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Tax Guide

More Tax Tips for Day Traders

THINKING ABOUT becoming a day trader? More power to you. If 2000's stock performance didn't scare you away from the idea, then you just might have the nerve that job requires.

Keep in mind, though, there is a difference — at least in the eyes of Uncle Sam — between an active investor and a stock trader. (See "[Taxes on Day Trading](#).") Essentially, achieving trader status confers many more tax benefits than simple active investorhood. Of course, it also comes with the inherent risks of being a trader. In this column, I'll go into more detail on what it takes to meet the tax-law definition of a "trader" and what happens if you do.

Nailing Down Your Tax Status

The IRS doesn't consider you a trader just because you like the way it sounds. But the government also hasn't gotten around to defining the term. All we have to go by are court cases decided before anyone imagined that everyone from soccer moms to college students would be clicking the "trade now" buttons on their PCs while waiting for the microwave oven to count down. Nevertheless, I'm going to step way out on a limb and tell you how I think you should make the call on your status. Please take the following quiz.

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1. Do you spend lots of time researching and executing your trades?

Just to pick a figure, I'd say you need at least 16 hours a week to be a trader. Of course, more is better.

2. Can you demonstrate a regular and continuous pattern of averaging several "round trips" (a buy and the related sale) for every day the market is open?

Vacations are allowed. But you can't have weeks or months without much going on unless you have a good reason like the market is dropping and you have no borrowing capacity to sell stocks short.

3. Are you strictly playing short-term positions?

Getting in and out of all your positions on the same day proves you intend only to profit from short-term market swings, as befits trader status. While every round trip doesn't have to be a day trade, holding some stocks for as long as a month or two flushes your claim to be a trader unless these are isolated instances. So-called swing traders may have average holds of about a week, which is OK. You can, however, keep longer-term holdings in a separate investment portfolio without jeopardizing your trader status. More on that later.

4. Can you answer yes to all the preceding questions for an unbroken string of at least six months?

Of course, all year is best. If the six months are the last six months of the year, you are probably OK. Starting and stopping after six full months but before year end may allow you to claim you entered the business of trading and then abandoned it. But this is pushing the envelope.

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