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HOW MANY TRADES MUST A TRADER MAKE TO BE IN THE TRADING BUSINESS?

Glenn P. Schwartz

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I. INTRODUCTION

In recent years, a confluence of several factors has resulted in an explosion in on-line trading of equities by individuals. The resulting attention given to the on-line trading phenomenon in the equity markets has been accompanied by increased attention to the disparate treatment that individuals who buy and sell securities are afforded under the Internal Revenue Code (Code). In this regard, the determination of whether an individual’s trading constitutes a trade or
business has significant tax implications for the individual taxpayer. In general, those traders whose activities constitute a "trade or business" receive more favorable tax consequences than their counterparts who are characterized as investors. The long-term investor still receives preferential treatment for long-term capital gains, but this is of little consequence to the trader who is focused on the short term and not seeking this particular tax benefit except, perhaps, with respect to a segregated personal investment account.

The critical factor for determining whether a taxpayer is engaged in the trade or business of a trader is the level of his or her trading activity. The taxpayer who trades especially often is more likely to be in the business of trading. The shorter the taxpayer's holding periods, the more likely he or she will be viewed as a trader by the Internal Revenue Service (Service). Most day traders, i.e., those who trade securities as their main income-generating activity, are unable to trade profitably over a period of time and are forced to seek other sources of income. There are additional reasons why individuals may wish to trade frequently but not to day trade. Many are unable or unwilling

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2 Affording favorable treatment to the most active in-and-out traders seems ironic in view of the fact that Congress has always favored long-term investors over short-term investors by conferring preferential rates of taxation for only long-term capital gains. See I.R.C. § 1(h). While both Congress and commentators have given several reasons for such preferential treatment (e.g., to stimulate investment, that a portion of the gain may simply reflect inflation, and the view that it is unfair to force a taxpayer into a higher marginal rate for an anomalous, high-income year resulting from the sale of an appreciated asset), it reflected, at least in part, an attitude that "investors" should receive more beneficial treatment than "speculators." See Lynn A. Stout, Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives, 48 DUKE L.J. 701, 733-34 & n.139 (1999).

3 Of course, gains have been most elusive in the last two to three years.

4 As discussed infra Part V.B., the Service, in its communication to the public, suggests that intra-day trading, or something close to intra-day trading, is necessary for trader classification.

5 Erika Gonzalez, It's Life in a Very Fast Lane: Day Trading's Allure Hasn't Faded Despite Demise of Bull Market, ROCKY MTN. NEWS, May 26, 2001, at 1C. Bryan Babcock, principal in a firm that trains day traders and provides them with trading terminals, estimates that seventy percent of all day traders fail: "If it had a 100 percent success rate everybody and their dog would be doing this[.]" Id. In a highly-publicized tragic case, a distraught day trader who lost $500,000 day trading killed his wife and two children and then murdered nine more victims at two day trading offices. See Trisha Renaud, Victims of Day-Trader Rampage Say Industry to Blame, LEGAL INTELLIGENCER, December 3, 2001, at 4. Several families of victims filed suit against the day trading firm where the perpetrator traded, taking the position that the nature of day trading makes it foreseeable that individuals will lose money and that it is foreseeable that one or more of them will become violent. Id.
to give up their regular "day jobs" and are thus unable to sit at a computer screen all day to take advantage of multiple intra-day moves. On the other hand, some individuals inclined to trade who could monitor the market closely all day are nevertheless unwilling to do so and choose to pursue other interests. Others eschew day trading because they are reluctant to expose themselves to its attendant stress. Still others are influenced not to day trade by the cost of the necessary technology. These position traders may hold securities somewhat longer than intra-day, such as a few days or weeks, which, by any standard, is still short-term. Such traders may fear the loss of advantageous tax treatment clearly available to day traders and therefore feel pressure to shorten their holding periods. This could adversely affect their performance, their chosen lifestyle, or both. In view of these concerns, this article takes the position that the Service imposes requirements for trader status that are too restrictive and not supported by the Code, Treasury Regulations, or case law.

In Part II, this article will outline the factors that created the opportunity for nonprofessionals to trade successfully and the subsequent explosion in on-line trading volume. Part III discusses some of the more significant tax consequences flowing from a determination that a trader is engaged in a trade or business. Part IV reviews the case law in an attempt to ascertain which standards the courts have applied in determining whether traders are in fact so engaged. Part V discusses the recent amendment to the Code allowing "traders in securities" to elect the mark-to-market method of

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7 See id.
8 See id.
9 See id. Mr. Smith summed up his preference for position trading over day trading by stating:

Yeah, I know. I thought it would be closer too. But... [p]osition trading, with an edge in net earnings, technology requirements, time commitment, pressure and ease of use, has simply swamped day trading, which could muster a victory only in the area of risk.

....

So, then why is day trading getting so much attention? Why are people so attracted to it that they're willing to quit decent jobs and sit in front of a screen all day, with the assumption that they're going to make millions? I don't know. Perhaps if I were better at day trading, I'd have a clear answer. Somehow, though, I doubt it.

Id.
accounting and its tax consequences, followed by an analysis of the level of trading activity necessary to qualify the taxpayer to make the election.

This article will demonstrate that the standards that determine "trader in securities" status also control whether a trader is engaged in a trade or business. An analysis of the Service's only pronouncement regarding the standards for determining whether a taxpayer is a trader in securities follows. This article argues that these standards are too restrictive and that the case-by-case approach of the courts does not give adequate guidance to traders and their advisors. Finally, this article recommends the adoption of more specific standards, preferably in the form of Treasury Regulations, so that taxpayers and tax professionals can make an informed appraisal of a trader's status.

II. BACKGROUND: THE EMERGENCE OF DAY TRADING BY THE PUBLIC

The recent bull market, which lasted nearly eighteen years, was a significant factor in the increase in the volume and frequency of trading in equity securities by individuals. That great bull market in stocks commenced in August 1982 and continued until January or

The consequences of the election are discussed in detail infra Part V. For now, it suffices to say that the mark-to-market method of accounting produces favorable results for short-term traders.

There are no relevant Code provisions, Treasury Regulations, or Revenue Rulings setting forth standards to determine whether an individual trader is engaged in a trade or business.

While most observers agree that a secular bull market commenced in August, 1982 (see, e.g., Suzanne McGee, Bull Market Turns 15 as Landscape Is Changing, WALL ST. J., Aug. 12, 1997, at C1), some commentators believe that there have been one or more intervening bear markets between then and now. See, e.g., Study Finds Index Funds Usually Beat Actively Managed Funds in Bear Markets, ST. LOUIS POST-DISPATCH, July 20, 2001, at C1. Some market pundits believe that we have entered a new secular bear market. See Susan Tompor, Sunny Forecast Using Software and Their Instincts, Market Timers Say Good Times are Coming, DETROIT FREE PRESS, Aug. 12, 2002, at 6F (quoting Michael Burke, editor of Investors Intelligence newsletter). Interestingly, in the same article, Don Wolanchuck, editor of another newsletter, The Wolanchuk Report, is quoted as predicting a roaring bull market with the Dow Jones exceeding 40,000 in this decade. Id. The New York Times has quoted David W. Tice, who runs the Prudent Bear fund in Dallas as stating: "We believe we are in a secular bear market – and we still have a long way to fall." Robert D. Hershey, Jr., Opposite Paths, No Middle Ground, N.Y. TIMES, Sept. 8, 2002, § 3, at 9. Again, in the same article, a roaring bull is quoted. Gus Sauter, a Vanguard Group fund manager, states that the market is suffering from "irrational exasperation" making it a screaming buy. Id.
March 2000, depending on which stock index is used as a point of reference. A significant market decline in 1987, a major portion of which occurred on one day, reversed so quickly that some technical analysis considered it to be merely a correction, rather than a bear market. Likewise, a relatively brief decline in 1990 did not significantly detract from the general upward trend in the stock market. The extent of the bull market can be appreciated by reference to a few statistics. The Dow Jones Industrial Average rose from 777 in August 1982 to a peak of 11,750 in January 2000. Further, in 1989, the average number of U.S. households owning stock directly or indirectly was 31.6% while the percentage of participating households today is nearly 50%.

The rise in the stock market reflected an unprecedented growth in the economy accompanied by an increase in productivity and a low rate of inflation. The ability to maintain economic growth without inflation has been attributed to an increase in workers' productivity as

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13 A bear market is generally considered to be a decline of twenty percent from the peak. Kathleen Lynn, Rutgers Professor Looks at Where Slump Came From and Where It's Going, THE RECORD, Oct. 6, 2002, at B1. The three most widely followed stock indexes are the Dow Jones Industrial Average, the Standard & Poor's 500 Index, and the National Association of Securities Dealers Automatic Quotation (NASDAQ) Composite Index. The Dow began its decline in January 2000, from a high of 11,750 and reached a low of 7197 on October 10, 2002, a decline of thirty-nine percent. Haitham Haddadin, No Bedtime for Bears as Nasdaq Peak Turns 3, at http://www.forbes.com/work/newswire/2003/03/10/trt902461.html (Mar. 10, 2003). The S&P 500 peaked in March 2000 at 1553 and fell to its five-year low of 768 on October 10, 2002, a decline of fifty-one percent. Id. The NASDAQ Composite Index, which had the greatest rise in the bull market, has suffered the greatest decline. It peaked at 5132 in March 2000 and declined seventy-eight percent to 1108 on October 10, 2002. Id.


16 See id.; see also Dan Moreau, This Bear Is Striking Historic Pose in Market Depth and Duration of Slumps Have Varied Widely Over the Years, INVESTOR'S BUS. DAILY, Mar. 21, 2001, at B3 (describing the extent and duration of the 1987 and 1990 market declines).

17 McGee, supra note 12.

18 Haddadin, supra note 13.


20 Jim McTague, Centrist Democrats Unlikely to Bite on GOP Bait, BARRON'S, Dec. 11, 2000, at 32.
well as to the greater efficiency enjoyed by businesses as a result of technological developments.\(^{21}\) One of the primary benefits of the economic growth was a corresponding growth in personal income.\(^{22}\) The combination of rising income and rising equity markets led to an increase in stock ownership by individuals, either directly or indirectly, through the ownership of mutual funds. This public ownership of stock accelerated partly as a result of the growing number of employees who were able to participate in 401(k)\(^{23}\) plans through which they could make tax-deferred contributions to custodial retirement accounts. Many employers matched or partially matched employee contributions. Similar plans were available to the self-employed. In this manner, stocks and stock funds became the predominant asset of choice for the plan beneficiaries.\(^{24}\)

A critical factor responsible for increased individual equity trading has been the dramatic decrease in brokerage commissions over the years. As recently as 1975,\(^{25}\) brokerage commissions were fixed. In 1975, Congress, concerned about lack of competition in the marketplace, passed the Securities Acts Amendments of 1975.\(^{26}\) The legislation set forth the following principles for the purpose of protecting investors: (1) economically efficient execution of securities transactions; (2) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets; (3) transparency of quotations and

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\(^{22}\) Kenneth A. Guenther, *Community Banks Have a Solid Place in Future*, CHI. TRIB., June 17, 2002, at 14.

\(^{23}\) See I.R.C. § 401(k). Eleemosynary and other not-for-profit organizations are eligible to participate in similar plans under I.R.C. § 403(b).


A Hewitt Associates survey of 401(k) plans covering 1.5 million workers showed that about 58 percent of plan assets were in stocks in June. That is down from about 67 percent in June 2000, principally because the market has declined so sharply rather than because investors have stopped buying stocks through their 401(k) plans.

