GreenTraderTax.com retirement-plan strategies

Whether you want to trade securities, futures or currencies in your retirement plan, build up your retirement plan with annual tax-deductible contributions, borrow money from it to start a trading business, convert it to a Roth IRA for permanent tax-free build-up or take early withdrawals with fewer tax pitfalls, we can help you accomplish your goals.

By Robert A. Green, CPA on July 15, 2009.

GreenTraderTax offers educational resources and consulting services on setting up and using existing retirement plans.

<u>We can help you accomplish these retirement-plan objectives</u>:

- **All investors may actively trade securities, futures or forex and/or make third-party alternative investments directly within their IRA, Roth IRA and qualified retirement plans.**
    - Many online brokers now offer IRA accounts for trading futures and forex. Very few brokers offer Mini 401k plans (otherwise known as solo or individual 401(k) plans) for securities, futures and forex. We can show you how to use an intermediary firm to facilitate opening trust trading accounts with almost all the leading brokers, who otherwise do not offer the type of trading account you want for your retirement funds. The trust account often has lower commissions and more features than a typical retirement account.
    - For traders falling short of trader tax status, trading within your retirement plan account is a wise way to grow your assets. Fiduciary duty rules require that you trade in a safe-manner.
    - We can show you how to pay for your trading expenses with your retirement funds, because you won't receive a tax deduction for these expenses since they are not investment expenses for taxable investments. Again, you may need to set up a trust account with an intermediary firm to gain this benefit.
- **Business traders can further build up their retirement funds with higher annual tax-deductible and more tax-efficient contributions.**
    - We recommend a defined-contribution Mini 401(k). It contains both a 401(k) elective deferral ($16,500 in 2009, plus a $5,000 "catch-up" provision for ages 50 or older), plus a 20-percent profit sharing plan.
    - Maximum compensation needed for the highest Mini 401k contribution ($46,500 in 2009, plus $5,000 catch-up provision) is $160,000 versus

$245,000 needed for a SEP IRA, which only contains a 20-percent profit-sharing plan.

A Mini 401(k) doesn't incur the 2.9-percent Medicare tax on the difference in compensation, whereas a SEP IRA is subject to that tax. For the Mini 401(k), this means up to $2,465 (2.9-percent times $85,000 of difference in compensation) in SE tax savings. Learn more about the retirement-plan compensation limits at http://www.irs.gov/retirement/article/0,,id=96461,00.html.

- However, not many brokers offer Mini 401(k) trading accounts for securities and even less offer them for futures and forex. You can easily get over this hurdle with a trust account using an intermediary firm's Mini 401(k) plan product.

- Mini 401(k) plans offer traditional and Roth choices. Money deposited into a Roth IRA is not tax deductible upon contribution into the account; however the funds can be withdrawn 100-percent tax-free when you reach retirement age (or even sooner under special Roth IRA rules). With a Roth IRA, all income growth in the account is permanently tax-free.

  Conversely, traditional IRAs offer tax deductions up front, but when you begin to withdraw funds, you will owe (or withhold) income taxes on the entire distribution at the higher ordinary-income tax rates. Both the original contributions and net income or loss (from trading gains and losses, portfolio income and valid expenses) are subject to these income taxes. "Early withdrawals" (before age 59 ½) are subject to an additional 10-percent excise tax penalty, with only a few narrow exceptions. With a traditional IRA, all income growth in the account is eventually taxed, so it's only a deferred tax benefit, unlike the permanent tax benefit of the Roth IRA.

- Traders with smaller retirement-fund balances can catch up (based on actuarial tables) with very high annual contribution retirement plans (defined-benefit plans).

- In order to make retirement-plan contributions each tax year, you need earned income, but trading gains are generally not earned income (unless you are a full member of a futures exchange). You need to qualify for trader tax status and form a business entity to create earned income. Pay yourself a fee or salary for the exact amount you need for your retirement-plan contribution and no more, as the overage will be subject to SE tax. This strategy unlocks a retirement-plan contribution deduction, as well as health-insurance premium deductions (i.e., the AGI deductions for business traders). Do it in the right manner to save more in income taxes (bad taxes), than you pay in SE taxes (good taxes which benefit you in retirement).

