plan you choose will depend on your individual needs and circumstances, like your age and how much cash you have available to contribute.

Of the two basic types of plans, one family of plans defines the annual contribution to the plan. The second type of plan defines the retirement benefits to be provided.

A *defined benefit plan* provides for a fixed benefit at retirement based generally upon years of service and compensation. Adoption of a defined benefit plan is a nondiscretionary commitment to fund the plan. These plans will often provide the greatest current deduction from income, and the greatest retirement benefit, where the owners of the business are older and nearing retirement.

Defined benefit plans are more complex and costly than *defined contribution plans*, because they require the use of an independent actuary to set your annual contribution and the plan documents must be tailor-made by an experienced retirement attorney. Defined contribution plans are available from many brokerage firms or banks and little customization is required. Profit-sharing plans are defined contribution plans and can provide you with the flexibility of determining the amount of contributions to be made for a particular year.

TRADING YOUR RETIREMENT PLAN

The bear market clawed away at many traders' working capital. Traders seek new sources of capital to ride the bull (markets) again. Some traders are interested in joining proprietary trading firms to gain access to a firm's trading capital, with a subtrading account using greater leverage. Most proprietary trading firms require a brokerage license and minimum capital of $25,000 or more.

Other traders are interested in forming their own hedge fund to raise capital from investors (friends, family, and others) and to make money off other people's money. This plan is a good opportunity for successful traders, but losing traders may have trouble executing this business plan.

A last resort for many traders is closer to home—their own retirement plan assets. But before you start day trading your retirement assets, you should learn about many restrictions that apply. Various government agencies regulate retirement account investments. For the benefit of tax-free deferral or permanent savings, the government insists on investment protection, prudence, diversification, liquidity, and no self-dealing.

Navigating around these rules to actively trade your retirement accounts is limited. In all cases, try to follow the spirit of the law; prudence is a virtue, and you want to retire one day on these assets. Throwing caution to the wind and losing all your retirement assets in risky day trading is not a wise undertaking.

It's Not a Perfect World!

In a perfect world, a business trader has sufficient capital to fund his or her trading business. If a reasonable-to-aggressive return on trading capital is 25 to 50 percent, a trader needs capital of $200,000-plus to generate income of $100,000. This amount is what many traders need to cover their living and business expenses. Certainly, the past few years have not been a perfect world for traders and many have suffered losses to their trading capital. Can you make a good living on trading capital of $25,000 or less?

For many traders their last resort for trading capital is their retirement plan assets. It's not easy finding ways to take money out of your retirement plans to put in your trading accounts. If you take money out of your retirement plan before retirement age, it's an early withdrawal subject to regular income tax (at ordinary tax rates up to 35 percent), plus a nasty excise tax penalty of 10 percent (with few exceptions). Many traders tap into their retirement plans figuring they have no income or losses and can take the distribution into income. They are later surprised and upset about the 10 percent penalty.

Most qualified retirement plans allow for loans, and you can use the loan proceeds to fund your taxable trading accounts. IRAs are not qualified plans, and they do not allow loans.

Leave the Money in Your Plan and Benefit from Tax-Deferred Trading

You don't have to pay taxes and excise tax penalties on early withdrawals to have access to trading your retirement plan assets. Some limited ways allow you to leave the money in your retirement plans and trade it there for continued tax-deferral on the existing money and all the trading gains you generate.

Short-term trading on securities is taxed at ordinary tax rates anyway, so when you retire and take distributions, you will pay those same ordinary tax rates (tax laws can change the rates at retirement).

Find a financial calculator on the Internet and see the power of tax-free compounded returns; you will be impressed. However, many pitfalls, restrictions, and possible violations await, so read on.

Brokers Take a Pound of Flesh

Barron's reviews and rates online and direct-access brokerage firms each year, and they design charts showing off who has the lowest commissions. They are all low these days, which is a huge benefit for traders. The problem is that when it comes to retirement plan accounts, brokerage firms cover the gamut in terms of commissions (most are high), number of allowed trades, and other terms and conditions. Some of their terms are based on ERISA and IRS rules, and others are simply their own policies.

WHAT IS ERISA?

