The NEW Tax Act of 2001

by Ted Tesser, CPA

The tax circus is in town again, bringing with it the latest version of current changes, future promises, and of course, the proverbial smoke and mirrors. The fact that Congress thinks that any tax bill will withstand ten years and two and a half presidencies, without change, is somewhat ludicrous. The life of an average tax bill in this country is about 3 - 4 years. The 2001 Tax Act is actually is not a bad piece of legislation. The only problem with this tax bill is that the biggest tax reductions come in year ten. The question of whether you and I, or, in fact, whether the tax bill itself will be around in ten years, has to be just that - a question!

The **2001 Tax Act** significantly affects the following areas of the tax code:

- Current tax rates
- Estate Tax Provisions
- Retirement Planning

It isn't purely coincidental that these three areas are the exact same areas I use in the **Triple Crown Strategy**, which will be explained in full detail in the accompanying video. These areas of the tax law are, in fact, the three major sources of taxation from both traders and non-traders alike.

This Tax Act makes over 400 changes to the law, but it is the timetable for full enactment, the many phase-outs, and multiple effective dates, which makes this bill so much fun. The true test for any tax law is ultimately how it is interpreted, and we always must await further refinement of the grey areas, by the IRS (through future IRS rev. procs. or Revenue Procedures) to clarify and interpret the law. This law will be no exception to how that process unfolds.

I. Tax Rate Cuts:

A) 10% Tax Bracket: A section of this tax bill reinstates a 10% tax bracket, which replaces the 15% minimum tax rate of the previous law.

B) Upper Brackets Reduced: More significant in dollar value, there is a general reduction of tax rates which is granted in installments, with the first reduction effective as of July 1, 2001. Eventually the top rate will effectively drop from 39.6% to 35%. The rates will decrease in **percentage** points with the schedule looking something like this:

Year:	28% Rate To:	31% Rate To:	36% Rate To:	39.6% Rate To:
2001:	27.5%	30.5%	35.5%	39.1%
2002 - 3:	27%	30%	35%	38.5%
2004 - 5:	26%	29%	34%	37.6%
2006 on:	25%	28%	33%	35%

C) Capital Gain Rates: With a few exceptions, the capital gain rates stay the same, for now, at a 20% maximum rate for any capital asset held for a year or more. The two most common exceptions to this are for collectibles (28% maximum) and depreciation recapture (25%). Any capital asset held for less than a year will be taxed at the short term rate (same as ordinary income), and consequently will now benefit from the overall decrease in tax rates.

This is a comparison of what typical tax savings could look like for three tax payers based on the combination of decreases just discussed:

Taxable Income:	**Filing Status:**	**Saved In - 2001:**	**Saved In - 2002:**	**Saved in - 2010:**
$100,000	Single	$669	$1,038	$2,513
	Married	$881	$1,162	$2,730
$500,000	Single	$2,669	$5,038	$17,889
	Married	$2,881	$5,162	$18,116
$2,000,000	Single	$10,169	$20,038	$86,899
	Married	$10,381	$20,162	$90,987

As you can see by the above chart, the true savings kick in during the last phase of this bill, and this is especially true if you have taxable income of over $1,000,000. Please note that the above chart does not consider the Alternative Minimum Tax or “AMT” (more on the AMT will be discussed in this video). It is estimated, however, that the number of taxpayers impacted by the AMT will increase significantly under the new Tax Act.

As I have already stated, a major problem I have with this new law is that I hope we all live long enough to see it fully enacted. The second problem I have with it is that even if we survive, and the tax bill survives, the tax savings from the bill all virtually disappear on January 1, 2011!

II. Estate Tax Planning in three words or less - Call Dr. Kervorkian!

There are very few unambiguous, crystal-clear sections of the new tax bill, but here is one of them: if you die between January 1st, 2010 and December 31, 2010, you will pay **NO** estate tax on your estate. If you die January 1st, 2011, or anytime subsequent to that, you get stuck with the whole 55% tax on your estate -- again.

From what I hear, Kervorchian’s 2010 schedule is “waiting list only”, but surely if you put it off any longer, he will not even have room on this. So to really do some shrewd estate tax planning, call and schedule your appointment with him today.

Some people believe that the repeal of estate tax is the centerpiece of the new Tax Act. However, most people do not realize that, number one, this repeal is not effective until January 1, 2010, and, number two, that it disappears on December 31st, 2010! The uncertainty of all the events that will take place between now and then, and the potential political climate at that time, make reliance on this repeal a poor approach to planning your estate. More appropriate is the use of the Triple Crown, as addressed in depth in this video. Nonetheless, the understanding of what will transpire now and prior to 2010, are important.

A) <u>Provisions effective in 2002</u>

The following provisions of the Act are effective in 2002:

1) Increase in the gift and estate tax unified exemption from **$675,000 to $1,000,000.**

2) Reduction of the top rate from **55% to 50%**

B) <u>Provisions after 2002</u>

These are the provisions effective after 2002:

Reduction of the Gift and Estate Tax as illustrated on the following chart.

YEAR	MAXIMUM TAX BRACKET	APPLICABLE LEVEL
2001	55% + 5% Surtax	$ 675,00
2002	50%	1,000,000 *(Gift = $1,060,000)
2003	49%	1,000,000 *(Gift = $1,060,000)
2004	48%	1,500,000
2005	47%	1,500,000
2006	46%	2,000,000
2007-8	45%	2,000,000
2009	45%	3,500,000
2010	Estates are not taxed –Gifts taxed at individual rates	$0

(*) Currently, this exemption amount is the same for Gift and Estate Tax, except for the year 2001 - 2003 when it is $1,000,000 for Estate Taxes, but $1,060,000 for Gift Tax.

There are other considerations such as basis calculation, guidelines for non-resident aliens, gift tax strategies, etc. Fine points such as these are too lengthy and too complex to address in full detail in this short summary, and, if you are interested, my new book "The New Trader's Tax Solution " gives more detail on the finer points of the new law.

