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Traders Accounting Advice

Tax Pro Tells You How to Claim and Defend Your 'Trader Status'

By Jim Forrester, CPA

Just because you call yourself a securities trader doesn't make you one in the eyes of the Internal Revenue Service. In fact, Uncle Sam is predisposed to consider you merely an investor, and thus deny you more favorable tax status—unless you meet a number of tests that are frustratingly open to interpretation.

That's right. The tax code contains no actual definition of trader status. Instead, the IRS has issued guidelines that the courts have further delineated by case law, most of which denied taxpayer appeals. What we're left with is a blurred image, like a photograph of a trader taken from a speeding car.

According to the IRS, to qualify as a trader:

- You must seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation
- Your activity must be substantial
- You must carry on the activity with continuity and regularity

To help determine if you meet these three tests, the IRS considers these qualifiers:

- Typical holding periods for securities bought and sold
- Frequency and dollar amount of trades during the year *(continue on page 2)*



Jim Forrester, CPA, is the tax director of Traders Accounting, the nation's leading provider of tax consulting, entity formation, tax preparation, and 401(k) services to the trading industry.

Traders Accounting teaches traders how to properly set up their trading business and take advantage of all the money-saving tax strategies available to home-based businesses. Jim Crimmins, president of Traders Accounting, will speak at AIQ's Fall Seminar October 17 to 19.

For more information on tax issues for active traders, please visit www.aiqsystems.com and look at the link in the third column.

- Extent to which you pursue trading to produce income for a livelihood
- Amount of time you devote to the activity

Swoosh, right? What is “substantial” activity? “Continuity and regularity?” And what’s an acceptable holding period? Is a week too long? A month?

“Investors are subject to the 2% threshold for deductible investment expenses...and are limited to a \$3,000 capital loss deduction. But as a trader, you write off 100% of your expenses, and if you elect the mark to market accounting option, can offset all of your losses against income.”

We know who investors are. They’re our hardworking neighbors who buy securities and hold them for such long-term goals as a college fund or retirement.

Traders, on the other hand, buy and sell securities solely to take advantage of short-term market changes. Your profits come from price swings, not dividends and interests. Since your holding period is brief, often a day at most (hence

the term “day trader”), there’s no need to perform due diligence on the companies you trade.

Who cares how the IRS classifies you? You do! Investors are subject to the 2% threshold for deductible investment expenses (and hence cannot write off most of their expenses) and are limited to a \$3,000 capital loss deduction. But as a trader, you write off 100% of your expenses, and if you elect the mark to market accounting option, can offset all of your losses against income.

Here’s how to claim and protect your trader status:

Step one: Prove beyond doubt that you are a bona fide trader; that is, you “seek to profit from daily market movements.” The best way to accomplish this is by showing a pattern of high trading volume and short holding periods. Keep your personal investments well separated from your trading business. The IRS is looking for “earnest intent”—that is, you work diligently to manage transactions, conduct strategy sessions, and make frequent trades.

Step two: Clear the “substantial activity” hurdle. The hallmarks the feds are looking for here are “frequent, regular, and continuous” trading. That means volume. One court case ruled that 75 trades a year was insufficient to warrant trader status. The feds need to know that you approach this as a business, not a hobby. Fail to convince them of that and you’re back in investor-land.

Step three: Trade with “continuity and regularity.” If you want business status, it only stands to reason that you must actually be in and remain in business. Here’s where the IRS is looking for a healthy flow of trades, significant dollar amounts, short holding periods, all the signs that you are at least attempting to make a living as a trader. If you take the summer off or show other gaps in your trading, the IRS will be disinclined to grant you trader status. If you’re a “newbie” and flame out after nine months, while it seems unfair, the IRS has made it clear—no trader status for you.

Once you obtain trader status, you’re not entirely in the clear. Owing to the capricious nature of appellate rulings and the ever-evolving tax code, there are no guarantees that the trader status you enjoy today might not be gone tomorrow.

“One court case ruled that 75 trades a year was insufficient to warrant trader status. The feds need to know that you approach this as a business, not a hobby. Fail to convince them of that and you’re back in investor-land.”

One good way to claim and protect your trader status is to trade under the umbrella of a business. Not only is that where the biggest tax advantages reside, but a legal entity such as a C corporation or Limited Liability Company sends a strong message to the IRS that yours is an earnest and legitimate business enterprise worthy of trader tax status. We’ll have more on this in an upcoming issue.

For more detailed information on Traders Accounting, please visit www.aigsystems.com and look at the link in the third column.