Kathy Kristof, *In These Trying Times, Try a 401(k) Action Plan*, FORT LAUDERDALE SUN-SENTINEL, Aug. 6, 2002, at 3D.


transactions (price discovery); (4) execution of investors’ orders in the best market; and (5) an opportunity for investors’ orders to be executed without the participation of a dealer.\(^{27}\) To that end, the legislation directed the Securities and Exchange Commission (SEC) to facilitate the establishment of a national market system for securities.\(^{28}\) Congress also granted broad powers to the SEC to implement the legislative goals.\(^{29}\) Pursuant to this congressional mandate, the SEC required the institution of negotiated commissions, which in turn introduced competition to the securities brokerage industry and effectively sounded the death knell for fixed commissions.\(^{30}\) Prior to May 1, 1975, fixed retail commissions were so high as to make profitable trading by individuals a practical impossibility.\(^{31}\) As a result of increased competition between brokers,


\(^{31}\) Under the fixed-commission regime, off-floor traders could not survive with small gains because they would be more than offset by commissions and other transaction costs, as well as losses. Today, off-floor traders get the benefit of commissions that are close to being as low as those paid by floor traders. Even so, they add up and make it difficult for the trader who only garners small profits on every successful trade to offset the inevitable losses that all traders incur.

Another obstacle to profitability for the short-term trader is the spread between the bid and the offer. For example, if the spread between the bid and offer of a particular issue is $.25 (e.g., 65.10 bid, 65.35 offer), the trader must buy at the offer price and starts off $.25 per share behind. He will also have to give up the spread (sell at the bid price) at the time of sale. The amount of the spread varies from issue to issue. In general, the amount of the spread is inversely proportional to the issue’s trading volume; that is, the higher the volume, the smaller the spread. See Ted Allrich, Liquid vs. Illiquid Stocks: Knowing The Difference Can Help You, at http://www.theonlineinvestor.com/yayb.phtml?content=yb_liquid (last visited Feb. 15, 2003). However, things here have also improved for members of the public who want to trade frequently. Until recently, stocks were traded in fractions and the minimum spread for individual traders was 1/16th of a point ($0.0625 per share). In an effort to narrow the spreads, the markets now require decimal trading so that the bid and offer must be in pennies with the result that the spread can be as low as a penny. See Jed Graham, Online Brokers: Dempsey Acquisition Gives E-Trade More Traditional Look, INVESTOR’S BUS. DAILY, Sept. 10, 2001, at A6. If a stock is thinly traded, however, the spread will continue to be significant.

A number of successful traders state that, to be profitable, a trader must cut losses short and let profits run. For example, prominent trader Mark Weinstein
their commissions began to decline. The advent of discount brokers and, later, deep discount brokers, accelerated the dramatic declines in commissions. When fixed commissions were abolished on May 1, 1975, Charles Schwab and a few other brokers responded by slashing their commissions, and the discount brokerage industry was born. By 1999, there were more than one hundred discount brokers. The competition among these firms has resulted in commission rates as low as four dollars per trade, a far cry from the prohibitive fixed commissions that were based on a percentage of the value of the securities traded.

advises beginning traders to “[l]imit losses quickly. . . . [M]ost traders hold on to their losses too long because they hope the loss will not get larger. They take profits too soon, because they fear the profit will diminish. Instead, traders should fear a larger loss and hope for a larger profit.” JACK D. SCHWAGER, MARKET WIZARDS: INTERVIEWS WITH TOP TRADERS 341 (1993). It may be difficult for traders to follow this indispensable advice and still be considered traders for federal income tax purposes. “Letting profits run” will almost inevitably entail holding onto positions for a few days or weeks as opposed to being required to close out all positions by the end of each trading day.

32 See JOHN KADOR, CHARLES SCHWAB: HOW ONE COMPANY BEAT WALL STREET AND REINVENTED THE BROKERAGE INDUSTRY 43-44 (2002). Charles Schwab also participated in a one-year pilot program that commenced in 1974 allowing discounted commissions on trades of $2000 or less. Id. at 42.

33 See id.

34 Katie Sweeney, How to Find the On-line Broker That’s Best for You, INVESTOR’S BUS. DAILY, Mar. 26, 1999, at B1. The number of discount brokerage firms is declining somewhat due to the bear market that began in 2000 and to consolidation within the industry. See Jed Graham, E-Trade Waves Cash in Effort to Lure Datek Customers, INVESTOR’S BUS. DAILY, May 16, 2002, at A10; Rick Miller, Web Brokers Face Darwinian Fate; Merger Signals Industry Shakeout, INVESTMENT NEWS, Apr. 15, 2002, at 3; Stephen Cohen, E-Trade Agrees to Buy Tradescape for $100 Million in Stock, BLOOMBERG NEWS, Apr. 10, 2002, LEXIS, Nexis Library, Bloomberg File. The consolidation in the industry has not affected the downward movement of competitive discount commissions available to investors and traders.

35 ShareBuilder has a plan that allows investors to automatically invest for only four dollars per recurring or one-time purchase. See ShareBuilder Securities Corp., at http://www.sharebuilder.com (last visited Sept. 30, 2002). While a four-dollar commission is at the extreme low end, ten dollars and below is now common. See Lauren Rudd, Find Your Own Dividend Achievers, SARASOTA HERALD-TRIB., Aug. 26, 2002, at 8 (“If you use a deep discount brokerage house, putting together a portfolio of 10 stocks should not generate commissions of more than about $100 total.”)

36 As recently as 1995, they still averaged a now astounding $285 per transaction. See Paul Katzeff, No Such Thing as a Free Lunch? Try Free Stock Trades[,] Four Online Brokerages Charge No Fee on Some Trades – But There Are Restrictions, INVESTOR’S BUS. DAILY, Nov. 13, 2000, at B2.
The final, and perhaps the most significant, factor leading to a dramatic increase in frequent on-line trading by individuals has been the development of the technology that allows traders to trade on the Internet. On-line investment sites, particularly those operated by discount brokerage firms, now provide real-time market information, including quotes on stocks and derivatives, company news, and SEC filings, to a broad spectrum of nonprofessional investors either without charge or at a nominal cost. More importantly, individuals can execute trades on the Internet using their personal computers and can obtain executions and confirmations of their transactions within seconds. The ease of trading on-line has not gone unnoticed. In the fourth quarter of 2001, on-line trading accounted for thirty-two percent of New York Stock Exchange (NYSE) and NASDAQ trading volume.

Since March 2000, the markets have suffered a decline of sufficient magnitude to constitute a bear market. During this period, as in other bear markets, the volume of trading has declined. This is the first bear market where a significant percentage of trading has been conducted on-line and, not surprisingly, the volume of on-line and day trading has likewise declined. As a result, discount brokerage firms have made particular efforts to attract those traders who remain active. There have been nine bear markets since 1949.

37 Several years ago, the National Association of Securities Dealers (NASD) changed its rules so that individuals could, with special software, bypass the broker and send their orders in electronically. This software is called SOES (Small Order Execution System). The trader using this system can deal directly with any of the broker-dealers that make a market in a stock. The trader has a level two computer screen which shows each market-makers bid and offer prices. Since these market spreads can vary somewhat from dealer to dealer, it affords an opportunity for the nimble trader to arbitrage. More important, it allows the trader to search for the best bid when he is selling and the best offer when he is buying. Mark Anderson, Young Day-Trading Field Has Rough Ride, SACRAMENTO BUS. J., Aug. 28, 1998, at 13.


40 Graham, supra note 39. The Bear Stearns Report, supra note 38, at 5, expects the consolidation under way in the direct-access technology segment to gain momentum in the near future with a goal of vertical integration, the convergence of clearing, execution technology, and order flow capabilities. Also, the report notes that "the trading technology companies have introduced a slew of new products and
All of the prior bear markets eventually ended and the long-term upward trend in equity prices resumed. Thus, there is a strong likelihood that the present bear market, now almost three years old, will end as well. If the market resumes its long-term uptrend, the on-line and day trading volume should increase. In contrast, even if the market continues to decline or trades in a narrow range, the absolute number of on-line and day trades should nevertheless continue to be substantial. It is therefore important that those individuals who trade actively be apprised of reasonably clear standards to determine whether their activities constitute a trade or business so they can accurately assess, plan for, and report their tax liability.

III. TAX CONSEQUENCES OF BEING CHARACTERIZED AS A TRADER

The term “trade or business” appears in 348 sections of the Code but is nowhere defined. The following section sets forth some of the more important provisions employing the term “trade or business” that are relevant to traders. Whether an individual is engaged in the trade or business of trading securities can have significant tax consequences.

A. Characterization of Gains and Losses

Perhaps the most significant tax consequence affecting traders is the characterization of gains and losses. A capital gain is the gain services aimed at the semi-professional trader, encompassing options trading, single stock futures trading capabilities..., enhanced decision support tools, and trader education courses.” Id.

Lawrence Kudlow, Safer in the Long Leap, WASH. TIMES Mar. 18, 2001, at B1; Quoth the Mavens, WASH. POST, Dec. 9, 2001, at H11; Moreau, supra note 16.

The reader may wonder “when?” If this author knew, he would probably be on a beach somewhere trading on a device with a wireless Internet connection.

Though the online retail segment as a whole lost market share and trading was lower last year, it continues to account for nearly one-third of total NYSE and Nasdaq share volume. All in all, our analysis, which relied mainly on year-end 2001 and 2000 data, reaffirmed our long-standing thesis that the online retail segment (particularly the semi-pro contingent) is a force to be reckoned with in this ever-changing market.

Bear Stearns Report, supra note 38, at 7. While active traders' trades declined from 16.3% to 13.7% of total daily trades, id., that still constitutes a very substantial amount of trading activity.

While discussed in greater detail infra Part V, it should at least be noted that characterizing gains and losses as capital can, depending on a taxpayer's particular situation, be beneficial, harmful, or neutral in any given taxable year. Very briefly,
derived from the sale or exchange of a capital asset,\textsuperscript{45} and a capital loss is the loss derived from the sale or exchange of a capital asset.\textsuperscript{46} Since the sale or exchange requirement is a non-issue for traders, as they are clearly engaged in the sale and exchange of securities, the characterization of gains and losses turns on whether the stock is a capital asset in the hands of the taxpayer. The Code defines a capital asset as

property held by the taxpayer (whether or not connected with his trade or business), but does not include – (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer for sale to customers in the ordinary course of his trade or business.\textsuperscript{47}

For the purpose of characterizing gains and losses from securities transactions, there are three relevant categories of buyers and sellers of securities: (1) dealers, (2) investors, and (3) traders.

1. Dealers

Property held for sale to customers in the ordinary course of a taxpayer's trade or business is not a capital asset.\textsuperscript{48} Therefore, gains and losses from the sale of such property are ordinary, not capital.\textsuperscript{49}

\begin{itemize}
\item long-term capital gains (as opposed to short-term capital gains) are taxed at a lower rate than other (ordinary) income. See I.R.C. § 1(h).
\item If, however, a taxpayer's capital losses (regardless of whether long- or short-term) exceed the capital gains for the year (regardless of whether long- or short-term), the deductibility of those losses are severely restricted. Only $3000 of those excess capital losses can be deducted against ordinary income and the remainder carried forward hopefully to be used in a happier year when the taxpayer once again has gains to offset. See I.R.C. §§ 1211(b), 1212(b).
\end{itemize}

Thus, the short-term trader will normally fare better if his or her gains and losses are characterized as ordinary. The ordinary gain will be taxed at the same rate as short-term gains but, in a bad year, the ordinary loss is fully deductible (and can be carried back two years and forward twenty years) whereas short-term losses are restricted in use. There are current proposals to increase the amount of capital loss that can be used to offset ordinary income. See Rob Norton, \textit{Not So Fast -- The Democrats Election Mirage}, \textit{FORTUNE}, Sept. 16, 2002, at 48.

45 I.R.C. § 1222(1), (3).
46 I.R.C. § 1222(2), (4).
47 I.R.C. § 1221 (emphasis added).
48 I.R.C. § 1221(a)(1).
49 See I.R.C. § 1222(1)-(4).
Of the three categories above, only dealers sell to customers. Dealers basically treat stock as inventory, in much the same way as a grocer would treat canned goods. A dealer buys securities from one source and sells them to customers. The rule that a securities dealer has ordinary income and loss on the sales of his or her inventory has been specifically codified:

The term dealer in securities includes, but is not limited to, a taxpayer, that, in the ordinary course of the taxpayer's trade or business, regularly holds itself out as being willing and able to enter into either side of a transaction to [assume, offset, assign, or otherwise terminate positions with customers].

Whether a taxpayer is transacting business with customers is determined on the basis of all of the relevant facts and circumstances.

