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A Structural Critique of Trader Taxation

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A STRUCTURAL CRITIQUE OF TRADER TAXATION

by
Shu-Yi Oei*

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SECTION I: INTRODUCTION

Taxpayers who are securities traders are subject to unusual treatment under the tax law.¹ Such a taxpayer is, like any other merchant or businessperson, allowed to deduct various expenses incurred in his business of trading securities but, unlike any other merchant or businessperson, is simultaneously allowed to treat gains and losses from the sale of such securities as capital, rather than ordinary, gains and losses. Such capital gains and losses may be taxed at reduced rates and subject to other different tax treatments.² Since the enactment of IRC section 475(f) in 1997, traders have also been allowed to make a special election to “mark to market” gains and losses from their securities-trading activities.³ Making this election allows a trader to recognize gains and losses on the securities he holds as if those securities were sold at fair market value on the last business day of the trader’s taxable year, and to convert such gains or losses to ordinary, rather than capital, gains or losses.⁴

The distinctive tax treatment of securities traders has been frequently pointed out, and various commentators have noted that, although the standards for qualifying for trader treatment are uncertain, favorable planning opportunities arise upon achieving such classification.⁵ However,

1. Harrison B. McCawley, *Transactions in Stock, Securities and Other Financial Instruments*, 184-4th Tax Mgmt. (BNA) A-1 – A-4(1); IRS Tax Topic 429, available at <http://www.irs.gov/taxtopics/tc429.html> (last visited Jan. 26, 2008).

2. Under present law, taxpayers who hold “capital assets” over a long-term holding period (generally, more than 12 months) will be subject to reduced tax rates on disposition of that asset. IRC §§ 1(h)(1), 1222(3), 1222(4). The history of and reasons for the differential tax treatment of capital assets is a subject that has been much discussed. See Leonard E. Burman, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed* (Brookings Instit. Press 1999).

3. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §§ 1001(b), (d)(4), 111 Stat. 788, 906-08 (1997).

4. IRC § 475(f).

5. See, e.g., Glenn P. Schwartz, *How Many Trades Must a Trader Make to be in the Trading Business*, 22 Va. Tax Rev. 395, 409-10 (2003); Burgess J.W. Raby & William L. Raby, *Effect of “Sporadic” Activity on Securities Trader Status*, 103 Tax Notes 1375 (June 14, 2004) [hereinafter Raby, *Effect of “Sporadic” Activity*]; Burgess J.W. Raby & William L. Raby, *Nondealer Security Losses: Capital or Ordinary?* 115 Tax Notes 45, 46 (Apr. 2, 2007) [hereinafter Raby, *Nondealer Security Losses*]; Lee A. Sheppard, *News Analysis: Making Traders Mark to Market*, 76 Tax Notes 721 (Aug. 11, 1997); Burgess J.W. Raby & William L. Raby, *Ordinary Deductions, but Capital Losses for Securities Traders*, 74 Tax Notes 611 (Feb. 3, 1997) [hereinafter Raby, *Ordinary Deductions but Capital Losses*] (referring to trader status as a “tax oddity”); Burgess J.W. Raby & William L. Raby, *Trader, Gambler, or Investor, & Tax Consequences Thereof*, 85 Tax Notes 1665 (Dec. 27,

the structural elements of the tax law underlying trader tax treatment and the problems created by this statutory structure have somewhat escaped scrutiny. This article approaches the unusual treatment of traders through a structural lens. By focusing on the structure of the statutory tax rules that apply to securities traders, this article explains at the outset how the unusual treatment of securities traders today has occurred due to a long-standing, legislatively created structural disjuncture at the point where the capital asset rules and the “trade or business” concept intersect. This disjuncture was created by the 1934 introduction of the “to customers” requirement into the capital asset statute, that is, the requirement that property otherwise held for sale in the ordinary course of the taxpayer’s trade or business must also be held for sale “to customers” in order to escape being treated as a capital asset.⁶ Prior to the 1934 introduction of the “to customers” requirement, the statute was essentially symmetrical in the sense that whether or not a trader–taxpayer was in a “trade or business” led to basically all of the tax consequences to that taxpayer. The introduction of the “to customers” requirement has led to a statutory scheme in which one standard determines the character of the gain or loss from the sale of securities of the trader–taxpayer, but a completely different standard (the trade or business requirement) gives rise to almost all of the other consequences with respect to deductions from gross income that apply to a trader.

This article explores some of the problems created by this disjuncture in the structure of the current tax rules that apply to traders, and argues that the effects of this structural disjuncture would be even more pronounced if not for the interventions of the courts and the legislature, which, from a structural standpoint, have served to minimize the impact of this disjuncture without eliminating it altogether. Given the volatility inherent in the statutory structure of the trader tax rules, and given that the courts and the legislature have already taken steps to minimize the impact of the disjoint statutory structure, it is the position of this article that a different approach needs to be taken in taxing traders. Specifically, the “to customers” requirement should be eliminated altogether, traders should be taxed like dealers (including with respect to the accounting method required), and the IRS should supplement court decisions, which make trader status difficult to attain, with stringent and concrete guidance of its own. Such an approach would reduce complexity and add a degree of rationality to the taxation of traders that is missing from the current approach.

Section II of this article briefly outlines the tax treatment of securities traders under current law, and discusses the basic differences

1999) [hereinafter Raby, *Trader, Gambler, or Investor*]; Kaye A. Thomas, *Trading, but Not a Trader*, 104 *Tax Notes* 274 (July 19, 2004).

6. Revenue Act of 1934, Pub L. No. 73-216, § 117(b), 48 Stat. 680, 714 (1934).

between the tax treatment of securities traders, dealers, and investors. Section III delves into a structural analysis of the actual tax concepts that underlie the differing tax treatments of traders, dealers, and investors and shows that, while the majority of the tax consequences to a securities trader on the deductions side are based on whether the taxpayer is “engaged in a trade or business,” the character of such trader’s gains or losses is determined based on whether the assets bought or sold are capital assets under the capital asset statute, IRC section 1221. As a result of the 1934 introduction of the “to customers” requirement into IRC section 1221, the gating item in determining whether such assets are capital assets lies not with whether or not the taxpayer is engaged in a trade or business, but rather with whether she has customers to whom such securities are being sold. Section III then argues that these rules represent an intrinsically problematic asymmetry in the statutory structure that creates odd tax results for the securities trader and that needs to be examined critically. Section IV surveys some of the criticisms that have been lodged against the way traders are taxed, and offers some new critiques of trader taxation from a structural perspective. Section V shows that the reason the structural asymmetry and volatility in the statutory rules wrought by the “to customers” requirement have not been more problematic is because of structural remediation efforts by the courts and the legislature: courts have outright ignored the “to customers” requirement outside of the securities context, and Congress has taken steps – via the creation of the IRC section 475(f) “mark-to-market” election – to ameliorate the nonsensical results created by the statutory structure without actually addressing the fundamental problem caused by the statutory language. In Section VI, this article concludes that since (i) the structure of the statutory rules has the potential to cause pervasive problems, (ii) courts are essentially creating a judicial fix by ignoring the statutory language of the capital asset statute in other contexts, (iii) Congress has essentially created its own opt-in solution to the problem, and (iv) the courts and the IRS have taken steps to render attainment of trader classification difficult, the “to customers” requirement in the capital asset definition should be eliminated, and a different approach taken, in order to effect a more efficient and equitable statutory structure. The approach recommended in Section VI of this article would minimize the problems associated with the tax treatment of traders, and would ease the degree of complexity and irrationality embedded in trader taxation, and would do so without necessarily creating further abuses or difficulties in place of the current ones.

SECTION II: RULES GOVERNING THE TAXATION OF SECURITIES TRADERS

Broadly speaking, the tax law distinguishes between three different classes of taxpayers in determining the tax consequences to a taxpayer who

buys, sells, or holds securities: traders, dealers, and investors.⁷ The tax consequences of buying, selling, and holding such securities differ significantly depending on the classification of the person doing the buying, selling, or holding.⁸ Traders in some sense occupy the middle ground between dealers and investors. Therefore, it is essential to understand the meaning of the terms “investor” and “dealer” in order to understand “trader” classification.

“Investor” is the default tax classification of most taxpayers owning securities. Therefore, a typical individual who holds stocks and securities will usually be assumed to be an investor, absent circumstances suggesting otherwise.⁹ An investor, unlike a dealer or a trader, is one who purchases and sells securities for the principal purpose of realizing gains from appreciation in the value of the security over a relatively long period of time.¹⁰ Therefore, an investor’s holding period for securities is usually longer than that of a trader.¹¹ In direct contrast to investors in securities, those taxpayers classified as dealers are taxpayers that are in the business of buying and selling securities to customers, and are usually broker–dealers registered with the SEC and licensed by state securities regulators.¹² “Dealer” has been defined in Treasury Regulations as “a merchant of securities, whether an individual, partnership or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers.”¹³ As discussed further below, dealers generally hold securities as inventory, seek to profit on the resale of those securities at marked up prices (having bought them at a lower cost), and may engage in hedging transactions to minimize risk.¹⁴ Dealers therefore act like merchants with respect to securities they buy and sell.

“Trader” classification is reserved for those taxpayers who are not securities broker–dealers but who have managed to establish to the IRS that they are not investors. In everyday parlance, the term generally refers to those individuals who actively buy and sell securities held over the short

7. See Thomas, *supra* note 5, at 274.

8. *Id.*

9. McCawley, *supra* note 1, at A-4; see also Federal Tax Coordinator (RIA) 2d at ¶ L-1112 (“[m]ost taxpayers who manage their own investments will be treated as investors rather than traders”).

10. McCawley, *supra* note 1 at A-4; see also Raby, *Effect of Sporadic Activity*, *supra* note 5, at 1375.

11. See generally Raby, *Effect of Sporadic Activity*, *supra* note 5 at 1375-76; Federal Tax Coordinator (RIA) 2d at ¶¶ L-1112, L-1112.1.

12. McCawley, *supra* note 1, at A-2.

13. Treas. Regs. § 1.471-5.

14. McCawley, *supra* note 1, at A-2; see also Federal Tax Coordinator (RIA) 2d at ¶ I-6205 (“a dealer...intends to profit by earning a ‘mark-up’ from laboring as a middleman”).

term for their own account, such as individuals who engage in online trading of stocks and securities.¹⁵ The term has a similar meaning in the tax law, although a taxpayer has to meet certain specific requirements in order to be considered a trader for tax purposes, and not every online trader or day trader will qualify to be treated as a trader under the tax law.¹⁶ A trader, unlike a dealer, does not hold securities as inventory to be sold to brokerage clients, but instead tends to engage primarily in speculation in securities and seeks to profit from short swings in the market.¹⁷ As will be elaborated later in this article, traders are distinct from investors in that they are engaged in the “trade or business” of trading in securities.¹⁸

The United States Supreme Court first drew a clear distinction between the category of “investor” and that of “trader” in *Snyder v. Comm’r*, a case in which it held that a margin trader had not shown that his trading operations constituted a trade or business.¹⁹ The court noted (Justice Brandeis writing) that the Board of Tax Appeals had held that a taxpayer who “devotes a major portion of his time to speculating on the stock exchange” could treat his losses as incurred in the course of a trade or business, but that the taxpayer in *Snyder* had not shown that he had devoted the requisite time and effort to his stock transactions, and therefore had not shown that he should be properly characterized as a “trader on an exchange, who makes a living buying and selling securities.”²⁰ Thus, the possibility of claiming the status of being a trader was born.²¹ The question of whether a

15. See, e.g., Black’s Law Dictionary 1501 (7th ed. 1999) (defining “trader” as “3. One who, as a member of a stock exchange, buys and sells securities on the exchange floor either for brokers or for on his or her own account”); Webster’s New World College Dictionary 1517 (4th ed. 1999) (defining “trader” as “3. a stockbroker who trades esp. for his own account rather than customers’ accounts”); see also Schwartz, *supra* note 5, at 399-405 (discussing the emergence of day trading by members of the public).

16. See Section III, *infra*; see also McCawley, *supra* note 1, at A-4.

17. McCawley, *supra* note 1, at A-2 see also Federal Tax Coordinator at ¶ I-6205 (“[a] trader ... intends to profit solely from advantageous purchases of stocks or securities or from rises in the values of stock or securities during the time he holds them”).

18. See Section III, *infra*.

19. *Snyder v. Comm’r*, 295 U.S. 134 (1935).

20. *Id.* at 139 (citing *Schwinn v. Comm’r*, 9 B.T.A. 1304 (1928); *Elliott v. Comm’r*, 15 B.T.A. 494 (1929); *Hodgson v. Comm’r*, 24 B.T.A. 256 (1931); *Schermerhorn v. Comm’r*, 26 B.T.A. 1031(1932)).