- **Business traders can borrow up to $50,000 from a qualified retirement plan (note: IRAs do not qualify)** to help fund their trading business entity (with trader tax status), or for any other personal reason. This is referred to as a "qualified plan loan."
    - TD Ameritrade is the only broker we currently know about offering a Mini 401(k) with a plan-loan feature within their free cookie-cutter product. Our Mini 401(k) trust product through an intermediary firm offers the plan-loan feature; you can then open this trust trading account at most of the leading online brokers.
    - Plan loans must be paid back with market interest within five years on a quarterly basis. Further details are below.
    - Traders can use plan-loan strategies to form a new trading business or to keep their existing trading business afloat. Examples of this strategy are included below.
- **Everyone can convert a traditional IRA or qualified retirement plans (which are temporarily tax-free until retirement) into a Roth IRA for subsequent permanent tax-free growth.**
    - There is a special one-time opportunity in 2010 that temporarily suspends the income threshold of $100,000 of modified adjusted gross income (MAGI) per year. Plus, the income taxes from the conversion can be deferred over two tax years.
    - Normally, only taxpayers with under $100,000 of MAGI can make this Roth IRA conversion. After a down year, the Roth conversion can be used to soak up ordinary losses (with Section 475 MTM) and business expenses, instead of using a net operating loss (NOL) carryback, which is a wise move if the IRS can challenge you on trader tax status.
    - Roth conversions need to occur before year-end and there are ways to unwind them if you made a mistake. Last year, some investors converted, paid the taxes, and then lost the converted amounts in the market. Better to have those losses in the retirement account before conversion and reduce conversion tax payments.
- **Everyone can take early withdrawals (before age 59 ½) from their retirement plans with a few exceptions to the onerous 10-percent excise tax penalty.**
    - One such method is "substantially equal periodic payments." Rollover a targeted amount of retirement funds into a Rollover IRA and set up a

stream of annual distributions over your lifespan using actuarial tables. You must adhere to the fixed schedule.

- There are other exceptions to the penalty involving medical expenses, education, disability and otherwise. See IRS Form 5329 for the exceptions at http://www.irs.gov/pub/irs-pdf/i5329.pdf.

We can also help you avoid early income taxes, excise taxes and penalties, and drastic consequences in connection with inappropriate use of your retirement funds:

- **Early withdrawals (before age 59 ½) lead to full payment of federal and state income taxes, at the higher ordinary income tax rates. Plus, there is an extra 10-percent excise tax penalty on the early withdrawal amount (see Form 5329).** There are only a handful of exceptions to each of these taxes (and they are hard to qualify for).

- **Investing your IRA and/or qualified retirement plans (and your family members' IRAs and/or their qualified retirement plans) into your own trading account or company is a big problem.**

    - There's a lot of misinformation published on the Internet promoting these inappropriate schemes for traders.

    - The fiduciary prohibition transaction rules state that a fiduciary cannot use IRA funds or qualified plan assets to directly *or indirectly* benefit themselves or their, spouse, parents, children or businesses controlled by those individuals (referred to as "disqualified persons") outside of the IRA or plan. Accordingly, the prohibition transaction rules do not permit a fiduciary, such as an IRA owner, to direct the IRA trustee to enter into any transaction with the owner or a disqualified person. Therefore, an IRA investment in an enterprise in which the IRA owner and family members already own 50-percent or more is on its face likely a prohibited transaction.

    - This type of equity scheme can work under strict conditions for outside managers, but not if you're the trader and the plan asset owner. Plus, if you receive a fee for the AGI deductions from your trading LLC, it's further evidence of "self-dealing."

    - The IRS considers this scheme a "prohibited transaction" which calls for a non-deductible 15-percent tax penalty and up to 100-percent in uncured cases.

    - The entire assets of the IRA are subject to early withdrawal tax treatment (which triggers full ordinary income taxes and the 10-percent excise tax penalty as well).