ERISA stands for the Employee Retirement Income Security Act of 1974 and is administered by the U.S. Department of Labor. ERISA was passed in order to better protect employees' retirement plan assets. Far too many companies were abusing their company retirement plans for the benefit of management and shareholders and not employees.

Before ERISA, companies could purchase only their own stock in their retirement plans. Bankrupt companies ended up taking jobs and retirement plan assets. A Department of Labor (DOL) ruling for ERISA on plan diversification prevents a company from investing all retirement plan assets into its own stock, or any one stock.

Under ERISA, company administrators are charged with a fiduciary duty to diversify investments and manage the risk of losses. Traders are familiar with this type of risk management, but this rule presents a problem for many traders. Is active trading in an ERISA-covered retirement plan a violation of the plan diversification rules?

No clear DOL or ERISA guidance or case law indicates how to apply the plan diversification rule to active trading. Each case should be evaluated on individual facts and circumstances in consultation with a CPA or tax attorney specializing in ERISA and tax regulations.

Before you start worrying about ERISA rules, though, find out whether your retirement plans are even subject to ERISA regulations. If you have an IRA or individual-level plan, you are exempt from ERISA rules. SEP IRAs and Mini 401 (k) plans set up on the individual level (with no employees) are not covered by ERISA. SEP IRAs and Mini 401 (k) plans set up on the company level are ERISA-covered plans. This distinction makes sense because retirement plans that include third-party employees are ERISA-covered to protect those employees. On the other hand, plans for individuals without employees have significantly less government oversight and protection.

RESTRICTIONS ON IRA INVESTMENTS

IRA investment guidelines limit what investments can be made and disallow self-dealing or prohibited transactions. Some investments that are allowed generate unrelated business income (UBI), which leads to the payment of taxes (UBIT) on that income, even though the investment is made in a tax-deferred IRA account.

IRAs may not invest in life insurance and collectibles (art works, antiques, and most precious metals). Foreign investments should be limited to ADRs and domestic mutual funds. Real estate investments are allowed, providing your trustee is a qualified provider, and he or she allows it and can navigate around complex rules.

When it comes to brokerage accounts, IRAs are cash accounts and may not use margin to buy stocks (or other forms of debt-leverage for purchasing stocks). An IRA that invests in a hedge fund or other investment company that uses leverage is breaking the rule on the use of leverage. The consequence is the generation of UBI from the income in the hedge fund and taxes on that income.

Taxes on Day Trading of Your IRA

Many traders are interested in actively trading their IRA accounts, even though they can't use margin to buy stocks. Some traders will enter and exit trades on a daily basis, similar to how they operate their day trading business in taxable accounts. This activity raises an important question of great concern to many traders: Will the IRS consider day or swing trading in an IRA account a camouflaged profit-producing activity that is subject to UBIT? Many traders may not mind paying taxes on their day trading gains in their IRA account, because they would have to pay similar taxes anyway in a taxable account. Their goal may be to tap additional sources of trading capital, and they don't mind losing the tax-deferral benefits. If a trader stops trading, then the future profit growth is tax-deferred in the IRA account.

Prohibited Transactions and Self-Dealing

The IRS does not allow self-dealing or prohibited transactions between your retirement plan assets and yourself. For example, if you actively trade your retirement plan assets (ERISA or not), you may not pay yourself a management or administration fee. Such activity is deemed self-dealing and subject to prohibited transaction tax penalties. The initial tax on a prohibited transaction is 15 percent, which is not your only problem. You also have an early withdrawal subject to ordinary taxation plus a 10 percent excise tax penalty (Form 5329).

Other self-dealing and prohibited transactions need to be avoided:

- Your retirement plan may not be a partner in your trading entity.
- You can't sell securities from your taxable accounts to your retirement accounts.
- You and your family members may not invest their retirement plan assets into your own hedge fund.

Based on a more aggressive interpretation of the law, some CPAs and attorneys may not categorize an owner's IRA investment in their own hedge fund as a self-dealing prohibited transaction, providing the following facts and circumstances apply:

- The managing member does not earn any revenue from his or her own IRA (i.e., fees at zero).
- The IRA capital may not be material enough to help the managing member launch the hedge fund (showing others that the fund has other investors of certain magnitude).
- The IRA does not help pay the fund expenses in a material manner.