21. *Id.*; see also *Comm’r v. Groetzinger*, 480 U.S. 23, 33-34 (1987) (noting Justice Brandeis’ “impli[cation] that a full-time trader may qualify as being in a trade or business”).

holder of securities is a trader or an investor for tax purposes has been approached by many courts over several decades.²²

In some sense, the terms “dealer,” “trader,” and “investor” are merely shorthand descriptions for how these taxpayers are treated under the tax law.²³ Put another way, to say that a taxpayer is a trader or a dealer or an investor is simply to say that the taxpayer is subject to the tax rules that apply to that class of taxpayers. The following summarizes some of the major tax rules that may apply to each of these types of taxpayers, depending on how they are classified. In brief, traders and dealers in securities will be entitled to take certain ordinary deductions incurred in their securities trade or business, while investors will not. Traders, unlike dealers, however, will be entitled to treat their gains and losses from the sales of securities as capital gains and losses, rather than ordinary gains and losses.

a. Rules with Respect to Deductions

As is the case with other taxpayers, the tax picture of the taxpayer who holds securities is made up of income, gains, and profits, as well as deductions for expenses and losses. Many of the cases in which courts are called upon to determine whether a taxpayer is a trader, as opposed to an investor, arise on the deductions side, in the context of needing to determine whether that taxpayer is entitled to take certain deductions. Taxpayers who are classified as investors will generally be denied “trade or business”-related deductions, which can be quite valuable, while taxpayers who are either dealers or traders are allowed such deductions. The following are some of the “trade or business”-type deductions that may be allowed to traders (and dealers) in securities, but that are denied investors.

i. IRC section 162 deductions

Perhaps the most significant deduction allowed to traders and dealers that is denied to mere investors is the deduction under IRC section 162 for “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”²⁴ IRC section 162 deductions are

22. See, e.g., *Higgins v. Comm’r*, 312 U.S. 212 (1941); *Chen v. Comm’r*, 2004 T.C.M. (RIA) ¶ 2004-132; *Archaya v. Comm’r*, No. 9461-05 (7th Cir. 2007) (Fed. R. App. P. 32.1 nonprecedential disposition).

23. Boris I. Bittker & Lawrence Lokken, *Federal Income Taxation of Income, Estates & Gifts*, at ¶ 47.2 (3d ed. 2005) (“the terms ‘dealer’ and ‘trader,’ which do not appear in § 1221(a)(1) itself, are simply labels – the ‘dealer’ referring to a taxpayer who holds securities for sale to customers in the ordinary course of a trade or business and the ‘trader’ to a taxpayer who does not have ‘customers’ even though he or she buys and sells securities with great frequency”).

24. IRC § 162.

deducted on the taxpayers Schedule C (Profit or Loss from Business) and are “above the line” deductions that reduce adjusted gross income.²⁵ Mere investors, on the other hand, not being in a trade or business, are not eligible for IRC section 162’s trade or business deductions, and instead will deduct most of their investment expenses under IRC section 212 as “below the line” itemized deductions.²⁶ Such itemized deductions are subject to limitations, such as the 2% floor on miscellaneous itemized deductions, and may be completely eliminated if the taxpayer is subject to the alternative minimum tax.²⁷

ii. Applicability of investment interest limitations

IRC section 163 generally allows a deduction for all interest paid on indebtedness during the taxable year, but limits the deductibility of “investment interest” to “net investment income.”²⁸ Investors will therefore only be able to deduct their interest expenses to the extent that they have “net investment interest,” that is, the excess of “investment income” over “investment expenses.”²⁹ Traders and dealers, however, who are actively engaged in a trade or business, may be able to take unlimited interest expense deductions, although their ability to take such interest deductions may be limited if the trader or dealer is found to not “materially participate” in the trade or business activity to which the interest expense relates.³⁰

25. See Schedule C to Form 1040, available at <http://www.irs.gov/pub/irs-pdf/f1040sc.pdf> (last visited Jan. 19, 2008).

26. IRC § 212 (providing that “[i]n the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year – (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax”); see also Schedule A to Form 1040, available at <http://www.irs.gov/pub/irs-pdf/f1040sab.pdf> (last visited Jan. 19, 2008); see also Federal Tax Coordinator (RIA) 2d at ¶ L-4005 (listing some of the deductions that have been allowed investors under IRC § 212).

27. IRC § 67(a); Treas. Reg. § 1.67-1T(a)(1)(ii); see, e.g., *Mayer v. United States*, 67 T.C.M. (CCH) 2949, 2949-5 n. 11 (1994); see also Raby, *Ordinary Deductions but Capital Losses*, supra note 5, at 612 (discussing *Mayer*).

28. IRC § 163.

29. IRC § 163(d)(4).

30. “Investment interest” is defined as interest on indebtedness that is properly allocable to “property held for investment,” and “net investment income” is defined, generally, as the taxpayer’s net income from “property held for investment” plus certain gains from the disposition of such property. IRC § 163(d). Generally, gain from dispositions that is included in “investment income” is the excess of any net gain over any net capital gain from dispositions of property held for investment, subject to an election to include the taxpayer’s net capital gain as “investment

Therefore, traders who hold large amounts of debt, which exceed their income from investments, will be at an advantage as compared to investors who attempt to do the same.³¹

iii. Election to deduct certain depreciable property

Traders and dealers may be able to elect to deduct expenses for certain depreciable property under IRC section 179(a).³² That section provides that “[a] taxpayer may elect to treat the cost of any section 179 property [i.e., certain depreciable property] as an expense which is not chargeable to capital account” and that “[a]ny cost so treated shall be allowed as a deduction for the taxable year in which the section 179 property is placed in service.”³³ However, one of the requirements for qualification as “section 179 property” is that the property must be “acquired by purchase for use in the active conduct of a trade or business.”³⁴ Therefore, investors who, unlike traders and dealers, are not engaged in the “active conduct of a trade

income” by foregoing favorable capital asset treatment with respect to such gain. Since “property held for investment” includes property that produces, in general, interest, dividends, annuities, or royalties “not derived in the ordinary course of a trade or business,” or gain or loss on the disposition of property producing such income (IRC §§ 163(d)(5), 469(e)(1)), traders and dealers for whom such income is, in fact, “derived in the ordinary course of a trade or business” are not considered to hold “property held for investment” (in this case, securities), and their interest expense incurred to purchase such securities will not be subject to the limitations on investment interest. However, the trader or dealer may nonetheless be subject to the investment interest limitations if the interest is held by the trader or dealer in an activity involving the conduct of a trade or business that is not a “passive activity within the meaning of the Code and with respect to which the trader or dealer does not “materially participate.” If the trader or dealer does not “materially participate” in the trade or business, then the property held by the trader or dealer may be treated as “property held for investment” the interest expense may be subject to the limitation on investment interest notwithstanding the existence of the trade or business. IRC § 163(d)(5); see also Rev. Rul. 2008-12, 2008-10 IRB 520 (Feb. 19, 2008) (non-corporate limited partner’s distributive share of partnership interest expense allocable to securities trading was subject to investment interest deduction limitation, where limited partners did not “materially participate”).

31. See also Instructions to 2007 Internal Revenue Service Form 1040 Schedule D, at D-3 (“[t]he limitation on investment interest expense that applies to investors does not apply to interest paid or incurred in a trading business”), available at <http://www.irs.gov/pub/irs-pdf/i1040sd.pdf> (last visited Jan. 6, 2008).

32. IRC § 179(a). Such property would include tangible MACRS property and certain computer software, if such property meets certain other requirements. IRC §§ 179(d)(1)(A); 168.

33. IRC § 179(a).

34. IRC § 179(d)(1)(C).

or business” will not be eligible to expense such property as a deduction under IRC section 179 but must instead capitalize their costs.

iv. Election to deduct certain start-up expenditures

Under IRC section 195, a taxpayer who begins an active trade or business during a taxable year may elect to deduct certain start-up expenses rather than capitalizing them.³⁵ A trader or dealer in securities, being in the trade or business of trading, may be eligible to elect to take such deductions in the year he starts his trade or business of trading. However, such an election would not be available to an investor, since an investor is not similarly engaged in a trade or business.

v. Home office deductions

Unlike investors, traders and dealers may be able to take a deduction for expenses incurred for a “home office.” IRC section 280A(a) generally disallows deductions that might otherwise be allowable with respect to the use of a “dwelling unit” that is also used by the taxpayer as a residence during the taxable year.³⁶ Therefore, an investor who has a “home office” may not take any deductions attributable to that home office. However, IRC section 280A(c)(1) creates an exception for the portion of the “dwelling unit” that is used exclusively and regularly by the taxpayer as its “principal place of business for any trade or business.”³⁷ Therefore, a trader who is engaged in the trade or business of trading and who uses a home office as the principal place of his business may be able to deduct expenses incurred for that home office, while an investor will not.

vi. Other deductions

In addition to the deductions mentioned above, dealers and traders may be able to take various other deductions for trade or business-related expenses. These deductions may include depreciation deductions and net operating loss deductions.³⁸

35. IRC § 195.

36. IRC § 280A.

37. IRC § 280A(c)(1).

38. IRC §§ 167, 168, 172. See *Hart v. Comm’r*, 73 T.C.M. (CCH) 1684 (1997), *aff’d* 135 F.3d 764 (3d Cir. 1997) (investor taxpayer was denied net operating loss deduction); *Ball v. Comm’r*, 80 T.C.M. (CCH) 184 (2000) (investor taxpayer was denied deductions for office expenses, interest and depreciation).

vii. Application of IRC section 469 “passive loss” rules

The application of the passive activity loss rules to traders is also worth noting. These rules were enacted in 1986 to prevent individuals from using passive losses from tax shelters to reduce taxable income by offsetting such passive losses against non-passive income.³⁹ The passive loss rules define a “passive activity” as any activity involving the conduct of any “trade or business” in which the taxpayer does not “materially participate.”⁴⁰ However, for purposes of the passive loss rules, the term “trade or business” includes an “activity in connection with a trade or business” as well as an activity with respect to which expenses are allowable as a deduction under IRC section 212.⁴¹ Since investors may take deductions under IRC section 212, both traders and investors have the potential to be subject to the passive loss limitations of IRC section 469. However, in the case of a trader (or dealer) taxpayer who actively carries out his trading or dealing activities himself, such trading activity should not normally be considered a passive activity, as long as that taxpayer “materially participates” in such activity.⁴² Therefore, if the trader–taxpayer shows a business loss on Schedule C after taking these deductions, such loss should normally be available to offset ordinary, non-passive income, (including personal services income). Such deductions would therefore be beneficial to a trader or dealer as offsets to ordinary income. Whether the investor would be subject to the passive loss rules would ultimately depend on whether that investor “materially participates” in managing his investments and on whether that investor’s income is portfolio income, or is otherwise excluded from treatment as passive income.⁴³

39. Tax Reform Act of 1986, Pub. L. 99-514, § 501(a), 100 Stat. 2085, 2233-41 (1986).

40. IRC § 469(c)(1).

41. IRC § 469(c)(6).

42. IRC § 469(c), (h). As discussed in Section III below, an individual trader who is actually actively involved in trading would likely be regarded as “materially participating” in the trade or business of trading, and in such case, the deductions described in this Section II should not be regarded as losses from a passive activity. See Treas. Reg. § 1.469-5T(a). See also Treas. Reg. § 1.469-1T(e)(6)(ii),(iii) (activity of trading personal property for the account of owners of interests in the activity is not a passive activity, without regard to whether such activity is a trade or business activity; for example, a partnership securities trader is treated as conducting such an activity for the account of its partners, so the activity is not a passive activity). But see *Dean v. IRS*, 2007 WL 445938 (W.D. Wash.) (passive loss limitations barred taxpayer’s claim to carry back his share of family-owned partnership’s securities activities loss where taxpayer failed to show material participation).

43. See, e.g., *Mayer v. Comm’r*, 67 T.C.M. (CCH) at 2951 (taxpayer who was an investor materially participated in securities activities, so such activities were

b. Rules with Respect to Character of Income

While traders and dealers are treated similarly to each other (and differently from investors) with respect to their eligibility for deductions allowable under IRC section 162 and other business-related deductions for expenses incurred in carrying on a “trade or business,” their treatment diverges with respect to the character of the income realized upon the sale of such securities. Securities dealers will realize ordinary gains and losses on sales of securities they hold as inventory (that is, most of the securities they hold).⁴⁴ Such ordinary income treatment is akin to that accorded to other kinds of merchants who hold their goods as inventory or “stock in trade” to be sold to their customers at a profit.⁴⁵ On the other hand, a securities trader’s profit or loss from his trading activity will generally be considered capital gain or loss, although it will usually be short-term capital gain or loss, since traders by definition usually seek to profit from short-term swings in the market.⁴⁶ Such short-term capital gain or loss will be taxed at ordinary income rates under present law, rather than at the more favorable rates accorded to capital assets with a long-term holding period.⁴⁷ However, traders are not altogether precluded from realizing long-term capital gain or loss from those investments held for longer periods of time, although (as discussed below) the existence of too many of such securities may be evidence of non-trader status.⁴⁸ Furthermore, as capital losses, the trader’s losses may only be offset against capital gains, and individual taxpayers may only deduct \$3,000 of their excess capital losses against their taxable (ordinary) income.⁴⁹ Dealers, on the other hand, may deduct their losses, which are ordinary, against ordinary income.

not subject to passive loss limitations under IRC § 469; income from securities investments was portfolio income); see also IRC § 469(e)(1)(A).

44. McCawley, *supra* note 1, at A-2. However, apart from having inventory securities, a dealer may also hold some securities for his own account as investment. If the securities dealer “properly identifies” a security as held for investment rather than inventory, then he will have capital gain or loss on the sale of that security. IRC § 1236(a).

45. IRC § 1221(a)(1).

46. See, e.g., *Kemon v. Comm’r*, 16 T.C. 1026, 1033 (1951); see generally McCawley, *supra* note 1, at A-3.

47. IRC §§ 1(h), 1222, 1223.

48. See, e.g., *Moller v. U.S.*, 721 F.2d 810 (Fed. Cir. 1983); *Mayer v. U.S.*, 32 Fed. Cl. 149 (1994); *Mayer*, 67 T.C.M. (CCH) at 2949-5; *Estate of Yaeger v. Comm’r*, 889 F.2d 29, 34 (2d Cir. 1989); see also *infra* Section III.