2. Investors

Since investors are not in a trade or business and do not sell securities to customers, the securities held by them are capital assets,

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50 The Code defines the term "dealer in securities" as a taxpayer who "(A) regularly purchases from or sells to customers in the ordinary course of a trade or business or (B) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business." I.R.C. § 475(c)(1) (emphasis added).

51 Usually, the purchase is from another market player but sometimes, as in the case of an initial or secondary offer, from the issuer or major shareholders of the issuer.

52 See I.R.C. § 475(d)(3). A dealer can maintain a separate investment account and will sustain capital gains and losses therein. The dealer must identify any securities held for investment by the end of the day on which the securities are acquired. See I.R.C. § 475(b)(2).


54 Treas. Reg. § 1.475(c)-1(a)(1) (1996). An example of a dealer in securities for tax purposes would be a broker/dealer such as Merrill Lynch or Goldman Sachs, making a market in a security such as Microsoft. In their capacity as a dealer in Microsoft, these companies would constantly publish a bid price that they are willing to pay for Microsoft and an offer price at which they would be willing to sell. In their capacity as dealers in securities within the meaning of the Code, these firm's traders do not attempt to predict and bet on the direction of the market. The income that they generate in this capacity is based on constantly pocketing the spread between the bid and the offer price. They will prosper so long as their employee/traders are able to move with the market and avoid having too much inventory of Microsoft stock in a declining market or too little inventory in a rising market.
and the sales of those securities generate capital gains and losses. Investors ordinarily hold stocks for extended periods of time. Their income from dealings in securities is primarily derived from gains due to capital appreciation and dividends. For the long-term investor who experiences gains, this treatment is favorable because long-term capital gains are taxed at preferentially lower rates. To obtain the preferential rates, the securities must be held for "more than one year." Conversely, investors suffer adverse tax treatment when their losses exceed gains because capital losses for any taxable year can be deducted only to the extent of the capital gains for that year. When losses exceed gains, however, the losses can be used to offset only $3000 of ordinary income. While the excess losses may be carried forward to subsequent years, a large capital loss may be of little use to a taxpayer who is not fortunate enough to generate capital gains in subsequent years.

3. Traders

Until recently, traders, including those whose activities were sufficiently extensive to constitute a trade or business, received capital gain and loss treatment with respect to their trading transactions. Stock in the hands of a trader is still deemed to be a capital asset because the shares are property and not held for sale to customers in

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55 See I.R.C. § 1(h).

56 Section 1(h) of the Code affords the preferential rates to "net capital gain." Net capital gain is defined in section 1222(11) as the excess of the net long-term capital gain for the year over the net short-term capital loss for such year. Section 1222(7) defines net long-term capital gain as the excess of long-term capital gains for the taxable year over the long-term capital losses for such year. Section 1222(3), in turn, defines long-term capital gain as gain from the sale or exchange of a capital asset held for more than one year.

57 I.R.C. § 1211(b).


59 Assume that a taxpayer sustains a capital loss of $100,000 and no capital gains during the taxable year. He may use $3000 of that gain to offset ordinary income, such as salary, and carry forward the $97,000 capital loss to the following year. Assuming no capital gains the following year, he can again deduct $3000 and carry forward a $94,000 capital loss. Assuming the worst, it will take thirty-four years to get the tax benefit of the loss. Because of the time value of money, the further the deductions will be obtained in the future, the less is their present value.

60 See I.R.C. §§ 1221(a), 1222(1)-(4).
the ordinary course of the trader’s trade or business. In 1997, however, Congress amended the Code to allow “traders in securities” to make an election to adopt a mark-to-market accounting method. If a qualifying taxpayer makes the election, all gains and losses from the sales in his securities trading account will be artificially treated as ordinary. The election to mark-to-market is discussed in detail below.

B. Process for Computing Taxable Income – Deductibility in Arriving at or from Adjusted Gross Income

The characterization of a trader’s activities as a trade or business affects how the trader computes his or her taxable income. Specifically, a trader who is deemed to conduct a trade or business can deduct expenses attributable to trading in arriving at adjusted gross income. In contrast, traders whose activities fail to constitute a trade or business may only deduct their expenses as itemized expenses from adjusted gross income. For taxpayers who do not itemize their deductions, this distinction is crucial. If the deduction is “above the line,” it will reduce taxable income dollar for dollar. If the deduction is “below the line,” there are three potential outcomes. First, if the taxpayer’s itemized deductions (which are most often generated by mortgage interest and real estate taxes on a residence) exceed the standard deduction, there will be no adverse effect on the usefulness of the deduction. However, if the itemized deductions do not exceed the standard deduction, the taxpayer may choose to itemize. If the taxpayer itemizes, the deduction is treated as a “below the line” itemized deduction and, if it is greater than the standard deduction, the taxpayer will receive an additional tax benefit.

61 See I.R.C. § 1221(a)(1).
64 See discussion infra Part V.
66 The deductions would be allowed under section 212(1), which allows deductions for ordinary and necessary expenses incurred in connection with the production of income. Section 212 deductions, other than those attributable to rents and royalties under section 62(a)(4), are not deductible in arriving at adjusted gross income. I.R.C. § 62(a). They are, however, itemized deductions under section 63(d), and deductible from only the adjusted gross income. I.R.C. § 63(b).
67 Taxpayers who do not own homes have no deductions for real estate taxes and mortgage interest, and most do not have sufficient itemized deductions to exceed their standard deduction. In fact, unless itemized deductions exceed the standard deduction by a substantial amount, it may not be worth the extra time spent on record keeping and return preparation time to itemize.
68 The term “above the line” is frequently used by tax professionals to refer to deductions taken in arriving at adjusted gross income. Conversely, the term “below the line” is used to denote itemized deductions taken from adjusted gross income.
of the deduction.\textsuperscript{69} In the second possible situation, the total of the itemized deductions, including those related to the trading activities, is less than the standard deduction. In this case, the section 212 deductions\textsuperscript{70} related to the trading activity are wasted.\textsuperscript{71} The third possibility is that the itemized deductions, including those related to the trading activity, exceed the standard deduction. Because of the dollar amounts involved, however, the benefit of any section 212 deductions is diluted.\textsuperscript{72}

\textit{C. Floor on Miscellaneous Itemized Deductions: Section 67}

The Tax Reform Act of 1986\textsuperscript{73} lowered the maximum marginal tax rate from fifty percent to twenty-eight percent. Since Congress intended the bill to be revenue-neutral, it also created provisions that impose restrictions upon a number of deductions. One of those provisions, section 67(a), limits the deductibility of miscellaneous itemized deductions to the extent that their sum exceeds two percent of the individual taxpayer’s adjusted gross income. A miscellaneous itemized deduction is one that is itemized and not specifically excluded from that category by section 67(b). A taxpayer whose trading activity constitutes a trade or business takes his or her deductions under section 162. Section 162 deductions are deducted in arriving at adjusted gross income (“above the line”)\textsuperscript{74} and are deductible in full regardless of whether the taxpayer itemizes his or her deductions. Since section 162 deductions are deductible in

\textsuperscript{69} But see discussion \textit{infra} Part III.C of the “floor” for miscellaneous itemized deductions.

\textsuperscript{70} Section 212 provides a deduction for expenses incurred in connection with a profit-seeking activity, including investing, which does not rise to the level of a trade or business. Investing expenses, while deductible, are miscellaneous itemized deductions subject to a two-percent floor. \textit{See} I.R.C. §§ 62; 67(a), (b).

\textsuperscript{71} For example, assume the taxpayer’s standard deduction is $5000, and that he or she has a $1000 deduction for charitable contributions and, after application of the floor on miscellaneous itemized deductions, a $3000 deduction under section 212 for trading-related expenses. Since the standard deduction is greater than the itemized deductions, the taxpayer will use the former. Therefore, the section 212 deductions are effectively wasted.

\textsuperscript{72} Assume the same numbers as in \textit{supra} note 71, except that the section 212 deductions total $5000 instead of $3000. The total itemized deductions are $6000, which would be used by the taxpayer instead of the $5000 standard deduction. The effective deduction under section 212 is only $1000 ($6000 actual deduction minus $5000 standard deduction allowable in any event).


\textsuperscript{74} I.R.C. § 62(a)(1).
arriving at adjusted gross income, they are not itemized deductions\textsuperscript{75} and, a fortiori, cannot be miscellaneous itemized deductions.

On the other hand, a taxpayer whose trading activity is not sufficient to constitute a trade or business must take his or her deductions for investment-related expenses under section 212. Most section 212 deductions are itemized\textsuperscript{76} and are also deemed to be miscellaneous itemized deductions\textsuperscript{77} subject to the two-percent floor.\textsuperscript{78} If a trader is not engaged in a trade or business, any deductions under section 212 would be miscellaneous itemized deductions\textsuperscript{79} subject to the two-percent floor. In contrast, the trader whose activities are extensive enough to constitute a trade or business can deduct in full under section 162 all ordinary and necessary expenses incurred in connection with his or her trading activities and need not be concerned with the section 67(b) limitation. A trader who is deemed to be engaged in a trade or business could deduct without limitation such items as subscriptions to investment advisory services and financial publications, software to assist trading decisions, and depreciation on a personal computer employed for trading. Consequently, the difference in tax liability dependent on the trader's status can be considerable. For example, assume that a taxpayer has $200,000 in adjusted gross income and $10,000 in expenses related to trading. If the taxpayer is involved in a trade or business, the full $10,000 is deductible in arriving at adjusted gross income. If the taxpayer's trading activities are not characterized as a trade or business, only $6000 is deductible ($10,000-($200,000 x 2%)) as an itemized deduction.\textsuperscript{80}

\textsuperscript{75} I.R.C. § 63(d)(1).

\textsuperscript{76} I.R.C. §§ 63(d), 6262(a)(4).

\textsuperscript{77} I.R.C. § 67(a), (b).

\textsuperscript{78} I.R.C. § 67(a).

\textsuperscript{79} I.R.C. §§ 62; 67(a), (b).

\textsuperscript{80} This, of course, assumes that the taxpayer has reason to itemize deductions as opposed to taking the standard deduction. Specifically, the aggregate amount of itemized deductions (after applying the two-percent floor for miscellaneous itemized deductions) must still be greater than the standard deduction. For the year 2001, the standard deduction was $7600 for a married couple filing a joint return and $4550 for a single taxpayer. \textsc{Internal Revenue Service, Department of the Treasury, Form} 1040-ES: \textsc{Estimated Tax for Individuals} 2 (2001), \textit{available at} http://www.irs.gov/pub/irs-pdf/f1040e01.pdf. Ordinarily, only homeowners itemize their deductions because their deductible real estate taxes and mortgage interest often exceed the standard deduction. The total itemized deductions, including the miscellaneous itemized deductions that exceed two percent of adjusted gross income, of many taxpayers who rent do not exceed their standard deduction, making it impracticable for them to itemize. Thus, a trader who rents may be unwise to itemize.
D. Deductibility of Investment Interest

Section 163 of the Code generally permits a deduction for all interest paid during the year on indebtedness.\(^{81}\) The Tax Reform Act of 1986 largely subsumed the general rule of section 163 by disallowing deductions for personal interest.\(^{82}\) The term "personal interest," however, does not include interest allocable to a trade or business\(^ {83}\) or to an investment interest.\(^ {84}\) While both categories of interest remain deductible, the deduction for business-related interest is unlimited, whereas the deduction for investment interest is limited to net investment income.\(^ {85}\) Therefore, the trader who is considered to be engaged in a trade or business may gain a significant tax benefit. This issue is of particular concern to traders who carry large margin balances with corresponding high interest expense that exceeds net investment income.