C) <u>What To Do Until 2010</u>

Whatever your ultimate goals are, I strongly recommend that you take advantage of the increased gift and estate tax exemption which goes up to $1,000,000 in 2001; $1,500,000 in 2004; $2,000,000 in 2006; and $3,500,000 in 2009. In 2009 the top estate tax rate will drop to 45%, and is then repealed to 0% in 2010. You must plan to utilize this amount, no matter if your assets' net worth is greater or lesser than the threshold amounts in the chart on illustrated above. You should consider using the complete exemption as soon as possible, but you should get counsel on how to properly set this up (possibly by using a family limited partnership, as I discuss in the video). The difference may well be worth any cost to you to do so.

You should also review your will and make sure the amounts stated in it do not lock you into small specific amounts that will be useless with this law in effect. If the will needs to be changed, I advise doing so, as soon as possible.

III. Retirement Plan Provisions

The Tax Act increased the **maximum amount** of **deductible contributions** that can be made to Individual Retirement Accounts (IRAs) and other retirement plans (KEOGHs, SEPs, etc.). The most significant change, however, is a **catch-up provision** has been passed which allows individuals who have reached the age of 50 to kick in a little more for their retirement, and get the benefit of this larger deduction. Other provisions include:

1) The maximum annual contribution limit for qualified plan purposes increases from $170,000 to $200,000 after 2001
2) The rules permitting rollovers between various plans have been liberalized
3) Plan loans to sole proprietors, partners, are S corporation owners are permitted starting in 2002.The loans must be made available to participants who are not owners as well.

IV. Education Changes:

No tax bill would be complete without some tinkering with programs that effect social policy towards education. This tax bill is no different; the 2001 Tax Act clearly demonstrates our elected officials' stance on promoting education through various tax incentives.

A) Educational IRAs

Education IRAs have been expanded significantly to increase both the amount that can be contributed to the plans and the number of individuals that will qualify for the program. Additionally, tax-free distributions will be allowed for a wider range of qualified education expenses.

B) Employer Provided Educational Assistance

Distributions from employer provided educational plans are excluded from income to the tune of $5,250

annually, if used to pay for qualified education expenses.

V. Changes For The Trader:

Traders were very lucky, once again, that the Government did not tinker with any provisions which affect the qualifications for Trader Status, the manner in which to file as a Trader, or any other provisions which affect Section 475, the Mark to Market election. Traders were given tremendous tax benefits in the previous tax law (1997), and at least for the present, the government has allowed most of those benefits to remain in effect. In 1999, however, the IRS put out Revenue Procedure 99-17 (Rev. Proc. 99-17) which severely restricted the timing of when Traders must make the Section 475 election. This curtailed some of the tax reduction strategies that we were previously able to enact. However, in sum, the Trader has still been granted a very advantageous position, relative to the investor.

Much more on this in the accompanying video, which I hope you will enjoy, and from which you will reap much tax benefit. **<u>For more information on the benefits of Trader Status and the strategies which can be enacted by its use, you can purchase "The New Trader's Tax Solution" from Trader's Library (800-282-2755), and, for a free "Trader Status Questionnaire and Evaluation", and more information on the tremendous tax benefits afforded Traders under current law, you can call our office at (800-556-9829).</u>**

Original online support manual begins here:

This tutorial was originally titled "Bottom Line Tax Strategies for Online Traders" and was recorded at the Online Trading Expo

Cut Your Trading Taxes In Half

Ted Tesser

email - tbtesser@aol.com

Introduction:

This session will illustrate how to accomplish three tax reduction goals which will allow you to cut your current taxes by up to fifty percent, build up substantial wealth for retirement, and ultimately create a multi-million dollar estate for your heirs -- tax free.

Having been in the financial services industry for the past 25 years, and having practiced as a Certified Public Accountant for most of them, these are the concerns that I most frequently must address. The answer to these concerns and the path to these goals can be found in a three-step plan of action which I call "BottomLine Strategies for OnLine Traders".

STEP I -- THE BUSINESS

The Basics

Most people don't realize that having a business is truly the last great tax reduction opportunity left in America today. There are really two tax systems in existence for U.S. citizens. One is for employees; the second is for the owners of businesses. If you're an employee, you can deduct itemized deductions *below the line* such as mortgage interest, real estate taxes, charitable contributions, IRA contributions and other miscellaneous itemized deductions. However, if you are a business owner, you get all sorts of deductions in addition to the ones that employees get. These deductions are not only more numerous, but are also deducted in a different manner *above the line* rather than below it.

In other words, business owners get all the deductions of an employee plus a whole bunch of additional deductions not available to people without businesses. They not only get more deductions, but they get to deduct them in a more advantageous manner.

B. Establish a Business

This is step one of my three-part plan.

Anyone already in business has the structure through which we can enact the second and third parts of my strategy. But for those of you that don't, let me say that a business is like money in the bank -- it is something everyone should have.

For those of you who have no business, let me offer you one - **the business of Trading**.

C. The Trading Business

Background: If you read my original works, *The Serious Investor's Tax Survival Guide, The Trader's Tax Survival Guide,* or *The Trader's Solution,* my latest follow-up, you know that there is now a new breed of investor — the Trader. In order to understand the exact nature of what a Trader does and his or her advantages, you must understand the other types of participants in the market.

I. Broker-Dealer/Market Maker. Under Reg Section 1.471-5, the Code defines "a dealer in securities" and delineates this participant as someone who engages in the purchase of securities for resale to customers with the intent of making a profit. The Broker-Dealer/Market Maker is a merchant with an established place of business who regularly engages in this practice. He therefore treats his securities or commodities as inventory and unlike other investors, these items which are held for sale to his customers are treated as **ordinary, not capital assets**. ***This results in the generation of ordinary income or loss, not capital income or loss***.

