

Traders in Securities

(Information for Form 1040 Filers)

The following is a description of who the IRS classifies as an Investor and a Trader, and the IRS rules that apply for both.

January, 2009

Investors typically buy and sell securities and expect income from dividends, interest, or capital appreciation. Sales of these securities result in capital gains and losses that must be reported on Form 1040, Schedule D, *Capital Gains and Losses*.

- Investors are subject to the capital loss limitations described in section 1211(b), in addition to the section 1091 wash sales rules.
- Investors can generally deduct the expenses of producing taxable investment income. These include expenses for investment counseling and advice, legal and accounting fees, and investment newsletters. These expenses are deductible on Form 1040, Schedule A, *Itemized Deductions*, as miscellaneous deductions to the extent that they exceed 2% of adjusted gross income. Interest paid on money to buy or carry investment property that produces taxable income is also deductible on Schedule A, but under section 163(d) the deduction cannot exceed the net investment income.
- Commissions and other costs of acquiring or disposing of securities are not deductible but must be used to figure gain or loss upon disposition of the securities. An investor is not subject to self-employment tax.

Traders in securities are subject to special rules. Traders are in the business of buying and selling securities for their own account. To a Trader, engaged in business as a trader in securities, you must meet all of the following conditions:

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

The following facts and circumstances should be considered in determining if your activity is a securities trading business:

- Typical holding periods for securities bought and sold.
- The frequency and dollar amount of your trades during the year.
- The extent to which you pursue the activity to produce income for a livelihood, and
- The amount of time you devote to the activity.

If the nature of your trading activities does not qualify as a business, you are considered an investor, and not a trader. It does not matter whether you call yourself a trader or a "day trader." Further, a taxpayer may be a trader in some securities and hold other securities for investment. The special rules for traders do not apply to the securities held for investment. A trader must keep detailed records to distinguish the securities held for investment from the securities in the trading business. The securities held for investment must be identified as such in the trader's records on the day he or she acquires them.

Traders report their business expenses on Form 1040, Schedule C, Profit or Loss From Business. The limit on investment interest expense, which applies to investors, does not apply to interest paid or incurred in a trading business. Commissions and other costs of acquiring or disposing of securities are not deductible but must be used to figure gain or loss upon disposition of the securities. Gains and losses from selling securities as part of a trading business are not subject to self-employment tax.

The tax treatment of sales of securities held in connection with a trading business depends on whether a trader has previously made an election under section 475(f) to use the mark-to-market method of accounting. If the mark-to-market election was not made, then the gains and losses from sales of securities are treated as capital gains and losses that must be reported on Form 1040, Schedule D. Both the limitations on capital losses and the wash sale rules continue to apply. However, if the mark-to-market election was timely made, then the gains and losses from sales of securities are treated as ordinary gains and losses (except for securities held for investment — see above) that must be reported on Part II of Form 4797, *Sales of Business Property*. Further, neither the limitations on capital losses nor the wash sale rules apply to traders using the mark-to-market method of accounting.

In general, the mark-to-market election must be made by the due date (not including extensions) of the tax return for the year prior to the year for which the election becomes effective. The election is made by attaching a statement either to your income tax return or to a request for an extension of time to file your return. The statement should include the following information:

- That you are making an election under section 475(f) of the Internal Revenue Code;
- The first tax year for which the election is effective; and
- The trade or business for which you are making the election.

For more information, please refer to the IRS Web site (www.irs.gov).

Nadine M Lord EA CFP

**Individual, Business
and Estate
Tax Preparation**

30021 Tomas, Suite 300
Rancho Santa Margarita CA 92688

Phone: 949-766-7808

Toll Free: 800-350-1299

Fax: 949-766-7809

NadineLord@cox.net

www.NadineLord.com