49. IRC §§ 172(d)(2), 1211(b), 1212(b); *Jamie v. Comm’r*, 2007 T.C.M. (RIA) ¶ 2007-022 (trader–taxpayer’s losses were capital losses deductible only to the extent of capital gains, plus \$3,000).

c. The IRC section 475(f) Mark-to-Market Election

Since the enactment of IRC section 475(f) in 1997, traders, like dealers, have had the option of “marking-to-market” their securities-trading gains and losses, thereby converting such gain or loss into ordinary gain or loss.⁵⁰ Under IRC section 475(f), securities traders who make the mark-to-market election may recognize gain or loss on any security held in connection with his securities-trading trade or business as if that security were sold at fair market value on the last day of the taxable year, and may take any such gain or loss into account for such taxable year.⁵¹ Because “[r]ules similar to the rules of [IRC section 475(d)]” will apply to the securities with respect to which such an election is made, any such gain or loss on a disposition of a security will be treated as ordinary, not capital, income or loss.⁵² For the election to be effective, the taxpayer must generally have filed a statement not later than the due date of the original federal income tax return for the taxable year immediately preceding the election year, and that statement must be attached either to that return or, if applicable, to a request for a filing extension.⁵³ This means that the taxpayer may not generally wait until he has experienced losses throughout the tax year before making the election; late filing relief will not usually be granted for the mark-to-market election where the taxpayer is believed to be making the election with the benefit of hindsight.⁵⁴ Once the mark-to-market election is made, the trader’s losses from his trades, having been rendered ordinary, are recognized at the close of the trader’s tax year as if sold for fair market value and may be deducted against his ordinary income, and presumably may also be carried backward and forward like “normal” net operating losses as offsets to ordinary income.⁵⁵

50. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §§ 1001(b), (d)(4), 111 Stat. 788, 906-08 (1997).

51. IRC § 475(f).

52. IRC § 475(f)(1)(D); IRC § 475(d)(3).

53. Rev. Proc. 99-17, 1999-1 C.B. 503, at § 5.03 (Feb. 9, 1999) (as modified and superseded).

54. See, e.g., IRS Priv. Ltr. Rul. 200736018 (Sept. 7, 2007) (securities trader’s request for extension to make IRC § 475(f) mark-to-market election was denied for lack of reasonable action and good faith, where taxpayer could not demonstrate that his pursuit of relief did not rely on hindsight); IRS Priv. Ltr. Ruls. 200209052-54 (Mar. 1, 2002); IRS Priv. Ltr. Rul. 200709015, (Mar. 2, 2007); *Contra Vines v. Comm’r*, 126 T.C. 279 (2006) (taxpayer was not getting benefit of hindsight and was allowed late filing relief where he had made no trades and incurred no added gains or losses between election due date and date the late election was filed).

55. For a general discussion of the mark-to-market election, see Steven D. Conlon & Vincent M. Aquilino, *Principles of Financial Derivatives: U.S. and International Taxation*, at ¶ B3.08[2] (1999) (updated Nov. 2007); Boris I. Bittker,

In addition to affecting the character of a trader's income, the making of a mark-to-market election also has an effect on timing of income recognition: A trader who does not in fact dispose of his stock or securities in a given year will nonetheless be able to recognize gains and losses from those securities as if they had been sold at the taxable year's end. Thus, a trader (or dealer), by making the mark-to-market election, may be able to trigger gain or loss recognition in a way that is only available to an investor if that investor actually sells his stock or securities.

Finally, a securities trader will not be subject to the self-employment tax on his gain or loss from securities trading, even if that trader makes a IRC section 475(f) mark-to-market election. As a general rule, a securities trader who has not made a mark-to-market election under IRC section 475(f) will not be subject to the self-employment tax imposed by IRC section 1402 (i.e., the tax imposed on a taxpayer's "net earnings from self employment"), since capital gains and losses are excluded from the "net earnings from self employment" under the statute.⁵⁶ It should be noted that although making a mark-to-market election under IRC section 475(f) generally converts a trader's income and losses to ordinary income and losses for purposes of the income tax law, any such gain or loss remains capital gain or loss for self-employment tax purposes.⁵⁷

d. Summary

The main differences between investors, traders, and dealers are summarized in the following table:

Martin J. McMahon, Jr. & Lawrence A Zelenak, *Federal Income Taxation of Individuals*, at ¶ 28.08 (3d ed. 2002) (updated Nov. 2007).

56. IRC § 1402(a)(3)(A); Treas. Reg. § 1.1402(a)-6(a).

57. IRC § 475(f)(1)(D).

| | Character of Income from Securities Activities | Deductions Allowable for Securities Activities | Mark-to-Market Election |
|------------------|--|---|---|
| Investors | Income is treated as capital gain or loss, reported on Form 1040 Schedule D (Capital Gains & Losses). May be short-term or long-term capital gain or loss depending on holding period. Losses are subject to IRC § 1211(b) limitations. | Expenses are itemized under IRC § 212. Deductibility is subject to 2% floor on AGI, and may be eliminated under AMT computation. “Trade or business” deductions are not allowed. Other limitations may apply. | No mark-to-market election is available. |
| Traders | Unless mark-to-market election is made, income is treated as capital gain or loss, reported on Schedule D (Capital Gains & Losses). May be short-term or long-term capital gain or loss depending on holding period. Losses are subject to IRC § 1211(b) limitations. | Schedule C “trade or business” deductions are allowable. | IRC § 475(f) mark-to-market election may be made, converting income and loss to ordinary income and loss. Mark-to-market election may enable income recognition, even if securities are not disposed of. |
| Dealers | Income and loss from sale of inventory securities is ordinary income or loss reported on Schedule C (Profit or Loss from Business). Losses are deductible against ordinary income. | Schedule C “trade or business” deductions are allowable. | IRC § 475 Mark-to-market accounting is required. |

In summary, traders, like investors, have their gains and losses from their securities-trading activities treated as capital gains and losses.⁵⁸

58. As pointed out by some commentators, trader-taxpayers who file Form 1040 will therefore have a Schedule C that shows substantial expenses (deducted

However, unlike investors (and like securities dealers), traders are eligible for various elections and deductions for expenses incurred in their trade or business of trading. Also unlike investors, traders are eligible to make a mark-to-market election to convert their gains and losses from capital gains and losses to ordinary gains and losses, and to otherwise affect the time at which they realize such gains and losses. In sum, traders are the only category of taxpayers entitled to capital gains and losses, but ordinary deductions, for their securities activities.

SECTION III: “TRADER” TAXATION: A TALE OF TWO CONCEPTS

What are the standards, then, that lead to classification as a trader and the resulting unusual tax treatment? While the above discussion demonstrates that there are many tax consequences to a taxpayer that depend on whether a taxpayer is classified as a trader, dealer, or investor, most of these tax consequences boil down to the application of two competing concepts. This section shows that this situation – wherein two competing concepts underpin and create a trader’s unusual tax treatment – was introduced into the statutory structure as a result of the 1934 introduction of the “to customers” requirement.

The first concept, which can be broadly stated as “whether or not the taxpayer is in a ‘trade or business’” is a long-standing, though ill-defined, concept in the tax Code, which is critical in determining whether a taxpayer may be classified as a trader and entitled to deductions for expenses incurred in securities trading. The second concept, which is generally an inquiry into whether the taxpayer has “customers,” was “newly” introduced into the analysis in 1934, and has become crucial in affording capital income and loss treatment to a trader–taxpayer, notwithstanding the fact that such taxpayer has been found to be in the “trade or business” of trading.⁵⁹ Fundamentally, the oddness of allowing traders capital asset treatment along with ordinary deductions stems from the fact that, while the majority of the tax consequences to a securities trader are based on whether or not the taxpayer is “engaged in a trade or business,” the character of such trader’s gains or losses is determined based on whether the assets bought or sold are capital assets under the capital asset statute, and more specifically whether they are held for sale “to customers.”

under IRC § 162) but little or no income (since gains and losses will be capital). See generally Raby & Raby, *Nondealer Security Losses*, *supra* note 5.

59. Revenue Act of 1934, Pub. L. No. 73-216, § 117(b), 48 Stat. 680, 714 (1934).

a. *The Importance of Being “Engaged in a Trade or Business”*

The notion of engagement in a “trade or business” is a concept that underlies the vast majority of the tax rules applicable to traders outlined in Section I above. This statement is in some ways a tautological observation, because to call a taxpayer a trader under the tax law in fact essentially means that that taxpayer is “trading in securities as a trade or business” and will be subject to the tax consequences applicable to such a taxpayer.⁶⁰ However, the point should not be obscured for all its apparent obviousness. A finding that a taxpayer is engaged in a trade or business as a securities trader gives rise to a number of important tax consequences precisely because of the way in which the concept of “engagement in a trade or business” is embedded in the various tax statutes dealing with deductions that are discussed above.⁶¹ While there may be variations in the exact standards that must be met for a taxpayer who is engaged in the “trade or business” of trading (or dealing) securities to qualify under each individual tax statute, the state of being engaged in a trade or business is undeniably an important criterion underlying a number of those statutory rules. For purposes of this article, an understanding of the “trade or business” concept is therefore essential to understanding the current statutory structure, and the interplay of the current tax rules, with respect to securities traders.

For example, as discussed in Section II above, the “trade or business” standard comes directly into play with respect to the deduction allowable under IRC section 162 for “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”⁶² Traders and dealers may qualify to deduct expenses incurred in their “trade or business,” while mere investors cannot.⁶³ Also as discussed above, a taxpayer’s eligibility to deduct “investment interest” may depend on whether he is engaged in a trade or business.⁶⁴ Whether the taxpayer is conducting a “trade or business” is also central to whether he may take a “home office” deduction under IRC section 280A.⁶⁵ Likewise, whether a taxpayer is engaged in a “trade or business” determines the taxpayer’s entitlement to elect certain tax treatments, such as the election to take

60. See *Yaeger*, 889 F.2d 29. Compare IRC § 475(f) (mark-to-market election is available “[i]n the case of a person who is engaged in a *trade or business* as a trader in securities”(emphasis added)); with Thomas, *supra* note 5 at 274 (“[t]o call someone a securities trader means nothing more or less than to say he is engaged in trading securities as a trade or business”).

61. See *supra* Section II.

62. IRC § 162.

63. IRC § 212; IRC § 67(a); Treas. Reg. § 1.67-1T(a)(1)(ii). See, e.g., *Mayer*, 32 Fed. Cl. 149.

64. IRC § 163(d)(1).

65. See IRC § 280A(c)(1)(A).

deductions for, rather than depreciate, certain depreciable property known as “section 179 property” and the election to deduct start-up expenses under IRC section 195.⁶⁶ Finally, the IRC section 475(f) mark-to-market election for which securities traders are eligible will only be available “[i]n the case of a person who is *engaged in a trade or business* as a trader in securities.”⁶⁷

The exact standard for eligibility for the deductions and other favorable tax items do vary in their details, and traders and dealers attempting to qualify for such items may have to satisfy certain other criteria as well as being in a trade or business. For example, in order to take IRC section 162 deductions, the taxpayer must not only have been conducting a “trade or business,” but the expense must also have been “ordinary and necessary” and must have been “incurred ... in carrying on” that trade or business.⁶⁸ To be excepted from the IRC section 163(d) investment interest limitations, the income of the trader or dealer must have been derived in the “ordinary course” of the trade or business.⁶⁹ To take a deduction for a home office, the home office must be the “principal place” of the trader’s or dealer’s trade or business.⁷⁰ To be eligible for the election under IRC section 195, the trade or business conducted by the taxpayer must be “active.”⁷¹ However, these variations in the exact requirements do not detract from the fundamental observation that, as a general matter, conduct of a trade or business is a critical gating item – a taxpayer–trader or dealer who conducts a

66. IRC §§ 179(a), (d)(1)(C); §§ 195(a), (c)(1). Section 179 property generally includes tangible property which is “section 1245 property” (i.e., certain categories of property with respect to which depreciation is allowed) and which is “acquired by purchase for use in the active conduct of a trade or business.” IRC § 179(d)(1)(C). Under IRC § 195, a taxpayer may elect to deduct some amount of “start-up expenditures,” which are, generally, otherwise deductible expenditures incurred in creating (or investigating the creation or acquisition of) “an active trade or business,” and certain other income-producing activities performed in anticipation of such activity becoming “an active trade or business.” IRC §§ 195(a), (c)(1). Thus, only traders and dealers who create and conduct an “active trade or business” will be eligible to elect to deduct such start-up expenses, while investors will be forced to capitalize any such expenses.

67. IRC § 475(f) (emphasis added). The language of IRC § 475(f) clarifies the perhaps obvious point that if the electing taxpayer is not “engaged in a trade or business” as a trader, the mark-to-market election is not available to that taxpayer. At least one author has noted that the act of marking the mark-to-market election does not in itself make a taxpayer a trader. Raby, *Nondealer Security Losses*, supra note 5, at 48 (“[t]he election itself is not what makes the taxpayer a trader of course. The taxpayer’s activity must qualify him, her, or it as a security or commodity trader or commodity dealer”).

68. IRC § 162.

69. IRC § 163(d).

70. IRC § 280A.

71. IRC § 195.

trade or business and ordinarily incurs expenses in such trade or business has a chance of meeting the requirements for application of some or all of the tax rules described above. A taxpayer who does not conduct a trade or business has no chance of qualifying for any of those tax treatments.

