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Taxable Gains

Don't let the IRS spoil the fun of online trading

By Theresa W. Carey

Edited by Randall W. Forsyth

When it comes to trading, online or otherwise, winning isn't everything, or even the only thing. Taxes are a big thing, too, because whether you win or lose, you still have to account for it to the IRS. Though the 1998 tax season just ended, you should start planning now for the 1999 reckoning next April 15.


Recently, Discover Brokerage conducted a survey showing that online investors are as self-directed when it comes to tax preparation as they are when investing. Nearly two-thirds of those responding planned to do their own taxes, using tax software, Internet tax preparation sites or a collection of broken pencils and a well-worn calculator.

A very informal and completely unscientific survey (of four of my friends who are income-tax-preparation experts) turned up the startling finding that day-traders seldom turn a profit. Among these four tax preparers (one lawyer, three accountants), there were 36 day-traders represented. Of those, only eight showed a gain. That, however, doesn't necessarily mean these online investors really wound up in the red. It actually could reflect their tax and investing savvy if they booked their losing trades and let their winning ones run.

I doubt this tiny sample is representative of the true state of the trading universe. So if you're a tax professional, please help me gather a few more numbers for future reference by writing to electronicinvest@mailcity.com (we've bagged our former Hotmail account because the service has gotten erratic) and let me know how many day-traders are among your clients, and of those, how many actually paid taxes on their gains for 1998.

Win, lose or draw, you still have to track those trades and inform Uncle Sam of their consequences. The ability to do tax-lot trading with your online broker is important; you want to be the one who decides which stack of (virtual) stock certificates you're selling rather than leaving it up to an automated system to pick last-in-first-out or first-in-first-out on your behalf.

The ability to minimize taxes also may be another reason why more and more investors are opting to buy stocks on their own and forsaking mutual funds. You get all the gains -- and losses -- from your trading, and you take them when you want to. Not so with mutual funds. For example, suppose you buy a hot fund whose performance owes to past savvy buys of say, Internet stocks, at prices that are a small fraction of their current quotes. And say the fund's manager thinks their current price reflects not irrational exuberance but outright insanity, so he takes his profits. If you're a holder of that fund when those capital gains are distributed, you're socked with the tax bill -- even if you didn't participate in the runup. No wonder folks would rather buy their

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Taxes are even more complicated for hard-core traders. They should check out the Trader Tax Solution Package.

own AOL.

All the brokers we checked in the top two-thirds of our annual survey ("Growing Pains," March 15) have tax-lot trading capability, but their reporting history varies. Some brokers give you access to only the most recent 30 days of trades, while others go back up to 120 days. It's currently very rare to have access to an entire year's worth of trading data online, though, so don't count on a report from the broker's site to help you with that tax return next year.

A growing number of brokers (including DLJ Direct, Fidelity, Charles Schwab, Datek, Discover, E*Trade and Waterhouse) allow you to download your transactions from their Websites into the most popular personal-finance software, Intuit's Quicken or Microsoft's Money. That helps you in two ways: It eliminates the need for you to type all your trades into the programs, a tedious chore at best and an error-prone one at worst. Those records then can be directly fed into a tax-preparation program, such as Intuit's TurboTax or Kiplinger's TaxCut, or supplied to your accountant next year. Mac users, unfortunately, will have to make the entries manually: These downloads work only for the Windows version of Quicken.

Tax software does a good job of sorting out long- and short-term gains for the typical individual investor, for whom trading is an avocation but not a vocation. For the devoted trader, things get more complicated.

The active trader, who is mostly a short-term speculator, can choose to be classified in one of three categories: investors, traders and mark-to-market traders. If you've given up your day job and become a full-time trader, though, you can be classified as a trader as far as the IRS is concerned, and write off office expenses, seminars, supplies and educational materials on your Schedule C.

The mark-to-market trader status is a bit more complicated but it has its advantages -- if you can justify to the IRS that you're trying to make a profit. Simply stated (and I assure you it's more complicated than this), you're allowed to claim income and losses as though you'd liquidated all your positions on New Year's Eve, even though you may still hold some open positions. You're also allowed to avoid the "wash sale" rule (which prevents you from repurchasing a security for 30 days after you've taken a loss for tax purposes). So leaping in and out of the same issue is okay if you can prove to the IRS that you're a full-time trader.

The tax return of a day trader can be a mighty complicated document if every single trade is listed; one ruling says you can get around this as long as the figures on all your 1099s add up to

what you list on your tax returns. You should still include a monthly summary or perhaps a summary by holding, and tell the IRS they can request the 22-inch stack of confirmation slips you've been hoarding if they've really got to see it.

Starting now, if you haven't gotten to it already, match your purchases and sales for the IRS' benefit so you can do some tax planning. Another option: Make all your short-term trades in your IRA so you don't have to keep track of them. The downside to that strategy is that you can't use any losses in a tax-deferred account to offset taxable capital gains.

For the glorious, gory details on these rules and how they apply to traders, check out the Trader Tax Solution Package offered at www.greencompany.com. They're not cheap (\$200 and up) but they can help you determine which category of trading activity you qualify for as far as the IRS is concerned. And, if you get lucky, the expense is deductible on your 1999 return.

In what has become an annual ritual, readers are complaining that our No. 1 pick in our annual online brokers survey is suffering from inadequate customer service. DLJ Direct customers have been complaining to us about slow service, delays executing trades and other woes, after it eked out our top ranking.

One of the questions asked as we interviewed many of the online brokers this year was, "If we give you our No. 1 spot, will you be able to handle the traffic?" Almost everyone said yes. (The sole exception: AB Watley's Ultimate Trader, which admitted that they'd phase in the new customers if they experienced a sudden flood.)

When we make our evaluations for the annual survey, we're looking at the service from the point of view of an established customer, but your fearless correspondent is currently out there trying to establish personal accounts with about a dozen online brokers so that I'll have a more accurate appraisal of the process.

As mentioned last month, opening an account with a home address outside the United States has generated turn-down letters with most of the brokers. We signed up for an E*Trade account using a United Airlines mileage promotion letter; after three weeks, the check has been cashed but we've seen no sign of the account information yet. So far, we're underwhelmed.

We'd like to stay current with your experiences with the online brokers we've ranked, and even with the ones that haven't yet made the list. We're especially interested in hearing about what it took to open your account, whether or not it met your expectations, and how you've been treated as a customer. Write

to electronicinvestor@mailcity.com.



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