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Testing Expert Design Studio Rules

Create Valuable Short-Selling Strategies By Combining Least Effective EDS Rules

By David Vomund

As noted in previous articles about AIQ's Expert Design Studio (EDS) rules, TradingExpert is delivered with over 200 pre-built EDS rules. Most of the pre-built rules are based on the action of a specific indicator. For each indicator, several rules were created to represent most of the indicator's technically significant actions. Trading systems can be created by simply copying and pasting these individual rules.

Recently, we performed the time-consuming task of testing all the pre-built rules. In last month's *Opening Bell*, we identified the most effective of the 200 rules using a 22-day holding period. New Expert Design Studio models can be created by combining some of these most effective rules.

“An important finding in this study is the third rule, the Dark Cloud Candlestick pattern...there were 1202 trades. That increases its reliability....”

This month, we will reveal which rules are the least effective. Why care about the least effective rules? Because the worst performing rules on the Long side can be used effectively for short selling. By combining some of these least effective rules, valuable short-selling strategies can be created.

Our tests were run on a database of the S&P 1500 stocks. The tests were run from 1999 through 2004. A fixed holding period of 22 business

days (approximately one month) was used. This is a longer time period than what most of the pre-built rules were designed for. For that reason, many of the trading results were very similar and represent simple market activity. For example, a Stochastic buy signal may be significant for a few days after the buy but it is insignificant for the next month. The rules that performed the best were ones that were designed for longer time periods.

Table 1 (next page) shows the 25 least effective rules, sorted by their annual return on investment (ROI). To help identify the pre-built rules listed, we indicate which folders they reside in and what the rule names are. The first column of the table displays the name of the folder (or folders) followed by the file name. The second column shows the file name. The third column shows the rule that was tested. Finally the ROI and number of trades are shown.

To find a pre-built rule, open Expert Design Studio (EDS) and select *File, Open*, and double-click the *EDS Strategies* folder. This accesses the folder list found in Table 1. Double-click the appropriate folder name and then highlight and open the file name. With the file open, the rule will be displayed in the *Rule Library* page of the EDS window.

The average ROI on all the models that were tested was 21%.

Consider that figure to be the return on the market. Results below that figure underperformed the market.

Please use the ROI as a reference for the effectiveness of the strategy instead of the return that you would actually have seen. The ROI on an EDS backtest does not show the return the model would have made. AIQ's Portfolio Simulator is needed for that task.

“The single worst performing rule (i.e. the best short-selling rule) used a Candlestick charting pattern called Meeting Lines...Unfortunately, this rule only provided 25 trades.”

The single worst performing rule (i.e. the best short-selling rule) used a Candlestick charting pattern called Meeting Lines. Meeting Lines are formed when opposite colored Candlesticks have the same closing price. Unfortunately, this rule only provided 25 trades. It will be worth loosening the criteria for the rule in order to increase the number of trades.

For example, part of the rule states that the value of yesterday's close minus the value of yesterday's open is greater than \$2. By changing the rule to use percentage figures instead of dollar figures, there would be more trades.

An important finding in this study is the third rule, the Dark Cloud Candlestick pattern. That's because there were 1202 trades. That increases its reliability and with so many trades it can be combined with other ineffective rules to create a short-selling model.

(continued on page 5)

Table 1 - Lowest ROI Trades

The following lists the results of testing the pre-built EDS rules using an S&P 1500 database. A fixed 22-business-day holding period was used. The testing time period was 1/1/99 to 12/31/04.

