ClearStation Education:
Mr. Tax Man

Version 2.0

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Mr. Tax Man

So you made a bundle in the market this year, huh? Have you thought about the tax consequences? They can make a BIG difference come April. Best to plan now. . .

Let marc, ClearStation's own tax man, teach you about the tax laws that affect traders and investors, which kind of IRA is best for you, and the basics of capital gains. He'll also help you understand the wash sale rule and the tax implications of incentive stock options.

In this section, you'll learn:

- Whether the IRS considers you a trader;
- What incentive stock options mean to your bottom line;
- The difference between traditional and Roth IRA's;
- How wash sales work;
- How best to prepare to meet with your tax expert.

Trader or Investor? by **marc**

The growth in day trading has had a profound impact in how certain individuals file their tax returns. Active traders, who engage in a great deal of short-term trading, may have a chance to qualify for a preferred filing status with the IRS. Most taxpayers fall into the default filing status of "investor" when they file their tax returns. However, if you spend your days buying and selling stocks like a hedge fund manager, you may want to consider filing your tax return as a "trader". Doing so could result in substantial savings at tax time, **but** you might also be exposed to increased audit risk.

So what are you, a trader or an investor? It's an important distinction, yet there's considerable ambiguity surrounding the trader status. In tax terminology a trader is someone who trades to catch short-term swings in the stock market (not long-term appreciation or dividends and interest), and does so in large enough volume, consistently over a long enough period of time. This "definition" does not do a good job in clarifying what a trader is, and it actually produces more questions; what constitutes "large enough volume" and "long enough period"?

Unfortunately, not even the IRS has established clear guidelines to answer those questions. All you have on which to base your decision are guidelines developed through court decisions dating back more than fifty years. As a matter of fact, it wasn't until the Taxpayers' Relief Act of 1997 that the IRS even addressed the issue of day trading.

Why doesn't the IRS specifically address the issue? I've read some interesting literature about the subject and the general consensus seems to be that it's not in the IRS's best interest to clarify the law. Doing so would facilitate taxpayers' efforts to reduce their taxes, which is counterproductive to the IRS's mission in life.

What are the Tax Benefits?

The IRS considers investing a hobby. It limits the losses you can take on a given year and the expenses you can deduct from the activity. As a side comment I think it's funny that it doesn't place any limits on how much of your investment earnings it can tax! No wonder we've a got budget surplus, but that's another topic.

Trading is considered a business, eligible for tax "write-off's" not available to investors and 100% deduction of legitimate business expenses, such as newsletter subscriptions, a home office, and computer equipment.

Trades are further entitled to elect a special method of accounting called "mark-to-market". This method wipes out the $3,000 capital loss limitation and eliminates the despicable "wash sale" rule. I'll go into more detail about mark-to-market further along this article. What are the Disadvantages?

I can just see the wheels turning in your Clearhead right now. You're probably thinking, "sounds like a cool deal, where do I sign up for this trader thing?" But before you start making plans to file as a trader, you'll need to consider the disadvantages. What disadvantages you may ask? How about is the increased risk of audit?

As we discussed earlier, there are no clear definitions or standards for determining whether or not you are a trader. If you take an aggressive stance and file as a trader and later the IRS decides that you are not, you may end up with a hefty tax liability, and penalties plus interest on top of it!

Another disadvantage is if you elect mark-to-market method of accounting, you have to pick up your trade earnings as ordinary income, not capital gain. You further have to report, at year-end, your earnings from all stocks, sold or **not**!

Another disadvantage, and this is a big one, is that there are a lot of tax professionals out there who are unfamiliar with trader status. Couple that with the amount if misinformation that's currently floating around (some of it from our friends at IRS) and there's a real potential for disaster. I'm not trying to dissuade anyone from pursuing what he or she are entitled to, but I am emphatic about encouraging you to exercise a great deal of caution in this area.

With that said, let's discuss how you would file for trader status.

Am I a Trader?

The courts say you are a trader if the following elements are met:

1. The trading has to be geared to take advantage of short-term market price swings. Traders are typically not concerned with the long-term prospects of the companies they trade. They don't care about a company's balance sheet or income statement, and generally disregard any sort of fundamental analysis. The holding period is critical because the courts have given it considerable weight to determine whether one is or is not a trader. If securities are held for months instead of days, the courts assume that the individual is an investor instead of a trader, looking to capitalize on long-term appreciation, or to produce a significant amount of dividend or investment income.

2. The trading is "substantial." The trading has to occur frequently and over a long enough period of time. What qualifies as "frequent"? The answer to this question is not readily available, but the Supreme Court has stated that the taxpayer must be "involved in the activity with continuity and regularity." The basic assumption that can be drawn is that a trader would be trading with a number of transactions each day. Of course, that leads to the question of how many daily trades must be executed to qualify as a trader? According to Kaye Thomas, a tax attorney who's an authority on the subject, the courts should "look at whether the activity was carried on the way someone would if they treated it as a serious business. If you have a good business reason for executing only a few trades, or none at all, for a period of time, then your absence from the market should not disqualify you from trader status." Makes sense to me.

3. You must trade for your own account and you must do the trading yourself. If you sell securities to customers, you're a dealer, not a trader.

4. Trading must be your primary business, not a hobby or something you do on your spare time. You must meet all of the above criteria to qualify as a trader, and even then there could be questions. Check out the details and if you're still not sure you meet the requirements, seek the advice of a knowledgeable professional.

Yeah, I'm a Trader...Now How do I File? Once you've done the homework, and concluded that you satisfy the requirements to file as a trader, you should prepare your return as follows:

1. Report your gains and losses on Schedule D. You will still be limited to $3,000 in net capital losses and will be subject to the wash sale rule, if you have not made the mark-to-market election (more on that later).

2. Report all your expenses from your trading business on Schedule C like any other sole proprietor. These include your books, seminars, reference materials, and margin account interest. You can also deduct expenses relative to your home office and probably take and immediate deduction of up to $19,000 for equipment and furniture used in your business (called a Section 179 Deduction).

3. Your Schedule C will reflect a net loss that gets carried to line 12 on Form 1040, and serves to reduce your ordinary income and gains from capital transactions.