The significance of the “trade or business” threshold concept is echoed in court decisions distinguishing traders from other securities-buying taxpayers. These court decisions reflect the importance of the trade or business standard in determining the tax consequences to a taxpayer. Once the courts have determined whether the taxpayer is in a trade or business, the correlative tax results swiftly follow.

In *Paoli v. Comm’r*, for example, the court was asked to determine whether the taxpayer was subject to the investment interest limitation under IRC section 163(d).⁷² The court first distinguished between investors, traders, and dealers, and stated that “[b]oth traders and dealers engage in the trade or business of buying and selling securities, whereas the activities of an investor do not qualify as a trade or business.”⁷³ The court said that the taxpayer had to qualify as “a trader who is engaged in a trade or business” in order to be eligible for a full deduction. In *Estate of Yaeger v. Comm’r*, the court was called upon to decide the same issue. The court likewise stated that the “issue turned on whether Yaeger’s stock market activities constituted investment activity or the activity of trading in securities as a trade or business,” and determined that the taxpayer was an investor not engaged in such trade or business, rather than a securities trader.⁷⁴ Similarly, in *Boatner v. Comm’r*, the court, in deciding whether the taxpayer’s expenses could be deducted in determining adjusted gross income rather than being itemized as expenses, stated that it must consider the question of whether petitioner was engaged in the trade or business of buying and selling stocks. If so, petitioner was a “trader” as opposed to an “investor” and was eligible to deduct his business expenses.⁷⁵ In *Moller v. Comm’r*, the court had to decide whether the taxpayer was a trader engaged in a trade or business who was therefore entitled to a “home office” deduction under IRC section 280A, or an investor who was not so entitled.⁷⁶ The court stated that “[t]he principal question in the instant case [was] whether the taxpayer’s investment activity was a trade or business.”⁷⁷ In *Chen v. Comm’r*, the tax court considered whether a taxpayer who was a full-time engineer was a securities trader entitled to make a market-to-market election rendering his losses ordinary, or whether

72. *Paoli v. Comm’r*, 62 T.C.M. (CCH) 275 (1991); see also *Paoli v. United States*, 92-1 USTC ¶ 50102 (1991) (involving earlier years).

73. 62 T.C.M. (CCH) at 280.

74. *Yaeger*, 889 F.2d 29.

75. *Boatner v. Comm’r*, 74 T.C.M. (CCH) 342 (1997), *aff’d*, 164 F.3d 629 (9th Cir. 1998).

76. *Moller v. Comm’r*, 721 F.2d 810, 811 (1983).

77. *Id.* at 813.

he was an investor subject to the rules on capital loss limitations.⁷⁸ The court recognized the three distinct categories of dealer, trader, and investor in securities, and stated that “[i]n order to qualify as a trader (as opposed to an investor) petitioner’s purchases and sales of securities...must have constituted a trade or business.”⁷⁹

The above cases demonstrate that, in accordance with the requirements of the applicable statute, court inquiries have focused on the threshold question of whether the taxpayer in question was in a trade or business. However, despite its multiple appearances in the Code, the term “engaged in a trade or business” is not defined in the Code.⁸⁰ Courts have therefore had to resolve the question themselves, and have, in general, looked at a variety of different factors in making this determination. In the specific context of securities traders, courts have developed a fairly consistent list of factors they examine when making this determination: generally, court determinations come down to (1) the frequency, extent, and regularity of the taxpayer’s activity and (2) the nature of the income derived from the activity and the taxpayer “investment intent” in performing the activity.⁸¹

i. Whether the taxpayer’s activity is frequent, regular, and continuous

In order to be considered to be in the trade or business of securities trading, the taxpayer’s activity must be frequent, regular, and continuous enough to so qualify. This was evident in *Fuld v. Comm’r*, an early case involving the question of whether the taxpayers were engaged in the trade or business of trading.⁸² In *Fuld*, the tax court determined, and the Second Circuit agreed, that the taxpayers’ activities were continuous and intensive enough to constitute engagement in the securities-trading trade or business.⁸³

78. *Chen v. Comm’r*, T.C.M., 2004-132, 2004 T.C.M. (RIA) at 852.

79. 2004 T.C.M. (RIA) at 854.

80. See, e.g., Bittker & Lokken, *supra* note 23 at ¶ 20.1 (“[T]he term ‘trade or business’ is not defined by the statute or the regulations; neither is there an authoritative judicial definition”); see also Bittker, McMahon & Zelenak, *supra* note 55, at ¶ 11.01[2].

81. *Moller*, 721 F.2d at 813; *Yaeger*, 889 F.2d at 33; *Cameron v. Comm’r*, 2007 T.C.M. (RIA) ¶ 2007-260, 94 T.C.M. (CCH) 245; *Mayer v. U.S.*, 32 Fed. Cl. 149 (1994); *Chen*, 2004 T.C.M. (RIA) at 854; see also Instructions to 2007 Internal Revenue Service Form 1040 Schedule D, at D-3 (describing requirements to be classified as a securities trader), available at <http://www.irs.gov/pub/irs-pdf/i1040sd.pdf> (last visited Jan. 6, 2008).

82. *Fuld v. Comm’r*, 139 F.2d 465 (2d Cir. 1943), *aff’g* 44 B.T.A. 1268 (1941).

83. *Fuld*, 139 F.2d at 468-69.

The taxpayers, a brother and sister, had made long-term investments prior to October 1930 but had changed their approach in October 1930 to engage in short-term speculation.⁸⁴ In holding that the brother and sister taxpayers were engaged in a trade or business on and after October 1930, the tax court found that (1) the brother had devoted an average of eight hours a day to studying texts and services, charting prices, conferring with his broker, attending meetings, and consulting corporate executives; (2) the sister had no trade or business other than buying and selling securities, and she, too, studied services, read corporate annual reports, charted prices, attended meetings, and consulted with corporate executives; (3) the main source of livelihood of both taxpayers was from their securities transactions; (4) the taxpayers maintained no business offices and had no customers to whom they sold securities; and (5) the taxpayers never sold short and never held themselves out to the public as dealers (although the brother was registered with the SEC as a dealer).⁸⁵ The tax court also found that in 1933 the brother made about 249 sales of securities held for more than two years and about 98 sales of securities held for two years or less, and the sister in 1933 made about 229 sales of securities held for more than two years and about 89 sales of securities held for two years or less.⁸⁶ On the basis of these findings, the tax court found that, from October 1930 until 1933, the taxpayers were “engaged in the business of trading in securities.”⁸⁷ The tax court in *Fuld* thus primarily emphasized the continuity and the intensity of the taxpayers’ efforts in determining that they were in the “trade or business” of securities trading, while also considering the frequency of trades.⁸⁸ On appeal, the tax court’s findings were affirmed by the Second Circuit.⁸⁹

The requirements of continuity, frequency, and intensiveness have continued in existence to more recent cases. In *Chen*, discussed above, for example, the court noted that to be considered a trade or business the taxpayer’s trading activity must be frequent, regular, continuous, and substantial, and cannot be sporadic.⁹⁰ In *Chen*, the taxpayer’s securities-trading activities took place only sporadically, with 94% occurring between February and April, and no transactions occurred in six of the other nine months of the tax year.⁹¹ The court determined that the trading activity covered only part of one taxable year and was not the only (or even the

84. *Fuld*, 44 B.T.A. 1269-70; see also 139 F.2d at 466.

85. *Fuld*, 44 B.T.A. at 1270; see also 139 F.2d at 467.

86. *Fuld*, 44 B.T.A. at 1271; see also 139 F.2d at 467.

87. *Fuld*, 139 F.2d at 467.

88. *Fuld*, 44 B.T.A. at 1272.

89. *Fuld*, 139 F.2d at 469.

90. *Chen*, 2004 T.C.M. (RIA) at 854 (citing *Moller*, 721 F.2d at 813; *Boatner v. Comm’r*, 74 T.C.M. (CCH) 342 (1997)).

91. *Chen*, 2004 T.C.M. (RIA) at 852, 854.

primary) activity via which the taxpayer produced income, and that the taxpayer therefore failed to qualify as a trader.⁹² In *Mayer*, on the other hand, the court considered the taxpayer's trading activity to be "substantial" where the taxpayer had over 1,100 executed sales and purchases in each of the years at issue.⁹³ In *Cameron*, the court held that the taxpayer's trading activity was not adequate to be considered a trade or business, where the taxpayer did not trade five days a week, and traded on more than 10 days a month in only two months.⁹⁴ The taxpayer's trading activity consisted of 46 purchases and 14 sales in 2002, and in 2003 he completed 109 purchases and 103 sales.⁹⁵

It should be noted that, in those cases in which the taxpayer has successfully claimed trader status, the securities-trading activity has usually been that taxpayer's only income-producing activity, or at least his primary one. For instance, in *Chen*, the court noted that

[i]n the cases in which taxpayers have been held to be traders in securities, the number and frequency of transactions indicated that they were engaged in market transactions almost daily for a substantial and continuous period, generally exceeding a single taxable year; and those activities constituted the taxpayers' sole or primary income-producing activity. Conversely, where, as in this case, (1) the taxpayer's daily trading activities covered only a portion of a single taxable year, and (2) securities trading was not the sole or even primary activity in which the taxpayer engaged for the production of income, trader status was denied. Daily trading in securities for only a quarter of a single taxable year is reasonably characterized as "sporadic" rather than "frequent, regular, and continuous," and, therefore, insufficient to achieve trader status.⁹⁶

In *Moller*, too, the court stated that "[i]n the cases in which taxpayers have been held to be in the business of trading in securities for their own account, the number of their transactions indicated that they were engaged in

92. *Chen*, 2004 T.C.M. (RIA) at 845-55; see also *Boatner v. Comm'r*, 74 T.C.M. (CCH) 342 (taxpayer's 75 securities transactions during the taxable year fell short of being "frequent, regular, and continuous.")

93. *Mayer*, 67 T.C.M. (CCH) 2949, 2949-4 – 2949-5 (1994).

94. *Cameron v Comm'r*, 2007 T.C.M. (RIA) ¶2007-260 at 1510.

95. *Id.* The court also noted that the taxpayer collected unemployment compensation during 2003, which further undermined his claim that he was engaged in a trade or business during that year. *Id.*

96. *Chen*, 2004 T.C.M. (RIA) at 845-55 (citations omitted).

market transactions on an almost daily basis.⁹⁷ This standard means that a taxpayer claiming trader status who is engaged in another income-producing occupation must show that being a trader is his full-time primary occupation, rather than an occasional hobby, no matter how seriously he takes his trading.⁹⁸

Therefore, the cases above demonstrate that the taxpayer seeking to qualify as a trader in the “trade or business” of trading must prove that his trading activity is substantial enough to constitute such trade or business. Commentators have pointed out that the exact level of trading activity required in order to be a trader is not clear.⁹⁹ However, what is clear is that the standard applied by the courts is generally extremely high.¹⁰⁰

ii. Nature of the income derived from the activity and the taxpayer’s intent

In order to be considered a trader, the taxpayer must also meet certain requirements regarding his intent with respect to holding, buying, or selling the securities, and regarding the character of the income derived from his securities activities. Generally, the courts have held that investors hold securities for the “production of income,” while traders derive profits from the “direct management of purchasing and selling” securities.¹⁰¹ Traders, unlike investors, “buy and sell securities with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis.”¹⁰² Therefore, the taxpayer’s holding period of

97. *Moller*, 721 F.2d at 813-14 (citing *Levin v. Comm’r*, 597 F.2d 760, 765 (Ct. Cl. 1979); *Fuld*, 139 F.2d 465).

98. See *Thomas*, supra note 5, at 275-76 (“The Internal Revenue Service has sometimes suggested that a taxpayer should not be considered a trader unless the activities constitutes his sole or primary income-producing activity. ... To deny trader status to such a taxpayer because he maintains other employment would be arbitrary and unfair, and contrary to the body of law on this subject”).

99. See, e.g., *Schwartz*, supra note 5, at 399; see also, generally, Buagu, Musazi, and Krishna Rana, On the Tax Classification of Day Stock Traders as Investors or Traders, American Accounting Association 2004 Mid-Atlantic Region Meeting Paper (Jan. 7, 2004) (presenting analytical model to help judges distinguish between investors and traders without arbitrariness); Avi O. Liveson, Cases Illustrate Nature and Level of Investment Activities Needed to Attain Trader Status, 82 J. Tax’n 290 (1995).

100. See Federal Tax Coordinator (RIA) 2d at ¶ L-1112 (“[p]roving that one’s investment activities rise to the level of carrying on a trade or business is a difficult hill to climb”).

101. *Yaeger*, 889 F.2d at 33.

102. *Id.*

the securities and the source of the taxpayer's profit are significant in determining whether the taxpayer is in the trade or business of "trading."

That a distinction exists between the nature and type of income earned by traders and that earned by mere investors was recognized by the Supreme Court itself in 1941 in *Higgins v. Comm'r*, where the court held that "[n]o matter how large the estate or how continuous or extended the work required [to oversee taxpayer's estate] may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board [of Tax Appeals, that the taxpayer's activities did not amount to the carrying on of a business]" and that "no amount of personal investment management would turn [taxpayer's] activities into a business."¹⁰³ The holding in *Higgins* demonstrates that there is a difference between mere management of one's own personal investments (which tend to be held for appreciation over the longer term), and the active trading that is required in order to constitute being in the trade or business of securities trading.