- Rather than considering a problematic-investment scheme, consider a plan loan from your qualified retirement plan.

- If you need more than the $50,000 plan-loan maximum from your retirement funds, it may be more prudent to take an early withdrawal and pay the ordinary income taxes and 10-percent excise tax penalty. The penalty is for that one year, which can compare favorably to interest expenses over many years. Plus, it's always wise to avoid prohibited transaction treatment.

As a leading CPA firm for traders, we conceived many different strategies for traders to use retirement-plan assets in the most tax-efficient manner. We apply these concepts to your specific situation. It often comes down to a combination of strategies to balance temporarily tax-free money with permanently tax-free money (Roth IRAs), with taxable business and investor activities. You can have it all!

Some of our good ideas, strategies and recommendations are mentioned below. We gained this experience in working with hundreds of traders over the years on their retirement-plan strategies and listening carefully to their objectives and goals for retirement.

Our entity formation services are more valuable than services from vendors who only offer online filing — they lack the integration to our important trader tax strategies.

Many brokerage firms offer free cookie-cutter self-directed IRA accounts to trade securities with direct access, futures and forex. That's an excellent solution for many traders wishing to actively trade their retirement assets and it may be all they need, especially if they don't qualify for trader tax status and they can't make higher tax-deductible contributions.

Many of these active investor (and non-business) traders should be interested in a Roth IRA conversion in 2010 (or 2009 if they qualify), when the income threshold test is suspended for that year only. A Roth IRA conversion requires paying ordinary income taxes on the converted income — deemed an early withdrawal, but not subject to the 10-percent excise tax penalty — over two years. Traders benefit from permanent tax-free growth (trading gains) over the rest of their lifetime and with generous tax-free distributions.

Income tax rates are headed higher under the Obama administration and a Democratic-controlled Congress in an effort to reduce the budget deficit and "pay go" for universal health care, stimulus packages and social spending. Why not cash out earlier than planned and be set for life tax-wise? Most tax increases being discussed now are targeted on upper-income individuals, for application in 2011; converting a Roth IRA in 2010 may be a wise move. Senator Roth of Delaware created the Roth IRA idea; at that time, his junior senator was Joe Biden. I highly doubt Vice President Biden would ever be part of a (back-stabbing) move to tax a Roth IRA account. Trust a Roth IRA.

One problem for business traders is that only a few direct-access brokerage firms offer a Mini 401(k) qualified retirement plan. Fidelity has a solo 401(k) plan that offers direct-access trading in securities, but its plan doesn't have a plan-loan feature (unless you add the services of a third-party plan provider). TD Ameritrade offers a solo 401(k) plan with direct-access trading in securities and it recently added a plan-loan option (within its free cookie-cutter product). TD Ameritrade may also make this product available in its recently acquired Think or Swim (TOS) platform. Interactive Brokers (IB), TradeStation and many other popular direct-access brokers do not currently offer Mini 401(k) plans. This is where a self-directed Mini-401(k) trust with our intermediary firm can come in handy! For a reasonable annual fee, you can set up a Mini 401(k) trust with this firm and then open a trust trading account with TradeStation and many other leading online brokers. Our trust firm is working to establish this arrangement with IB too.

Other benefits of an intermediary Mini 401(k) trust account include:

- **Consolidation of retirement-plan assets** into one trust retirement plan product, which eases tax reporting and related paper work. You can aggregate IRAs and other retirement-plan assets into a Mini 401(k) plan, something that is hard to do with other retirement-plan products at brokerage firms. You can have one trust account with the intermediary firm and then open a trust trading account at different brokerage firms, plus make alternative investments with outside managers (not with yourself).

- **Your "money is safe" based on the funds you have within each brokerage firm**; arrange to keep those balances at SIPC and FDIC coverage levels.

- **Plan loans up to $50,000** (details above). TD Ameritrade is currently the only brokerage offering free plan loans within its standard solo 401(k) plan product. With a trust account, you can have a plan loan and the brokerage firm of your choice too.