4. It's important to note that although traders file a Schedule C for their trade or business, they are not subject to self-employment tax because capital gains are exempted. Pretty nice deal, huh?

All this makes for a funky-looking tax return. Schedule C will have expenses and no income, while your earnings from trading end up on the Schedule D. I can just imagine some IRS auditor in Fargo looking at a trader return and crying out "Golly, geez! What the heck do you mean?" Yet, this is the right way to do it.

Finally, Mark-to-Market!

If you qualify as a trader, the IRS allows you to make the mark-to-market election. Yes folks, this is an election, meaning you don't automatically get mark-to-market treatment when you become a trader.

The election must be made by the tax return filing deadline for the year before the year for which you want the election to be effective, excluding extensions. "Golly, geez! What the heck do you mean?" For example, if you want you election to be effective for the year 2000, you must elect by April 17, 2000.

So what does mark-to-market do for you? Well, under normal circumstances, when you sell a security at a loss, you can deduct that loss from your trading gains. But if you buy the same security within 30 days, before or after the sale, the IRS considers the transaction a "wash sale", and the loss deduction is disallowed.

By electing mark-to-market method of accounting, you will automatically become exempt from the wash sale rule. The way it works is on the last trading day of the year you treat any stocks you hold as if you sold them. Even though you still hold the stocks, you book the gains and losses as of that day for tax purposes. You then begin the new tax year with no unrealized gains or losses, and the basis for the stock is adjusted as if you had bought back all the shares you "sold". The logic here is: if all your gains and losses are going to disappear after year-end, then there's no reason for the IRS to be concerned about wash sales that may occur during the year.

Another advantage of mark-to-market method of accounting is your trading gains and losses are converted to ordinary income and loss. This change in character allows mark-to-market traders to deduct an unlimited amount of losses, which can be of great benefit in a loser year. You'd report your gains and losses on Schedule C, not Schedule D. But don't worry - this ordinary income and loss treatment does not apply for purposes of self-employment tax.

The one downside to mark-to-market election is that you will never have any long-term capital gains. But being a trader you should not have any, so this aspect of the election is of no significance. To quote an enlightened Clearhead trader, "an investment is a trade gone bad."

Identifying Your Holdings:

Before you make your mark-to-market election, you need to identify which of your holdings are investments. Failing to do so could be disastrous.

Imagine you're a mark-to-market trader and you own Microsoft stock that you've held since the late 80's. Can you see it coming...? If these stocks are considered to be a part of your trading business, you will have to mark them to market at the end of the year and pick up the gain as ordinary income. This is what I mean by disaster.

The mark-to-market rules permit you to identify such investment holdings and take them out of the picture to prevent something like the above scenario from happening to you. You make this identification when you make your mark-to-market election.

The Treasury Department has not yet finalized regulations that address the identification issue, but there exist proposed regulations. According to Kaye Thomas, here's what the proposed regulations say:

1. If you make the mark-to-market election, you must identify any securities held other than in connection with your trading business.

2. Your identification isn't effective unless you can demonstrate by clear and convincing evidence that the securities have no connection to your trading business.

   Side note: Point 2 is crucial! It effectively states that the IRS can disregard your identification if you haven't shown by "clear and convincing evidence" that the security has "no connection" to your business. I'll tell you how to minimize the chance of that happening a little further down.

3. If you hold an investment security and also trade the same security, or substantially similar securities, your identification isn't effective unless you hold the investment securities in a separate non-trading account maintained with a third party.

   Point 3 tells you how to avoid having your investments declared as part of your trading business. Establish separate accounts for investing and for trading and DON'T MIX THE TWO!

Mark-to-Market Election:

Once you've 1) determined that you are a trader and 2) identified your investment holdings, you are ready to make the mark-to-market election.

As discussed, the election has to be made by the unextended filing deadline for the previous year's return. You want to be a mark-to-market trader in 2000? Elect by April 17, 2000. That's the easy part.

The election must be attached to your tax return or extension. According to Kaye Thomas, your election statements should look like this:

John Q. Taxpayer
SSN 555-55-5555
Attachment to 1999 Form 1040 (or Form 4868 if you are extending)

I hereby elect to use the mark-to-market method of accounting under section 475(f) of the Internal Revenue Code for my trade or business or trading securities. The first year for which the election is effective is the taxable year beginning January 1, 2000.

____
John Q. Taxpayer

BIG NOTE: When you file your tax return for the effective year of your election (in our example that would be your 2000 tax return), you must attach Form 3115, Application for Change in Accounting Method. This is a lengthy, pain in the rear form that just reeks of bureaucratic red tape. But you have to file it. The good news is only the first three pages of the eight-page document apply to mark-to-market traders. Once you've filed Form 3115 you won't have to do it again, unless you decide to change accounting method later.

That's it. I hope this has been informative, because I know it sure as hell ain't fun. Happy trading y'all!

Incentive Stock Options by **marc**

So "Who Wants to be an ISO Millionaire?" I see Bill Gates, Steve Jobs, or Steve Case as potential game show hosts and the contestants are hotshot software engineers who get asked interview-type questions, with the winner receiving Incentive Stock Options worth millions when they become exercisable.

When you think about it, that's not so far off from how it works in the real world. As I've heard over and over, ISO's are the equivalent of a present day Gold Rush. "Forget salaries…I want my stock options!" is the new Silicon Valley battle cry. But do ISO's deserve all the hype they've been getting? Or are they in truth the "fool's gold" of the new millennium? Let's start by briefly discussing the ISO process and then we'll move on to tax ramifications.

More and more employers are giving their employees stock options as part of their compensation package. In simplest terms an option is the right to buy (or in more complex options, the right to sell) a certain number of shares of a company for a specific price by a specific date. The difference between the "strike price" ("exercise price" in tax terms) and the fair market value (FMV) of the stock is the "spread" ("bargain element" in tax terms). If the spread exceeds the cost of exercising the option, then the option is in the money.

I.E.: You pay $10 for the rights to purchase one share of stock at $25 a share for 24 months. If during the option period the FMV of the stock climbs above $35 a share, you are "in the money".

Stock options basically come in two varieties:

1. **Statutory options:** These are stock options that meet Internal Revenue provisions 421 through 424 and are also commonly referred to as incentive stock options, ISO's and qualified options.
2. **Nonstatutory options:** These are all other options.