Dealers can deduct, dollar for dollar, any amount of expense they incur in transacting their business. **The Broker Dealer/Market Maker is not limited to a $3,000 per year capital loss as are other taxpayers including most Traders**. This is a major distinction. Also, any income generated from these assets will also be considered ordinary with regard to self-employment tax, retirement plan contributions, self-employed health deduction and, as of 1993, mark-to-market considerations (Section 475).

Broker Dealer/Market Makers must pay self-employment tax on their trading income.

II. Investors, on the other hand, is defined in the tax code under Section 263(a). He is a person who buys or sells securities **for his own account**. Investors are clearly defined as investing for their own accounts as opposed to dealers who buy and sell for resale to customers. All expenses of the investing activity are considered to be investment expenses. They are treated as miscellaneous itemized deductions on Schedule A of an Investor's tax return and are also subject to significant limitations and phase-outs.

All income is considered to be capital gain income and **not subject to self-employment tax (under most circumstances)**, not eligible for retirement plan contributions and hence reported on Schedule D. Furthermore, an Investor is always limited to a $3,000 per year net capital loss deduction, which can be carried forward (or even back, in the case of Section 1256 transactions) see Appendix in the original text of *The Trader's Tax Survival Guide*.

III. Traders. This is a hybrid category. There is no election on the tax return that one would make to indicate that he or she is a Trader. There have been cases decided over the past 65 years in the Supreme Court and various district tax courts which have recognized this hybrid category. The decisions in these cases have recognized that Traders are investors who engage in the purchase and sale of securities for their own accounts. However, they do so at such a high level of activity that it becomes a business to them.

There are **no objective requirements in the tax code to qualify a person as a Trader**, and up until the Taxpayer Relief Act of 1997 the distinction was barely acknowledged in the Code. It was agreed that the taxpayer must trade in stock, securities, futures contracts or options on a relatively short-term basis; however, this classification was purely subjective. But now, in paragraph 341 of the new tax act, Congress has defined a Trader as follows:

> *"Traders are taxpayers who are in the business of actively buying, selling or exchanging securities or commodities in the market. On the other hand, dealers deal directly with customers when they regularly buy or sell securities in the course of their business . . "*

Furthermore, on December 17, 1997 the Joint Committee on Taxation issued its report (a.k.a., the Blue Book), to explain the new tax law. On page 180 of this report, Title X, Section A (financial products), sub-section 1001(b), they stated:

> *"Traders in securities generally are taxpayers who engage in a trade or business involving active sales or exchanges of securities on the market rather than to customers . . ."*

What they basically have done is alluded to, but not strictly define, the definition of a Trader. The court cases throughout history have defined what really determines Trader Status. These cases still define the criteria that separate an investor from a Trader.

? They are looking for someone who trades on a **frequent, regular and continuous** basis.
? They're looking for someone who has a **substantial number of trades**.
? They're looking for someone who does **short-term trading**.
? They're looking for someone who spends a **substantial amount of time trading**.
? They're looking for someone who has the existence of a **small percentage of income derived**

from dividends.

? They're looking for someone who takes these **expenses on a Schedule C**.
? They're looking for someone who has the **existence of an office** either home or otherwise.

What they do ***not*** tell you is how frequent *regular* and *continuous* the trading must be, although they ***do*** shed new light on what they consider it to be. They ***never tell*** you how many trades are substantial. They ***never tell*** you what short-term trading must be in order to qualify you as a trader. They ***never tell*** you what a substantial amount of time is spent trading.

They ***never tell*** you what amount of dividends they will allow you to earn before they disqualify you from being a trader. They ***do*** tell you that it must be on a Schedule C. Although they do not discount a home office, they ***do*** require that an office be present. In fact, part of the provisions of the new tax act has liberalized the deduction of a home office.

Until the requirements are made objective, you can obtain a free Trader Status Evaluation by calling our toll free phone number (1-800-556-9829) to request a form. If you fill it out and send us the Questionnaire, each inquiry will be responded to, free of charge. Be sure to include your name, address and daytime phone number, and a copy of last year's tax return so that we may do a thorough evaluation.

Implementation: This truly is the best tax shelter available for Investors who meet the requirements. With the higher phase-outs, you need as many deductions as possible. **For those of you that don't believe you meet the criteria of being Traders, do not despair, I have worked with many *Investors*, and helped them to achieve *Trader Status*.**

The Results:

Here is a brief summary of the major advantages that a Trader has over an Investor.

1. Expenses are not subject to a 2% to 3% floor on Schedule A that investment expenses are. They are deducted on Schedule C, dollar for dollar.

2. Itemized deductions are not even necessary in order to deduct trading expenses. A Trader can take a standard deduction and still deduct trading expenses in addition to this on Schedule C.

3. Investment seminars, which were determined as non-deductible to Investors in the 1986 tax act, are now considered trading seminars and are still deductible.

4. Investment interest expense, which was severely limited under the 1986 tax act, is now considered to be trading interest (a normal business expense) and is 100% deductible.

5. Section 179 depreciation, which was not allowed to Investors, is now available to Traders.

6. The home office expense, which cannot be deducted by Investors, now becomes deductible, and, in fact, becomes one of the criteria in establishing Trader Status.

Although the Trader is still subject to a $3,000 per year net capital loss deduction for his trading loss, he may deduct 100% of his business expenses as ordinary. With the passage of the Taxpayers' Relief Act of 1997, <u>this $3,000 limitation can be avoided if he elects to mark-to-market under Code Section 475</u>. Read on for information on making a Section 475 election.

<u>D. More on Section 475</u>

You can elect Section 475 mark-to-market. By doing so, **a Trader may deduct more than a $3,000 net loss (if he or she had losing year)**. In a profitable year, a Trader may more easily set up a Section 419 Plan by making such an election (see Step #3).