- **Reimbursement for trading expenses related to your retirement-plan trading and investments.** Most brokerage firms will only allow payment of their own fees from their retirement-plan product directly (such as IRA fees or that firm's own advisory fees).

    - In some cases, a taxpayer may prefer paying for advisory fees directly, thinking it may be better to unlock an additional income tax deduction. Unfortunately, that doesn't work in most instances. The advisory fees and other expenses related to retirement-plan investments can't be deducted as trading business expenses or as investment expenses (miscellaneous itemized deductions). These expenses must be matched with the non-taxable retirement plan income.

    - Most brokerage firm retirement plans don't allow traders to seek reimbursement of their retirement-plan trading expenses from the retirement account. These expenses must be funded with after-tax personal cash funds, which is tax-inefficient. It's far better to get reimbursement from the retirement-plan account for these expenses.

    - Reimbursement of these trading expenses can all be accomplished with an intermediary firm IRA trust or qualified plan account.

- **Outside-manager alternative investments**. You can invest in other peoples' hedge funds, but watch out for UBIT (Unrelated Business Income Tax) related to the use of leverage and otherwise. You can't invest in your own self-managed LLC.

    - It may be possible to invest in your own hedge fund, provided it's mostly populated with outside investors from the start (not including your own family members). Consult a tax and legal advisor on this matter. See our hedge-fund section for our recommended law firm for investment management businesses. We often discuss this topic on our weekly conference calls.

- **Real estate investments**. Under strict conditions and restrictions, you can invest in real estate, including your own properties. It's beyond the scope of this article, but we will showcase these options on a Webinar and/or conference call soon (stay tuned).

Prohibited transaction rules provide an exception for allowing limited qualified plan loans.

A narrow exception to the very strict "prohibited transaction rules" for qualified plans allow a plan loan to participants.

- **IRAs don't qualify for plan loans**.

- **The qualified plan-loan amount is limited; it may not exceed $50,000 or 50 percent of plan assets, whichever is lower.** There are complex worksheets for adjustments and more during the tax year.

- **The plan-loan repayment terms are also very strict**. Loan principal must be paid back to the retirement plan with a competitive market rate of interest expense over a term not to exceed five tax years. You need a fixed-payment amortization schedule containing loan principal and interest expense; those payments must be made on a quarterly basis (or more frequently). Prepayment of principal is allowed, but you can't reduce the initial fixed amortization schedule. Prepayment will lead to a faster pay off, but not to a reduction of quarterly payments.

  - If the qualified plan loan is for paying off the plan owner's mortgage on his current principal residence (or acquiring a new principal residence), the repayment term can be extended to a longer reasonable period not to exceed 10 years.

- **The interest expense is not deductible** by the plan owner (borrower) on his individual or business tax return.

- **The key point** is that although the plan-loan terms may be strict **the $50,000 plan-loan maximum amount is sufficient to entirely fund a new trading business or to keep one afloat after it experiences losses.**

Consider this example of using a plan loan for a trading business.
If you want to start, or keep afloat, a trading business, but lack the necessary trading capital to maintain a "pattern day trader" (4/1 margin rules) securities brokerage account (which requires $25,000 or $30,000 at most direct-access brokerage firms), consider these tactics:

- Rollover your existing retirement plans – including traditional IRAs, qualified retirement plans or employee 401(k) plans (upon separation from the company) — into a new Mini 401(k) plan at an intermediary trust firm.

- You can only establish a Mini 401(k) plan if you are simultaneously also setting up or maintaining an existing business activity (trading or otherwise).

- Through the intermediary trust firm's Mini 401k plan, you can take a plan loan of up to $50,000, provided you have $100,000 in the plan account (it's allowed up to 50 percent of plan assets). Use the $50,000 to fund your business trading account.

- You can simultaneously form a trading business LLC, general partnership or S-Corp. You need the entity to facilitate earned income for the Mini 401(k) plan. You can take advantage of the annual tax-deductible retirement-plan contributions too.