Statutory options consist of:

1. Incentive Stock Options (ISO) and
2. Options granted under Employee Stock Purchase Plans

Incentive stock options are the most popular stock option plan. ISO's are granted in connection with employment and can have regular tax and alternative minimum tax (AMT) implications. We'll address AMT in more detail further along this article. The mere receipt of an ISO is not a taxable event; however, there are tax consequences that arise from the exercise and sale of ISO shares.

When you exercise your ISO, the difference between the FMV over the option price on the date of exercise (the spread) will increase alternative minimum taxable income (AMTI), which may trigger AMT. This is not a big deal if you don't owe AMT in the year of exercise, but if you do, your AMT bill will be higher. As a consolation, you may qualify for an AMT credit that can be used in subsequent years when your regular tax is higher than you AMT.

After exercise, the next taxable event occurs when the ISO shares are sold, and is based on (1) profit and (2) period of time the stock was owned prior to the sale. This is an area where good tax advice comes in handy. Here's why:

Profit (gain in tax terms) is the difference in sale price and the FMV on the date of exercise. How long you owned the stock (holding period) determines if your profit is subject to long-term capital gain (LTCG) or ordinary income tax. The new maximum LTCG rate is 20% as opposed to the maximum ordinary income tax rate of 39.6%. In essence, poor planning can potentially cost you twice as much in tax!

The favorable LTCG rate applies only if the stock is held for at least (1) two years after the option was granted and (2) one year after exercising the option. In addition, to qualify for LTCG rate on sale of stock,

the employee must be an employee of the Optionor at the time of the exercise, or have terminated employment not more than three months before exercise.

Example:
If you received ISO's on 12/31/99, you would have to wait until the following dates to receive LTCG treatment:

Date ISO received	Date of Exercise	Date of Stock Sale
	(on or before)	LTCG Treatment
		(on or after)
12/31/99	12/31/00	12/31/01

Employee stock purchase plans are written plans approved by shareholders that give employees the option to purchase stock of parent or subsidiary companies, usually using payroll deductions to pay for the shares. Purchase plan options are stock option plans primarily intended for rank and file employees (unlike incentive stock options, which are primarily intended for key employees).

To receive favorable (LTCG) tax treatment, the employee stock purchase plan must meet certain requirements.

1. The exercise price of the options granted under a stock purchase plan must be no less than 85% of the stock's fair market value at the time the option is granted.
2. Upon the sale of the stock, the gain is treated as LTCG if (1) the sale occurs not less than two years after the option was granted and (2) one year after exercising the option.
3. The option must be exercised within 27 months of receipt or 5 years if the option price is at least 85% of the stock FMV at the date of exercise.
4. No employee can acquire the right to buy more than $25,000 of stock per year at the time the option is granted.

How does exercise trigger AMT?

As I mentioned earlier, the ISO spread on the exercise date goes untaxed for regular income tax purposes but does get picked up for AMT purposes as a "positive adjustment." "Positive" for Uncle Sam but definitely not for the taxpayer! Here's an example:

You elected to exercise your option to buy 1000 shares of your company's stock at $100/share when the FMV of the stock was $150/share.

FMV of stock at exercise (1000 sh @ $150/sh)	**$150,000.00**
Less ISO price (1000 sh @ $100/sh)	**($100,000.00)**
AMT positive adjustment	**$50,000.00**

The AMT adjustment is reported on the "incentive stock options line" of IRS Form 6251.

I found a neat shorthand method to avoid the AMT if you plan to exercise. This is a calculation you have to do **before** you exercise. Let's consider the following scenario:

1. You calculated your regular income tax on Form 1040 to be $50,000.
2. Your separate AMT tentative tax calculated on Form 6251 is $40,000.
3. Subtract the difference

4. Divide the difference by the AMT rate of 26%. This calculation will tell you how much additional AMTI you can have before triggering AMT.
5. Divide this number by the spread per share from our previous example ($50,000/1000 shares = $50/share)
6. The result is the maximum number of shares you can exercise before triggering AMT.

Let's do the math:

Regular Tax (Form 1040)	$50,000
AMT (Form 6251)	$40,000
Difference	$10,000
Divide by AMT Rate (26%)	$38,462
Divide by Spread per share	$50
Maximum shares that may be exercised without AMT	769

Nonstatutory stock options, also known as non-qualified stock options (NQSO), do not meet the requirements of, and are not bound by, the rules of IRS Code Sections 421 through 424. I know I previously referenced these code sections, and you may have wondered "What do these sections say?"

In broadest and most basic terms, IRS Code Sections 421 through 424 make it so under very specific rules, the recipient of **statutory stock options** may:

1. Defer income recognition on the spread until sale of the stock.
2. Receive total capital gain treatment.

The recipient of an NQSO is not allowed that. Instead, the spread is taxable as compensation (ordinary income) in the year of exercise. However, if the FMV of the option is "readily ascertainable" when the option is granted, income will be recognized then. If the stock is expected to increase substantially in value, this could be advantageous to the employee.

Unsurprisingly, the IRS has strict guidelines relative to when an option has a "readily ascertainable" FMV. Here's a breakdown:

1. The option may be transferred freely.
2. The option is exercisable immediately in full.
3. There are no restrictions on the option or stock that impact FMV of either.
4. The value of the property subject to the option, the probability of an increase of decrease in value, and the length of the option period determines the FMV of the option.

But what if restrictions exist which prevent you from being able to readily ascertain the FMV of your option? The IRS does provide a relief mechanism for this situation, known as Code Section 83(b).

Code Section 83(b) allows you to elect immediate taxation on the option, instead of waiting until the restrictions have lapsed and/or you're fully vested.

This election may at first seem odd, since you'll have to pay ordinary income tax on the spread **BUT** an 83(b) ensures that any future appreciation is not compensation and begins the holding period for LTCG treatment when you sell the stock.

What's more, you then own the option and your basis included the exercise price **PLUS** the amount you picked up as income by virtue of the 83(b).

Consult your tax pro before accepting or exercising any stock options. Doing so may mean the difference between hitting pay dirt or just hitting the dirt.