Taking this more aggressive approach may give you the answer you want to hear, but recognize that you may turn your tax-deferred or tax-exempt IRA into a taxable account. This approach is not suggested.

Solo Traders with ERISA Plans

Traders may raise the following question: I don't have any employees, so why should this ERISA plan diversification rule apply to me? If you have an ERISA plan, the rule applies to you even if you don't have any employees. If you trade an ERISA plan that only includes yourself (no employees) you may think, "What's the risk if no employees can sue me for ERISA violations?" You should also consider that if you get divorced and it's contested, your spouse's attorney can allege ERISA violations. A spouse may be entitled to half or another portion of your ERISA retirement plan assets and deserve the protection of ERISA.

Consider the following example of trading in an ERISA plan: A business trader actively trades 10 stocks on a daily basis and does not keep any positions overnight. This trader hedges positions and monitors risk closely, using stops and other available methods. This trader is diversified and, notwithstanding the perceived risk of day trading, is consistently profitable. The spirit of the plan diversification rule calls for risk management, liquidity, and diversification. It does not specifically state that active trading is prohibited. It can be argued that this trader is not buying and holding one or a few stocks with great market risk. In fact, the trader is diversified and trading with lots of risk management.

What can be argued is that the pursuit of day trading is risky. A profitable trader can argue that consistent profitability proves that day trading is not high risk for that trader.

Of course this trader may not need to tap into retirement plan assets. On the other hand, a consistent losing trader may need to tap these retirement plan assets and, as such, may have a problem with this argument. This more aggressive approach is based on theory and has not been tested under the law; so proceed with caution and at your own risk. Consult with an expert to better assess this risk.

Consider the reverse example: A consistent losing trader actively trades stocks in an ERISA plan in a risky manner without the use of stop losses or hedging. An argument can be made that this trader violated ERISA rules by not diversifying out of risky swing and day trading activities.

Trader Tax Status Benefits and Trading Your Retirement Accounts

Now that you solved how to actively trade your retirement plan accounts without ERISA or tax trouble, keep in mind that you are still lacking trader tax status unless you actively trade a taxable account as well. If you just trade retirement plan accounts and no taxable accounts, all your expenses are matched to your retirement plan income, which is tax-deferred, making your expenses also tax-deferred. It will be difficult (but possible) to keep appropriate records so that when you retire and take taxable distributions, you can reduce that income by the deferred expenses. An administrator will not allow you to record those tax-deferred expenses in the retirement account.

To protect against deferral of your expenses, achieve trader tax status on at least a small taxable trading account. Within reason, you can allocate all your business expenses to the taxable account and not be stuck with any expense deferral. You will then get the best of both worlds.

The Bottom Line: If you want to actively trade your retirement plan accounts, first determine which EIRSA and IRS rules may apply to your trading plan.

It's a mine field with gray areas, and you need to protect yourself against ordinary taxation on unrelated business income or early withdrawals, plus the 10 percent excise tax penalties on early withdrawals, plus the 15 percent tax penalties on prohibited transactions on self-dealing.

Ask yourself whether these extra costs, uncertainties, and headaches are worth putting your retirement accounts at great risk. For some the answer may be Yes, so do your homework and try to stay clear of these extra costs and gray areas.

FRINGE BENEFIT PLANS

As an owner/employee of your trading business, you have limited opportunities for fringe benefit plans. By employing your spouse and classifying yourself as a spouse of a nonowner/employee, you can unlock valuable fringe benefit plan tax savings.

Fringe benefits, commonly known as perks, include retirement plans; health, life, and disability insurance; education, dependent care, and adoption assistance; meals, lodging, and parking; and many other types of plans.

The Details

If you are interested in opportunities to convert more of your nondeductible family expenses into deductible business expenses, you should learn about fringe benefit plans. Most small businesses, including trading businesses, overlook fringe benefit plans; many larger companies rely on fringe benefit plans to attract and retain employees.

These plans are somewhat complex and some require written accountable plans with annual reporting. So, you will need the help of a competent CPA or attorney specializing in employee benefits. It's wise to get a quote on costs and a projection of tax benefits to see whether it's worthwhile for you.