E. Deductibility of Home Office

In general, a taxpayer may not take any deduction allocable to a "dwelling unit" that is used as a principal residence.\(^ {86}\) In contrast, deductions are allowable for items allocable to a portion of the dwelling unit that is used exclusively on a regular basis "as the principal place of business for any trade or business of the taxpayer,"\(^ {87}\) or "in the case of a separate structure which is not attached to the

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\(^{81}\) I.R.C. § 163(a).
\(^{82}\) See I.R.C. § 163(h)(1).
\(^{83}\) I.R.C. § 163(h)(2)(A).
\(^{85}\) I.R.C. § 163(d). Net investment income is the excess of investment income over investment expenses. I.R.C. § 163(d)(4). The term "investment income" means the sum of gross income from property (other than gain on the sale of such property) plus the gain on the sale of such property which is not net capital gain (defined in section 1222(11) as the excess of the net long-term capital gain over the net short-term capital loss) subject to preferential treatment in section 1(h). See I.R.C. § 163(d)(4). In other words, to the extent that the gains are taxed at the preferential rate, they cannot also be employed to soak up investment interest expense. The taxpayer, however, can elect to treat some of his or her net capital gain as not being net capital gain. To the extent that a taxpayer so elects, the gain is investment income, thereby increasing the amount of investment interest that can be deducted.
\(^{86}\) I.R.C. § 280A(a).
\(^{87}\) I.R.C. § 280A(c)(1)(A).
dwelling unit, in connection with the taxpayer's trade or business. Thus, only a trader who is engaged in a trade or business can deduct expenses attributable to a home office.

F. Alternative Minimum Tax

In recent years, the alternative minimum tax has applied to an increasing number of taxpayers. The reasons for this trend are a general rise in personal income and the fact that a higher percentage of many taxpayers' income consists of items that receive preferential tax treatment. For purposes of computing the alternative minimum tax, trade or business expenses are deductible in arriving at alternative minimum taxable income whereas investment expenses are not deductible. Traders are neither more nor less likely than other taxpayers to be subject to the alternative minimum tax, the imposition of which is largely dependent on whether a particular taxpayer has items of tax preference such as tax-exempt interest. Since the alternative minimum tax is computed on the basis of alternative minimum taxable income, a trader is less likely to be subject to the tax if his or her expenses are deductible in arriving at alternative minimum taxable income.

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88 I.R.C. § 280A(c)(1)(C).

The percentage of taxpayers subject to the AMT will be 85 percent for taxpayers with AGIs between $100,000 and $200,000; 98 percent for taxpayers with AGIs between $200,000 and $500,000; 68 percent for taxpayers with AGIs between $500,000 and $1 million; and 29 percent for taxpayers with AGIs greater than $1 million. The percentage of AMT taxpayers drops as AGI increases above $500,000 because the highest regular-tax statutory marginal tax rate of 35 percent (after 2005) is greater than the top AMT statutory marginal rate of 28 percent.

Id.

90 Id.
92 See I.R.C. § 57(a)(5).
93 See I.R.C. § 55(b)(2).
G. Net Operating Losses

Section 172 allows a net operating loss deduction for net operating loss carrybacks and carryovers. Under that section, a taxpayer can carry net operating losses back to the two years preceding the loss and forward to the twenty years following the loss. For purposes of computing the net operating loss, trade or business deductions are fully deductible, whereas deductions that are not attributable to a trade or business are deductible only to the extent of nonbusiness income. This result can be illustrated by a scenario in which a trader is successful in years one and two, but incurs a loss from trading activities in year three. If the trader’s activities constitute a trade or business, the trader can carry the losses back and receive a refund in year three of some or all of the taxes that the trader paid in years one and two. If, however, the trader’s level of activity is insufficient to constitute a trade or business, the trader can only treat the losses as capital, deduct $3000 in year three against ordinary income, and carry the capital loss forward. If the trader is not fortunate enough to enjoy some capital gains in future years against which the loss can be offset, the trader will continue to be limited to a $3000 deduction each year. If the losses are sizable, it could take years to obtain the full deduction.

H. Election to Expense Certain Depreciable Assets

Section 179 grants taxpayers an election to treat as a deduction the cost of certain depreciable property, which would otherwise have to be capitalized. The Code requires, however, that the property be acquired for use in the active conduct of a trade or business. Therefore, only traders whose trading activities are extensive enough to be engaged in a trade or business can make this election.

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94 I.R.C. § 172(a).
95 I.R.C. § 172(b)(1)(A).
96 I.R.C. § 172(d)(4).
97 Specifically, section 179(a) allows the election with respect to “any section 179 property.” Section 179 defines “section 179 property” as “any tangible property (to which section 168 applies) which is section 1245 property (as defined in section 1245(a)(3)) and which is acquired by purchase for use in the active conduct of a trade or business.” I.R.C. § 179(d)(1) (emphasis added).
98 I.R.C. § 179(a), (d).
I. Start-Up Expenditures

Section 195 allows a taxpayer an election to amortize over a "period of not less than 60 months" certain start-up costs that would otherwise be required to be capitalized. The benefits of this provision, however, are available only to those taxpayers who actually commence operation of an active trade or business.

J. Self-Employment Tax

Even if a trader is considered to be engaged in a trade or business, net gains from trading do not constitute "net earnings from self-employment" and, therefore, are not subject to FICA or Medicare taxes.

IV. WHAT LEVEL OF TRADING ACTIVITY IS NECESSARY FOR A TRADER TO BE ENGAGED IN A TRADE OR BUSINESS?

There is no provision in the Code or Treasury Regulations defining the term "trade or business" in any context. The only authority in this area is case law. This part reviews the relevant cases.

A. Supreme Court Decisions

The Supreme Court has never decided whether an individual's trading activities, as opposed to investment managerial activities, were extensive enough to constitute a trade or business. As a result, the Court has not articulated specific factors to determine the level of trading activity necessary in order for a taxpayer to be engaged in the trade or business of trading. Nevertheless, opinions that discuss the term "trade or business" in different contexts shed some light on this issue.

One of the earliest cases to consider the term "trade or business" was Snyder v. Commissioner. This case dealt with a taxpayer who

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99 I.R.C. § 195(b)(1). Unlike the assets described in section 179, the expenditures described in section 195 would not be depreciable. Therefore, absent section 195, the cost of those assets would ordinarily not be recoverable until the business is sold.


101 See I.R.C. §§ 1402(a), 475(f)(1)(D).

102 See I.R.C. §§ 1401(a), 475(f)(1)(D).

103 I.R.C. §§ 1402(b), 475(f)(1)(D).

traded securities, but only as a supplement to his other business activities. The Court observed that the facts did not indicate that the taxpayer "might properly be characterized as a 'trader on an exchange who makes a living in buying and selling securities.'" The Court recognized, however, that a taxpayer could be engaged in more than one trade or business and that "one may be 'regularly engaged in the business of buying and selling corporate stocks.'"

A few years later, in Deputy v. du Pont, the Court considered whether interest and other charges related to a one-time short sale of stock were deductible as "ordinary and necessary" expenses in carrying on a trade or business under the predecessor of section 162, which permitted a deduction for the ordinary and necessary expenses incurred in carrying on a trade or business. The taxpayer managed his large estate but there was no evidence that he was engaged in "trading" under any reasonable interpretation of that term. The taxpayer's trading activity clearly fell short of constituting a trade or business. While the Court assumed, arguendo, that the taxpayer was engaged in a trade or business, it nevertheless denied the deductions because it found that the taxpayer's expenses were not "ordinary." The Court, however, did refer with apparent approval to a Fourth Circuit decision that allowed an active trader deductions only if incurred in carrying on a trade or business.

_Du Pont_ is best known for Justice Frankfurter's concurring

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105 _Id._ at 135-36.
106 _Id._ at 139.
107 _Id._
109 _Id._ at 489.
110 _See id._ at 491-93.
111 _Id._ at 493-95. The district court correctly held that the taxpayer's management of his estate, including the du Pont stock, was not a trade or business. By holding that the expenses were not "ordinary," however, the Supreme Court was relieved of having "to pass on that contention and to make the delicate dissection of administrative practice which that would entail." _Id._ at 493. By avoiding the "trade or business" issue, the Supreme Court essentially made bad law. Under section 212, which was not yet enacted when _du Pont_ was decided, a deduction is allowable for all "ordinary and necessary" expenses incurred in connection with the production of income or the conservation of income producing property. I.R.C. § 212(1), (2). The terms "ordinary and necessary" under section 212 are to be construed pari passu with the same words in section 162. _See_ I.R.C. § 162(a). Applying the analysis in _du Pont_ to a similarly situated taxpayer today would result in the denial of a deduction under section 212, a clearly incorrect and unacceptable result.
112 _See du Pont_, 308 U.S. at 495 (citing Dart v. Commissioner, 74 F.2d 845 (4th Cir. 1935)).
opinion. Justice Frankfurter would have made explicit that the term “trade or business” contemplates “holding one’s self out to others as engaged in the selling of goods or services.”\(^{113}\) If this definition had become generally accepted, traders in securities (other than dealers) could never qualify for trade or business treatment no matter how extensive or short-term their trading. The Court, however, has rejected Frankfurter’s interpretation, leaving open the possibility that active traders can be engaged in a trade or business even though they do not sell securities to customers.

The following year, the Court decided *Higgins v. Commissioner*,\(^ {114}\) a case where the taxpayer had extensive investments in stocks, bonds, and real estate. Higgins devoted a substantial portion of his time to managing those investments.\(^ {115}\) He rented and staffed an office in New York, which he used in connection with the management and maintenance of both the real estate and securities holdings.\(^ {116}\) Higgins claimed his expenses as deductions under the predecessor of section 162.\(^ {117}\) The Service conceded that the portion of the expenses allocable to the real estate activities were deductible, but denied the deduction for that portion of the expenses allocable to the securities activities on the ground that the management of Higgins’s portfolio did not constitute a trade or business.\(^ {118}\) The Court noted that the determination as to whether a taxpayer carries on a business requires a case-by-case examination of the facts in each case.\(^ {119}\) Further, the Court observed that the taxpayer merely kept records and collected interest and dividends from his securities; for this reason, the Court concluded that no matter how extensive these managerial activities were, as a matter of law, they did not amount to carrying on a business.\(^ {120}\)

The *Higgins* opinion contained very little analysis and did not resolve what is required for a trader to be engaged in a trade or business.

\(^ {113}\) *Id.* at 499.
\(^ {114}\) 312 U.S. 212 (1941).
\(^ {115}\) *Id.* at 213.
\(^ {116}\) *Id.* at 213-14.
\(^ {117}\) *See id.* at 213. In support of his position that his activities constituted a trade or business, the taxpayer argued “that the ‘elements of continuity, constant repetition, regularity and extent’ differentiate[d] his activities from the occasional like actions of the small investor.” *Id.* at 215.
\(^ {118}\) The Commissioner argued that “mere personal investment activities never constitute carrying on a trade or business, no matter how much of one’s time or of one’s employee’s time they may occupy.” *Id.*
\(^ {119}\) *Id.* at 217.
\(^ {120}\) *Id.* at 218.
business. While observing that Higgins primarily made long-term investments, the Court did not focus on the frequency of his trades. At most, three conclusions can be drawn from the Higgins opinion: (1) the question of whether a taxpayer is engaged in a trade or business is to be determined case-by-case; (2) frequent and continuous managerial tasks with respect to one’s own investments, such as the collection and deposit of dividends, are insufficient to constitute carrying on a trade or business; and (3) the opinion does not contradict the Court’s statements in Snyder and du Pont that active traders of securities are engaged in a trade or business.121

Interestingly, the Supreme Court decision that is most relevant to traders’ status did not involve a trader but a gambler.122 In Groetzinger v. United States,123 the Supreme Court held that a full-time gambler124 was in a “trade or business” for the purpose of applying the alternative minimum tax.125 The Court observed that despite the ubiquitous presence of the term “trade or business” in the Code, neither the Code sections nor the regulations provided a definition of the term.126 Nor was there judicial authority for a broadly applicable definition.127 Despite implying the need for such a definition, the Court limited its decision in Groetzinger to “the meaning of the phrase as it appears in the sections of the Code with which [it was

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121 Higgins resulted in an effective tax on the gross, rather than the net income of Higgins’ investing activities. The congressional response to this patently unfair result was the enactment of section 212, which allowed “as a deduction all the ordinary and necessary expenses paid or incurred . . . (1) for the production or collection of income; [or] (2) for the management, conservation, or maintenance of property held for the production of income.” I.R.C. § 212 (1), (2). The enactment of section 212 alleviated the most egregious inequity in tax treatment of traders. As noted above, however, deductions under section 212 can be less useful to taxpayers than deductions under section 162, or worse, of no use at all. See supra notes 66-72 and accompanying text.