IRAs: Traditional or Roth? by **marc**

In August of 1997, President Clinton signed into law the Taxpayer Relief Act. This wonderful piece of legislation provided many new benefits to taxpayers, including a new vehicle for retirement savings called the Roth IRA.

Named for its sponsor, Senator William Roth from Delaware, the Roth IRA offers relaxed rules for eligibility, contributions, and distributions. But the real attraction of the Roth is that your earnings grow tax-free! That's right folks, when it comes time to break into the Roth piggy bank your withdrawals, provided you complied with certain rules, will not be taxed.

Before getting into the details of the Roth IRA however, let's understand that all retirement accounts have a three-step cycle. (1) Treatment for contributions i.e. money going "in", (2) Treatment during the Growth/Accumulation Phase, (3) treatment for money going "out", i.e. distributions.

Contributions: Contributions to your traditional retirement plans, which includes 401(K)'s, personal IRA's, SEP's and Keogh's, are all tax deductible. That is, the contribution that you make into these accounts generates a tax deduction on your personal tax return.

In contrast, the Roth does not generate any tax deduction for your contribution.

Growth/Accumulation Phase: All retirement accounts are identical during the growth phase in that any income generated from the assets is not subject to income tax.

Distributions: Distributions from your traditional retirement plans are taxable to the recipient as ordinary income. Distributions out of a Roth are totally tax-free to the recipient! Let's repeat that. Any monies taken out of a traditional IRA, SEP, Keogh, 401(K) are taxed to the recipient as ordinary income versus your Roth distribution, where amounts taken out are totally exempt from income taxation.

Here are some of the specific rules regarding Roth IRA's.

You can contribute up to $2000 per year to a Roth IRA account. But, unlike its cousin the Traditional IRA (which we'll talk more about later), you get no tax deduction for your contribution.

Roth IRA Distributions: To take distributions from a Roth IRA totally tax-free, you must meet two basic requirements. First, you must be at least age 59 ½, and second, you must have held the money in the Roth account for at least five tax years (as opposed to dog years). If you meet these two requirements, then your distribution is termed a **"qualified distribution"** and it's totally tax-free.

But what if you have to break into your stash before you are 59 ½, or before you've had the account for at least five tax years? The IRS calls this a **"non-qualified distribution"** and has very specific rules regarding the tax treatment of these distributions.

Amounts withdrawn are first deemed to be distributions of your **principal** contributions. Because these were after-tax contributions, i.e. you did not get a tax deduction for them you are entitled to recover these contributions at any time on a tax and penalty-free basis.

After you've recovered your contributions, what remain must be earnings, and these earnings have never been taxed. On nonqualified distributions, these untaxed earnings will be subject to income tax but not to the premature distribution penalty of 10%, if the following exceptions apply:

1. Medical expenses that exceed 7.5% of your Adjusted Gross Income (AGI),
2. Health care insurance if you've been on unemployment for at least 12 weeks,

3. Substantially equal periodic payments,
4. Qualified higher education expenses (though I would advise that a $500 per child per year education IRA is a better option),
5. Distributions taken with the first five years for any of the following reasons:
    a. You reached age 59 ½,
    b. You died (don't ask me to explain),
    c. You became disabled,
    d. You are buying your first home.

Distributions taken from a Roth IRA for any reason other than those listed above are subject to income tax **and** the 10% IRS penalty on the earnings withdrawal. By the way, for those of you in California, there is an additional 2½% premature penalty tax that applies, making the total penalty on premature withdrawals 12½%.

Roth Contribution Requirements: There are two basic requirements: (1) you or your spouse must have earned income and (2) your Modified Adjusted Gross Income (MAGI) cannot exceed certain limits.

Single Filers	MAGI	Contribution Amount
	$95,000 or less	$2000
	$95,001 - $110,000	Partial contribution
	More than $110,000	No contribution
Married Filing Joint	MAGI	Contribution Amount
	$150,000 or less	$2000
	$150,001 - $160,000	Partial contribution
	More than $160,000	No contribution

Now let's talk about our old buddy the Traditional IRA. Biggest attractions:

1. You can deduct your contributions,
2. Your earnings grow tax deferred.

The money you deposit to your Traditional IRA will reduce your taxable income, provided you meet eligibility requirements. For example, if you have earnings of $30,000 and you contribute $2000 to your IRA, your taxable income gets reduced to $28,000. Easy, right?

The earnings from your tax-deductible contributions then grow **tax deferred** until you reach age 59 ½ and become eligible to take qualified distributions. At that time, any distributions you take will be taxed at your then-present tax rate. This is a good thing for individuals who expect to be in a lower income tax bracket when they retire.

What if you need your Traditional IRA money before you're 59 ½? Can you withdraw funds without being taxed and/or penalized? You can't avoid the tax, but you can avoid the 10% IRS premature distribution penalty under the following conditions:

1. You become disabled,
2. The distributions are for medical expenses that exceed 7 ½% of your AGI,
3. The distributions are part of substantially equal periodic payments,
4. For health care insurance if you've been on unemployment for at least 12 weeks,
5. For qualified higher education expenses (you know my advice on that),
6. For first-time home purchase.

You will be taxed at your ordinary income tax rate on these distributions.

How do you qualify for a Traditional IRA? If you are under the age of 70 ½ and have earned income, you qualify.

How do you get a tax deduction for your contribution? That depends on whether or not you actively participate in an employer-sponsored retirement plan. If you're single, or married for that matter, and neither you nor your spouse is an active participant, you are each eligible for a full $2000 deduction, no matter how much income you earned during the year.

If either one of you is an active participant, the deduction will depend on you MAGI and filing status.

Single Filers	MAGI	Contribution Amount
	Less than $32,000	$2000
	$32,000 - $41,999	Partial contribution
	More than $42,000	No contribution
Married Filing Joint	MAGI	Contribution Amount
	Less than $52,000	$2000
	$52,000 - $61,999	Partial contribution
	More than $62,000	No contribution

For those who are covered by a retirement plan at work, and whose income exceeds these limits, a contribution to a traditional IRA would not be tax-deductible.

Which IRA is better? The answer to this question depends on many factors, such as:

1. Your current rate of taxation,
2. Your anticipated future rate of taxation,
3. Your estimated rate of return on investment assets while in the growth phase,
4. The number of years before retirement,
5. Alternative uses of your money-what would you do with the money you've saved because of the tax deduction of the traditional IRA? Would you invest it or would you spend it?