If you can convert $15,000 of family expenses into business expenses and save taxes at 40 percent marginal tax rates, you generate tax savings of $6,000. If your professional fees and other costs are $1,500, your return is 4:1. Plus, your costs are deductible business expenses, and tax credits are also available for forming retirement plans.

Easy Basic Plans

Most business traders want to cover the basic employee benefits, which include compensation, retirement plans, and health insurance coverage. These plans are relatively easy to set up for owner/traders.

Retirement plans are available "off the shelf" from most financial institutions, and require no additional expenses. No additional expenses are part of obtaining a health insurance plan; the only costs are the monthly premiums.

Sole proprietor (unincorporated) business traders may not set up retirement plans or deduct health insurance premiums (both are AGI deductions) because trading gains are not earned income, except for commodities dealers registered on an exchange.

Business traders need to form a separate legal entity to pay themselves a fee or salary on which they can then base tax-deductible retirement and health insurance plans.

Other Fringe Benefit Plans

Fringe benefit plans are designed for larger companies with lots of rank-and-file employees. Discrimination rules are intended to prevent highly compensated employees (owner types) from monopolizing the majority of the plan benefits. If owners and management want these benefits, they must also cover all employees.

The problem for owner/traders is that their entities of choice are pass-through entities and many fringe benefit plans are not allowed for these types of owner/employees. Self-employed individuals (and pass-through entity owner/employees) who want to benefit from fringe benefit plans can do so if their spouses work for the business. By covering employees and spouses, they become entitled to benefits by virtue of being the spouse of an employee.

The Power of Fringe Benefit Plans

An effective way for small businesses to maximize tax savings is to find ways to convert fixed personal expenses into allowable business expenses. For example, many traders convert some of their home expenses into deductible home office expenses. At-home traders also take business depreciation on furniture, fixtures, and equipment.

Fringe benefit plans provide additional opportunities to convert more family expenses into business deductions. The employee (your spouse) is reimbursed by your trading business for his or her nonbusiness-related education, dependent care, at-home meals, and more. These types of expenses would not otherwise qualify for business expense treatment, because they are not "ordinary and necessary" for a business.

Your company deducts the reimbursed amounts as a business expense and your employee excludes the reimbursement from income. In other words, the reimbursement is not included in their gross wages reported on a W-2 or gross compensation on a Form 1099-Misc. In many cases, the fringe benefit is also not included in wages calculating payroll taxes (FICA and Medicare).

For more information on all types of fringe benefits and what is excludable for income versus payroll tax, see IRS Publication 15-B, Employer's Tax Guide to Fringe Benefits, at www.irs.gov.

Don't Feel Bad for the IRS

Fringe benefit plans are win-win for the employer and employee; only the IRS loses. However, don't feel bad for the IRS because most fringe benefits plans are geared for C-corporations, which are subject to double-taxation (paying taxes first on the corporate level up to 35 percent, and then a second time on the shareholder level—qualifying dividends and long-term capital gains are taxed up to 15 percent).

But, you don't need a C-corporation for fringe benefits, so choose a much better type of entity for trading businesses. With a pass-through entity, a business trader avoids double taxation and gets immediate tax refunds on trading losses. All items of income or loss are passing through to the individual tax level, and taxes are not paid on the entity level.

Public companies and other larger companies don't have a choice of entities; they can only be a C-corporation. It is simply not possible (and not allowed) to pass items of income and expense to what could be thousands of individual shareholders. Smaller businesses are allowed to use pass-through entity taxation, and almost all prefer it.

Health insurance deductions were raised to 100 percent in 2003, putting them on par with C-corporations.

No further advantages accrue to a C-corporation. Business traders can use a pass-through entity coupled with the spouse of a nonowner/employee strategy to unlock every conceivable tax benefit.

Choose the Best Pass-Through Entity

A sole proprietorship (unincorporated business) is good for all fringe benefit plans, except a retirement plan for the owner/employee. Because it is the biggest benefit, you should consider a separate entity instead. Limited liability companies (LLC) are good for many traders. An LLC files a partnership tax return, unless you elect to be taxed as a C-corporation (not recommended per the previous discussion).

If you are the single member, then it's a disregarded entity (no partner, so no partnership return) and you file a Schedule C, similar to a sole proprietorship (except you can have a retirement plan).