Yaeger v. Comm'r is another good example of this difference. In *Yaeger*, the court found that the taxpayer was an investor rather than a trader, even though he had initiated over 2000 securities transactions in 1979 and 1980, and had "pursued his security activities vigorously and extensively."¹⁰⁴ The court pointed to the fact that most of the taxpayer's securities were held for over a year, and he did not sell any securities held for less than three months.¹⁰⁵ The court found that the taxpayer had realized his profits from both dividends and interest, and that his "emphasis on capital growth and profit from resale indicate[d] an investment motivated activity."¹⁰⁶ Notably, the court stated that "no matter how large the estate or how continuous or extended the work required may be, the management of securities investments is not the trade or business of a trader."¹⁰⁷ Thus, the unacceptably long holding period of the taxpayer's securities betrayed the fact that the taxpayer was not trying to capture short-term market swings, and hence was not a trader.

The Court of Appeals for the Federal Circuit also addressed the nature of the taxpayer's income and the taxpayer's intent in *Moller v. Comm'r*.¹⁰⁸ The court noted that "in order to be a trader, a taxpayer's activities must be directed to short-term trading, not the long-term holding of investments, and income must be principally derived from the sale of securities rather than from dividends and interest paid on those securities."¹⁰⁹

103. *Higgins*, 312 U.S. at 216, 218.

104. *Yaeger*, 889 F.2d at 33.

105. *Id.* at 34.

106. *Id.* at 34 (citing *Miller v. Comm'r*, 70 T.C. 448, 457 (1978)).

107. *Id.* at 34 (citing *Higgins*, 312 U.S. at 218).

108. *Moller*, 721 F.2d 810.

109. *Id.* at 813.

The court concluded that the taxpayers were investors rather than traders because they were “primarily interested in the long-term growth potential of their stocks” and “did not derive their income from the relatively short-term turnover of stocks, nor did they derive any significant profits through the act of trading.”¹¹⁰ The court noted that interest and dividend payments constituted over 98% of taxpayers’ gross income for 1976 and 1977, and in 1976 their profit from the sale of securities was only \$612, while in 1977 their sales resulted in a loss of \$223.¹¹¹

Hence, in order to show “engagement in a trade or business,” which is required in order to qualify for trader classification, a taxpayer must not only demonstrate that his securities activities are continuous, substantial, and frequent (rather than sporadic), but he must also show an intent to profit from short swings in the market, rather than from interest, dividends, or long-term appreciation. Once the taxpayer meets these dual requirements to be considered a trader engaged in the “trade or business” of securities trading, then, as discussed above, the taxpayer has the potential to be eligible for certain tax deductions and elections, such as IRC section 162 trade or business deductions, IRC section 280A home office deductions, unlimited interest deductions under IRC section 163, the election to deduct “section 179 property,” the election to deduct start-up expenses under IRC section 195, and the mark-to-market election under IRC section 475(f).¹¹² This result stems from the fact that the “trade or business” test underpins the statutory language of each of these deductions. As further discussed in Section III.b. below, the same “trade or business” test is also used to underpin the analysis in determining the character of a trader’s income. However, since 1934, another standard (discussed below) has also been applied to making this determination.

110. *Moller*, 721 F.2d at 813.

111. *Id.* at 812.

112. See, e.g., *Yaeger*, 889 F.2d at 29 (finding that taxpayer was an investor not engaged in a trade or business meant that he was subject to the IRC § 163(d) investment interest limitation); *Paoli*, 62 T.C.M. (CCH) 275 (same); *Hart*, 73 T.C.M. (CCH) 1684 (same); *Boatner*, 74 T.C.M. (CCH) at 345 (determination that taxpayer was not engaged in the trade or business of buying and selling stock meant that he was not eligible for business deductions but rather had to itemize deductions); *Moller*, 721 F.2d 810 (finding that taxpayer was an investor and not in the “trade or business” resulted in disallowance of IRC § 280A home office expense deductions); *Cameron*, 2007 T.C.M. (RIA) ¶ 2007-260, 94 T.C.M. (CCH) 245 (taxpayer who was an investor, not a trader, was disallowed IRC § 162 trade or business deduction); *Mayer*, 67 T.C.M. (CCH) 2949 (same).

b. The “To Customers” Requirement and the Character of Income

While most of the important tax consequences (on the deductions side) to a taxpayer who buys, sells, and holds securities depend, at a threshold level, on whether the taxpayer is engaged in or conducting a “trade or business,” a trader’s gain and loss from his securities-trading activities are treated as capital gain or loss despite the fact that the trader may be engaged in a trade or business. This “character of income” issue is not determined based on whether a trade or business is being conducted, but instead depends on whether the securities held by such trader are “capital assets” within the meaning of IRC section 1221.¹¹³ Conceptually, a trader’s gains and losses are treated as capital gains and losses because courts have held that the securities in which a trader trades are “capital assets” within the meaning of the statute, and do not fall within any of the exceptions to capital asset treatment.

By way of background, the term “capital asset” is defined in IRC section 1221 not in positive terms, but rather by carving out certain types of property that are not “capital assets.”¹¹⁴ The Code states that the term includes any “property held by the taxpayer (whether or not connected with his trade or business)” other than certain enumerated assets.¹¹⁵ Over time, many exceptions to the term “capital asset” have entered the statute, which now includes exceptions for “stock in trade of the taxpayer,” property properly included in “inventory,” property that is “held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,” real or depreciable personal property used in a taxpayer’s trade or business, certain intellectual property, accounts or notes receivable acquired in the ordinary course of trade or business in exchange for services or from the sale of stock in trade, certain commodities–derivative financial instruments held by commodities–derivatives dealers, certain hedging transactions, and supplies regularly used or consumed by a taxpayer in the ordinary course of his trade or business.¹¹⁶ These exceptions appear to generally concern property held by a taxpayer in a trade or business, rather than for long-term investment.¹¹⁷ However, the exceptions are interpreted quite narrowly, and, particularly since the demise of the *Corn Products* doctrine, an asset must usually fall within one of the exceptions explicitly set out in the Code in order to be exempt from capital asset treatment.¹¹⁸

113. IRC § 1221.

114. IRC § 1221(a).

115. IRC § 1221(a).

116. IRC § 1221(a).

117. See generally Note, Judicial Treatment of “Capital Assets” Acquired for Business: The New Criterion, 65 Yale L.J. 401 (1995); see also *Corn Products Refining Co. v Comm’r*, 350 U.S. 46 (1955), discussed at *infra* note 118.

118. In *Corn Products Refining Co. v Comm’r*, 350 U.S. 46 (1955), the United States Supreme Court held that purchases and sales of corn futures were not

With respect to traders, the courts have historically analyzed whether such trader's stocks and securities may be excepted from capital asset treatment as property "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."¹¹⁹ In this regard, courts have universally found that, unlike dealers, traders do not have customers (despite the fact that some party is obviously buying the securities sold by such trader), and therefore their securities do not fall within this exception. These court holdings therefore result in capital asset treatment for trader sales of securities.

The findings of the courts that traders do not sell "to customers" appear to fall in line with the intent of the legislature in adding the "for sale to customers" exception to "capital asset" treatment. Prior to 1934, the statute merely carved out from "capital asset" treatment "property held by the taxpayer primarily for sale in the course of his trade or business."¹²⁰ There was no additional requirement that the property be held for sale "to customers," and a taxpayer determined to be in the trade or business of trading was automatically entitled to ordinary gain and loss treatment on the sale of those securities.¹²¹ The requirement that the property had to be held primarily for sale "to customers" to qualify for exception from capital asset

purchases and sales of capital assets, even though the futures did not come within the literal language of any of the exclusions from capital asset classification. The court stated that "the transactions were vitally important to the company's business as a form of insurance" and that "the capital asset provision of § 117 must not be so broadly applied as to defeat rather than further the purpose of Congress" and concluded that "the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly." *Id.* at 50, 52. However, the court subsequently held in *Arkansas Best Corp. v. Comm'r*, 485 U.S. 212 (1988) that the disposition of bank stock was a disposition of a capital asset, even though such bank stock was acquired for a business purposes, where the stock did not fall within any of the exceptions listed in the capital assets statute, and noted that the taxpayer's tax motivation is irrelevant. The court clarified in *Arkansas Best* that *Corn Products* does not create a general exemption from capital asset status for any assets acquired for a business (rather than an investment) purpose. *Id.* at 221.

119. IRC § 1221(a)(1)(emphasis added); see *King v. Comm'r*, 89 T.C. 445 (1987), *Kemon*, 16 T.C. 1026; *Marrin v. Comm'r*, 73 T.C.M. (CCH) 1748 (1997), *aff'd*, 147 F.3d 147 (1998).

120. Revenue Act of 1924, ch. 234, § 208(a)(8), 43 Stat. 253, 263. The statute, as amended in 1924, defined "capital asset" as "property held by the taxpayer for more than two years (whether or not connected with this trade or business), but does not include 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 primarily for sale in the course of his trade or business." See also, generally, *Fuld*, 139 F.2d 465.

121. See *Schwinn*, 9 B.T.A. 1304, see also *Fuld*, 139 F.2d at 469 (discussing law change).

treatment was introduced into the statute by section 117(b) the Revenue Act of 1934.¹²² The report of the Senate Finance Committee stated that the policy reason behind this change was “to prevent tax avoidance by excluding from the category of a ‘capital asset’ property held by the taxpayer primarily for sale ‘to customers’ in the ordinary course of his trade or business, instead of merely property held by the taxpayer primarily for sale in the course of his trade or business.”¹²³ The Conference Report on this provision was even more explicit, stating that “[t]he Senate amendment confines the exclusion to property held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business, thus making it impossible to contend that a stock speculator trading on his own account is not subject to the provisions of section 117.”¹²⁴ The enactment of this provision was apparently undertaken in part because some taxpayers had paid no federal income tax in the preceding tax years because they had used their (then ordinary) losses on securities sales to offset vast amounts of income from other sources, and because of Congressional concerns about protecting national revenue during a depressed period.¹²⁵ Therefore, it is clear that the addition of the “to customers” requirement to the statute was squarely aimed at preventing stock traders (or “speculators” as they were then called) from contending that they were eligible for ordinary gain and (more pertinently) ordinary losses from their trading activities.

In the light of this statutory change and the legislative commentary accompanying that change, courts began to decide that, even if a taxpayer were a trader found to be engaged in the trade or business of securities trading, and entitled to all of the tax treatments accorded to a taxpayer engaged in a trade or business, his gain and loss from the sale of securities were capital gain and loss for the simple reason that a trader, unlike a dealer, has no customers. One of the early cases addressing the issue was *Kemon v.*

122. Revenue Act of 1934, Pub L. No. 73-216, § 117(b), 48 Stat. 680, 714 (1934). With respect to the “to customers” provision, § 117(b) was substantially identical in form to what is currently IRC § 1221(a)(1).

123. *Burnett v. Comm’r*, 40 B.T.A. 605, 608 (1939), *aff’d by Comm’r v. Burnett*, 118 F.2d 659 (5th Cir. 1941) (quoting Senate Finance Committee Report to 1934 Revenue Act at 12).

124. H. Rep. No. 1385, 73rd Cong. 2d Sess. at 22.

125. Peter Miller, The “Capital Asset” Concept: A Critique of Capital Gains Taxation, 59 Yale L.J. 837, 844 (1950) (citing Latham, Taxation of Capital Gains, 23 Calif. L. Rev. 30, 34 n.13 (1935)); see also Joseph Byron Cartee, Note, A Historical Essay and Economic Essay of the Capital Asset Definition: The Taxpayer and Courts are Still Mindfully Guessing While Congress Doesn’t Seem to (Have A) Mind, 34 Wm. & Mary L. Rev. 885, 909 (1993) (noting that the “to customers” addition was made to prevent professional traders in securities from taking ordinary loss deductions).

*Comm'r.*¹²⁶ In *Kemon*, decided in 1951, the Tax Court had to decide whether the taxpayer, a partnership whose principal activity was the buying and selling of unlisted securities for its own account, was a trader taxed at capital gains rates or a dealer taxed at ordinary income rates. The court held that the taxpayer was a securities trader, rather than a dealer, and was entitled to capital gain treatment on its sales of securities.¹²⁷ In so holding, the court discussed the legislative history of section 117(a)(1) in some detail, noting that the “crucial phrase” “to customers” had been added to the statute specifically so that a speculator trading on an exchange on his own account could not claim that the securities that he sold were other than capital assets, and that “[t]he theory of the amendment was that those who sell securities on an exchange have no customers.”¹²⁸ The court then famously explained:

In determining whether a seller of securities sells to “customers,” the merchant analogy has been employed...Those who sell “to customers” are comparable to a merchant in that they purchase their stock in trade, in this case securities, with the expectation of reselling at a profit, not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. This excess or mark-up represents remuneration for their labors as a middle man bringing together buyer and seller, and performing the usual services of retailer or wholesaler of goods....

Contrasted to “dealers” are those sellers of securities who perform no such merchandising functions and whose status as to the source of supply is not significantly different from that of those to whom they sell. That is, the securities are as easily accessible to one as the other and the seller performs no services that need be compensated for by a mark-up of the price of the securities he sells. The sellers depend upon such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost. Such sellers are known as “traders.”¹²⁹

126. *Kemon*, 16 T.C. 1026.

127. *Id.* The court’s holding was with respect to securities held for more than six months. The court said that it did not need to determine whether securities held for six months or less were capital assets, because those securities had been reported in full.

128. *Kemon*, 16 T.C. at 1032 (quoting *Burnett v. Comm’r*, 40 B.T.A. 605, 118 F.2d 659; *Wood v. Comm’r*, 16 T.C. 213).

129. *Kemon*, 16 T.C. at 1032-33 (citations omitted).