122 There are some who would say that trading stocks is gambling. See, e.g., Erika Gonzalez, It’s Life in a Very Fast Lane: Day Trading’s Allure Hasn’t Faded Despite Demise of Bull Market, ROCKY MTN. NEWS, May 26, 2001, at 1C (“‘I think its legalized gambling,’ said Colorado Securities Commissioner Fred Joseph. ‘There’s no analysis that goes into it — it’s like pushing a handle on a slot machine.’”).


124 Groetzinger, 480 U.S. at 33-34. Groetzinger devoted sixty to eighty hours per week to gambling, gambled solely for his own account, and had no other profession or type of employment. He went to racetracks six days a week, forty-eight weeks a year. Winnings from gambling were his primary source of income. Id.

125 See I.R.C. § 55.

126 Groetzinger, 480 U.S. at 27.

127 Id.
Nevertheless, courts have applied Groetzinger outside the context of the alternative minimum tax. After reviewing its earlier decisions, the Court rejected the requirement, suggested by Justice Frankfurter in his concurring opinion in du Pont, that a taxpayer must offer goods or services to be considered engaged in a trade or business. The Court set forth a less stringent standard:

If a taxpayer, as Groetzinger is stipulated to have done in 1978, devotes his full-time activity to gambling, and it is his intended livelihood source, it would seem that basic concepts of fairness (if there be much of that in the income tax law) demand that his activity be regarded as a trade or business just as any other readily accepted activity, such as being a retail store proprietor or, to come closer categorically, as being a casino operator or as being an active trader on the exchanges.

... One might well feel that a full-time gambler ought to qualify as much as a full-time trader, as Justice Brandeis in Snyder implied and as courts have held. The Commissioner, indeed, accepts the trader result.

... We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.

The Court observed that Groetzinger gambled full-time and relied on his gambling winnings for his livelihood. Since he gambled continuously and the income came from his personal efforts rather

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128 Id.
129 A recent Shepard's search on Groetzinger showed 336 citations, and in only nineteen of those searches did the citing opinion contain the term "alternative minimum tax." Additionally, Groetzinger was cited in some cases dealing with the issue of whether the taxpayer was engaged in the "trade or business" of trading securities. See, e.g., Mayer v. Commissioner, 67 T.C.M. (CCH) 2949 (1994); Paoli v. Commissioner, 62 T.C.M. (CCH) 275 (1991); Ropfogel v. United States, 1991 WL 128593 (D. Kan. July 3, 1991).
130 Groetzinger, 480 U.S. at 34.
131 Id. at 33-35 (citations omitted).
132 Id. at 35-36.
than appreciation in property, the Court reasoned that he was a businessman rather than an investor.\textsuperscript{133} Groetzinger was unlike a taxpayer whose "expenses [were] incident to caring for one's own investments even though that endeavor is fulltime."\textsuperscript{134} The Court applied a "common-sense concept of what is a trade or business," which required "an examination of the facts in each case."\textsuperscript{135} Even though the case-by-case method fails to supply a rule of general application, the Supreme Court left repair or revision of the process to Congress.\textsuperscript{136} While the Court lamented the fact that Congress had not defined the term "trade or business," it did articulate an interpretive standard: The activity must be for profit and the taxpayer must be involved in the activity with continuity and regularity.\textsuperscript{137}

\textbf{B. Lower Court Decisions}

There are two important appellate decisions that appear to be the source of the Service's position on the issue of who is engaged in a trade or business and a "trader in securities."\textsuperscript{138} The first of these is \textit{Purvis v. Commissioner}.\textsuperscript{139} There, the taxpayer sought trade or business status in order to employ the tax loss carryover provided by section 172 and to deduct lobbying expenses under section 162.\textsuperscript{140} The Ninth Circuit Court of Appeals affirmed the Tax Court's decision\textsuperscript{141}

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\begin{itemize}
\item \textsuperscript{133} See \textit{id}. at 28, 35-56.
\item \textsuperscript{134} \textit{Id}. at 31.
\item \textsuperscript{135} \textit{Id}. at 35-36.
\item \textsuperscript{136} \textit{Id}. at 36. This article suggests that more specific guidelines for determining whether a trader is engaged in a trade or business should be communicated to the public and tax professionals. While the facts of each situation may still have to be examined, both the taxpayer and the government should have a better idea of the appropriate determination. The Supreme Court suggested that Congress intervene, but it is submitted in this article that the guidelines be implemented as Treasury Regulations.
\item \textsuperscript{137} \textit{Id}. at 35.
\item \textsuperscript{138} The language of the Instructions is very close and, in some parts, identical to language in the opinions. See \textit{infra} Part V.B. Therefore, it would not be surprising if the Service had employed \textit{Purvis v. Commissioner}, 530 F.2d 1332 (9th Cir. 1976) (per curiam), and \textit{Moller v. United States}, 721 F.2d 810 (Fed. Cir. 1983) in drafting the Instructions.
\item \textsuperscript{139} 530 F.2d 1332 (9th Cir. 1976).
\item \textsuperscript{140} \textit{Id}. at 1333. At the time of the taxable years in question (1963-1968), section 162(e) allowed a deduction for all ordinary and necessary expenses incurred in carrying on a trade or business in connection with appearances before legislative appearances (state, federal, or local), as well as other lobbying expenses.
\item \textsuperscript{141} \textit{Purvis v. Commissioner}, 33 T.C.M. (CCH) 702 (1974).
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that the taxpayer was not engaged in a trade or business. Purvis engaged in a total of seventy-five sales of securities and ten short-term commodities sales between 1963 and 1968. Thirty-one of the securities sold had been held for more than six months (the holding period for long-term gains and losses at that time) and some were held for more than three years.

The Ninth Circuit followed the Supreme Court's mandate that each case of this nature must be decided on its peculiar facts. It then approved of the Tax Court's application of the factors distinguishing a trader from an investor. Specifically, the Ninth Circuit held that the regularity, frequency, and extent of the trading, along with the holding period of the securities sold, are the major factors in determining the ultimate purpose of the taxpayer. Accordingly, if the purpose is to profit from capital appreciation and dividends, the taxpayer is an investor. If, however, the purpose is to catch the swings in the daily market movements and trade with reasonable frequency, the taxpayer is engaged in the trade or business of trading.

In *Moller v. United States*, the Federal Circuit provided further guidance with respect to the trade or business issue. In that case, the taxpayers, a married couple, wished to deduct expenses attributable to two home offices. The taxpayers devoted their full time to their investment activities. The court held that the deduction was allowable only if the expenses were incurred in the course of the

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142 *Purvis*, 530 F.2d at 1334.
143 *Id.*
144 *Id.*
145 *Id.* at 1333 (citing *Higgins v. Commissioner*, 312 U.S. 212, 218 (1941)).
146 "[I]n the former, securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of securities on the daily market. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short term basis.
147 *Id.* at 1333 (citing *Chang Hsiao Liang v. Commissioner*, 23 T.C. 1040, 1043 (1955)).
148 *Id.*
149 *See also* *Asch v. Commissioner*, 51 T.C.M. (CCH) 1167 (1986) (holding that taxpayers were not traders where a husband and wife each had accounts, the wife presented no evidence that she managed her account at all, and the husband had twenty-nine purchases and twenty-two sales in his account for the year).
150 721 F.2d 810 (Fed. Cir. 1983).
151 *Id.* at 811.
taxpayer's trade or business.\textsuperscript{152}

The Federal Circuit reversed the Claims Court, which had held that the regular, extensive, and continuous investment activities of the taxpayers constituted a trade or business.\textsuperscript{153} The Court of Appeals observed that despite the extensive amount of time the taxpayers devoted to their investments, the number of transactions was relatively small and the average holding periods of the stocks were several years.\textsuperscript{154} In order to be engaged in a trade or business, the taxpayer must derive his income from short-term trading, as opposed to long-term gains and dividends.\textsuperscript{155} The Claims Court had ruled in favor of the taxpayers, reasoning that the Mollers were active, as opposed to passive, investors and, therefore, engaged in a trade or business.\textsuperscript{156} The Federal Circuit, relying on and consistent with \textit{Higgins}, rejected that line of reasoning as missing the point. It held instead that the relevant distinction is not between active and passive investing, but between investing and being engaged in the trade or business of trading.\textsuperscript{157}

There are also several Tax Court decisions dealing with this issue. While these cases do not articulate any standards that are inconsistent with those contained in \textit{Purvis} and \textit{Moller}, they illustrate various factual situations. Unfortunately, most of the results are obvious because the taxpayers were primarily seeking capital appreciation and dividends and not short-term trading profits.\textsuperscript{158} None of these cases

\begin{itemize}
  \item\textsuperscript{152} \textit{Id.} at 812-13 & nn.4-5. Deductions for home office expenses are not subject to the general disallowance rule of section 280A(a) if the home office is:
  \begin{itemize}
    \item exclusively used on a regular basis – (A) as the principal place of business for any trade or business of the taxpayer, as a place of business which is used by patients, clients or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or (C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer’s trade or business.
  \end{itemize}
  I.R.C. § 280A(c)(1).
  \item\textsuperscript{153} \textit{Moller}, 721 F.2d at 814.
  \item\textsuperscript{154} \textit{Id.}.
  \item\textsuperscript{155} \textit{Id.}.
  \item\textsuperscript{156} \textit{Id.}.
  \item\textsuperscript{157} See \textit{id.} at 814-15.
  \item\textsuperscript{158} See, e.g., Mayer v. Commissioner, 67 T.C.M. (CCH) 2949 (1994). In \textit{Mayer}, the taxpayer sold his oil drilling business and transferred the proceeds into equities. \textit{Id.} at 2949-2. Mayer hired investment managers and instructed them to pursue long-term capital gains. \textit{Id.} at 2949-2 to 2949-3. He incurred various expenses, the most significant of which were the management fees. \textit{Id.} at 2949-2. The Tax Court referred to earlier decisions that “distinguished between traders, who are in a trade
The Trading Business involves a close call where a taxpayer traded regularly and frequently throughout the year and had short holding periods.

V. ANALYSIS

A. Election to Mark-to-Market and Characterization of Gains and Losses

It is advantageous for the trader who is generating short-term gains and losses to have those gains and losses treated as ordinary. In a successful year, the trader’s net gains would be ordinary income taxed at his or her marginal rate. In a bad year, the trader’s ordinary loss from trading could be used to offset ordinary income from other sources. If the trading loss exceeds the trader’s income for the taxable year, any excess could be carried back two years and forward twenty years under section 172.

The tax consequences are less favorable for the short-term trader if his or her gains and losses are characterized as capital. Short-term capital gains are taxed at the same rate as ordinary income, providing

or business and ‘investors’, who are not, and stated that no matter how extensive a taxpayer’s activities with respect to the management of investment securities, he is acting as an investor and not a trader. Id. at 2949-4 to 2949-5; see also Paoli v. Commissioner, 62 T.C.M. (CCH) 275 (1991) (taxpayer apparently proved, for a one-month period, that he traded regularly, frequently, in substantial volume, and for short-term profit, but failed to maintain the pace for the rest of the year); Beals v. Commissioner, 53 T.C.M. (CCH) 492 (1987) (trader status denied because taxpayer’s investment positions were static; court, relying on Whipple and Higgins, rejected argument that he was entitled to trader status because he was an active, as opposed to a passive, investor); cf. Levin v. United States, 597 F. 2d 760 (Ct. Cl. 1979), (holding that the taxpayer, who devoted full-time to managing his securities and had virtually no income from other sources, whose transactions were continuous and extensive, and who was primarily seeking significant long-term gains, was engaged in the trade or business of trading); Ropfogel v. United States, 1991 WL 128593, (D. Kan. July 3, 1991) (denying taxpayer’s motion for summary judgment on the issue of applicability of limitations of sections 163(d) and 1091, which turned on characterization of taxpayer as either an investor in securities or a trader of securities, where taxpayer had executed almost 22,000 stock transactions in the two years in question; the court ruling suggested that a jury verdict in favor of the taxpayer could stand despite evidence that a substantial portion of the taxpayer’s gains came from long-term capital appreciation and dividend and interest income).

