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Tax Guide

More Tax Tips for Day Traders

UNLESS YOU ANSWERED yes to everything in Part I, you've already flunked. You are an investor in my book. Sorry. Yes answers to the remaining questions are preferred but not mandatory. If some of your earlier yes answers were a bit shaky, resounding affirmatives will bolster your case for claiming trader status. On the other hand, two or three no answers weaken your position, even if you have nothing but solid yes responses in Part I.

PART II

1. Did you actually make money after all your deductible expenses (investment publications, ISP charges, computer, software, seminars, etc.)?

While traders are allowed to have bad years (just like baseball players), the tax law says a real business generally must be profitable at least three years out of five. You probably don't have that much history yet, but making a net profit (however small) always helps.

2. Can you say you have no regular full-time job or profession?

I believe you can be a part-time trader, but the IRS is skeptical.

3. If you are claiming trader status for last year, will you be able to do so for this year as well?

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as well:

Remember you are supposed to be in the continuous business of trading stocks. A multiyear commitment looks more like a business, while a one-year (or shorter) commitment looks more like an aborted investment strategy or a hobby. Granted, a restaurant can rise and fall in the same year, and so can your business of being a trader. It just doesn't look as good. Having said all that, this question is probably the least important one in this quiz.

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OK. That concludes the test, which is nothing more than my humble interpretation of some old court cases along with what I think are appropriate adjustments for the Internet era. Just to make sure I'm not leading you astray, I asked New York CPA Robert Green (a noted guru on the subject of trader tax rules) to check my work. He gave me a passing grade. Green's firm publishes comprehensive materials on this subject and assists traders all over the country with their tax returns.

Based on the quiz results, let's assume you qualify as a trader. As explained in "[Taxes on Day Trading](#)," the IRS now considers you to be in the business of buying and selling stocks for a profit. You are therefore entitled to fully deduct your trader-related expenses on Schedule C. However, unlike most sole proprietors (me, for example), you don't have to pay the dreaded self-employment tax on your net profit. That's wonderful, but it gets better.

Save More Taxes With a Mark-to-Market Election

As a trader, you can also make the special "mark-to-market" election. If you do, two very important tax benefits come your way.

First, you don't have to worry about the [wash sale rule](#), which defers the tax loss when you buy the same stock within 30 days before or after a loss sale. If you make lots of trades, this can happen all the time. The disallowed wash sale loss gets added to the basis of the shares that caused the problem. In other words, with the mark-to-market election you won't have to spend as much time on bookkeeping as you do researching and trading stocks.

You are also exempt from the \$3,000 annual limit on net capital losses. Why? Because as a mark-to-market trader, all your trading gains and losses are considered "ordinary," just like garden-variety business income and expenses. If you have a biblically awful year, you can deduct your trading losses when you would otherwise be limited to a mere \$3,000 writeoff. The tax savings should ease your pain.

Naturally, there's a price for these goodies. On the last trading day of the year, you as a mark-to-market trader must pretend to sell your entire trading portfolio at market and book all the resulting gains and losses on your return. You then pretend to buy everything back at the same price. So your stocks start off the new year with basis equal to market value and no unrealized gains or losses.

Also, you can't take advantage of the 20% long-term capital gains rate for stocks in your trading portfolio. However, this really isn't a problem because you shouldn't have anything but short-timers in your trading stable anyway. (See below regarding segregating your long-term investments.)

Unfortunately, many traders already missed the chance to make the mark-to-market election for 2000. And you'll miss out for 2001 as well if you're not careful.

What if 2000 was the first year you met the tax-law definition of a trader? The feds say it's too late to make the mark-to-market election for this year. You should have included it on a statement filed back in April of last year with your 1999 return or with an extension request for that return. (This according to [Revenue Procedure 99-17](#), which supplies the nitty-gritty details on making the election.) If you think this is a crazy rule, I agree. But it's the IRS's party.

The bottom line: Many traders won't be able to take advantage of the mark-to-market rules until this year. Write a note to yourself: You must attach an election statement for the year 2001 to your 2000 return filed by April 16, 2001, or to an extension request (Form 4868) filed by that date. At least that's what the rules currently say.

One more thing. If you are a trader during the year before the mark-to-market election takes effect, you have made an "accounting-method change." This requires filling out Form 3115 (a complicated little sucker previously known only to seasoned tax pros). For example, say you were a trader in 2000 and make the mark-to-market election for 2001 (don't forget the April 16, 2001, deadline). You'll have to deal with Form 3115 when you prepare this year's return sometime in 2002. (You may want professional assistance with that.)

How Traders Should Handle Stock Gains and Losses

If you are a trader who has not made the mark-to-market election, your capital gains and losses from trading go on Schedule D, the same as gains and losses from investing. As mentioned earlier, trading expenses go on Schedule C, which means you'll automatically show a loss on that form. Of course, this makes the IRS nervous, so you should attach a statement to Schedule C explaining that the positive side of your trading business shows up on Schedule D. The statement should also quantify your net trading gain. At least we hope there's a gain. We also hope it's more than enough to offset your expenses.

If you are using mark-to-market accounting, I think you should once again report all your trading gains and losses on Schedule D. This allows IRS computers to reconcile the form to sales-proceeds data collected electronically from your brokers. However, since your net gain or loss from trading is actually not a capital gain or loss, it really shouldn't stay on Schedule D. Instead, you should transfer the number to Schedule C, where it will appear side by side with your related expenses. Even though you will now (hopefully) show a Schedule C profit, you still won't owe the self-employment tax.

Why You Should Segregate Your Long-Term Investments

I've mentioned that you can be both a trader and an investor. So gains from your long-term investments will still qualify for that nice 20% rate without diminishing your trader tax benefits.

However, to occupy this "best-of-both-worlds" scenario, your records must clearly identify investment holdings as such on the day you buy them. Also, you should keep investment and trading stocks in separate brokerage accounts if you are investing in and trading the same issues.

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