The essence of this “merchant” analogy used by the court in *Kemon* seems to be that (1) unlike merchants, securities traders depend on market changes, rather than buying at cost and selling at a higher price, and (2) securities traders, unlike dealers, do not act as “middlemen” whose profit is essentially compensation for their services and, more generally, do not add any value to the process that would explain the profit.¹³⁰ While the court’s analysis in *Kemon* incorporates more far-reaching concepts than the literal words “to customers” that are contained in the statute, the court’s interpretive gloss on the statutory wording, as well as the court’s conclusion that a trader does not have customers, has since been adopted by other courts.¹³¹

For example, the “merchant” analogy and conclusion articulated in *Kemon* was accepted by the Tax Court in *Marrin v. Comm’r*, where the court decided that the taxpayer did not have customers and was therefore a trader instead of a dealer.¹³² Like the court in *Kemon*, the *Marrin* court recognized that the “to customers” requirement was “of paramount importance.”¹³³ The court concluded that since “[a]ll of the securities transactions of petitioner for the years in issue were undertaken on an exchange and effected through broker-dealers” and “[a]ll such transactions were for petitioner’s own account,” the taxpayer was “[I]acking customers” and was not eligible for ordinary loss treatment on his sales of securities.¹³⁴ The court rejected the taxpayer’s arguments that (1) the broker-dealers handling his orders were his customers, and that, (2) alternatively, under an agency theory, the customers of the broker-dealers should be regarded as his customers.¹³⁵

The court decisions above, together with the legislative history of the “capital asset” definition, illustrate that the reason that traders are given capital gain and loss treatment on the sale of their traded securities is that they do not meet the “to customers” requirement in the capital asset statute, which must be met in order to fall within an exception to the capital asset definition.¹³⁶ In this regard, the judicial interpretations have fallen in line

130. *Id.*

131. See *Marrin*, 73 T.C.M. (CCH) 1748 (1997); *King*, 89 T.C. 445 (1987); *Wood v. Comm’r*, 16 T.C. 213 (1951); see also Chief Couns. Adv. 200817035 (Apr. 25, 2008) (citing *Kemon*).

132. *Marrin*, 73 T.C.M. (CCH) at 1751.

133. *Id.* at 1750 (noting that “this Court and other have used the ‘to customers’ requirement to distinguish between securities ‘dealers’ who are intended to come within the capital asset exclusion of § 1221(1) and mere ‘traders’ who are not”).

134. *Id.* at 1751.

135. *Id.* at 1751-52.

136. Another case in which the “to customers” requirement was articulated was *King*, 89 T.C. 445, a case involving whether a commodities trader was subject to the IRC § 163(d) investment interest limitation. The court noted in *King* that “a primary distinction for Federal tax purposes between a trader and a dealer in

with the sentiment articulated in the 1934 legislative history of the capital asset statute, and have interpreted trader transactions in a manner consistent with the legislative intent. While one might argue that to say that a securities trader has no customers is illogical, the courts have not bought this argument. It may be true that, examined literally, or at least from the standpoint of economics, the fact that when a securities trader sells his securities some party in the market obviously has bought them from that trader means that the trader has “customers.”¹³⁷ However, the courts have rejected this “economic” argument and have, with the aid of judicial glosses and interpretation, held that a securities trader does not have “customers” notwithstanding the fact that he buys and sells securities on a “frequent,” “regular,” and “continuous” basis.¹³⁸

c. The Intersection of Disjoint Concepts: A Structural Look at Trader Taxation

The above analysis shows that, while most of the tax consequences to a taxpayer who buys, sells, and holds securities are controlled by a threshold inquiry into whether that taxpayer conducts a “trade or business” of buying, selling, or holding securities,¹³⁹ the proper character of the

securities or commodities is that a dealer does not hold securities or commodities as capital assets if held in connection with his trade or business, where as a trader holds securities or commodities as capital assets whether or not such assets are held in connection with his trade or business. A dealer falls within an exception to capital asset treatment because he deals in property held primarily for sale to customers in the ordinary course of his trade or business. A trader, on the other hand, does not have customers and is therefore not considered to fall within an exception to capital asset treatment.” Id. at 458 (footnote omitted).

137. See, e.g., *Archaya*, 225 F.App’x 391 (7th Cir. 2007) (Fed. R. App. P. 32.1 nonprecedential disposition) (taxpayer argued that the people who bought the securities he had sold were “customers”); *Marrin*, 73 T.C.M. (CCH) at 1751 (taxpayer argued that broker-dealers were his customers, or, alternatively, that the customers of the broker-dealers were his customers under agency law); see also, generally, *Groetzinger*, 480 U.S. at 33-34 n.12 (citing Boyle, What is a Trade or Business? 39 Tax Lawyer 737, 763 (1986) (“It takes a buyer to make a seller and it takes an opposing gambler to make a bet”).

138. See *Archaya*, 225 F.App’x 391 (7th Cir. 2007) (“that characterization [that people who bought securities were customers] may be useful for some economic purposes but is not relevant to the legal analysis”); *Marrin*, 73 T.C.M. (CCH) at 1751 (rejecting taxpayer’s argument that broker-dealers were his customers).

139. As discussed, some of these tax consequences are entitlement to IRC § 162 trade or business deductions, entitlement to unlimited interest deductions under IRC § 163, entitlement to home office expense deductions under IRC § 280A, and

taxpayer's income is determined instead based on whether the taxpayer has "customers" to whom he sells those securities. The applicable exception in IRC section 1221(a)(1) from capital asset treatment requires that the property at issue be "held by the taxpayer primarily for sale 'to customers' in the ordinary course of his trade or business."¹⁴⁰ It is clear from the language of the statute that, in order to come within this exception, the taxpayer needs to first of all be in a "trade or business" of buying, selling, and holding securities. This is the same gating item that must be satisfied in order for the taxpayer to be entitled to the other tax treatments discussed above, whose availability also hinges on whether the taxpayer is in a "trade or business." However, the "to customers" requirement represents an additional hurdle that must be overcome to attain ordinary income treatment, a hurdle that is not a requirement with respect to any other aspect of the treatment of a securities-buying, selling, or trading taxpayer. As discussed above, courts have determined, based on the legislative history of the provision, that this hurdle is insurmountable for securities traders.¹⁴¹ This disjuncture between two competing concepts gives rise to the atypical treatment of securities traders.

Looking at the issue from a different angle, while the requirements laid down by the courts for a taxpayer to show that he is engaged in a trade or business are not trivial, and in fact can be quite onerous, there has never been a requirement that the taxpayer demonstrate that he is engaged in providing goods and services "to customers" in order to be found to be in a trade or business. This notion was explicitly rejected by the Supreme Court holding in *Comm'r v. Groetzinger*, a case that held that a full-time gambler, who was not holding himself out as selling anything to anyone, was engaged in the trade or business of gambling.¹⁴² In direct contrast to the development of the trade or business doctrine, however, a post-1934 trader must make just such a showing (which the courts have decided that he cannot do) in order to be subject to ordinary income treatment as opposed to capital asset treatment.

entitlement to elect start-up expenditure deductions under IRC § 195. See also, e.g., IRC §§ 172, 179.

140. IRC § 1221(a)(1) (emphasis added).

141. See *Archaya v. Comm'r*, 225 F.App'x 391 (7th Cir. 2007); *Marrin*, 73 T.C.M. (CCH) at 1751.

142. *Comm'r v. Groetzinger*, 480 U.S. 23 (1987). The court in *Groetzinger* famously rejected a prior observation by Justice Frankfurter in a concurring opinion in *Deputy v. DuPont* that "carrying on any trade or business ... involves holding one's self out to others as engaged in the selling of goods and services." *Groetzinger* at 29 (quoting *DuPont*, 208 U.S. 488, 499 (1940) (dissent, J. Frankfurter)). The Supreme Court's position in *Groetzinger* has carried over from the gambling area into the securities area such that in none of the cases distinguishing traders and investors has a court ever held that a trader requires advertising or otherwise "holding oneself out to customers" as providing goods and services as one of the tests in evaluating engagement in a trade or business.

The disjuncture between the application of the trade or business concept and the “to customers” requirement to traders, which has been wrought by the 1934 addition of the “to customers” requirement to the capital assets definition, comes into stark contrast upon comparing court decisions before the addition of that language with decisions after the statutory addition. As discussed above, after the addition of the “to customers” language, courts have focused on the fact that traders, unlike dealers, have no “customers,” and therefore get capital gain or loss treatment on the sale of their securities. Prior to the 1934 addition, however, the standard used by the courts to determine eligibility for ordinary income treatment of securities-trading gains and losses was, in fact, essentially identical to that used for determining the aforementioned other aspects of the securities traders tax picture. That is, it was identical to the “trade or business” standard. To illustrate the point, in *Schwinn v. Comm’r*, an early case dealing with the law prior to the 1934 addition, the Tax Court was called upon to decide whether losses from the sale of stock by the taxpayer could be treated as ordinary losses rather than capital losses.¹⁴³ The court noted that under section 208(a)(8) of the Revenue Act of 1924, the term “capital asset” meant

property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include 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 primarily for sale in the course of his trade or business.¹⁴⁴

Therefore, the court said that the determining issue in its analysis was whether “the petitioner’s speculations ... [were] *of such a nature as to properly be regarded as his trade or business*” (emphasis added).¹⁴⁵ The court held that the taxpayer had devoted “the largest part of his business time to, and made the most money from, speculating” and had spent “[l]arge sums of money ... in his marginal dealings,” and that, therefore, the resulting losses occurred “with respect to property held primarily for sale in the course of the petitioner’s trade or business” (i.e., were ordinary losses).¹⁴⁶ The court therefore essentially applied the “trade or business” standard—the same standard applied to other aspects of the taxpayer’s tax return picture—in deciding whether or not the taxpayer’s losses were ordinary.

143. *Schwinn*, 9 B.T.A 1304.

144. *Id.* at 1307 (emphasis added).

145. *Id.* at 1307.

146. *Id.* at 1308-09.

The court's analysis in *Schwinn* demonstrates that the disjuncture between courts' analyses with respect to the "nature of income" issue and the courts' analyses with respect to other aspects of a trader's tax picture clearly came about as a result of the 1934 addition of the "to customers" requirement into the statute, and was not present before that.¹⁴⁷ Prior to this Congressional addition, courts applied the same standard (that is, they inquired into whether the trader or "speculator" was in the trade or business of securities trading) in determining all facets of that taxpayer's tax picture.¹⁴⁸ The standard, although non-trivial, was comparatively internally consistent, with the same requirements determining the character of gain and the deductions available. The addition of the "to customers" requirement, however, necessitated a second level of inquiry, and rendered the standards for determining the taxpayer's character of income and for determining his deductions different from one another. While most aspects of a securities trader's tax treatments are still determined based on whether that taxpayer is in the "trade or business" of trading, the nature of that taxpayer's income and losses now depends on the taxpayer additionally meeting a totally different standard: the taxpayer must also show that the securities he traded were held for sale "to customers."¹⁴⁹

By introducing a new requirement relating to the existence of customers to the "character of income" side of the taxpayer's equation, the "to customers" requirement has added a layer of complexity into the analysis surrounding trader taxation, and has caused the taxation of traders to be imbalanced or asymmetrical with respect to the inquiries applied to income and deductions, respectively. Prior to the 1934 introduction of the "to customers" requirement, the statute was essentially symmetrical. After the 1934 addition of the "to customers" requirement, the statutes were rendered asymmetrical, creating the present-day unusual treatment of traders.

147. See also *Bryce v. Keith*, 257 F. 133 (E.D.N.Y. 1919) (interpreting Section 2(b) of October 3, 1913 Act of Congress, the court held that since decedent's stock transactions were carried on over a considerable period, were complicated, involved a lot of money, and required much time and attention, losses therefrom were "incurred in trade" within the meaning of the statute, and taxpayer was entitled to deduct such losses from ordinary income); see also, generally, *Penrose v. Skinner*, 298 F. 335 (D. Colo. 1923).

148. *Schwinn*, 9 B.T.A. 1304; *Bryce*, 257 F.133.

149. As the court in *King* cogently put it, the "to customers" requirement places the securities trader (as well as, arguably, any taxpayer in a trade or business who is not engaged in selling "to customers") in an "unusual situation"—that of being "a taxpayer engaged in a trade or business which produces capital gains and losses." *King*, 89 T.C. at 460.

SECTION IV: SOME CRITIQUES OF TRADER TAXATION

The asymmetrical taxation of traders created by the introduction of the “to customers” requirement as described in Section III has been subject to a number of criticisms. This section discusses some of the criticisms that have historically been leveled at the taxation of traders, and offers some further critiques from a structural standpoint.

a. Non-Structural Criticisms

i. Fairness, as compared to other businesspersons

- *Favorable capital gains rates for traders*

One of the biggest critiques of trader taxation has been that it is not “fair” as compared to the taxation of other taxpayers in a trade or business.¹⁵⁰ It is certainly very odd that a taxpayer who engages in the trade or business of trading should have his income and losses treated differently from any other taxpayer in the trade or business of buying or selling anything else, merely due to the fact that the trader, unlike a dealer or other merchant, sells his “goods” on an anonymous exchange and supposedly does not have “customers.”¹⁵¹ An individual taxpayer who is a trader will, in fact, have a Form 1040 Schedule C (Profit or Loss from Business) that reports sizeable “trade or business” expenses but no income from the securities trading (since these gains and losses are capital), and his income from trading will show up instead as capital gain or loss on Schedule D.¹⁵² This treatment is especially problematic from the standpoint of fairness, where a trader, having taken Schedule C deductions, is in a position to have some of his income taxed at reduced long-term capital gain rates. While it is no doubt true that much of the securities trader’s capital gain will be short-term capital gain, which is taxed at ordinary income rates, traders are not altogether precluded from taking long-term capital gains treatment on their securities that have a long-term holding period. The current treatment of traders may stem, in part, from the fact that traders are in the trade or business of buying and selling securities, which are commonly thought of as capital assets. On the other hand, however, if traders are in the trade or business of trading, they should

150. See, e.g., *Miller*, supra note 125 (“[s]peculation is a way of securing a living in whole or in part. This income should be treated exactly the same as the income of a merchant, a lawyer, or a wage earner...” (citation omitted)).