159 Capital gains and losses are short-term if the stock has been held one year or less. I.R.C. § 1222(1), (2).

160 An eligible trader with a substantial capital loss carryover may wish to defer making the election until he or she has generated sufficient gains to offset that loss.
no tax advantage.\textsuperscript{161} Short-term capital losses, however, can only be deducted to the extent of capital gains for the taxable year plus $3000 of ordinary income.\textsuperscript{162} Thus, a trader having a successful year would usually incur the same tax liability whether his or her gains were characterized as capital or ordinary. Conversely, in a bad year, the tax consequences would be significantly worse if the losses were characterized as capital, rather than ordinary.

Prior to 1997, the treatment of traders whose activities qualified as a trade or business failed to follow a consistent scheme. Traders could deduct their expenses in full as ordinary and necessary business expenses under section 162 on Schedule C and enjoy the other tax advantages of being engaged in a trade or business.\textsuperscript{163} Stock in the hands of such traders, however, was still a capital asset because it was not held for sale to customers.\textsuperscript{164} Therefore, these traders’ sales produced capital gains or losses, even though they were engaged in a trade or business. In other words, these traders were treated as businesspeople with respect to their expenses, but as investors with respect to their gains and losses.

In 1997, Congress, perhaps recognizing the inconsistent treatment afforded to active traders, enacted section 475(f).\textsuperscript{165} If an eligible

\textsuperscript{161} Short-term capital gains have one advantage over ordinary income in that they can be used to offset capital losses either carried forward from prior years or generated in a separate investment account. See I.R.C. § 1211(b).

\textsuperscript{162} Id. The unused losses can be carried forward to subsequent taxable years. I.R.C. § 1212(b). The carryforward losses, however, are still subject to the limitations of section 1211. Thus, if a taxpayer has a large net capital loss in one year, he can only use $3000 per year of that loss unless he is able to generate capital gains in subsequent years (easier said in a footnote than done).

\textsuperscript{163} Other advantages are set forth in supra Part III.

\textsuperscript{164} See I.R.C. § 1221(a)(1).

\textsuperscript{165} I.R.C. § 475(f) (added by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1001(b), 111 Stat. 903). Enabling these traders to treat their gains and losses as ordinary is also consistent with the purpose of section 1221, which is to distinguish between gains and losses that are part of the taxpayer’s everyday business activities and those that are investment in character. See Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46 (1955), reh’g denied, 350 U.S. 943 (1956). In Corn Products, the Court held that corn futures were not capital assets in the hands of the taxpayer, a manufacturer of products made from corn that was hedging against an increase in price in the cash market. The Court broadly stated that the term “capital asset” did not include property held by the taxpayer as an integral part of the taxpayer’s trade or business. Id. at 50-51 & n. 6. The Court significantly restricted the holding of Corn Products in Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988). There, the Court held that Corn Products applied only to hedging transactions with respect to a substitute for inventory. Id. at 221. Further, the business (versus investment) purpose of the taxpayer was irrelevant. Id.
trader makes the election provided in that provision, the trader can eliminate the inconsistency between the tax treatment of business expenses and the securities traded. Section 475(f) allows "traders in securities"\(^{166}\) to mark-to-market their gains and losses from sales of securities in connection with their trading business. The three significant consequences of the election are: (1) all securities held on the last day of the taxable year are deemed to have been sold (and effectively repurchased)\(^{167}\) on that day resulting in the recognition that year of the unrealized gains and losses;\(^{168}\) (2) all gains and losses of securities, including those marked-to-market, will be treated as ordinary;\(^{169}\) and (3) section 1091, the wash sale rule,\(^{170}\) does not submitted that the *Corn Products* Court had a better grasp of the situation and congressional purpose than the *Arkansas Best* Court. The latter case created a furor in the business community. The Supreme Court did not foresee the practical difficulties caused by its decision. Legitimate hedgers such as farmers selling futures to hedge against a drop in price and manufacturers or purchasers engaged in international transactions subject to currency risks were put in an untenable position. If the spot price of the commodity or financial instrument moved favorably, it would increase the taxpayer's ordinary income. The hedge position could, in some cases, under *Arkansas Best*, produce a capital loss, thereby creating a character mismatch. See generally Edward D. Kleinbard & Suzanne F. Greenberg, *Business Hedges After Arkansas Best*, 43 TAX L. REV. 393 (1988). The Treasury Department responded by issuing regulations calling for ordinary treatment of gains and losses from legitimate hedging transactions. See Treas. Reg. § 1.1221-2 (2002); see also 2 ANDREA S. KRAMER, FINANCIAL PRODUCTS[: TAXATION, REGULATION AND DESIGN § 24.03, at 24-9 (Supp. 2002).

\(^{166}\) As discussed infra Part V, this term is not defined in the Code or Treasury Regulations.

\(^{167}\) I.R.C. § 475(f)(1)(A)(i); see also I.R.C. § 475(f)(1) (flush language) ("Proper adjustment shall be made in the amount of any gain or loss subsequently realized for gain or loss taken into account [under the mark to market rule]."). Presumably, this would mean an upward adjustment of basis to fair market value (as if the security were immediately repurchased) in the case of a gain recognized as a result of the mark-to-market election and a downward adjustment of basis to fair market value (as if the security were immediately repurchased) in the case of a loss recognized as a result of the mark to market election.


\(^{169}\) I.R.C. § 475 (f)(1)(D), (d)(3).

\(^{170}\) Section 1091 disallows the loss (the loss is actually deferred through the use of a substitute basis) on the sale of stock or securities when identical stock or securities are purchased within thirty days before or after the date on which the stock or security for which the loss is claimed is sold. I.R.C. § 1091(a). The purpose of the wash sale rule is to require the closing out of a position in the event that the taxpayer wishes to claim a loss. Congress has designated an arbitrary test to determine whether a taxpayer meets the requirement. Section 1091 disallows a loss on the sale of securities where substantially identical securities are purchased within thirty days.
This section discusses several issues raised by the enactment of section 475(f). First, it considers who is a “trader in securities” within the meaning of section 475(f). Next, it examines the relationship between the standards applied in determining that a trader is engaged in a trade or business and the standards for determining who is a “trader in securities.” The Service’s communications to the public are then analyzed with respect to the requirements for “trader in securities” status. Finally, this section concludes that more specific guidelines, in the form of Treasury Regulations, are needed.

1. Who Is a “Trader in Securities?”

It will almost always be advantageous for the active short-term trader to make the mark-to-market election. It thus becomes incumbent upon the trader to demonstrate that he or she is a “trader in securities.” Neither section 475 of the Code nor the Treasury Regulations define the term “trader in securities.” The only

(prior or subsequent to) of the date of the sale for which the loss is claimed. To avoid application of the rule where the taxpayer still views the stock favorably and wishes to maintain the investment, the taxpayer must take an investment risk. A taxpayer can sell the stock at a loss, wait thirty-one days, and repurchase the stock. The investment risk is that the stock will go up in the interim and that the taxpayer will have to repurchase the stock at a higher price, generating a nondeductible economic loss (although obviously the taxpayer’s basis will reflect the higher cost). The other way to maintain the investment and finesse the wash sale rule is to “double up.” The taxpayer purchases an equivalent amount of shares and sells the original shares thirty-one days later. The investment risk is that the stock declines in the interim and the taxpayer’s loss (realized or unrealized) is doubled. If the taxpayer’s trade or business is short-term trading, it makes no sense to deny deductions for losses because of the wash sale rule. Although the taxpayer would be taxed on gains, many of his or her losses would be postponed until the shares, the purchase of which caused the disallowance of loss, were disposed of in a transaction not involving another disallowed loss under section 1091. Further, an active trader focusing on a few liquid stocks may trade in and out of the same stock very frequently. Applying the wash sale rule to such traders would involve continuous calculations of disallowed losses and substituted bases with adjustment under section 1091(d). This would constitute an intolerable administrative burden for taxpayers and the Service alike.


172 There is one situation where a trader may be better off deferring an election. A taxpayer with a capital loss carryover may be better off waiting until he or she generates sufficient capital gains to absorb the carryover before making the election. The key, of course, is generating the gains.

173 There is a proposed regulation concerning the manner in which a trader makes the election to mark-to-market. See Prop. Treas. Reg. § 1.475(f)-1, 64 Fed.
guidance available is the legislative history, which is meager. For instance, the House Report\textsuperscript{174} does not explain the term's meaning or purpose. The House Conference Report\textsuperscript{175} discusses the issue of segregating the trader's investment securities from his or her trading account, but does not explain why Congress extended this election, which was previously available only to dealers, to nondealers.

In contrast, the Joint Committee on Taxation's General Explanation\textsuperscript{176} is more useful. It first notes that dealers,\textsuperscript{177} but not active traders engaged in a trade or business, were required under prior law\textsuperscript{178} to compute their income pursuant to a mark-to-market method of accounting.\textsuperscript{179} Investment securities that were segregated by dealers were not subject to the mark-to-market rule\textsuperscript{180} and had to be identified as such before the close of the day on which they were acquired.\textsuperscript{181} While the General Explanation gives a rather unpersuasive reason\textsuperscript{182} for extending these rules to nonprofessional

Reg. 4374, 4378 (Jan. 28, 1999). There is also a proposed regulation describing the manner in which a trader must identify and segregate investment securities not connected with a trading business and not subject to mark-to-market accounting. See Prop. Treas. Reg. § 1.475(f)-2, 64 Fed. Reg. 4374, 4378 (Jan. 28, 1999).

\textsuperscript{176} STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997 (Joint Comm. Print 1997).
\textsuperscript{177} The term "dealer in securities" means a taxpayer who – (1) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business; or (2) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.
\textsuperscript{178} I.R.C. § 475(c)(1).
\textsuperscript{179} I.R.C. § 475(a).
\textsuperscript{180} See I.R.C. § 475(b)(1)(A).
\textsuperscript{181} See I.R.C. § 475(b)(2). This is best accomplished by holding investment securities in a segregated account.
\textsuperscript{182} The document states that the reason for the enactment of section 475(f) is that the application of the mark-to-market treatment to traders in securities will provide a clear reflection of income. STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 180. Notably absent, however, is any comment that the use of the cash basis method of accounting by an active short-term trader would not accurately reflect the trader's income or that the mark-to-market method would be superior to the cash basis method. In and of
traders, this issue is not the focus of this article.

The General Explanation nevertheless sheds light on the crucial issue of how to determine who is a “trader in securities”:

Traders in securities generally are taxpayers who engage in a trade or business involving active sales or exchanges of securities on the market, rather than to customers. Under prior law, the mark-to-market treatment applicable to securities dealers did not apply to traders in securities or to dealers in other property.183

It is not clear how much weight one should give to the General Explanation since it was drafted after the legislation was enacted, but the document was prepared by members of the highly professional Staff of the Joint Committee on Taxation, who have constant contact with members of the Senate Finance and House Ways and Means Committees. According to the General Explanation’s interpretation, Congress intended that the term “trader in securities” as used in section 475(f) be equated with a taxpayer whose trading activities are extensive enough to constitute a trade or business. This is clearly the correct interpretation, for no other interpretation is logical. Congress could not have intended section 475(f) to apply to investors and traders who fall short of being engaged in a trade or business because that would produce the absurd result that all taxpayers would be allowed to adopt mark-to-market accounting. Nor could the term “traders in securities” refer to dealers since dealers were already required under section 475 to mark-to-market their gains and losses. Further, equating “traders in securities” with traders engaged in the trade or business of trading would eliminate the inconsistency itself, this rather unpersuasive rationale for change would not be of particular interest.

In the context of day-trading, however, the legislation also provides for characterization of gains and losses as ordinary, instead of capital; in most cases, characterization of gains and losses as ordinary will have a more significant (and beneficial) impact on a trader’s tax liability than the mark-to-market requirement. It is curious that the legislative history does not discuss this aspect of the legislation. Further, it is surprising that the legislative history gives no explanation for this significant change in treatment. The enactment of section 475(f) was accompanied by no fanfare and one can only speculate about which interests supported the legislation.