Most LLCs don't pay franchise taxes in their home state and have nominal annual report costs (less than a few hundred dollars). You can have special allocations with LLCs.

Single traders who have other jobs and are a close call for trader tax status may prefer an S-corporation over a single-member LLC; filing a separate tax return can deflect IRS questions. S-corporations may not use special allocations like LLCs and partnerships. Instead, S-corporations must allocate income and loss based on pro rata ownership of capital. This is not attractive to many traders.

Note: The IRS can argue that a sole proprietor who hires a spouse is really a husband-wife general partnership. This would make the spouse an owner and not entitled to many fringe benefits.

Statutory or Nonstatutory

Fringe benefit plans include statutory and nonstatutory plans. Statutory employee benefits (those benefits that are carved out by separate sections of the Internal Revenue Code).

Included are qualified retirement plans, group term life insurance, medical coverage, educational assistance, certain meals and lodging, dependent care assistance, and adoption assistance.

Nonstatutory fringe benefits (IRC § 132) include no-additional-cost services; qualified employee discounts; working condition fringes; de minimis fringes; certain transportation benefits; reimbursement of moving expenses; retirement, financial, and tax planning services; club dues; Christmas gifts; and interest-free loans.

Health Insurance Premiums

Health insurance premiums are rising dramatically and represent a significant cost for families. The new trend is for employers to cut back on these fringe benefits by passing on more of the premium to the employee, often times with a flexible spending account or wage withholding.

Business traders with entities can deduct health insurance premiums. These rules only apply for any calendar month in which a trader isn't eligible to participate in any subsidized health plan maintained by any employer of his or her spouse. No AGI deduction is allowed to the extent that the deduction exceeds the trader's fee earned from their trading business, with respect to which the plan providing the medical care coverage was established.

These rules also apply to partners in partnerships and more-than-2-percent shareholders of S-corporations where the partnership or corporation pays for health insurance coverage for its partners or shareholders.

If any of your health insurance premiums are not deductible from AGI, you can add those amounts to your itemized deductions for medical expenses, which are deductible if they are in excess of 7.5 percent of AGI.

Medical Reimbursement Plans

Families have lots of medical expenses not covered by insurance: co-pays, dental, vision, and noncovered procedures. Consider setting up an uninsured medical plan to pay noncovered medical costs (IRC § 105(b)).

Owner/employees are not covered, so set up the plan to cover nonowner/employees and their spouses (you the owner/trader). All medical benefits are excludable from income and payroll taxes.

Health Savings Accounts and Health Reimbursement Arrangements

Recent tax law changes have created attractive new options for dealing with health insurance and medical expense reimbursement. Before these changes, one had fewer options: to buy health insurance or not (self-insurance), and how big a deductible to take, which affected the amount of your annual health insurance premiums.

With the creation of health savings accounts (HSAs), taxpayers received many new advantages: tax-deductible contributions to HSAs similar to deducting health insurance premiums from AGI (adjusted gross income); more control and flexibility over paying medical expenses; and most important, a better chance to save money and not overpay your insurance company for benefits you never get. With HSAs, you, not the insurance companies, own the unused premiums.

Here is how HSAs work. First you need to have a high-deductible health insurance plan as your base plan, so you are not fully self-insuring, rather it's a combination.

This high-deductible plan allows you to obtain much lower insurance premium rates (whether you are in a group plan or not). In lieu of higher premiums, you pay the difference (give or take) to your own HSA account.

It's sort of like a hybrid health insurance and self-insurance plan, sanctioned by the IRS with tax-deferral benefits. The IRS patterns this concept off the IRA, where you provide for your own retirement funds with tax advantages.

After paying your high-deductible premiums (which are much lower than before), you next fund your own HSA account. Like an IRA, an HSA account is in your own name and the money in the account belongs to you, not an insurance company. So any money left over after paying eligible medical expenses belongs to you—and that's how you better your chances at winning the insurance game! Instead of giving all your money to the insurance company in premiums, you divide up the money and pay some to the insurance company and the rest to yourself in the HSA account.

If you have a serious medical problem and the bills are outrageously large, no problem; the insurance company pays those bills—over the $1,000 (single) or $2,000 (family) deductible amounts—which are the minimum deductibles. You can have higher deductibles as you see fit. Some insurance plans pay medical expenses without application of your deductible, saving you more of your HSA funds.