151. See *id.*

152. See Schedules C and D to Form 1040, available at <http://www.irs.gov/pub/irs-pdf/f1040sc.pdf> and <http://www.irs.gov/pub/irs-pdf/f1040sd.pdf> (last visited Jan. 19, 2008); Raby, *Nondealer Security Losses*, supra note 5, at 46 (noting trader’s unusual Schedule C).

be treated like any other taxpayer who conducts a trade or business, rather than being afforded capital asset treatment along with ordinary deductions.¹⁵³

- *Electiveness of the mark-to-market election*

In addition to getting comparatively favorable capital gain rates on their long-term capital gains, traders, unlike dealers, enjoy these potentially reduced tax rates for income earned (along with favorable business deductions), while also enjoying the choice of making with an optional mark-to-market election to take ordinary losses as of the year end. Mark-to-market treatment (and the timing and character-of-income benefits of the same) is not elective for dealers.¹⁵⁴

- ii. *Fairness, as compared to investors*

Another set of criticisms focuses on the taxation of traders as compared with that of ordinary investors.

- *Availability of expense deductions*

As discussed above, traders are able to take various business deductions that are denied to investors.¹⁵⁵ This puts the ordinary investor at a disadvantage as compared to a trader, since investors cannot take deductions for expenses incurred in making their investments, no matter how extensive, while traders may be eligible for such deductions.¹⁵⁶ Related criticisms are that the differential treatment of investors and traders promotes speculation, and may tend to favor more sophisticated or wealthy taxpayers who partake more actively in speculative trading of stocks and securities.¹⁵⁷

153. See, e.g., *Miller*, supra note 125; see also, e.g., Raby, *Trader, Gambler, or Investor*, supra note 5, at 1665, 1667 (noting that trader classification “offers some real tax inducements” and that securities traders “for tax purposes, have the best of two worlds”).

154. IRC § 475; see also Conlon & Aulino, supra note 55, at ¶ B3.08[1]; Sheppard, supra note 5 at 721-22.

155. See Section II, supra.

156. *Higgins*, 312 U.S. 212; see also, e.g., Raby, *Trader, Gambler, or Investor*, supra note 5, at 1665, 1667.

157. See, generally, John W. Lee III, *The Capital Gains “Sieve” and the “Farce” of Progressivity 1921-1986*, 1 *Hastings Bus. L. J.* 1 (2005); John W. Lee III, *Class Warfare 1988-2005 Over Top Individual Income Tax Rates: Teeter Totter from Soak-the Rich to “Robin-Hood-in-Reverse”*, 2 *Hastings Bus. J.* 47 (2006); Maureen A. Maloney, *Capital Gains taxation: Marching (Oh-So-Slowly) into the Future*, 17 *Man. L. J.* 299 (1988).

- *Availability of ordinary income treatment due to mark-to-market election*

The mark-to-market election available to traders under IRC section 475(f) is also subject to criticism. Perhaps most importantly, the mark-to-market election allows traders, but not investors, to choose to convert gains and losses to ordinary gains and losses.¹⁵⁸ Such converted ordinary losses recognized by a trader would be deductible against other kinds of ordinary income, a result that could be more favorable for the taxpayer (and more harmful for the revenue collector) than that with capital losses.¹⁵⁹ It seems inconsistent, for example, that between two individuals sitting in front of a home computer engaging in the online buying and selling of stocks and securities, the one considered a trader would be allowed to opt for ordinary treatment while the other (the investors) could make no such choice.¹⁶⁰ The choice to make a mark-to-market election also provides a degree of retroactive tax planning available to a trader that is not available to an investor.¹⁶¹

- *Availability of accelerated recognition due to mark-to-market election*

The making of the mark-to-market election also enables traders to recognize gains and losses at the end of the tax year, by creating the tax fiction that the trader has sold all of his securities at the end of the tax year.¹⁶² Therefore, in addition to being able to take valuable deductions and potentially offset ordinary losses, a trader can also accelerate income recognition through the making of such an election, while an investor (in addition to taking capital losses) is forced to postpone such recognition until actual disposal of the securities. Again, this result appears unfair.

iii. Uncertain standards

Finally, the taxation of traders has also been criticized on the grounds that the standards that must be met in order to demonstrate

158. IRC § 475(f).

159. Securities Trader Denied Ordinary Loss Treatment Because of Late Mark-to-Market Election, 108 J. Tax'n, vol. 1 (Jan. 2008) ("Allowing all taxpayers who trade securities to place their losses on Schedule C and treat them as ordinary losses instead of reporting them on Schedule D and characterizing them as capital losses could have an enormous negative impact on the public fisc").

160. See, e.g., <http://www.etrade.com> (last visited Jan. 19, 2008).

161. See Section V.c, *infra*.

162. IRC § 475(f).

engagement in a “trade or business” as a trader are not entirely clear.¹⁶³ While it is apparent, as discussed above, that courts will look at the frequency, regularity, and continuity of the taxpayer’s securities activities as well as the nature of the income derived from the activity (i.e., short term vs. long term) and the intent of the taxpayer, the exact standards with respect to factors such as the holding period of securities and the volume of trading are not clear or are overly fact dependent.¹⁶⁴ Therefore, it can be difficult for a taxpayer to know whether or not he qualifies for trader treatment. The fact-specific nature of the analysis with respect to whether a taxpayer qualifies as a trader also makes IRS enforcement difficult and breeds unnecessary and costly litigation.¹⁶⁵

b. Structural Criticisms

In addition to the above criticisms, the current taxation of traders is also problematic from a structural standpoint. Whatever other fairness-based critiques of trader taxation may be made, the lopsided tax treatment of traders also stems from the fact that the tax rules on the gain side and on the deductions side of that treatment are different, and the statute is therefore asymmetrical between the gains side and the deductions side. This asymmetry itself causes ongoing problems in the taxation of traders. It is not surprising that since one set of tax rules (the trade or business requirement) underlies the majority of the aspects of a trader’s tax treatment while a separate and additional requirement (the capital asset rules) determines character of income, the intersection of the two sets of rules would not be perfectly seamless and unproblematic. Most notably, because of the structure of the statutory rules, the magnitude of the difference between the taxation of traders and the taxation of other taxpayers in a trade or business is dependent on the rate differentials between ordinary and capital treatment at any given point in time, leading to an embedded volatility in trader taxation. Furthermore, in the light of ever more widespread trader activity, this volatility has the potential to be proliferated in ways never before possible.

163. See, e.g., Schwartz, *supra* note 5, at 399 (arguing for more specific guidance).

164. *Id.*

165. See also Jack Robinson & Richard S. Mark, *On-line Transactions Intensify Trader vs. Investor Question*, 66 *Practical Tax Strategies* 80 (Feb. 2001) (correctly determining whether a taxpayer is a trader or an investor “is difficult, not only because of the complexity of the law in this area but also because the case law deals with taxpayers in the pre-Internet age”).

i. Embedded volatility

Whether or not the treatment of traders is “fair,” the main concern from a structural standpoint is not so much that traders get favorable capital gain taxation as opposed to other taxpayers, but that exactly how favorably or differently traders are treated as compared to other taxpayers is dependent on a changing variable, namely, the way in which capital assets are treated under the Code. This notion is clearly illustrated by looking at the differences between capital asset taxation in 1934 and capital asset taxation today.¹⁶⁶ At the time the “to customers” requirement was introduced into the statute in 1934, the tax treatment resulting from “capital asset” classification under the tax law was fundamentally different than from the treatment of capital assets presently.¹⁶⁷ Unlike the present-day situation, capital gains were not taxed at reduced rates across the board in 1934.¹⁶⁸ Instead, for taxpayers other than corporations, a certain fraction of the capital gain or loss was not taken into account in computing net income, depending on the holding period of the capital asset, but the rest was taxed at ordinary income rates.¹⁶⁹ So, for example, 100% of the gain or loss was recognized with respect to capital assets held for a year or less, 80% of the gain or loss was recognized for capital assets held for more than a year but not more than two years, 60% for capital assets held for more than two but not more than five years, and so forth.¹⁷⁰ Under the system of taxing capital gains then in existence, a trader in 1934 holding capital assets for slightly over a year would have been not have been taxed at as low an effective tax rate as a present-day trader.¹⁷¹ Put another way, if the 1934 system of taxing capital gains were in effect today, then an individual trader taxed at a maximum marginal rate of 35% would be taxed at an effective rate of 28% on securities held for just over a year.¹⁷²

166. *Miller*, supra note 125, at 845 (citing Hendricks, Federal Income Tax: Capital Gains and Losses, 49 Harv. L. Rev. 262 (1935)) (noting that despite capital classification, a 1934 trader would have had a large proportion of capital gains taxed at ordinary income rates).

167. Compare IRC § 1(h)(1) with Revenue Act of 1934, Pub L. No. 73-216, § 117(a), 48 Stat. 680, 714.

168. *Id.*

169. *Id.* See generally Bonner Menking, Making Sense of Capital Gains Taxation, 39 U. Kan. L. Rev. 175, 177-78 (1990) (discussing this “inclusion ratio” concept); Frederick L. Pearce, Capital Gains and Losses, S.C. L. Q. 168, 170 (1953). The 1934 Code also provided that the amount of capital losses allowed was limited to the amount of capital gains plus \$2,000. IRC § 117(d) (1934).

170. Revenue Act of 1934, Pub L. No. 73-216, § 117(a), 48 Stat. 680, 714. A corporation was taxed in full on its capital gains.

171. *Miller*, supra note 125, at 845.

172. Such a hypothetical trader would be taxed on 80% of such capital gain at a 35% rate, giving rise to an effective marginal rate of 28% (because 80% x 35% rate = 28%).

This is obviously a much less favorable rate than the current usual 15% rate on long-term capital assets.¹⁷³ Hence, at the time of the 1934 addition of the “to customers” requirement, the prohibition against ordinary loss treatment for speculator losses that was enacted by that addition would not necessarily have given rise to very favorable treatment of such speculators on the gain side, and there would presumably have been less reason to be concerned about the flip side of the new legislation.¹⁷⁴ As discussed above, however, under the present-day scheme of taxing certain capital assets at reduced rates and the rates currently in effect, a trader with capital gains held for over a year will be taxed at a maximum rate of 15%, which is significantly less than the ordinary income tax rates that would be experienced by dealers or other taxpayers in a trade or business.

The method of taxing traders that has continued to the present day therefore seems particularly inappropriate in the light of changes in the taxation of capital gains since 1934, and not only because of the magnitude of the rate differential under current law. From a structural point of view, this inappropriateness also stems from the fact that by mandating capital asset treatment for securities held for sale by traders (who have no “customers”), the method of taxing traders that was introduced by Congress in 1934 in effect links the “gain side” of trader taxation to the way in which capital gains are taxed at *any* given point in time. Specifically, this method of taxing traders makes the extent to which trader taxation is more or less favorable than the taxation of investors or dealers dependent on the effective capital gains tax rates presently in existence. Quite apart from being a favorable system for traders given the current differential between capital and ordinary tax rates, a system that links the degree of favorableness of trader taxation to the treatment of capital assets at any given point in time is a system that by definition contains embedded irrationality. This is particularly so since capital asset taxation is a “live” and hotly debated area of the law, and is an area that has endured many modifications and reversals over the years.¹⁷⁵ In sum, from a structural standpoint, pegging the taxation of traders to capital assets taxation therefore ensures an innate volatility in the treatment of traders as compared to other types of investors. If the tax rate on capital gains were to fall as compared to the rates on ordinary income taxation, then traders would be afforded a correspondingly larger advantage over other taxpayers in a trade or business; if the capital gain tax preference were to be

173. IRC § 1(h).

174. This observation has been made by at least one commentator. *Miller*, *supra* note 125, at 845.

175. See, e.g., Gregg A. Esenwein, *Capital Gains Tax Rates and Revenues*, Cong. Research. Serv. Rep. RS 20250 (Apr. 4, 2007), available at Tax Analysts 2007 TNT 74-16; Burman, *supra* note 2; Menking, *supra* note 169, at 177-78 (1990); see also, generally, John W. Lee III, *supra* note 157.

repealed entirely, then the taxation of traders would presumably be more in alignment with the taxation of other taxpayers.¹⁷⁶

ii. Structural proliferation

A second and related structural defect in the treatment of traders is that the embedded volatility in the structure of trader taxation has the potential to be more problematic and widespread than ever before, given current-day exigencies. First, there are many more taxpayers who have the potential to qualify as traders today than there were in 1934. Commentators have pointed out the role of the internet and other economic factors, which have led to a vast increase in the amount of trading done by individuals and in the number of traders.¹⁷⁷ This means that any problems caused by the asymmetry and potential volatility of trader taxation under the law have the potential to be multiplied in scope. In contrast to 1934, rather than the handful of speculators whose attempts at using their losses against ordinary income needed to be thwarted, there is now a larger number of traders who have the potential to treat their gains as capital gains, while attempting to deduct trade or business expenses from these same activities. With the growth of the “trader” phenomenon, the problems caused by the embedded volatility inherent in trader taxation discussed above have the potential to be seriously magnified.