Below is a discussion of these factors.

1. **Retirement tax bracket:** The advantage of the Traditional IRA is that it offers the opportunity to claim a deduction when you are in a high tax bracket, and take a withdrawal as ordinary income when you are in a low tax bracket. The Roth does not provide this benefit because your contributions were never tax deductible.

   Also, if you expect to be in the same or higher tax bracket by retirement age, the Roth is more likely the better bet because of its tax-free growth character.

2. **Non-deductible Traditional IRA:** Not all contributions to a traditional IRA are tax deductible. If your contribution does not qualify as tax-deductible, the Roth is definitely the better way to go. Why pay tax on your earnings from a nondeductible IRA when you can withdraw **tax-free** earnings and principal from your Roth when you reach 59 ½?

3. **Nature of your assets/Estimated Rate of Return on Investment Assets** If you'll be investing in assets with a high potential for appreciation, then the Roth makes sense. All that appreciation will be distributed out tax-free to you.

4. **Years to Retirement:** A rough rule of thumb suggests that if you are more than 20 years away from retirement, and can afford to forego the tax deduction from a deductible IRA, then take the Roth IRA approach. The virtue of tax-free savings will more than make up for the current tax hit.

Converting Your Traditional IRA to a Roth IRA

Assets in a traditional IRA can be converted into a Roth IRA. There is a tax cost though-you must pick up as ordinary income the fair market value of your traditional IRA at the date of conversion. No premature distribution penalty applies however. The tax on Roth conversions must be paid in full in the year of conversion.

As always, discuss your financial and tax situation with your tax pro and good luck.

Capital Gain Basics by **marc**

The proliferation of online brokerages, up-to-the-minute stock quotes from broadcast and cable television programs and business radio and interactive websites has resulted in unprecedented number of Americans taking control of their financial destinies by becoming active investors.

Information that not long ago was available only to your broker and institutional investors is now at your fingertips via websites like ClearStation.com. You can get comprehensive market information, from background reports on publicly traded stocks to economic analyses and vital market statistics. By the way, you can also get all that and some much-needed humor when you listen to the ClearStation *Big Biz Radio Show* at www.ksdo.com, nightly at 5pm PST.

All this trading activity is, hopefully, resulting in lots of profits for investors. That's a good thing. However, it's also resulting in investors having to spend more time worrying about taxes, record keeping, and capital gains issues. That's not such a good thing, unless you're organized and know how to do it. The information in this article will hopefully help you in this task.

The IRS considers the buy and subsequent sale of a stock to be a completed transaction. You've bought a stock and you've sold it, and the difference between your proceeds and your cost basis is reportable as gain or loss on your Form 1040, Schedule D (Capital Gains and Losses).

Huh? Please explain some of those words for me!

The easiest way to clarify some of this new terminology is to take a look at the Schedule D, where you will actually report your stock sales. A copy of Schedule D is included, as part of this article for your reference, and the following examples will be coded to that Schedule D.

Example 1: Sale of Stock

You've bought 100 shares of Microsoft Corporation, symbol MSFT, for $85 per share on April 12, 1999, and paid a commission on the purchase of $10. Your cost basis for this transaction is $85 X 100 or $8,500 plus the commission for a total cost of $8,510. You sold this stock on December 21, 1999, for total proceeds after paying commission of $9,510.

From a tax viewpoint, your proceeds of $9,510 less your cost basis of $8,510 have created a capital gain of $1,000. Because you owned the stock for less than one year, this is considered a short-term capital gain. A holding period of more than one year would have converted this into a long-term capital gain.

By the way, who cares if the gain is long-term or short-term? You should! Short-term capital gains are taxed at ordinary income rates, which can go as high as 39.6%, while long-term capital gain rates are either 10% or 20%, depending on what is your tax rate for ordinary income. If your tax rate is 15%, the lowest tax bracket by the way, then your long term capital gains will be taxed at 10%; if the tax rate on your ordinary income is taxed at 28% or higher, then your long term capital gains will be taxed at a maximum rate of 20%.

This 20% ceiling rate of taxation on long-term capital gains versus the 39.6% rate of tax on ordinary income is the reason that long-term capital gains are considered to have "preferential tax treatment". Remember short-term capital gains are considered to be ordinary income and are taxed at that potentially much higher rate.

Your cost basis in this example is your cost of the stock plus the commission that you paid. It's your net investment in the stock. The difference between your cost basis and your proceeds determines the amount of your capital gain.

Example 2: Stock Splits

Because you're so smart, this time we're going to assume that you bought Microsoft Corporation just before a (hypothetical) stock split in May of 1999. Just as before, you've bought 100 shares of Microsoft on April 12, 1999, and paid $85 per share plus commission for a total cost of $8,510. After the stock split, you own 200 shares of Microsoft.

Are you better off now that you own 200 shares of Microsoft, while before you only owned 100 shares? To answer this question, let's think of a pie as an example. Yes, hot delicious strawberry rhubarb pie. Your dad cuts it into four slices. He gives you a slice, and so you have ¼ of the pie to eat. If you take your piece of pie and cut it into two portions, do you have more pie?

Hopefully, you realized the answer is NO! Stock splits do not increase the value of your investment. After a stock split, generally the price of the stock falls proportionate to the increase in the number of shares. So in our example, if the stock was selling at $88 per share just before the split, then after the stock split generally the price of the stock will decrease to $88/2 or approximately $44/share. Of course $88 X 100 shares is exactly equal to $44 X 200, which means that the value of your investment does not change because of the stock split!

Now if you sold 100 of your post-split Microsoft shares for $46/share, you'd have proceeds totaling $4,600. What would be your basis, and what would be your gain?

Your total investment in Microsoft was originally $8,510. After the split, your total cost basis must now be spread over 200 shares. Your cost basis per share is halved, from $8510/100 or $85.10 per share to $8510/200 or $42.55 per share. So the cost of the 100 shares is 100 X $42.55 or $4255, and your gain is the difference between your total proceeds of $4,600 and your cost of $4,255 for a capital gain of $345.