<u>Background</u>: With the passage of the 1993 tax act, Broker Dealer/Market Makers were required through Section 475 to mark their positions to market, thereby forcing them to put all their trading income or losses on Schedule C and not being able to carry over any unrealized gains into the next year. This really didn't do much to affect their tax situation other than prevent them from carrying over gains into the following year. Their income or losses were already reportable on Schedule C.

With the passage of the 1997 tax act, <u>Traders</u> were given the option of electing Section 475, thereby granting them the same privilege as market makers. *The major difference here is that if a Trader elects Section 475, although the income becomes Schedule C income, it is not self-employment income.* This was further clarified in the Technical Corrections Act which followed the tax bill. In the Congressional Blue Book report Congress further clarified this statin:

> *"The Act allows security Traders and commodity Traders and dealers to elect application of the mark-to-market accounting rules which apply only the security dealers under prior law . . . Congress intended that gain or loss that is treated as ordinary solely by reason of the election would <u>not</u> be treated as other than gain or loss from a capital asset, for purposes of determining an individual's net earnings from self-employment under the Self-employment Contributions Act (Section 1402) . . ."*

What this is essentially doing is giving the Trader a tremendous benefit -- the best of both worlds. They now have the option of deciding whether or not to treat their losses as ordinary and still maintain the integrity of keeping the income from being subject to self-employment tax.

Implementation: There is no box to check on the Schedule C for one to elect Section 475 -- as there is no box to check to elect Trader Status. The way to elect 475 is simply state you are doing so by the deadline date. You then report the income on the Schedule D first, and then back the capital gain income or loss off of the Schedule D. Transfer it then to Schedule C, noting that the Trader has elected Section 475, and the income or loss thereby becomes Schedule C income or loss. A form will be coming out in the future on which to make the election.

Caveat: If you trade commodities or commodity options, you give up some preferred tax treatment. Consult with your tax advisor before making this election to determine if it is appropriate for you. **This is serious business do not do it yourself!**

E. To Sum Up

For the first time in Tax Reform History, Congress validated the existence of Traders in the Tax Code. The Technical Corrections Act has been passed and like all tax bills certain issues which were skipped in the original Tax Act, or which needed clarification were addressed. They addressed the **Trader Status issue** but let the definition of who qualifies stay purposely vague. Because of this, however, we can still defer to the cases coming down from the tax court, the Supreme Court and the various district courts as to our interpretation of who qualifies for Trader Status and the various other issues that we must address with regard to the criteria.

In the final analysis, a Trader is judged by: the frequency of trades, the number of trades, the holding period of the trades, the amount of time spent trading, whether or not substantial dividends are accrued on the trading account, the existence of a Schedule C, and the existence of an office.

Until Trader Status is made more objective, you can obtain a free Trader Status Evaluation by calling our office toll-free [(800) 556-9829] to request a form. If you fill it out and send us the Questionnaire, each inquiry will be responded to, free of charge. Be sure to include your name, address, e-mail address and daytime phone number, and a copy of last year's tax return so that we may do a thorough evaluation..

For those of you that don't already have a business, I suggest you qualify for Trader Status - now more than ever, it is important to do so!

STEP II -- THE ENTITY

A. Common Misconceptions

The second component to my three-step approach is to put your business in an entity, which is most advantageous to you. The two most common misconceptions of Traders who telephone our offices on a daily basis are: (1) that they must trade in an entity to achieve Trader Status; and, (2) that they should conduct their trading activities through a "corporation". I wish to put both of these misconceptions to rest.

1. **It is not necessary to trade through an entity in order to receive the tax benefits afforded to Traders**. If you meet the criteria which has been outlined above you **are** considered a Trader and **will** receive the tax advantages afforded to Traders. This is done by filing a Schedule C along with your individual tax return. The existence or non-existence of a trading entity is irrelevant to the issue of Trader Status.

2. **"Corporations",** ***per se*****, are not necessarily the preferred entity of choice for conducting a trading business.** While there are many circumstances in which corporations are utilized, and in fact recommended, in structuring a trading business, there are equally important reasons NOT to place your trading accounts into a corporation.[?] The determination of a proper trading entity for your business should not be limited to corporations must take into account several very individualized factors, and proper planning requires consideration of not only corporations (both "C" and "S" corporations) but also, Limited Partnerships, Limited Liability Companies, Business Trusts and other entities.

However

Although an entity in general and a corporation in particular are not necessary in order to achieve Trader Status, proper entity structuring will provide you with all of the tax advantages afforded to Schedule C Traders PLUS many, many more advantages which are not available to a typical Trader. These will be addressed below.

B. Sole Proprietorship

This is the form of business under which most self-employed individuals operate. It is by far the easiest to establish, maintain and control. There are no governmental filings required and no special taxes. A Trader who files a Schedule C falls into this category

A Schedule C Trader, unless he elects Section 475 (mark-to-market) reports all his income on Schedule D and all his expenses as ordinary on Schedule C. Although the expenses are ordinary, the income maintains the character of capital gain income. *Because of this, it is not subject to self-employment tax, does not qualify for pension plan contributions, and does not allow the Trader the opportunity to deduct self-employed health deductions* ***(our revised interpretation).***

This is not etched in stone; however, these are the best interpretations I have been able to get from my

[?] NOTE: Key among these are the personal holding company (PHC) issue and petential imposition of a 36% PHC tax.

contacts at the IRS. There are no court cases specifically defining these allowances. It is generally agreed by my colleagues that subject to the above limitations, a Schedule C Trader can still elect to take Section 179 depreciation, assuming that there is income to allow for it.