Like an IRA, you get a tax deduction for your contributions to your HSA, but this is not really an advantage over AGI deductions for health insurance premiums. Traders have the same problem of needing earned income for either deduction. Also like an IRA, an HSA has the tax advantage of tax-free buildup of assets.

The worst tax scenario for taxpayers is going out of pocket on medical expenses without any insurance or HSA plan and then not being able to get any tax deduction for those expenses due to itemized deduction limitations.

Medical expenses are only deductible if they are in excess of 7.5 percent of AGI, and they are not deductible at all for alternative minimum taxes (AMT).

Like any retirement funds, HSAs are especially attractive for traders because traders more than other types of taxpayers can really take advantage of the tax-free buildup from trading their HSA assets.

Note: Many HSAs only pay interest income and don't allow trading. This should change over time.

You also can use the HSA assets to pay your eligible medical expenses that are not paid by the insurance company—those expenses you do not submit above your deductible amount and/or copays.

The GTT Alliance for Traders, an advocacy alliance of traders seeking tax reform and help for traders on health and other types of insurance, mortgages, and much more, provides the following information on their insurance Website:

> Congress has passed a new tax favored insurance plan that replaces Medical Savings Accounts. The new plan is now referred to as a Health Savings Accounts (HSAs). All Americans under the age of 65, regardless of their employment status, now qualify for an HSA.
>
> An HSA is a medical savings account without the restrictions or limitations the old legislation created. The new legislation allows people who buy medical policies with deductibles of at least $1,000 for a single person or $2,000 for a family to establish a tax-free "health savings

account" and potentially reduce their health insurance premiums by as much as 50 percent.

They, or their employers, can fund these accounts with an amount equal to the deductible and the money can be used to pay health care expenses. If the money is not needed, the money can be invested. All money going in the HSA are pretax dollars and withdrawals for health care, including dental services, are tax-free. All existing MSAs will be converted to HSAs during the 2004 year.

Another new option created from recent legislation is a health reimbursement arrangement (HRA). The GTT Alliance for Traders health site lists the following benefits for employees and employers:

- HRAs are the newest way for employers to give their employees freedom of choice in health care planning while controlling their own costs.
- HRAs are similar to Flexible Spending Accounts (FSAs) except that employees do not lose money at the end of the year. Unused dollars may be rolled over into the next year!
- HRAs are similar to Medical Savings Accounts (MSAs) except that HRAs are funded by employers, HRAs are available to employers of all sizes, and HRAs are flexible in design.
- HRAs permit the employee to accumulate money for future health care needs such as retirement health care expenses
- HRAs allow employers to redefine employer-employee health care financing and responsibility.
- HRAs allow employers to offer a high deductible plan and allocate the savings to the HRA for future employee-directed health care.

For more details on HSAs and HRAs, visit the GTT Alliance for Traders Website at GTT (GreenTraderTax) at http://www.greencompany .com/ Traders/ Advocacy.shtml.

Life Insurance Plans

Nonowner/employees can exclude the first $50,000 of group term life insurance coverage (IRC § 79). Excess coverage is taxable to the employee. Your trading business can deduct the life insurance premiums, and your spouse (the nonowner/employee) only reports taxable income on the excess coverage. Compare the actual premium cost to the IRS table rates (the phantom income) to see whether it's beneficial for excess coverage in this plan.

You can also have a "carve-out" plan—a replacement individual plan or cash in lieu of the policy.

Dependent Care Assistance Plans

Many traders with families spend money on dependent care assistance and can benefit from this type of fringe benefit plan. Employees can exclude up to $5,000 of employer-paid dependent care costs (not to exceed earned income, as covered in IRC § 129). The plan must be written. These excluded amounts cannot be part of a child care tax credit. You should consult with your accountant to see which is preferable for your situation. If you opt for a child care credit instead, note both spouses need earned income. Using a pass-through entity, a trader can pay a fee (earned income) to both spouses.

Benefits of Flexible Spending Accounts for Traders

Big companies use flexible spending accounts (FSAs) with salary reduction to shift the cost of fringe benefit plans onto employees. It's good for employees because it lowers their taxable salary amount; the excluded amounts are pretax. With some FSA plans, the excluded benefits are also exempt from payroll taxes (such as is the case with dependent care assistance FSA plans).