  - Husbands and wives can form a general partnership or multi-member LLC filing a partnership tax return. If an LLC costs very little in your home state to form and maintain, the married couple may prefer an LLC over a general partnership; which generally has zero state filing fees and annual report costs. Both the general partnership and multi-member LLC file the same annual Form 1065 partnership tax return.

  - Non-married taxpayers can form a single-member LLC and elect S-Corp tax status, so they can file a separate tax return. Or, they can form a C-

Corp to be a 1-percent partner in a general partnership (or LLC) with themselves.

  - You can use the loan to personally fund the trading entity as capital or the loan can fund the entity itself.

- Note that a tax-advantaged trading business first requires qualification for trader tax status, which generally means trading all day, every day (see our golden rules at http://www.greencompany.com/EducationCenter/GreenTraderTaxWebinarNYCExpoFeb232009.pdf (page 13).

- Trader tax status unlocks full and unrestricted ordinary business deduction treatment — home office expenses and other start up costs are deductible with trader tax status. Conversely, the default investor expense treatment only allows restricted and limited miscellaneous itemized deductions in excess of 2 percent of AGI; plus any amount allowed is subject to the AMT tax, meaning there is little likelihood of a meaningful tax deduction. Investment expenses may not include home office, start-up or ongoing training and seminar expenses.

- Trader tax status is also a requirement for the timely election of the preferred Section 475f mark-to-market (MTM) accounting, recommended on securities only for full "tax-loss insurance" rather than capital loss limitations. Futures and (electing) forex traders often skip Section 475 to retain the lower Section 1256 60/40 tax rates.

Investing your own retirement funds into your own trading LLC is trouble.
Plan loans are allowed with qualified plans, but equity investments are still considered prohibited transactions.

- Using plan loans to invest in your own trading businesses is very dangerous. Traders should understand the onerous rules recapped below and related tax penalties and drastic consequences before embarking on these equity (versus plan loan) schemes.

- Remember the strict rules for plan loans stated above. The IRS simply doesn't allow plan loans for IRAs. If you don't pay back a plan loan on time, it's treated as an early withdrawal and subject to taxation and excise tax penalties. Why would the IRS then allow you to treat it as equity? They don't.

- **Equity rules:** Using an intermediary trust firm, your IRA or qualified plan may invest in outside-manager alternative investments, which generally mean hedge funds. Many hedge funds are structured to accept "plan asset" (retirement and other non-taxable investment) funds.

- There have been opinions over the years from the IRS and Department of Labor (who enforces ERISA rules) allowing investors in one family to gather their retirement assets into one LLC, in order to then have access to a hedge-fund investment.
    - In fact, one leading opinion was issued in connection with the infamous Madoff (now declared a Ponzi scheme) fund. That opinion focused on the fact that Madoff was an outside manager and the investor's retirement plans (in question) were not large enough on their own to meet the minimum-investment requirements for Madoff at that time; hence they needed to aggregate their funds into a family LLC.
    - We believe if that investment partnership LLC engaged one of the plan asset owners as the manager (rather than an outside manager Madoff), the ruling would have been different: The LLC would have been considered a prohibited transaction.
- **Prohibited transaction rules are very strict and quite specific**. See a recap above. Remember that if a trader's or his family's IRA or company's qualified plan invests in that trader's own trading business LLC, it's a prohibited transaction subject to stiff tax penalties.
- **There is one very restricted equity scheme that can work and it involves ESOP (Employee Stock Ownership Plans) along with C-Corps**.
  These schemes can be expensive to structure and maintain and in general are unsuitable to the needs of a solo business trader. ESOPs are more appropriate for use with significant outside employees, and provide a method for them to take over your business over time.

Bottom Line.
Dreamy retirement service commercials on TV are not always realistic. Most taxpayers, especially traders, face financial challenges before and during retirement, and it's not easy to save for retirement during these recessionary times. It's very important to understand how to use your retirement assets for not only retirement, but for use in your business and to cover immediate personal living needs. There are several opportunities and pitfalls to be aware of and it's important to pick the right path for your retirement success. Can a trader or anyone afford to retire these days? The "retirement" word has become a teasing misnomer. Make retirement work for you and trade/work in retirement!