The real problem occurs with retirement plan contributions, as there is no <u>self-employment</u> income. The only way to establish a retirement plan and to allow for the deductions associated with defined benefit and defined contribution plans is by drawing salary against the trading income. A self-employed individual <u>cannot</u> accomplish this on a Schedule C. Thus, for retirement planning purposes, **a sole proprietor Trader CANNOT contribute to a Simple IRA, Roth IRA, Simplified Employee Plan (SEP) NOR any other type of qualified or non-qualified retirement plan.**

From a non-tax standpoint sole proprietors have unlimited personal liability for debts, losses and claims against the business. Thus, 100% of his/her assets (subject to certain limited exemptions) are at risk to litigation, poor business decisions, and divorce. These non-tax implications make the sole proprietorship the most vulnerable and undesirable form for conducting a trading business.

A. <u>General Partnership</u>

Where two or more people come together for a common business enterprise a partnership is established. Like sole proprietorships, they are easy to form (a handshake will do), require no governmental filings, have no special taxes and decision making is easy (just a nod and a wink). An informational return is filed to reflect the partnership's activities and each partner is issued a K-1 which reflects their individual income/loss. This is attached to and reported on their personal tax return.

The main disadvantages of general partnerships are non-tax in nature. Each partner is deemed to be an agent of the partnership and thus capable of making decisions which bind the partnership even in the absence of knowledge by the other partner. Each partner has joint and several liability for the debts and claims against the partnership, thus even an unaware partner with deep pockets can be held fully liable for financial decisions made by other partners.

<u>D. Limited Partnerships</u>

Limited Partnerships are the preferred structure for conducting business in partnership form precisely because of the liability issue discussed above. Limited partnerships are comprised of one or more *<u>Limited</u>* partners whose liability is limited to the amount of their partnership investment, and a *<u>General</u>* partner who assumes unlimited liability. Because of the separation of liability between general and limited partners, the general partner is typically issued a very small percentage of ownership in the entity (perhaps 1-2%) so as to further reduce the vulnerability to creditors.

Limited Partnerships are creatures of statute. Every state has enacted a statute authorizing the establishment of limited partnerships. A written agreement is required, there are restrictions on the ability of limited partners to participate in management, and there are statutory procedures to be following in terminating them. Thus, they are a bit more complex than general partnerships but the advantages far outweigh the disadvantages.

The IRS requires the filing of an informational return (Form 1065), however, income/loss is apportioned to each partner in proportion to their partnership interest on a K-1 and flows through and is reported on their individual tax returns. Whereas partners in a general partnership are required to pay 15.3% self-employment tax on their income, limited partners do not. A variation of limited partnerships known as Family Limited Partnerships (FLP) provide all of the same benefits plus many more where the partnership is comprised of family members. We have placed a great number of our clients in FLPs because of the tremendous benefits they afford for tax planning, retirement planning and estate planning.

E. Limited Liability Company

This entity is a hybrid between a corporation and a limited partnership. Similar to corporations and limited partnerships, LLC members' interests are limited to the amount of their investments. Unlike limited partners, however, member in an LLC may participate in management, and like limited partners, the gain/loss flows through to the members to be included on their individual returns.

LLCs can be either single-member or multi-member in nature, however, for tax purposes the IRS disregards single member LLCs and some states doen't authorize them. The effect is that while a single-member LLC may enjoy asset protection, it will continue to be taxed as a sole proprietorship requiring the filing of a Schedule C and a Schedule SE on which the 15.3% self-employment tax must be reported and paid. A multi-member LLC is taxed more like a limited partnership, in which income is generally not subject to self-employment tax, however, in the event the LLC is member-managed (as opposed to "manager-managed") the managing member will be subjected to such tax.

While there are some advantages to utilizing these entities there are also disadvantages. LLCs initially came on the scene in 1997 when Wyoming enacted the first statute in the country. Since then they have been adopted in nearly all states and the various states' statutes vary widely. Since the LLC is a relatively new entity structure there have not been a great deal of court cases deciding the tax and non-tax implications of this form of doing business. While there are some circumstances in which an LLC is appropriate, frequently we choose to use Limited Partnerships due to the fact that there is much more history and certainty to their use.

F. Corporations – In General

The consideration of whether to utilize a corporation in your entity structuring strategy requires a preliminary understanding of the two different types of corporations: S-Corporations and C-Corporations. All corporations when organized begin as C-Corporations, however, by making a special election with the

IRS on Form 2553 the corporation can elect, for tax purposes, to have its income/loss reported on the individual tax return of its shareholders.

All corporations (both C- and S-Corporations) share similar characteristics. They are created by state statutes and are the only business entity which is considered and treated as being totally separate and distinct from their owners (i.e. shareholders). They are the most complex structure to formulate and maintain and require for their continuation and validity the most formalities. Though more complex than other forms of doing business, the requirements are by no means unmanageable and in fact, corporations provide the greatest tax advantages for businesses – particularly Traders.

C-Corporations When most people think of corporate America it is the C-Corporation which is their frame of reference. These are the big-boys, IBM, Proctor & Gamble, General Motors, etc. – large publicly held companies. However, C-Corporations are also available for use by mom and pop grocery stores, shoe repair shops *and Traders too!*

C-Corps receive the widest array and highest limits of tax deductions of any business entity. There is far more flexibility in establishing VEBAs, 419 trusts, retirement plans, deducting travel and entertainment and seminar expenses, paying medical and educational expenses with tax deductible dollars and many other benefits which are either unavailable or severely limited in other forms of business.

The most frequent heard disadvantage about C-Corps is the double taxation issue. As a separate entity the income of a corporation is subject to taxation at the corporate level and then is taxed again at the individual level when paid as salary or dividends. However, through the use of proper planning and implementation of corporate programs, taxation at the individual level is kept to a minimum because more "business" expenses can be paid for you on a tax deductible manner. Additionally, the income of C-corporations are only taxed at 15% on the first $50,000 of income (compared to 28% for individuals).

