Tax Implications of Investor or Trader Status

Most taxpayers who trade stocks are classified as investors for tax purposes. This means any net gains are going to be treated as capital gains vs. ordinary income. That's good if your net gains are long term from positions held more than a year. However, any investment-related expenses (such as margin interest, stock tracking software, etc.) are deductible only if you itemize and, in some cases, only if the total of the expenses exceeds 2% of your adjusted gross income.

Traders have it better. Their expenses reduce gross income even if they can't itemize deductions, and not just for regular tax purposes, but also for alternative minimum tax purposes. Plus, in certain circumstances, if they have a net loss for the year, they can claim it as an ordinary loss (so it can offset other ordinary income) rather than a capital loss, which is limited to a $3,000 ($1,500 if married filing separate) per year deduction once any capital gains have been offset. Thus, it's no surprise that in two recent Tax Court cases the taxpayers were trying to convince the court they qualified as traders. Although both taxpayers failed, and got hit with negligence penalties on top of back taxes, the cases provide good insights into what it takes to successfully meet the test for trader status.

The answer is pretty simple. A taxpayer's trading must be "substantial." Also, it must be designed to try to catch the swings in the daily market movements, and to profit from these short-term changes rather than from the long-term holding of investments.

So, what counts as substantial? While there's no bright line test, the courts have tended to view more than a thousand trades a year, spread over most of the available trading days in the year, as substantial. Consequently, a few hundred trades, especially when occurring only sporadically during the year, are not likely to pass muster. In addition, the average duration for holding any one position needs to be very short, preferably only a day or two. If you satisfy all of these conditions, then even though there's no guarantee (because the test is subjective), the chances are good that you'd ultimately be able to prove trader vs. investor status if you were challenged. Of course, even if you don't satisfy one of the tests, you might still prevail, but the odds against you are presumably higher.

If you have any questions about this area of the tax law or any other tax compliance or planning issue, please feel free to contact us.

Double Benefit From a Tax Deduction

For most taxpayers, the amount of federal income tax they pay depends on where they fall in the federal income tax brackets and the breakdown of their taxable income between ordinary (e.g., wages) and capital gains from the sale of assets (e.g., common stock). Taxpayers eligible for the lower federal income tax brackets (those under 25%) on their ordinary income can generally expect to be taxed at 0% on their long-term capital gains. Taxpayers in the 25% or higher federal income tax brackets can generally expect to be taxed at either 15% or 20% (again, exceptions apply) on at least a portion of their long-term capital gains. It seems inevitable that, as federal taxable income increases, the rate we pay on at least a portion of that income also increases. The converse should and does apply. That is, as federal taxable income decreases, the rate of tax we pay on at least a portion of that income also decreases. In addition, if a taxpayer has a long-term capital gain that, after considering ordinary income, is partially taxed at the 0% rate, any additional deduction that decreases ordinary income will simultaneously decrease the tax rate on a comparable amount of long-term capital gain from 15% to 0%. This has the effect of producing a double benefit for that deduction, as shown in the following example.

Example: Jack and Julie, filing jointly for 2014, have net ordinary income of $60,000 and a long-term capital gain from the sale of stock of $40,000, for total income of $100,000. For 2014, the joint rates applicable to ordinary taxable income change from 15% to 25% at $73,800. Accordingly, $13,800 ($73,800 - $60,000) of their long-term capital gain will be taxed at 0% and the balance of $26,200 ($40,000 - $13,800) is taxable at 15%. All income, both capital and ordinary, is taxed at a rate of 15% or less.

If Jack and Julie contribute $11,000 to their deductible IRAs ($5,500 each for 2014, assuming they are both under age 50), they receive a 30% tax rate savings, even though their highest tax bracket is 15%. The $11,000 IRA deduction reduces ordinary income at the 15% rate, but also shifts $11,000 of capital gain taxation from the 15% to the 0% bracket, for another 15% savings. This produces a total tax benefit of 30% on the $11,000 reduction.

A similar impact would occur for any expenditure or deduction that reduced ordinary income (i.e., Section 179 expense, additional interest expense, etc.). Conversely, adding ordinary income at the 15% bracket would cause a 30% impact, as additional ordinary income would push a portion of the capital gains formerly at 0% upward into the 15% bracket.