ANOTHER DAY TRADER TAXED AS AN INVESTOR

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Successful stock market day-traders like to be characterized as mere investors for federal income tax purposes - this allows them to pay taxes on their trading gains at preferential capital gains rates. Unsuccessful stock market day traders want to avoid the "investor" label, and instead they want to be characterized as engaged in the trade or business of trading. This is because they don't want capital loss treatment for their trading losses - capital losses can only be used to offset capital gains (except as to $3,000 per year which can be used to offset ordinary income).

Traders that are engaged in the trade or business of trading securities may elect to have the Code Sec. 475(f) mark-to-market rules apply. Under these rules gain or loss is recognized on their securities held at the close of a tax year as if they were sold for their fair market value on the last business day of the tax year. Further, gain or loss is taken into account for the tax year as ordinary income or loss. Being engaged in a trade or business also avoids the expense limits on investors – investor trading expenses can only be deducted to the extent they and any other miscellaneous itemized expenses exceed 2% of adjusted gross income.

A recent Tax Court case involved a trader who engaged in substantial trading activities. The trader lost over $2 million in 2000, $400,000.00 in 2001, and $278,000.00 in 2002. With all those losses, the trader sought trade or business treatment so as to obtain ordinary loss treatment for the losses.

In 2000, the trader traded on 73 days with a total of 313 trades. In 2001, he traded on 18 days and had 72 trades, and in 2002 he traded on 21 days for 84 days.

A taxpayer's activities constitute a trade or business if (1) the taxpayer's trading is substantial, and (2) the taxpayer seeks to catch the swings in the daily market movements and to profit from these short-term changes rather than to profit from the long-term holding.

In regard to the first test of “substantiality,” the courts will examine the number of trades, the amount involved in the trades, the number of days on which trading occurs, and whether trading is the taxpayer’s sole or primary source of income. Since the taxpayer only traded on 29%, 7% and 8% of the trading days in 2000-02, this was not substantial enough for the court (even though they acknowledged that the dollar volume of the trades was significant).

In regard to the second test, the courts will examine whether stocks were held for more than 30 days, and how often stocks were both purchased and sold on the same day. In the instant case, a majority of the stocks purchased were held for over 30 day, and very few stocks were sold on the same day they were purchased. Thus, the court ruled against the taxpayer on this element, too. The taxpayer was denied ordinary loss/trade or business treatment.

This case is factually similar to *Holsinger v. Comm.,* which I wrote about here, and with a similar holding. Per these two cases, taxpayers with stock trades that number in the hundreds should not automatically assume they will achieve trade or business status. Of course, those traders at that level who are successful will not want trade or business status anyway so they can get preferential capital gains rates (for their long-term gains).

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