183 STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 180 (emphasis added).

184 For an excellent analysis of the role of the General Explanation in interpreting legislation see Michael Livingston, What’s Blue and White and Not Quite as Good as a Committee Report: General Explanations and the Role of “Subsequent” Tax Legislative History, 11 AM. J. TAX POL’Y 91 (1994).
whereby a sufficiently active trader is treated generally for tax purposes as being in a trade or business, while the trader’s gains and losses from the sales of securities are treated as capital and subject to the wash sale rule.

Finally, the Service appears to agree with this interpretation as evidenced by the 1040 Instructions. The first sentence of these Instructions states that one is a “trader in securities” if “engaged in the business” of buying or selling securities for the taxpayer’s own account. The remainder of this article will proceed on the assumption that a “trader in securities” is one who is engaged in the trade or business of trading. Therefore, if a trader is engaged in a trade or business, he or she not only enjoys the tax benefits enumerated above, but also has the advantage of reporting all gains and losses resulting from trading as ordinary. Conversely, a trader who is not engaged in a trade or business is not entitled to either advantage.

B. The Service’s Requirements for “Trader in Securities” (and Engaged in “Trade or Business”) Status

As noted above, the Service’s only communication to the public regarding the requirements for status as a “trader in securities” is to be found in the instructions to Form 1040 and Publication 550. The Instructions, in relevant part, provide as follows:

[1] You are a trader in securities if you are engaged in the business of buying and selling securities for your own account. To be engaged in business as a trader in securities:

[2] You must seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation.


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185 See infra Part V.B.
187 See discussion supra Part III.
188 See id.

[5] The following facts and circumstances should be considered in determining if your activity is a business.


[7] The frequency and dollar amount of your trades during the year.

[8] The extent to which you pursue the activity to produce income for a livelihood.

[9] The amount of time you devote to the activity.

[10] You are considered an investor, and not a trader, if your activity does not meet the above definition of a business. It does not matter whether you call yourself a trader or a “day trader.”

1. Reaction to the Service’s Position

The Service has drawn on the case law in drafting the Form 1040 Instructions, particularly the Ninth Circuit’s decision in Purvis and the Federal Circuit’s decision in Moller. Nevertheless, the Instructions have two significant shortcomings. First, they seem to articulate a standard for trade or business status that is more restrictive than the standards articulated in the case law. Second, they are too general and therefore do not give adequate guidance to

190 Id. In the absence of any other official statement of position on this issue, it is assumed that the instructions accurately reflect the Service’s position. The author has added the paragraph numbers for ease of reference. The bold face is from the 1040 Instructions drafted by the Service. Different words are in boldface in Publication 550, but the content is otherwise the same.

191 This is evident from the language of the Instructions and has been confirmed by the Service in an informal telephone conversation with the author.

192 530 F.2d 1332 (9th Cir. 1976).

193 721 F.2d 810 (Fed. Cir. 1983).

194 The explanation for the lack of specificity may, in part, be because the standards articulated in the cases were general. In fact, the “standards” are really “factors,” which results in uncertainty. One reason that the case law is not particularly helpful is that none of the cases have involved a close call. In most of them, it was quite clear that the predominant motivation of the taxpayer was to obtain
taxpayers who trade and the tax professionals who advise them.

Paragraph 1 of the instructions simply states that a taxpayer is a "trader in securities" if the taxpayer is "engaged in the business of buying and selling securities for [his or her] own account."\textsuperscript{195} As discussed above,\textsuperscript{196} this article concludes that the "trader in securities" described in section 475(f) is the equivalent of the trader who is engaged in the trade or business of trading for other tax purposes. Therefore, the cases deciding whether taxpayers were engaged in the trade or business of trading\textsuperscript{197} are relevant in determining whether a taxpayer is a "trader in securities."

Paragraph 2 of the 1040 Instructions is misleading and suggests a more rigid standard for "trader in securities" status than is warranted by the case law. In particular, the language "[y]ou must seek to profit from daily market movements in the prices of securities" implies that intra-day trading, or something very close to intra-day trading, is required. It may be the case that the Service will not take that position when confronted with a quite active trader who position trades with holding periods of several days to several weeks. The language of the Instructions suggests, however, that the Service will take an inflexible position on the requisite level of trading. At the very least, Paragraph 2 would be consistent with a requirement that traders must predominantly day trade to qualify.

The Paragraph 2 language attempts to paraphrase the following language used by the Ninth Circuit in \textit{Purvis:} "In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis."\textsuperscript{198} Unfortunately, the Service's paraphrase is misleading. While the 1040 Instructions reflect the "daily market movements" portion of the quoted language, it omits the language that requires that a trader only buy and sell with "reasonable frequency." The language from \textit{Purvis} that the Service excluded from Paragraph 2 of the Instructions suggests that a less income through long-term capital appreciation and/or interest and dividends. Had there been a case where, for example, a trader had some intra-day trades, some position trades with holding periods of two to four weeks and an average holding period of, say eight days, the court would have been forced to articulate more specific guidelines in order to decide the case.


\textsuperscript{196} \textit{See discussion supra} Part V.A.1.

\textsuperscript{197} \textit{See discussion of cases supra} Part IV.

\textsuperscript{198} 530 F.2d at 1334.
frenetic trading pace and somewhat longer holding periods will suffice for "trader in securities" status than does the language of the 1040 Instructions.

The relevant Supreme Court decisions also suggest a less rigorous standard for "trade or business" status than intra-day trading. The opinions in Snyder\(^{199}\) and \(\text{du Pont}\)^{200} offer the lower benchmarks of "active trader" and one who trades with "continuity and regularity." In Groetzinger, the Court stated that a trader should have a "primary purpose . . . for income or profit"\(^{201}\) and assumed that an active trader would be engaged in a trade or business.\(^ {202}\) The General Explanation also sets forth a less rigid standard: "Traders in securities generally are taxpayers who engage in a trade or business involving active sales or exchanges of securities on the market, rather than to customers."\(^ {203}\) In short, there is no authority for imposing a requirement that traders must trade intra-day to obtain the benefits of being classified as a "trader in securities." The available authority, to the contrary, requires only that a trader be reasonably active.

A cardinal rule of statutory construction demands that words be given their everyday meaning unless the statute dictates otherwise.\(^ {204}\) The term "trader" is defined as "a person who buys or sells (in this case, stocks or commodities futures) in search of short-term profits."\(^ {205}\) Short-term means, "occurring over or involving a relatively short period of time."\(^ {206}\) Clearly, "a relatively short period of time" need not be restricted to signifying one day. In addition, the phrase "relatively short period of time" is not materially different in meaning from "reasonable frequency," the language in \(\text{Purvis}\)^{207} that was not reflected in the 1040 Instructions.

Recently, Samuel B. Sterrett, a former Chief Judge of the Tax Court, has suggested an increased use of industry definitions when construing the Code.\(^ {208}\) He noted that a line of Supreme Court

\(^{199}\) 295 U.S. 134 (1935).

\(^{200}\) 308 U.S. 488 (1940).


\(^{202}\) \textit{Id.} at 33.

\(^{203}\) \textit{General Explanation of Tax Legislation Enacted in 1997}, at 180 (Joint Comm. Print 1997).

\(^{204}\) One of many Supreme Court opinions stating this rule was rendered in the well known case of \(\text{Crane v. Commissioner}\), 331 U.S. 1, 6 (1947).

\(^{205}\) \textit{Merrimaw Webster Collegiate Dictionary} (10th ed. 1998).

\(^{206}\) \textit{Id.}

\(^{207}\) \textit{Purvis v. Commissioner}, 530 F.2d 1332, 1334 (9th Cir. 1976).

\(^{208}\) Samuel B. Sterrett, \textit{Use of Industry Definitions in Interpretation of the Internal
decisions espouses the rule of construction that words are to be given their common and ordinary meaning to their intended audience and surmised that "when Code provisions target a particular industry, industry standards should govern, absent a legislative directive to the contrary."\footnote{209}

One representative articulation of an industry standard is included in a report by broker-dealer Bear Stearns. In this report on the brokerage industry’s efforts to obtain the business of on-line traders,\footnote{210} traders were divided into three categories: Self-Directed Asset Managers (fewer than ten trades per year), Active Traders (ten to thirty trades per year), and Semi-Professionals (twenty-five to fifty trades per day). Likewise, discount broker Charles Schwab set forth criteria distinguishing the sophisticated trader from others in a request for a no-action letter from the SEC.\footnote{211} In its request, Schwab indicated that it offered "Gold level" access to its website to individuals who had "significant trading experience," who were, in turn, defined as individuals who made twenty-four or more trades annually.\footnote{212} In a similar vein, the discount brokerage arm of Fidelity Investments has recently introduced a new service called "Active Trader Pro," which is available to customers who trade thirty-six or more times in a rolling twelve-month period.\footnote{213}

The SEC recently approved substantially identical rule changes made by the NYSE and the NASD.\footnote{214} The stock exchanges had made margin rules\footnote{215} more restrictive for "pattern day traders," defined as customers who trade four or more times in five business days and

\begin{itemize}
\item Id. at 4.
\item Bear Stearns Report, supra note 38, at 14.
\item Id.
\item This service gives those traders privileges not available to other customers, including direct trading capabilities, advanced on-line margin features and access to real-time streaming data through interactive charting, NASDAQ Level II quotes, and watch lists. Theresa W. Carey, Supersize It? Big Trades Don't Yield Big Savings at Some Online Brokers, BARRON'S, Sept. 30, 2002, at T6. The same article reports that discount brokerage firm Ameritrade/Datek allows frequent traders to opt into the firm’s Apex plan which allows traders a visual aerial view of liquidity for a particular equity. Frequent traders are those who trade more than an average of ten times per month for a three-month rolling period.
\item NASD Rule 2520 and NYSE Rule 431. See id. at *1.
\end{itemize}
where day trading exceeds six percent of all the customer's trades.\footnote{Id. at *3, *5.} Apparently, the NYSE, NASD, and the SEC agreed that this trading pace is sufficient to label those traders as higher risk.\footnote{See id. at *8-9.} It is telling that a trader satisfies the first prong of the test if he or she makes more than four trades in five days, a relatively modest number. Moreover, the second prong requires that only six percent or more of the trader's day trades be completed intra-day.\footnote{Under this prong, a trader who makes only one day trade out of sixteen trades would be labeled a pattern day trader.} A final example suggestive of an industry standard comes from Alan Abelson's well-known column, \textit{Up and Down Wall Street}, which appears in \textit{Barron's}, the widely-read financial weekly. Mr. Abelson frequently reports the views of Wall Street players, some identified and some anonymous:

A hedge-fund guy, our friend...[is currently] bullish – or the equivalent of bullish for him – expecting the rally to extend for a few more weeks.

... .

Our friend, we should warn you, for all his Street smarts, is an inveterate trader, and his enthusiasms burn brightly but not for long... .

When he takes a step back and surveys the investment scene, he assumes a much more dour mien.\footnote{Alan Abelson, \textit{Up & Down Wall Street}, BARRON'S, Aug. 19, 2002, at 8.}

Mr. Abelson's comments in a publication read by a high percentage of those in the securities industry imply that one who holds a position for a few weeks is still very much a trader, as opposed to an investor.

The explicit and implicit views of Bear Stearns, Charles Schwab, Fidelity Investments, Alan Abelson, SEC, NASD, and NYSE concerning who is a “trader,” “active trader,” or “pattern day trader” appear in documents or publications prepared for business reasons and were obviously not directed to the tax issues discussed in this article. Nevertheless, their characterizations, while not conclusive, clearly are relevant to a determination of an industry standard. The views expressed by these organizations and individuals deeply immersed in the securities industry strongly indicate that the required level of trading implied by the 1040 Instructions in order to be considered an active trader is higher than, and inconsistent with, the industry standard.
It would also run counter to sound policy to require for "trader in securities" status that all or most trades be intra-day, or close to intra-day. If a trader is limited to the relatively small gains obtainable intra-day (as opposed to somewhat longer periods), he or she is more likely to be unsuccessful. The trader must pay commissions that, while relatively low, can still represent a significant percentage of gross profits, if any, achieved from trading for small gains. More important, the off-floor trader is generally buying the offer and selling the bid. In this situation, a trader must pick up in price movement this spread plus commissions just to break even. If a trader is forced to make trades within one day and to accept gains smaller than those potential in "position" trades, the combination of transaction costs, consisting of commissions and spread, plus the inevitable losses will often outweigh any gains. If the tax law effectively forces a trader to lose money, the trader will inevitably fail and, incidentally, not generate any tax revenue. Indeed, as previously noted, most day traders fail. The chance for a substantial move in the price of a security increases if the holding period is several days or a week or two, rather than a few hours or a day or two. Congress has recognized that a taxpayer can be in the trade or business of trading and has enacted provisions favorable to that class of taxpayers. The Service

220 For example, if the stock of X Corp. is $15.00 bid, $15.20 offer, not an unusually high spread, a trader who buys a thousand shares is already down by $200 (purchase price of $15,200 less $15,000 (amount which would be realized on an immediate sale)) plus commissions. Some traders refer to the loss of the spread on purchases and sales as "slippage."