Example 3: Reinvested Dividends Constitute Basis

Your mother bought 100 shares of Schering Plough back in 1985 for a (hypothetical) cost of $50/share, and a total cost of $5,000. Schering Plough has been paying dividends all these years to its shareholders, and your mother has chosen not to receive the dividends as cash, but instead to reinvest those dividends and buy additional shares of Schering Plough stock.

Do you realize that reinvesting dividends is actually the equivalent of receiving cash dividends and then choosing to take that cash and buy additional shares of stock? You are increasing your net investment in your company by buying that additional stock. If you don't keep track of "reinvested dividends" you'll be understating your cost basis when you sell, and consequently, overstating your taxable capital gain!

Companies often offer dividend reinvestment. The positive side of dividend reinvestment is that it allows investors the option of purchasing additional shares of stock without paying commissions. It's a great way for people with limited funds to acquire small amounts of stock over time. On the down side, as so very often happens, nobody keeps track of the dividends reinvested into additional shares of stock, and the consequence is that the capital gain on sale is overstated!

For example, your mother sells in 1999 her 125 shares of Schering. You are her tax accountant, and you see that she purchased the 100 shares back in 1985. You ask her where did the extra 25 shares of Schering Plough come from, and what did she pay for them? Do you think that someone has been tracking fourteen years of reinvested dividends? If not, you are overstating your capital gain and paying too much tax!!!

Record-Keeping

In this day and age, it's almost inexcusable not to keep track of your capital transactions, including date of purchase, date of sale, sales proceeds, cost basis, and net gain or loss. You can keep track with a spreadsheet like Excel, or you can use various Internet Web Sites and input your portfolio's data.

A personal note. I'm a tax accountant, and have seen day traders who've sold hundreds of thousands of dollars of stocks during the year and yet have no idea what their net gain was. There have been situations where the trader has thought he'd lost hundreds of thousands, and yet had made big profits. Without tracking your portfolio, how can you know how you're doing?

We know the IRS demands an accounting for your stock sales, so to trade without adequate record keeping is like the ostrich burying his head in the sand. It won't make the IRS go away not to keep records!

Wash Sales by marc

So you've got this stock that's been a lame duck for a while, but for whatever reason you don't want to get rid of it. You feel like you should get some sort of tax benefit from the "loss" you've incurred, but you know the tax law won't allow that loss until you sell the stock. What do you do?

Some crafty Clearhead would probably come up with a scheme to sell the stock and claim the loss, and immediately buy it back. Pretty clever idea, right? Ah boys and girls, if only things were that simple. In its never-ending efforts to keep crafty taxpayers from outsmarting the system, our friend the IRS has crafted a rule to disallow losses resulting from such trades; this is known as the wash sale rule.

Under Internal Revenue Code 1091, a loss due to the sale or disposition of stock or securities is not deductible if, within a period beginning 30 days before the date of the sale and ending 30 days after the date of the sale, the taxpayer acquires substantially identical stock or securities. Say what? In English, please!

Say you bought 1000 shares of ABC stock in 1995 for $10 per share. January 15, 2000 the stock is trading at $5 per share and you know it's bottomed out. In addition, you've realized some gains during the year and want to offset these gains with some trade losses. So you sell all 1000 shares and realize a $5000 loss.

Under normal circumstances you'd be able to offset your trade gains with the $5000 loss and if any capital loss is left over, that loss can be applied against $3,000 of ordinary income, with any remaining capital loss being carried to future years. But this scenario has a twist.

As previously stated, you knew the stock had bottomed out, so there was nowhere to go but up. So you bought back 1000 shares of ABC stock the very next day, for $5 per share.

The IRS will not recognize the loss on this sale. You had 1000 shares and now you still have 1000 shares. You are in the **same place** as far as the IRS is concerned.

Also notice that these new shares are "substantially identical" to your original shares, i.e. it's the same stock in the same company.

So the IRS won't allow the loss, at least not until you sell those "replacement" shares.

The wash sale period for any trade that results in a loss is 61 days; 30 days before the sale, the day of the sale, and 30 days after the sale. So if you want your loss to stick, as far as the IRS is concerned, you need to avoid buying the same stock during the restricted wash sale period.

The wash sale rules apply only to trades that result in a loss. Trade gains resulting from wash sales are taxable in the year of the sale. As the Church Lady would say, "Isn't that conveeeee-nient!"

You may be asking yourself, "so does a wash sale disqualify the loss from ever being utilized?" The answer is, maybe and maybe not. Let's consider the consequences of a wash sale:

1. When a wash sale occurs, you are disqualified from taking a current year's tax loss on the sale of stock.
2. Your disallowed loss is added to the basis of the new stock.
3. The holding period of the original stock sold at a loss is added to the holding period of the new stock.

We've already discussed the first point. Let's talk about the other two points.

Basis Adjustment:

As previously stated, the disallowed wash sale loss is added to the cost basis of the new stock. So the new stock has, in effect, a "built-in" loss equal to the previously disallowed wash sale loss. This is how the wash sale loss can be recaptured. Let's take our previous example:

You buy 1,000 shares of ABC stock at $10/share. You sell the 1,000 shares at $5/share, resulting in a $5,000 loss. You then repurchase 1,000 shares, paying $6/share. This is a wash sale, and the $5,000 loss is disallowed. This disallowed $5000 loss is added to the $6,000 cost of the newly acquired stock, giving it a "step up" in basis from $6,000, its purchase price, to $11,000.

This basis adjustment makes the wash sale a bit more palatable. If you decide to sell the securities later in the year, the wash sale may have no tax consequence to you.

Let's expand on our previous example:

1. 1995 bought 1000 shares of ABC stock at $10.
2. January 15, 2000 sold 1000 share of ABC stock at $5.
3. January 16, 2000 bought 1000 shares of ABC stock at $6, causing a wash sale loss on 1/15/2000 of $5,000

Now lets say that on January 20, 2000 you sold the 1000 shares of ABC at $7 per share. The gain would ordinarily be $1000, ($7,000 selling price-$6,000 purchase price) but because of wash sales rules, you have to add the $5000 disallowed wash sale loss into the basis of the replacement stock. Consequently you have a $4,000 loss ($7,000 selling price-$6000 purchase price-$5000 disallowed wash sales loss).