| <u>Folder/Subfolder</u> | <u>File Name</u> | <u>Rule Name</u> | <u>ROI</u> | <u># of Trades</u> |
|---|---------------------------------------|--------------------|------------|--------------------|
| Technical Indicator Strategies/Strategies using Candlesticks | Candlestick - Meeting Lines | MeetingLines | -118.76 | 25 |
| Market Timing Indicators and Strategies | MktDnMktDirMovdn | MktDnMktDirMovdn | -11.91 | 57 |
| Technical Indicator Strategies/Strategies using Candlesticks | Candlestick - Dark Cloud | DarkCloud | -7.2 | 1202 |
| Expert System Based Strategies/Expert Rating Strategies | Market ER Down | downERmarket | -1.77 | 92 |
| Market Timing Indicators and Strategies | MktDnPhaseDn | MktDnPhaseDn | -1.48 | 84 |
| Market Timing Indicators and Strategies | MktupPhaseup | MktupPhaseup | 3.76 | 94 |
| Miscellaneous/Opening Bell Strategies | OBM July 2001 | marketrule | 4.72 | 156 |
| Miscellaneous/Opening Bell Strategies | Congesti | Breakout | 4.85 | 11022 |
| Expert System Based Strategies/Expert Rating Strategies | upERmarket | | 5.85 | 107 |
| Market Timing Indicators and Strategies | MktupMACDup | MktupMACDup | 6.81 | 30 |
| Miscellaneous/Stocks and Commodities Magazine | S&C_Oct2000 | Long | 8.03 | 15547 |
| Shorter term strategies/Hit and Run Trading - Jeff Cooper | 180s Buy | Buy180 | 10.45 | 18456 |
| Technical Indicator Strategies/Strategies using Candlesticks | Candlestick - Harami | Harami | 10.7 | 17011 |
| Shorter term strategies/Hit and Run Trading - Jeff Cooper | 5-day Momentum Buy | BuyLong | 11.54 | 3242 |
| Swing Trading Strategies/Street Smarts - Linda B Raschke | Volatile History | Buy | 11.63 | 16990 |
| Shorter term strategies/Hit and Run Trading - Jeff Cooper | Expansion Pivot Buys | ExpansionPivotsBuy | 12.32 | 14680 |
| Market Timing Indicators and Strategies | MktupDirMovup | MktupDirMovup | 12.42 | 39 |
| Shorter term strategies/Hit and Run Trading - Jeff Cooper | Lizards Buy | LizardBuy | 12.68 | 4371 |
| Swing Trading Strategies/Street Smarts - Linda B Raschke | Range Contraction | RangeContraction | 13.8 | 33789 |
| Technical Indicator Strategies/Strategies using one indicator/Simple Moving Avg | Price crosses IT MA | STMAcrossITMA | 13.85 | 23611 |
| Chart Pattern Strategies | Double Top Strategy | Doubletop | 13.92 | 15451 |
| Technical Indicator Strategies/Strategies using one indicator/OBV | New high not confirmed by OBV | OBVhiNON | 14.4 | 28856 |
| Technical Indicator Strategies/Strategies using one indicator/RSI Wilder | RSI Wilder slope down, price slope up | RSIWilderdnPRICEu | 14.51 | 42823 |
| Technical Indicator Strategies/Strategies using one indicator/Simple Moving Avg | ST MA crosses LT MA | STMAcrossLTMA | 14.59 | 14421 |

The Dark Cloud Cover is a bearish Candlestick charting pattern. It occurs in an uptrend where the first day is a Long White Day (the stock's close is well above its open). On the next day, the stock opens above the previous day's high, trades lower throughout the day, and then closes below the midpoint of the Long White Day.

In AIQ's pre-built EDS rule, there isn't a rule requiring the stock to be in an uptrend and the Long White Day needs to be greater than \$2. Also, on the second day of the pattern, the EDS rule requires a large Black candle but doesn't require the close to be below the midpoint of the prior day.

An example of a stock that passes this screening is Wellpoint Health Network (WLP) in **Figure 1**. Notice on the last two Candlestick patterns, the Long White Candle (close greater than open) is followed by a Long Black Candle (close less than open).

We were hoping for more

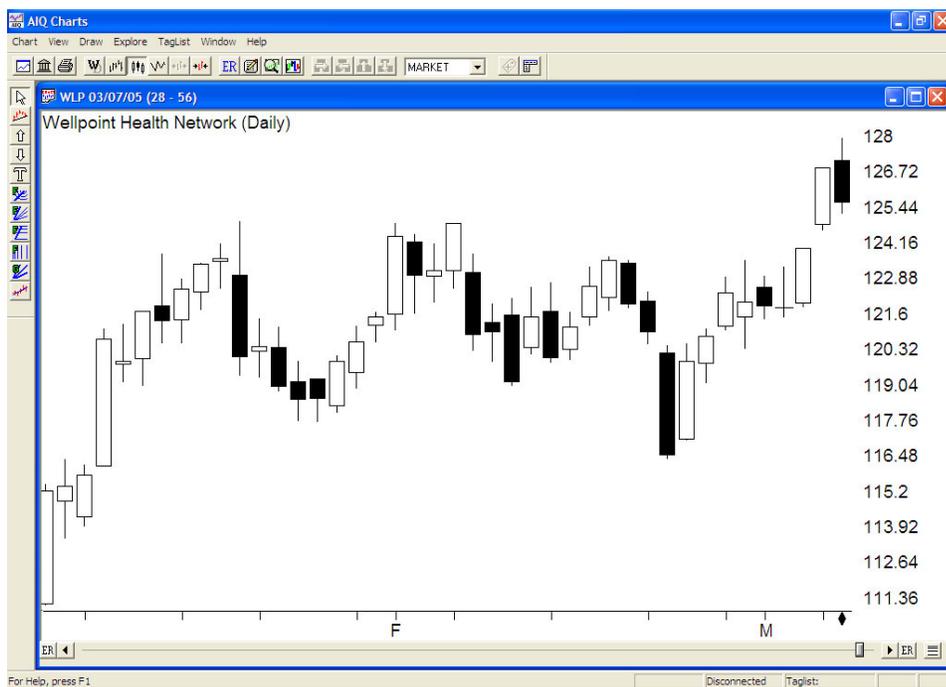


Figure 1. Daily Candlestick chart of Wellpoint Health Network. The last two Candlesticks are an example of a Dark Cloud Cover bearish pattern.