Caveat: If 60% or more of your C-Corp's income is derived from trading it may be considered a Personal Holding Company and subjected to a 36% tax rate. ***If ALL you do is trade C-Corps should not be used without first consulting*** *with competent accounting and legal professionals to implement strategies to avoid this result..*

S-Corporations A subchapter-S corporation looks and acts like a corporation but is taxed on the individual's tax return.? The flow-through nature of this entity makes it an ideal vehicle for trading. A second reason for establishing an S corporation is that of asset protection. Anybody suing the individual trader would not generally be able to get to the assets of the S Corporation. On the other hand, anyone suing the S Corporation would not be able to get at the assets of the Trader outside of the corporate entity, provided however, the corporate entity is properly maintained.

? S-Corporations are not recognized in the state of Connecticut which imposes the state's corporate tax rate to them.

S-Corps, do, however, have some limitations. Key tax limitations include the non-deductibility of disability premiums, limitations on deductibility of medical insurance premiums, limitations on deductibility of travel and entertainment expenses, and heightened scrutiny on the employment of family members. Additionally, there can be no more than 75 shareholders.

From a non-tax standpoint both C- and S-Corporations are quite similar from an asset protection standpoint so long as the corporate veil remains intact. The surest way to loose all of the tax and non-tax advantages of incorporating is for a person to conduct his/her corporate affairs without regard to the formalities required by a corporate structure. It has been our experience that S-Corporations are particularly susceptible to this, perhaps more so from a psychological standpoint than anything else (i.e. the owners perceive them as being more akin to a partnership than a "true" corporation and thus loose sight of the fact that formalities must be adhered to).

As a corporation, it is easy to deduct ordinary, normal and reasonable business expenses associated with doing business in the corporation. There will be no question as to the business nature of the entity if it is a corporation. Expenses such as these will now become dollar-for-dollar deductions.

1. VEBA and Section 419 Plan contributions
2. Accounting, legal and other professional fees
3. Automobile expenses (Traders be careful)
4. Books and audio/videotape courses on investing
5. Trading seminars, conferences and conventions
6. Brokerage account management fees
7. Calculators, adding machines, cassette tape recorders and typewriters
8. Cost of managing investments for a minor
9. Financial advice on audio/videotapes
10. Home computers, software, internet service and cable TV
11. Data retrieval service
12. Trading advice, coaching and mentoring
13. Business Interest expense
14. Qualified and Non-qualified pension plan contributions
15. Entertainment and meals during which business is conducted
16. Safe deposit box rental and storage space for trading documents
17. The salary of bookkeepers, accountants or others who keep your trading records
18. Subscriptions to trading publications
19. Trips to look after your trading account and conferences with trading advisors
20. A portion of your home expense that qualifies as home office deductions

G. Incorporate in a Tax-Free State

Most states charge an income tax all their own. There are several states, however, which do not charge income tax for residents. These states are: Florida, Texas, Nevada, Washington, Tennessee, Alaska and New Hampshire. A corporation, no matter what state it is authorized in, may legally operate in any other state of the country. Thus, **even though you reside in a state which has a state income tax you can still form a corporation in a state which does not**. The advantage is that income earned within the out of state corporation will not be subject to taxation in your home state.

ONLINE TRADERS BEWARE!!!

There are many who will tell you to form a Nevada corporation for your trading business and avoid state taxation. Much of this misinformation is from companies who want to "sell" you a corporation. **DO NOT BE DECEIVED**. What they **DO NOT** tell you is that if you place your trading business in a Nevada corporation but you are sitting in New York (or another taxable state) executing your trades, you have just subjected yourself to registering your corporation to do business in New York and are now subject to New York taxes! You've just defeated the whole purpose of incorporating in Nevada. **There are ways to structuring this to reduce and eliminate this result.**

Also, There are very complex rules regarding "apportionment", "nexus" and "controlled groups" which must be understood and properly applied. **Structuring your trading business in a tax free state can work but it requires very specialized knowledge and sophisticated planning and structuring**. **Do not attempt to do this yourself without competent professional advice and assistance.** Our firm's professional staff of certified public accountants, attorneys, enrolled agents an trading professionals spend numerous hours each week in reviewing the latest changes in applicable laws throughout the country and developing strategies to address them. We can guide you in properly structuring your trading business.

G. Audit Proof Your Trading Business

For both tax and non-tax reasons a Trader should consider forming a separate entity through which to conduct his trading business. Primarily, because it will make him a "small fish in a large pool" for audit purposes. I have long believed that corporations and limited partnerships are less subject to audit than are individuals and, in fact, on December 16th *The Wall Street Journal* reported that the IRS has acknowledged that it is shifting its audit personnel from the corporate division to the individual division.

This is especially true in light of the fact that a Trader will generally trade a large number of transactions throughout the year and generate a large amount of gross proceeds. This huge gross proceeds figure, often times in the millions, will be more susceptible to audit on an individual's tax return than in an entity. A corporation, for example, is in a pool with corporations such as Exxon, IBM, and Coca-Cola. Similarly, many large real estate, drilling and mining ventures frequently use limited partnerships and limited liability companies and these IRS is accustomed to seeing large dollar figures on these type of returns. For this reason, entity tax returns with gross proceeds in the multi-millions will not even raise an eyebrow, whereas, million dollar numbers on an individuals tax return may cause IRS auditor eyebrows to furrow.

If you have read my books *The Serious Investor's Tax Survival Guide, The Trader's Tax Survival*

Guide or *The Trader's Solution* you will recall that there is also a certain degree of comparison from year to year for audit selection. If somebody decides to be a Trader one year and starts generating millions of dollars of gross sales from trades, it may be kicked out in a computer comparison between this year and last year. However, if one switches entity to a corporation there will not be the discrepancy in the year-to-year figures on the individual's tax return (generated by multi-million dollar gross proceeds).

If your accountant tells you this is not so ⚉ fire him or her ⚉ it is!

