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NEWS ANALYSIS

A Tax Rule That Can Bring You Joy

By using "marked-to-market" accounting, active investors can shield more profits and simplify their returns. Catches? You bet

Active traders have until Apr. 15 to tell the IRS that they want to use the "marked-to-market" method for accounting for their 2004 gains and losses -- an approach that, if they qualify, will let them shield more of their profits from taxes.

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The alternative is to get stuck with a default method, called cash accounting -- the one that most individual taxpayers use, whether they realize it or not. Cash accounting limits the net capital loss from trading that you can claim each year to $3,000.

With exceptions, investors who are in and out of the market frequently would be best off using marked-to-market, says Robert Green, who runs Green Trader Tax, an accounting firm in Connecticut and New York City that specializes in tax advice for active traders.

SIMPLE STATE. To do so, you essentially pretend at yearend that you bought all the stocks in your existing portfolio at the beginning of January and sold them at the end of December. The difference between those two prices will count as your profit or loss.

Living in this financial fantasy world has several advantages for traders. They no longer have to hassle with all manner of tax rules, such as capital-gains guidelines, that depend on how long they've owned a stock. Also gone are the

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headaches of the "wash-sale" rule, which hampers your ability to claim losses on stocks if you repurchase your losers within 30 days -- an eternity for a day trader who specializes in a certain sector.

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Perhaps most important, marked-to-market accounting eliminates the $3,000 limit on trading losses that normal investors can apply against their income. Lost $1 million on a bad bet? You can deduct that dollar-for-dollar against your total income -- and even carry it back two years or forward.

GOTTA BE A PRO. The marked-to-market method has only two catches. First, you have to tell the IRS that you've elected this approach by the time you file your return (or extension) for the previous year. No fancy form -- just write the tax man a letter and attach it to your return.

"You used to be able to do it after the year. But now you must declare by Apr. 15, so you don't have the benefit of being a Monday-morning quarterback," says Ted Tesser, another trader-friendly accountant.

The second -- and much bigger -- catch is that you have to qualify as a professional trader, an IRS designation that allows you to claim expenses such as your home office or trading-class tuition (on the theory that you're running your own business). And if you're thinking of claiming such status for the first time, remember this: Don't take the leap if you're still lugging around huge capital losses from previous years and think you're going to strike it rich this year. That's because you can't claim past capital losses against current trading gains once you've switched to marked-to-market.

MOOD SWINGS. "Special Rules for Traders in Securities" in IRS Publication 550 includes no precise definition of a professional trader -- not even how many trades it takes to be one. Rather, it defines such a person simply as someone who engages in "substantial" trading activity with "continuity and regularity." If you have any doubt about whether than includes you, it's best to consult an accountant.

Indeed, the number of trades the IRS wants to see for a qualifying trader seems to rise and fall with the agency's moods, says accountant Green. The only type of trader who's probably in the clear, he adds, is someone who trades several times a day.

"It's not set in stone," adds Tesser, who offers a questionnaire on the subject. The firm will call or e-mail you back with results. He says his clients who averaged less than two trades a week have won trader status on an appeal of their audit.

"WHO THE IRS LIKES." Most traders would like to avoid that ordeal, of course. And Green says the IRS won't raise a huge fuss over taxpayers who trade irregularly or infrequently, as long as they make money doing it. Trading doesn't even have to be their primary source of income, Green says. "If you're making lots of money, you're a good customer," he laughs. "You're paying lots of taxes."

Conversely, however, the IRS hates losers. Even though the primary benefit of achieving trader status is that you can write off bigger losses, it's harder to hold onto that advantage when your losses are big.

By Carol Vinzant in New York

BACK TO TOP