221 "Position trade" is a term used to describe a trade where the holding period may be several days to several weeks. While not an intra-day trade, a position trade is still a trade in the sense that the stock typically is not held long-term for capital appreciation.

222 Indeed, if intra-day trading is required to maintain favorable tax status, a taxpayer may be forced to sell at a loss a position acquired (or buy back a position sold) earlier in the day at a loss even when the trader correctly believes that the price will reverse favorably the next day.

223 Of course, losses on unsuccessful trades will be amplified by the same commissions and spreads that reduce the gains from successful trades.

224 The following passage colorfully illustrates this point:

Day trading is much harder than most people think. Beginners stumbling into this field usually get the same financial results as from playing three-card monte on the street. The cards get shuffled a little too fast, the expense of getting in and out is a little too high, the player's attention flags just a little, and soon another day-trading wannabe bites the dust.

ALEXANDER ELDER, STUDY GUIDE FOR COME INTO MY TRADING ROOM 47 (2002).

225 See supra note 5 and accompanying text.
should not contravene congressional intent by imposing requirements through the 1040 Instructions that limit the ability of traders to avail themselves of the tax benefits that Congress intended them to have.

Paragraphs 3 and 4 of the 1040 Instructions require trading activity to be regular and continuous in order for a taxpayer to obtain trader status. These requirements, in contrast to the language of Paragraph 2, are accurate distillations of the standards set forth in Purvis and other cases. A trader's activities must be substantial and carried on with continuity and regularity. These requirements are so general, however, that they offer little guidance to taxpayers and tax professionals who, given a specific fact situation, must determine whether a section 475(f) election is appropriate.226

Finally, Paragraphs 6 through 9 of the 1040 Instructions list factors relevant to determining compliance with the requirements listed in Paragraphs 2 through 4. The holding periods of securities sold, the frequency and dollar amounts of trades, the extent to which a taxpayer relies on income from trading, and the amount of time devoted to trading, are clearly relevant. Unfortunately, these factors lack specificity and would not be useful in cases where the facts do not compel a finding that the taxpayer is or is not in the business of trading.

2. Need for More Specific Guidance

The failure of the Service to issue more specific guidelines may partly stem from the Supreme Court's statement in Higgins that "[t]o determine whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case."227 The Groetzinger Court was nevertheless aware of the shortcomings inherent in this approach: "Higgins, with its stress on examining the facts in each case affords no readily helpful standard."228 On the whole, the case law has failed to articulate specific standards. None of the reported decisions involved facts that required a court to address the extent of the trader's activity in a close call situation. The courts

226 As previously noted, eligibility to make the section 475(f) election depends on a finding that the trader is engaged in a trade or business. See supra Part V.A, B. The lack of specific guidance on this issue also makes it difficult to assess the applicability of the other tax provisions discussed above (such as the limitation on investment interest, deductibility of a home office, etc.) that are dependent on the existence, or lack thereof, of a trade or business.


may have developed more specific standards if required to decide cases where the result was not obvious.

Regardless of the reason for the lack of specific standards, active traders have been left without adequate guidance. They must nevertheless make a decision whether to file a Schedule C and elect the mark-to-market method of accounting. There may be traders who would qualify for "trade or business" and "trader in securities" status who are dissuaded from filing a Schedule C and electing to mark-to-market. To the extent that this occurs, the 1040 Instructions may currently prevent traders from obtaining the tax advantages to which they are entitled.

There is a clear need for more definite standards to determine whether a taxpayer is engaged in the business of trading. The most logical place to set forth those standards would be in the Treasury Regulations. This section will conclude with a list of subjects that should be covered in any new regulations. These suggestions cover only the subject matter that should be addressed. While examples are given to illustrate the type of rules that might be issued, this article neither recommends specific content, nor purports to set forth all subjects that are appropriate for new regulations. The details of any such regulations will, of course, result from the usual internal procedures for rulemaking and modifications made after the public comment period.

3. Holding Periods for Securities Purchased and Sold

The holding periods of securities and the frequency of trades are obviously critical factors in determining whether a taxpayer is a "trader in securities." Currently, the 1040 Instructions state only that the holding period is a factor, but they do not set forth even minimal standards for determining what kind of holding period would suffice to receive trader status. In this case, the Service should give further guidance to taxpayers and their advisors. For example, one approach would be to establish a rebuttable presumption of "trader in securities" status (and "trade or business" status) if the taxpayer's average holding period for securities in his trading account was equal to or less than a specific period of time (e.g., a week). Another approach would be to provide for the same presumption if a certain percentage of trades is closed out within a certain period, for example, eighty percent of the trades within three trading days, three weeks, or three months. These two approaches could also be applied in the

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229 The author does not presume to have the expertise or the necessary...
alternative.

4. Frequency and Dollar Amount of Trades

Since the wealth and portfolio size of traders will vary significantly, any regulations should approach these two factors separately. Standards for frequency should be applied to traders consistently but standards for dollar amounts should be in relation to portfolio size. The Treasury could create specific guidelines based on the absolute number of trades. For example, the regulations could provide for a rebuttable presumption of "trader in securities" status if a taxpayer averages ten trades per week. Although the case law calls for continuity and regularity, the regulations should make allowances for vacations and illness. Allowance should also be made for a decrease, or even cessation, of trading during periods when, in the judgment of the taxpayer, market conditions are not conducive to successful trading.\(^{230}\)

5. Dollar Amount of Trades

The dollar amount of trades is only relevant in relation to the value of securities held in the taxpayer's trading account and any Treasury guidelines should be drafted accordingly. Any standards based on the absolute dollar amount of trades could apply unfairly to traders with smaller accounts. One solution might be a standard familiarity with the securities industry to formulate the appropriate standards.

\(^{230}\) Jesse Livermore is probably the best-known trader. He was widely blamed for playing a prominent part in the stock market crash in 1929 because of his short-selling. In fact, according to some commentators, the rule that short sales can only be made on an uptick was a response to his short-selling techniques. As much as Jesse Livermore loved to trade, he recognized that there were times when market conditions were not conducive to trading, as exemplified from this excerpt from a work of fiction that is widely believed to be a thinly-veiled biography of his life:

> It has always rankled my mind that after I left Williamson & Brown's office the cream was off the market. We ran smack into a long moneyless period; four mighty lean years. There was not a penny to be made. As Billy Henriquez once said, "It was the kind of market in which not even a skunk could make a scent."

> ....

> I [continued to trade and] lost money. It served me right because I was trying to force the market into giving me what it didn't have to give - to wit, opportunities for making money.

based on the turnover ratio of the account during the taxable year.\textsuperscript{231} Since, in part, that figure is dependent on the frequency of trades, there is an overlap between the two factors.\textsuperscript{232} Standards for frequency and dollar amount could be stated in the alternative.

6. The Extent to Which Taxpayer Relies on Income from Trading and Amount of Time Devoted to Activity

These two factors are interrelated. The 1040 Instructions are misleading because they suggest that the taxpayer's sole, or even primary, source of income must be from trading in order for the taxpayer to qualify for "trader in securities" status. It is beyond dispute, however, that a taxpayer can be engaged in more than one trade or business.\textsuperscript{233} This conclusion should not be altered by the fact that the taxpayer (assuming two distinct trade or business activities) may be able to live on the income from one business but not the other, from the two combined, or from neither.\textsuperscript{234}

\textsuperscript{231} The "turnover ratio" is used in the securities regulation area to determine whether a broker has churned a customer's account.

The turnover ratio... is the ratio of the total cost of purchases made for the account during a given period to the total amount invested in the account, thereby giving the fact-finder the ability to determine how many times in that period the securities in a customer's account have been replaced by new securities recommended by the broker.

\textbf{JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS} 1152 (2001). This would appear to be a logical way to measure the velocity of trading. A regulation could, for example, create a rebuttable presumption of trade or business if a portfolio turned over five times.

\textsuperscript{232} The size of the trades would also influence how often the portfolio turned over. For example, one trader may have a pattern of making very frequent trades but limit the amount of any purchase to a small percentage of his or her trading account. Although another trader may trade less frequently, some of the trades may involve purchases that represent a significant portion of his or her trading account. The former would look more like a trader under a frequency analysis while the latter may fare better under a dollar amount analysis.

\textsuperscript{233} Snyder v. Commissioner, 295 U.S. 134 (1935); Bell v. Commissioner, 615 F.2d 226 (5th Cir. 1980); Cottle v. Commissioner, 89 T.C. 467 (1987).

\textsuperscript{234} A taxpayer may have sufficient income-producing assets so that the taxpayer does not need additional income from one or more trade or businesses to subsist. That should not preclude the taxpayer from treating activities that constitute a trade or business as such.
7. The Extent to Which the Taxpayer Pursues the Activity to Produce Income for a Livelihood (Paragraph 8 of the Instructions) and the Amount of Time Devoted to the Activity (Paragraph 9 of the Instructions)

These two factors have the greatest capacity for misuse in order to deny trader status. A reader of the 1040 Instructions may understand the language of Paragraphs 8 and 9 as implying conditions for trader status that are more stringent than required by the case law.

Specifically, the 1040 Instructions could be construed to imply that the taxpayer can have only one trade or business and/or must devote full or substantially full-time to trading to qualify for trader status. As noted above, however, it has long been established that a taxpayer can have more than one trade or business.235 A fortiori, one does not have to spend 100% of one's working day engaged in a particular trade or business. Something less than full-time trading should still qualify the taxpayer as a trader as long as he or she meets the case law standard of "active trader." For instance, a tax attorney could also be engaged in the real estate business by owning and operating several rental properties even though he or she devotes only five to ten hours per week to the latter activity. By the same token, that same tax attorney could also be engaged in the trade or business of trading. The tax attorney may, as many traders do, devote an hour or two in the evening or early morning studying his or her portfolio and market conditions. Such a trader may also periodically check positions and/or trade throughout the day. With the placement of limit and stop orders, a trader may be actively trading, even though at the time the trades are executed, he or she is taking a deposition.236

235 See Snyder, 295 U.S. 134; Bell, 615 F.2d 226; Cottle, 89 T.C. 467.
236 For example, an order could be entered to buy 500 shares of X Corp., which closed the previous trading session at $30 per share, at a limit price of $29.25 with a stop loss order at $27.15. As another example, assume that a trader owns 500 shares of Y Corp., which closed the previous day at $42.12. The trader is willing to risk no more than a $2 down movement and would be pleased to sell the shares $4 higher. The trader could place both a stop loss order to sell at $40.12 and a limit order to sell at $46.12, OCO (order cancels order, that is, the execution of one of the two orders automatically cancels the other). Those and other orders may or may not be executed on any given day, but there would be no reason to require the trader to sit around all day and watch a computer monitor to see if any or all of the orders are executed.
VI. CONCLUSION

In order to have the various tax advantages described above, as well as to be eligible to elect the mark-to-market method of accounting, a trader must be engaged in a trade or business. Currently, many taxpayers who trade securities cannot make an informed decision whether they are entitled to these benefits. With the promulgation of more specific standards that address the required holding periods of securities, the frequency and dollar amounts of trades, and the extent of reliance on income from trading, taxpayers and tax professionals will be able to make more informed decisions with respect to business and tax planning.

\[237\] \textit{See supra} Part III.