H. Entity Structuring – Putting It All Together

In considering the use of an entity for conducting your Trading business it is essential that your overall short and long term objectives be considered. These include, income tax planning, retirement planning, estate tax planning. Factors impacting these issues include your age, the existence and ages of a spouse and children, other non-trading sources of household income, assets, liabilities, etc. The emphasis is on **Planning!** ***There is no such thing as a "one-size-fits-all" entity structure***. Frequently it is most advantage to use multiple entities to achieve the desired result.

A hypothetical structure might include the establishment of a Limited Partnership (LP), a C-Corporation, and an S-Corporation. While an individual entity has its own advantages and disadvantages standing on its own, when united with others in a properly structured strategy symphonic harmony is created. In this example the C-Corporation could be established in a non-taxed state (e.g. Nevada) and would serve as the General Partner of the LP for the purpose of managing the affairs of the LP. The LP would hold your assets (trading accounts, etc.). The C-Corp would enter into a contract with the S-Corp for the purpose of trading the accounts of the LP. The C-Corp would hold a nominal interest in the LP with you and other investors (which could be a spouse, children, or unrelated) holding the significant partnership interests.

A multiple entity structure such as this would be utilized for the following purposes:

Family Limited Partnership:

? Income received will be capital gains. Though ineligible for funding retirement plans the income will not be subject to self-employment tax when passed through on your personal return.

? Pays a management fee to the C-Corp general partner thus transforming the capital gains income into ordinary income to the corporation which can be used to fund retirement plans.

? Shares can be easily transferred to children and other family members to reduce current income tax and reduce estate taxes without loosing control of the asset.

C-Corporation:

? If organized in a tax-free state such as Nevada there would be no state tax due on management fees received.

- ? Receives income from management fees to the FLP and leasing fees from the S-Corp.
- ? First $50,000 of taxable income taxed at 15% federal rate.
- ? Dividends receive preferential tax treatment
- ? Can have a fiscal year end thus allowing for the deferral of income to a subsequent tax period.

S-Corporation:

- ? Incorporated in the Trader's home state to prevent the requirement of registering the C-Corp to do business in the home state.
- ? Pays nominal salary which is subject to self-employment tax while non-salary income flows through to owners free of self-employment tax.

(The foregoing is by no means exhaustive and is provided merely to illustrate how a multiple-entity structure works together)

STEP III – THE BOTTOMLINE

A. Overview

This is where we pull it all together. This is in essence – The Bottom Line. All of the foregoing discussion has been leading you to this place where the actual tax savings takes place. Having established you as a Trader and structured your Entity, you are now ready to embark upon the greatest tax savings and wealth building techniques available to Traders. For months or years you have worked countless hours day in and day out planning your trades. You pour over charts, watch endless news reports and analyze the market until you spot just the right trade. Then after you're in, you endure the most rigorous psychological pressure just to squeeze out the last point of profit. But, if you're like most people, you spend very little time keeping the IRS from eating away at your hard fought dollars. You spend all your time and effort on making money and very little on how to keep it!

A. Retirement Benefits for Corporate Officers and Employees

As previously stated, the plans listed below are not available to Schedule C Traders. Some type of business entity must be established in order to take advantage of these plans. Some of the plans outlined below are mutually exclusive. Others are available only if your gross income falls below a certain ceiling. You should consult with a competent tax and accounting professional to review your specific situation to determine which of these plans are available and best suit your savings, tax, and retirement planning needs/goals.

While some of these plans can in some circumstances be established through a partnership they are most often established through a corporate structure. The corporation receives a tax deduction for the contributions and growth within the plans are tax deferred. Many of the plans can be self-directed, meaning that you can continue to trade the funds which are in the plans. Competent tax and accounting advise is essential as there are rules governing this.

401K: A corporation can establish a 401K plan for salaried officers and employees. You and can contribute up to $10,000 per year (or as limited by salary) which can be matched by the corporation up to 25% of pay.

ROTH IRA: You can contribute up to $2,000 for 1999 (or as limited by salary) and subsequent years (based upon current law). This amount may be limited and or phased out depending upon income level if coupled with certain other plans. (Note: contributions are not tax deductible and not taxable when withdrawn)

SEP (Simplified Employee Plan): You may be entitled to establish a SEP into which each of you may contribute up to $24,000 or 15% of pay, whichever is less.

IRA: A standard IRA plan can be established by into which you may contribute Two Thousand ($2,000.00) Dollars for 1999 (or as limited by salary) and subsequent years (based upon current law. This amount may be limited and or phased out depending upon income level if coupled with certain other plans.

KEOGH: There are two types.

A. In a Profit Sharing Plan you can contribute up to $24,000 or 15% of pay, whichever is less.

B. In a Money Purchase Plan you can contribute up to $30,000 or 25% of pay, whichever is less.

DEFINED BENEFIT PLAN: Has the advantage of allowing an unlimited contribution depending upon actuarial assumptions, the age of the participants, and the amount desired per year at retirement. This plan usually works best for those who do not have other retirement savings and have attained the age of at least 45 – the older the better the benefits.

B. Other Benefits

Following is a general outline of the many different benefits and plans available to you through your new structure. This list is by no means exhaustive. Our office will assist you in implementing any or all of the benefits outlined below.

Group Term Life Insurance: You can receive up to $50,000 in coverage and the premium is not included in your gross income. The expense is 100% deductible to the corporation.

Medical/Dental Reimbursement Plan: Medical and Dental Reimbursement Plans can be established whereby the corporation can reimburse you for any uncovered medical expenses that you pay out of your own pocket. Any reimbursements actually paid to you are deductible to the corporation and they are not considered income to you. This may include reimbursement for premiums currently being paid on any private plans currently in effect.

Dependent Care: Upon the birth of a child, the corporation can establish a dependent care plan. This plan can provide you with up to $5,000.00 per year for child care. This sum is deductible to the Corporation and it is not part of your gross income.

Medical Plans: The corporation can pay 100% of your health insurance and receive a deduction for it. This benefit is non-taxable to you.