effective short-selling rules with lots of trades so that we could build a highly effective short-selling model. We've made an assumption that the worst performing rules on the long

side may be the best rules on the short side. That assumption might be wrong. In that regard, in an upcoming issue we'll test all the pre-built rules using short-selling trades with a five-day holding period.

STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

| Stock | Ticker | Split | Approx. Date |
|---------------------|--------|-------|--------------|
| Timberland Co. | TBL | 2:1 | 05/03/05 |
| Featherlite Inc. | FTHR | 3:2 | 05/05/05 |
| Gentex Corp. | GNTX | 2:1 | 05/09/05 |
| Ultra Petroleum | UPL | 2:1 | 05/10/05 |
| Chemed Corp. | CHE | 2:1 | 05/12/05 |
| Quicksilver | ZQK | 2:1 | 05/12/05 |
| Nexen Inc. | NXY | 2:1 | 05/18/05 |
| Moody's Corp. | MCO | 2:1 | 05/19/05 |
| MGM Mirage | MGG | 2:1 | 05/19/05 |
| Barrett Business | BBSI | 3:2 | 05/20/05 |
| Adobe Systems | ADBE | 2:1 | 05/24/05 |
| Hunt (JB) Transport | JBHT | 2:1 | 05/24/05 |
| Precision Drilling | PDS | 2:1 | 05/27/05 |
| Courier Corp | CRRC | 3:2 | 05/30/05 |
| Canadian Nat. Res. | CNQ | 2:1 | 05/30/05 |

Trading Suspended:

Conrad Industries (CNRD), Fox Entertainment Group (FOX), Metro-Goldwyn-Mayer Inc (MGM), Sears Roebuck & Co. (S)

Name Changes:

Hershey Foods Corp. (HSY) to Hershey Co. (HSY)
 Kmart Holding Corp. (KMRT) to Sears Holding Corp. (SHLD)
 Scott Co. (SMG) to Scott Miracle-Gro (SMG)

MARKET REVIEW

April was the weakest month of the year. The S&P 500 had a mild correction of 2% but the rest of the market fell more.

The Nasdaq Composite fell close to 4% and the Russell 2000, a measure of small-cap stocks, fell 5.8%.

S&P 500 Changes

Changes to the S&P 500 Index and Industry Groups:

Sears Holdings (SHLD) replaces Sears Roebuck & Co. (S). SHLD is added to the Retail - Department Stores (RETAILDE) group.

National Oilwell Varco (NOV) replaces Power-One (PWER). NOV is added to the Oil & Gas Equipment & Services (OILGASEQ) group.

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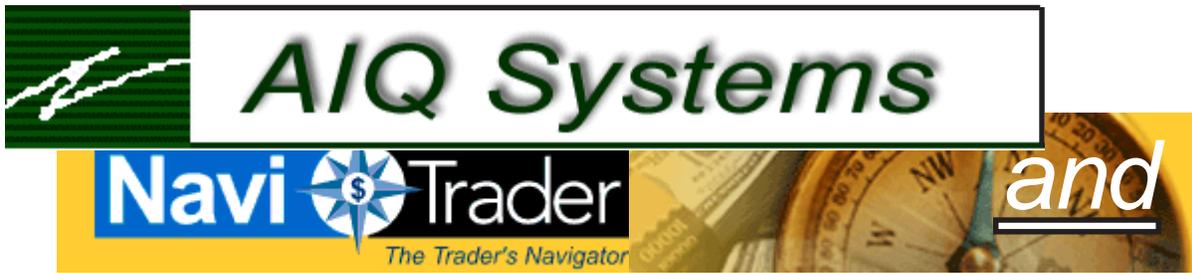
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AIQ Chief Analyst
Steven Wheeler & David Johnson,
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Topics

Becoming a Successful Trader:

In his presentation, David Vomund will discuss what successful traders need to know about the market. He will show how trading models are created using the AIQ software and will discuss some pitfalls that one can fall into in creating a system. Finally, he will highlight the system he uses for longer-term Exchange Traded Fund (ETFs) trading.

How To Develop a Profitable Trading Business

This portion of the presentation will focus on the following:

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Two scheduled events

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