Be careful of the "use it or lose it" features in FSAs. If you don't use the FSA amount deposited or withheld, you may lose it for good.

Business traders don't need FSAs because they are not concerned with shifting the burden to other family members.

Educational Assistance Plans and Education Deductions

Employees can exclude up to $5,250 of employer-paid educational assistance (IRC § 127). It applies to just about any kind of course or program including graduate-level courses, even if it isn't job or business related.

Excess amounts can still qualify for the exclusion under the working condition fringe benefit rules. For example, if you take computer training for $10,000 it can all be excluded (because it's job-related). Excludable amounts are not subject to payroll taxes.

Traders face challenges in deducting education expenses as normal business expenses. Business-related educational expenses paid after a trading business is commenced are deductible. However, education expenses paid before business commencement may be nondeductible, or start-up expenses IRC § 195 (amortized over sixty months on a straight-line basis.)

For a tax deduction, your education expenses must help you maintain or improve your employment or business skills, or be required for you to keep your job (or your business), your salary level, or your current status. The education cannot, however, enable you to meet the minimum qualifications for your job, or qualify you for a new trade or business.

A stock broker is already in the trading field, so pretrading business education can be deductible. An attorney studying the trading business before starting to trade may be denied the deduction. Protect your deduction by paying education bills after you commence actual trading. Many types of educational credits are also available for all family members.

Adoption Assistance

Employees can exclude adoption assistance up to $10,000 if their AGI is below set limits (IRC § 137). The exclusion applies to income and payroll taxes.

Meals and Lodging Plans

These expenses can be fully excluded providing you meet the following conditions:

- The meals must be provided on the employer's premises. Many traders don't go out to lunch; they are glued to their screens throughout the day, just like other traders working for large firms.
- Lodging must be furnished on the employer's premises and the employee must accept it as a condition of employment. This lodging exclusion is too aggressive to consider for at-home traders. The home office rules are intended to cover these expenses.

Shift of Income to Children

If your children are of working age and truly capable of helping you in your trading business, consider paying them wages or fees and including them in your employee and fringe benefit plans. This approach also shifts some of your income from higher marginal tax rates to a child's lower marginal tax rates. Consider Roth IRAs for your working children. You can trade their Roth IRA, and all the income builds tax-free on a permanent basis.

The Bottom Line: Fringe benefit plans are somewhat complex and cost some money to implement, but they can be well worth the effort and cost. Consult with a trader tax expert who also is experienced in benefits law. They can determine whether any or all of these plans are right for you and your family.

SELF-EMPLOYMENT TAXES

Unlike all other types of sole proprietorship or unincorporated businesses, securities and commodities traders, with trader tax status, are exempt from self-employment taxation (SE taxes). The exception is that options, commodities, and futures dealers or traders who are registered on commodities exchanges owe SE taxes. Saving SE taxes are great, but you may want to create earned income with an entity to have tax-deductible retirement and fringe benefit plans, in which case you will owe SE tax on that earned income (but you can limit the amount).

Here are the details: Per IRS Publication 550, "Gains and losses from selling securities as part of a trading business are not subject to self-employment tax." This is true whether the MTM election is made or not.

Internal Revenue Code Section 1402, the code section on self-employment taxes, has "special rules for options and commodities dealers."

- The general rule of Section 1402 states that gains and losses from trading in securities and commodities are not subject to self-employment taxation.
- This special rule, 1402(i), states, "in determining the net earnings from self-employment of any options dealer or commodities dealer, there shall not be excluded any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading section 1256 contracts) from section 1256 contracts or property related to such contracts. The term 'commodities dealer' means a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission."

Proprietary traders who receive a Form 1099-Misc for nonemployee compensation are also subject to SE tax.

CHAPTER SUMMARY

Retirement plans are a great idea for traders, but they cannot be formed without earned income. Forming an entity provides earned income and can help traders enjoy fringe benefit plans, most notably a retirement fund. One of the best retirement plans around is the Mini 401(k). It offers tax savings not available in plans such as the IRA. You can also trade your retirement plan, although you must observe certain restrictions.