Then, on January 25, 2000 you decide to buy back 1000 shares of ABC stock. The sale on January 20, 2000 is considered a wash sale. The lesson here is, wash sales can create subsequent wash sales.

Holding Period:

The holding period of the original securities sold at a loss in a wash sale is added to the holding period of the new securities.

So whether the sale of the replacement securities is long-term or short-term requires that you look back to the date of the original stock buy that was subject to wash sale rule. If that security was bought longer than 1 year ago, then the sale of the replacement securities is a long-term capital gain.

Can I Beat the Wash-Sale Rule?

What can you do to avoid the 30-day wash sale rule?

1. Don't buy replacement stock during the restricted wash sale period. **61 days** - 30 days before the sale, the actual day of sale, and 30 days after the sale.
2. If you're convinced the stock has bottomed out, buy replacement stock 31 days before selling it. If the stock goes up during this period your gains are doubled, and if it's value stays unchanged you can sell the older stock and claim your tax loss deduction. Just hope the value doesn't go further south-ouch!
3. If your stock moves identically to some other stock, you may be able to "have your cake and eat it too" by selling your losing shares and buying "replacement" stock in another company. Stock of one issuing company is not "substantially identical" to stock of another issuing company, even if they're in the same industry.

For further details regarding wash sale rules, read IRS Publication 550 "Investment Income and Expenses", or check out the IRS website at www.irs.ustres.gov. And, as always, consult with your tax expert.

Meeting with your Tax Expert by marc

You've survived the holidays, New Year's eve, and even the Y2K Apocalypse. You're bravely advancing full tilt into the 21st century, anxiously anticipating all the wondrous adventures that await you.

Not so fast, Racer X! Before you conquer the world and make the streets safe for all mankind, you must first overcome a momentous hurdle. By April 15th you must be prepared to report and pay your prior year's income taxes to your ol' Uncle Sam.

On August 5, 1997 President Clinton signed into law the 1997 Taxpayer Relief Act, which introduced new rules that affected virtually every 1998 filer. Individuals who prided themselves on their ability to prepare and file their own tax returns, unexpectedly found themselves searching the Yellow Pages and asking their Uncle Charlie to recommend a good tax professional.

Those who already had a tax professional who prepared their returns found that bringing a shoe box full of unopened envelopes marked "Important Tax Documents" would no longer suffice. It was time for individuals to get down in the proverbial tax trenches with their tax pros, and team up to maximize their tax savings.

By following the steps below, you will help ensure that your pro prepares your returns accurately and gets you the tax savings your deserve. In addition, by being prepared, you'll lower your tax preparation bill because your pro will have everything needed to prepare your returns.

So let's get started with what you need to provide to your tax pro:

1. **Organized, comprehensive documentation**. Most tax pros will send their clients a tax organizer sometime in mid to late January. The organizer is used differently by individuals. Some go through and fill out each applicable page of the rather extensive booklet while others use it to line the bottom of their parakeet's cage.

   As a prepared filer, you should carefully review the tax organizer. It will help jar your memory about treatments from previous years and it will also inform you of new tax developments that may apply to you.

   It doesn't hurt to review your prior year's return to see what deductions were taken and see if you're still eligible to take them. If you're not sure, write your questions down and ask your pro when you meet.

   You should review and organize all the third party tax documents you've received, such as W-2s, 1099s, 1098s, etc. If you find errors, contact the issuing party and request that they correct it right away. In case you're not aware, that information is reported to the government in addition to you. It would really suck if Uncle Sam was under the mistaken impression that you had an extra $90,000 in earnings because someone included an extra zero on your 1099. Don't laugh, I've seen it happen.

   Next, organize and compile your deductible expenses. This does not mean putting all your freakin' receipts in a shoebox and handing them to your pro. Give the guy / gal a break! The best way to do it is to group together your receipts and backups by tax schedule (A, C, E, etc.). Then, on an Excel spreadsheet (or on paper with pencil for those of you who think the US Post Office is the only true way to send a letter to a friend) total up the receipts (by expense category) under the heading for their respective tax schedules. For example:

Schedule A

medical expenses	$4,000
Mortgage interest	$15,000
state & local taxes	$6,000
Charitable donations	$250
Casualty & theft losses	$1,000
Miscellaneous expenses	$1,200

The above schedule is very general, but you get the picture. Incidentally, if you go through the tax organizer carefully, you'll find the requisite "Q&A" boxes where you can input your summarized totals.

For self-employed individuals who file a Schedule C, I recommend using an accounting software package such as Quicken or Quickbooks to track your income and expenses. I will address this issue in more detail on a future column.

2. **Update of 1999 events**. Were you married, divorced, or separated during the year? Was there a birth or death in the family? Did you provide support to an elderly parent? Did you pay any individual for domestic services during the year (i.e. a nanny)? Did your rotten, ungrateful kid drop out of college?

   You may or may not be aware but in addition to the various financial transactions that occurred in the previous year, there are personal events that may impact your taxes. With that in mind, you should be prepared to disclose all your life-changing events that occurred in 1999, even if you're unsure whether or not there's a tax consequence.

3. **Ask good questions**. You should have enough knowledge of current tax events to be able to ask effective questions when you meet with your tax pro. I'm not suggesting that you undertake learning the tax code or sign up for the H&R Block tax course. I am proposing, however, that you take some time and familiarize yourself with major recent changes in the tax code to see if any will impact you. In doing this, you will also impress on your tax pro that you're an informed client and he or she needs to pay close attention when preparing your return (read on to learn what you should expect from your tax pro).

   Now you may ask, "Where and how am I going to familiarize myself with tax news?" Good question! With the advent of the Internet, anyone with a computer and a modem can now access information that at one time was available only to tax professionals or government representatives, if it was available at all.

   There are excellent sites where you can obtain latest tax news and information, forms, even tax advice from professionals, **all for free**. The following are a few of the ones that are out there:

   - www.irs.gov - The IRS has a winner with this site! You can get the latest federal tax news, download tax forms, get information for businesses and individuals, order products, and more. Very user-friendly and understandable.
   - www.taxsites.com/state.html - This is a pretty cool site that offers links to state tax agencies for all 50 states, state tax law resources, news, federal and state-level tax organizations, and a zillion other directories. **Tons of information!**
   - www.taxresources.com - A comprehensive site that offers links to federal and state tax agencies, forms and publications, newsgroups, professional tax articles, software, and a whole lot more! If you want it, it's here!