Educational Assistance: You may elect to take an educational allotment of up to $5,250 per year which is not considered part of your gross income but is 100% deductible to the corporation.

Seminar Expenses: These Expenses, including meals and lodging, are 100% tax deductible to the Corporation and not considered part of your income.

Physical Fitness Facility: You can have a physical fitness facility on the premises totally paid for by the corporation. The cost of the facility is 100% tax deductible to the corporation.

Lease of Corporate Space: The corporation can lease office & storage space in your home. Income received will be rental in nature and thus not subject to self-employment tax. If you own your home you will also be entitled to a depreciation deduction as well as a deduction for a portion of the utilities and other upkeep expenses. The expense is 100% deductible to the corporation.

Entertainment/Meals/Lodging: Business travel expenses are 100% deductible to the corporation where as limits to deductibility are imposed upon Schedule C Traders.

Hiring your Spouse and Children: Children over the age of 7 can be employed. The child can receive a salary up to $4,300 per year tax free (due to personal exemption) and up to $25,349 the child will be only be taxed at a 15% rate. The wages paid are deductible to the corporation. This is an excellent way to pay your child's allowance with tax deductible dollars. The child's actual tax liability can be further reduced by the establishment of an IRA, or Educational IRA.

Awards and Gifts; Achievement awards for longevity and safety can be awarded annually and the corporation can receive a deduction of up to $1,600 per award per year. To obtain this a qualified plan must be adopted by the corporation. Similarly the corporation can present gifts to employees and associates and receive a deduction. The gifts and awards can be either in cash or property and are not taxable to the recipients.

Reduced Taxation on Dividends: If you place dividend paying investments (stocks, mutual funds etc) into the corporation you will benefit from reduced tax rates. For example, if as an individual you receive $1,000 in dividends and are in the 39.6% tax bracket your tax liability on the dividends would be $396. If, however, you transferred the stocks to a corporation 80% of the dividends would be received tax free and the remaining $200 would only be taxed at a 15% rate for a *$30 tax bill –* ***a savings of $336!***

Medical Savings Accounts: These plans permit you to contribute $5,000 per year in pre-tax dollars which can be invested and grow on a tax deferred basis then withdrawn tax free for paying medical expenses. We suggest that you coordinate this with a medical insurance policy with a high dollar deductible which will significantly reduce your monthly premium payments.

C. VEBAs and Section 419 Plans – The Granddaddy Of Them All

My wish list for an ideal investment would look something like this:

1. Avoid current tax through huge tax deductions;
2. Save an unlimited amount for retirement;
3. Grow it tax free in addition to getting an up-front tax deduction;
4. Pass the wealth down to your heirs, estate tax free;
5. Allow assets to accumulate on a tax-deferred basis forever;
6. Have the full blessing of the IRS and Congress with a favorable letter of determination – in other words, this strategy is pre-approved;
7. Have no vesting for employees who terminate prematurely;
8. Make contributions as flexible as you like in any amount;
9. Allow large contributions in peak years;
10. Allow early or late distributions without penalties for distributing prior to age 59 ½ or for contributing beyond age 70 ½;
11. Provide favorable tax relief for business owners (Traders);
12. Provide full safety of investment;
13. Provide the ability to grow funds in conjunction with market growth;
14. Acquire tax-deductible life insurance;

15. Provide funds to <u>pay estate taxes</u>; and

16. <u>Protect</u> funds from creditors;

17. It is <u>inexpensive</u> to set up and administer.

18. Access the funds after five years at <u>tax rates as low as 7 - 10%!</u>

My answer to all of these questions is a solution that has been on the books since 1928 called the VEBA (the Voluntary Employee Benefit Association) and its kissing cousin the Section 419 Plan. Section 501(c)(9) of the Internal Revenue Code describes the VEBA as a tax-exempt, ten or more multiple employer welfare benefit trust. It is further defined by Section 419(A)(f)(6) which was passed in 1984. Section 419(A)(f)(6) of the 419 and 419(A) rules were put in originally to curb abuses to VEBAs. If a program qualifies under this section, then it is exempted from the restrictions and prohibitions of Sections 419 and 419(a). In this manner, the greatest tax deferral and asset accumulation program allowed by Federal law came into existence.

Under this program, contributions become <u>100% tax deductible</u>. But more than that, the cash build-up inside a plan is 100% tax deferred, thus providing both a <u>great investment</u> vehicle as well as a tax-free death benefit. This may also be funded in addition to your current pension plan. This is the greatest thing in the world for a company with an over-funded pension or a retain-earnings problem OR A TRADER WHO HAS HAD A PHENOMENAL YEAR! You can have a qualified plan as well as a non-qualified VEBA. This will also allow you to transfer retirement plans, income and estate tax free, to your heirs.

There is another aspect, too involved to go into in detail here, which will allow us to access the funds in the VEBA at any time after the first 5 years -- at tax rates as low as 7 - 10%! This can be used for a variety of reasons, such as to fund a child's college education, buy a house, a car, or any number of employee benefits for the **ultimate employee** -- you! This is true even if you are under age 59 1/2.

Although it is not meant to be set up as a retirement plan, it is, in fact, a wonderful vehicle for accumulating tax-deferred wealth. In addition to being a tax-deductible vehicle, if set up properly, it will allow the business owner to accumulate and compound wealth for many years and ultimately distribute it for his retirement. **The way this works is that the law provides that any business owner may, "for reasonable cause," choose to terminate a VEBA program.**

This could mean that the business owner is going out of business, has an economic need not to continue VEBA program, or simply for any other reasonable cause (i.e., cannot afford to continue or maintain it). If and when this happens, the wealth built up inside the VEBA program will then revert back to the employees – including the owner/employee.

Anything within the VEBA trust will then be distributed in proportion to cumulative salary earned by any employees still with the firm.

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