You can also find a wealth of links by running a browser search for keywords "tax sites".

For those who prefer getting their information from books instead of the Internet, Taxes for Dummies®, 2000 Edition, is the latest release in the series of books that offer answers on various personal income tax topics in plain English and with much needed doses of humor.

Whatever method or source you select to use, the bottom line is that it is very much in your interest to get acquainted with current personal income tax rules so you and your tax pro can team up to prepare your winning return.

Now that you know what you need to provide to your tax pro, what should you expect in return (no pun intended)? Here's a list of criteria on which you should not compromise:

1. **Competence**. Your tax pro should be knowledgeable of the tax code and have up to date reference resources. He or she should be aware of changes in the tax laws that may impact you and be able to clearly explain them to you (this is where your familiarity with tax rules pays off). Don't be afraid to ask questions such as what type of continuing education he or she has taken recently and make sure your pro is using current high-end software for tax preparation (i.e. Intuit Pro Series or Lacerte) and tax research (i.e. Kleinrock or PPC).

2. Reasonable **Fees**. Most tax professionals will prepare an engagement letter for you to sign, detailing the work to be performed for you, who will specifically be performing the work, and the cost of the services. If your pro does not provide you with an engagement letter, insist on getting a quote of how much it will cost to prepare your returns. He or she should be experienced enough to give you a fairly accurate estimate. If the final bill far exceeds the original quote, your pro should provide you with a detailed schedule of charges.

3. **Support**. This is a broad, yet crucial, criterion. It encompasses various requirements that must be met in order for there to be a positive and effective relationship between you and your pro:

a. Your questions and concerns must be responded to promptly and accurately.
b. Your work must be completed within a reasonable time so as to assure that you are able to timely comply with all filing requirements.
c. You should be advised of any estimated payments that must be made during the year, and you should be encouraged to participate in year-end tax and financial planning.
d. Your pro should work with you to find ways for you to keep more of your earnings and pay less in taxes.
e. Your pro should never support or advise you to commit tax fraud.
f. Your pro should be available to support you if your return is selected for audit.
g. If your pro commits return errors that result in you being penalized, he or she should be willing to pay the penalties and related interest charges.

How do I find such a competent tax preparer? One good method is word of mouth reference by satisfied colleagues. There is nothing as good as a personal recommendation from a satisfied customer to turn you onto someone competent.

By observing the above suggestions, you'll greatly increase your chances of filing an accurate return this April 15th. You'll also increase your chances of keeping more of your income and paying less in taxes. Like my grandmother used to say, "a stitch in time, saves nine." I don't know how this relates to what we're discussing but it sounds kinda cool.

Tax Glossary

Adjusted Gross Income
Adjusted gross income equals gross income less reductions that are allowable irrespective of personal deductions or exemptions.

Alternative Minimum Tax
IRS mechanism created to ensure that high-income individuals pay at least some minimum amount of tax regardless of deductions, credits, or exemptions. It operates by adding certain tax-preference items back into Adjusted Gross Income (AGI). The alternative minimum tax is computed on Form 6251.

Bargain element
The difference between the strike price and the FMV of the stock; also referred to as the "spread".

Basis
Tax term meaning purchase price, including adjustments, used to determine capital gain or loss for tax purposes.

Basis of Stock
If purchased, the amount paid for the stock. If the stock is received as a gift, basis is generally the basis of the previous owner or the fair market value when received. The basis of inherited stock is usually its fair market value on the date of the decedent's death.

Capital Gain Tax
Tax assessed on profits realized from the sale of a capital asset, such as stock. This rate is more attractive than ordinary income tax rates.

Credit
Reductions of tax liability for various purposes to taxpayers who meet the qualifications. Some credits are refundable and the IRS will send the taxpayer a check for any amount that exceeds the tax liability. Most credits are not refundable, but some credits may be carried to other tax years.

Deduction
Amount that may be subtracted from taxable income. See also definitions for "credit" and "exemption".

Education IRA
Savings plan under which the taxpayer may contribute up to $500 per year per eligible beneficiary. Contributions are nondeductible. Earnings are tax free and withdrawals are also tax free if used to pay for qualified higher education expenses.

Exemption
An amount ($2,750 for 1999) allowed by law as a reduction of income that would otherwise be taxed. There are two kinds of exemptions: personal and dependency.

Fair Market Value (FMV)
The amount at which property would change hands between a willing buyer and a willing seller, neither being obliged to buy or sell and both having reasonable knowledge of the relevant facts.

Gain
The excess of the amount realized from a sale or exchange over the adjusted basis of the property sold or exchanged.

Holding Period
The length of time a capital asset is owned by an individual. Assets owned 12 months or less are held short term; those owned more than 12 months are held long term.

Incentive Stock Option
Option that has satisfied the qualification requirements under IRC Section 422(b); also referred to as ISO.

Nonstatutory Stock Option
Any option that does not fall within the definition of a qualified stock option; also referred to as NQSO.

Option Price
Tax term meaning the same thing as "strike" price; also referred to as "exercise" price.

Ordinary Income
Income that is fully includable in gross income and that does not have the characteristics of capital gain.

Realized Gain or Loss
The difference between the amount received upon the sale or other disposition of property and the adjusted basis of the property. See also definition for "recognized gain or loss".

Recognized Gain or Loss
Taxable portion of realized gain or loss.

Statutory Stock Option
Stock options that meet Internal Revenue provisions 421 through 424; also referred to as incentive stock options, ISO's and qualified options.

Stock Dividend
Additional shares of stock distributed to shareholders as a percentage of the shares owned.

Stock Option
The right to buy a fixed number of shares fo stock for a set price during a specific period of time.

Stock Split
Additional shares of stock distributed to shareholders based on the ratio of shares owned. The basis of the original shares is generally apportioned equally to the total shares owned after the split.

Taxable Income
Adjusted gross income, less personal deductions, less personal and dependent exemptions.

Vested
Having the rights of ownership even if your employment terminates.