Second, it should also be noted that while this article focuses mainly on what may be thought of as the “base case” of trader taxation – the case of an individual trader filing Form 1040 with Schedules C and D – modern-day exigencies have ensured that the structure of the tax rules concerning traders will have implications far beyond the basic scenario involving the prevention of a lone speculator from offsetting ordinary income with trading losses. Unlike in 1934, today’s traders are not just individual taxpayers speculating in securities but may also include several individuals grouped together to engage in trading via entities such as investment funds or other investment pools. Most notably, the statutory rules governing the taxation of traders apply not only to the solo trader but may also apply to the taxation of partnership traders such as hedge funds and other investment funds (typically

176. For an illustration of how the gap between ordinary income and capital gain has changed between 1998 and 2010 (hypothetically), see Joann M. Weiner, News Analysis: Saving Private Equity, 117 Tax Notes 309, 311 (Oct. 22, 2007) (Figure 1).

177. See, e.g., Schwartz, *supra* note 5, at 399; Robinson & Mark, *supra* note 165; see also, generally, <http://www.etrade.com> (last visited Jan. 19, 2008), <http://www.tdameritrade.com> (last visited Jan. 19, 2008), <http://www.fidelity.com> (last visited Jan. 19, 2008), <http://www.schwab.com> (last visited Jan. 19, 2008), as examples of websites via which an individual sitting at home may easily be able to trade in stocks and securities.

non-registered investment funds that are formed as offshore partnerships and that employ various investment strategies to make gains). The fund partnership itself typically receives capital treatment on the profits from the sales or exchanges of their investments, since the assets held by hedge funds are generally capital assets.¹⁷⁸ Under the partnership tax rules, this treatment would generally be passed through the partnership to the partners therein.¹⁷⁹ Therefore, investors in the fund will also be taxed on their distributive share of the gain realized by the fund at capital gain rates, with any losses being treated as capital losses.¹⁸⁰ Similarly, under current law, fund managers, as “carried interest” partners, also receive capital gain and loss treatment on such sales and exchanges that are allocable to the carried interest that they usually hold in the fund, since the carried interest is characterized as a share of partnership profits, rather than as compensation, under present law.¹⁸¹ As is the case for individual traders, gain from the sale of capital assets held for more than a year will therefore normally qualify for the 15% long-term capital gain rates under current law.¹⁸² At the same time, some funds may also take the position that they are traders for tax purposes.¹⁸³ As with any other taxpayer attempting to qualify as a trader, however, the determination of whether the partnership is in fact a trader will largely be based on the fund’s holding period of its assets, with longer-term holding periods suggesting investor rather than trader status, as well as on the frequency,

178. Weiner, *supra* note 176, at 310 (describing the capital asset treatment of general partner interests in private investment fund structures).

179. *Id.*; see also IRC §§ 702, 703, 704.

180. IRC §§ 702, 703, 704.

181. See Rev. Proc. 93-27, 1993-2 CB 343 (ruling that the receipt of a partnership profits interest for services is not a taxable event so long as the person receives that interest either as a partner or in anticipation of becoming one. The procedure does not apply if (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) the partner disposes of the profits interest *within* two years of its receipt; or (3) the profits interest is a limited partnership interest in a publicly traded partnership under section 7704), *clarified* by Rev. Proc. 2001-43, 2001-2 CB 191, 8/03/2001. Contrast *Campbell v. Comm’r*, 59 T.C.M. (CCH) 236, *rev’d*, 943 F.2d 815 (8th Cir. 1991); *St. John v. United States*, No. 82-1134 (C.D. Ill. Nov. 16, 1983) (holding that receipt of partnership profits interest is a taxable event under IRC § 83).

182. IRC §§ 1(h)(1), 1222(3), 1222(4).

183. See, e.g., Rev. Rul. 2008-12, 2008-10 IRB 520 (Feb. 19, 2008) (partnership trader in securities); see Lee A. Sheppard, *Are Hedge Funds in a Trade or Business?*, 114 Tax Notes 140 (Jan. 15, 2007) [hereinafter *Sheppard, Trade or Business*] (citing Arden Dale, *Moving the Market – Tracking the Numbers/Outside Audit: Hedge-Fund Tax Break Raises Flags; Come April 15, the Difference between “Trader,” “Investor” Can be a Substantial Sum*, Wall. St. J., Dec. 26, 2006, at C-3).

regularity, and continuity of the fund's trades.¹⁸⁴ As with individual investors, if the fund is a trader (i.e., is in a trade or business of trading), it may take IRC section 162 business deductions and other business deductions, which are passed through to its partners. If the fund is instead an investor, its partners will be limited to IRC section 212 deductions. It is therefore possible that a "trader" fund will be allowed trade or business-type deductions, while simultaneously being taxed at reduced rates on the disposition of those assets with a long-term holding period. Needless to say, the amounts at stake will be much larger in the partnership-trader context than in the individual trader context, since partnerships involve funds contributed from multiple partners.

The favorable capital asset treatment that hedge fund managers get on their carried interest, especially as compared to other taxpayers who receive amounts as compensation and are taxed at ordinary rates, has recently been subject to a good deal of criticism and the threat of reform.¹⁸⁵ A variety of proposals to tax hedge fund managers at ordinary income rates have already been brought to the table.¹⁸⁶ To the extent that one is already concerned about the allegedly inequitable treatment with respect to the character of income received by fund managers, the fact that the fund may simultaneously be allowed to claim trade or business-type deductions upon claiming trader status makes the inequity even worse. Disgruntlement regarding fund entitlement to the trade or business deductions that come with trader status may be further fueled in the case of hedge funds that change from a short-term to a long-term strategy (for example, a fund shifting toward private equity investments). The changing investment strategies of such funds (which may depend on factors such as the current economic climate) may raise further questions regarding the continuing eligibility of such funds for "trader" classification in the light of their longer-term holding

184. See, e.g., *Yaeger*, 889 F.2d at 33; *Moller*, 721 F.2d at 813-14; see also Sheppard, *Trade or Business*, supra note 183, at 143. Such determination may also, in reality, be decided by how zealously IRS enforcement accurate classification upon examining the returns.

185. See, e.g., Lee A. Sheppard, *Hedge Funds Managers' 15 Percent Tax on 20 Percent of the Profits*, 110 Tax Notes 1380 (Mar. 27, 2006) [hereinafter Sheppard, *Hedge Funds Managers*]; Darryl K. Jones, *Debunking the Carried Interests Myths: Part I*, 116 Tax Notes 799 (Aug. 27, 2007); but see Press Release, United States Treasury, *Testimony of Treasury Assistant Secretary for Tax Policy Eric Solomon on the Taxation of Carried Interests*, TPR HP-489 (July 11, 2007) (on file with author).

186. Jeremiah Coder, *Forum Panelists Discuss "Endgame" of Private Equity Tax Debate*, 116 Tax Notes 1103 (Sept. 24, 2007).

period of their assets.¹⁸⁷ Questions regarding fairness may also arise with respect to funds with substantial losses that claim trader status and make a mark-to-market election under IRC section 475(f) in order to convert such losses from capital to ordinary losses.¹⁸⁸

While the rules applicable to fund partnerships claiming to be traders are the same underlying rules as those applicable to individual traders (albeit channeled through the partnership tax rules), the aggregate nature of investment funds accentuates the magnitude of the problem with respect to the favorable tax treatment that traders receive. If nothing else, the amounts at issue are larger in the case of these grouped investors than ever before, and the parties more sophisticated. In sum, with the emergence of various private equity investment arrangements, the business of “speculating” or “trading” has become more large-scale and common, with the result that larger and larger sums of money are at stake. It is therefore probably fair to say that the extension of trader status on a “group” or systemic level to entity or fund traders was not on the radar screen in 1934, when the “to customers” requirement was enacted. To the extent that one is concerned about fairness in the tax treatment of traders as compared with other categories of taxpayers, the real or perceived inequity in the trader tax rules may be magnified when applied to grouped (rather than individual) traders.

c. Summary

Despite its good intentions, the introduction of the “to customers” requirement into the statute in 1934 has wrought a disjuncture in the previously symmetrical treatment of taxpayers in a trade or business, with the securities trader’s tax treatment squarely at the heart of this disjuncture. The treatment of traders has been subject to a number of fairness-based criticisms. In addition, there are also problems stemming from the structure of the statute itself: Trader taxation is currently linked to the ever-volatile minefield of capital asset taxation and therefore itself contains innate volatility. This volatility is magnified, given the modern-day phenomenon of “grouped” trading. From a policy standpoint, this is not a desirable or rational state of affairs. Section V of this article argues that, from a structural standpoint, the courts and the legislature have, purposefully or not, already taken steps to remedy this situation, and that the structural problems caused by the current method of taxing traders would be even more severe but for these legislative and judicial steps.

187. See generally Dale, *supra* note 183; see also, generally, *Fuld*, 139 F.2d 465 (involving taxpayers changing from a long-term investment strategy to a short-term strategy).

188. IRC § 475(f).

SECTION V: STRUCTURAL REMEDIATION BY THE COURTS AND THE LEGISLATURE

As discussed in Section IV above, the asymmetrical tax rules applicable to the gains and deductions side of trader taxation is problematic for a variety of reasons. This section argues that the reason the impact of the statutory asymmetry is not even more far reaching is because of the actions of the legislature and the courts (whether or not intended) in minimizing the effects of the asymmetry. From a structural standpoint, such judicial and congressional efforts are best seen as effecting an architectural remediation in order to inject more symmetry into the statutory structure by limiting the impact of the asymmetrical rules in certain important situations, notwithstanding the letter of the statutory tax rules.

a. Court Decisions Regarding Capital Asset Classification: Minimizing the “To Customers” Requirement

The structural problems inherent in the statute should not be limited to traders. This statement may appear counterintuitive, since the unusual result of allowing capital gain and loss treatment while also allowing various trade or business deductions is particularly a characteristic of traders. However, the asymmetrical structure of the statute has the potential to impact classes of taxpayers other than traders. Even though the legislative history of the 1934 amendment to the capital asset definition reflects that the addition of the “to customers” requirement was aimed squarely at “speculators” who were attempting to offset other income against the losses from securities speculation, the actual language of the statute as enacted did not in any way limit the “to customers” requirement to speculators.¹⁸⁹ This is still true of the statute in its present form, which merely states that the term “capital asset” does not include “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.”¹⁹⁰ Had it intended to do so, Congress could just as easily have created an exception to “capital asset” treatment exclusively applicable to securities. This, Congress did not do.

It is an important tenet of statutory interpretation that courts should give effect to each and every word in a statute, and that if the language of a statute is clear, courts should not go outside of the statute’s plain meaning in

189. Revenue Act of 1934, Pub. L. No. 73-216, § 117(b), 48 Stat. 680, 714 (1934).

190. IRC § 1221(a)(1).

interpreting the statute.¹⁹¹ It is equally a statutory interpretation tenet that courts should only resort to legislative history if the plain meaning of a statute is unclear.¹⁹² In this case, the plain meaning of the statute is perfectly clear: property must be held for sale “to customers” in order to come within the IRC section 1221(a)(1) exception to the capital asset definition.¹⁹³ Despite this plain statutory requirement however, courts have simply ignored the “to customers” requirement outside the securities context.¹⁹⁴ With respect to almost every other type of taxpayer, courts have held that anyone purchasing from a taxpayer engaged in a trade or business is a “customer.”¹⁹⁵

For example, in the real estate context (real estate being, aside from stocks and securities, probably the most commonly analyzed group of capital assets), courts have not for the most part given effect to the “to customers” requirement and instead have understood any buyer of a taxpayer’s property to be a “customer.”¹⁹⁶ With respect to real estate, courts have, in fact, held

191. 2A Norman J. Singer, *Sutherland States and Statutory Construction* § 46.06 (6th ed. 2006) (“[i]t is an elementary rule of construction that effect must be given, if possible, to every word, clause and sentence of a statute. A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant.... No clause sentence or word shall be construed as superfluous, void or insignificant if the construction can be found which will give force to and preserve all the words of the statute” (citations omitted; internal quotations omitted)); see also *id.* at § 46.01 (“when the language of the statute is clear and not unreasonable or illogical in its operation, the court may not go outside the statute to give it a different meaning.”).

192. Singer, *supra* note 191, at § 48.01 (“[g]enerally, a court would look to the legislative history for guidance when the enacted text was capable of two reasonable readings or when no one path of meaning was clearly indicated. ... It is said that extrinsic aids may be considered only when a statute is ambiguous and unclear. However, ambiguity is not always considered a prerequisite to the use of extrinsic aids. ... The Supreme Court has also said: ‘Unless exceptional circumstances dictate otherwise, judicial inquiry into the meaning of a statute is complete once the court finds that the terms of the statute are unambiguous.’” (citations omitted).

193. IRC § 1221(a)(1).

194. Bittker & Lokken, *supra* note 23, at ¶ 42.2.1 (“[t]he term [to customers]...has been construed to embrace anyone who purchases the taxpayer’s assets, with the result that it has virtually no operative significance except in the case of traders in securities and commodities, who are distinguished from dealers in these assets on the theory that traders do not sell to ‘customers’”).

195. *Id.*

196. See Bittker & Lokken, *supra* note 23, at ¶ 47.2.3 (“[b]ecause the courts have not recognized a comparable activity of “trading” in real estate, persons whose real estate transactions are comparable in scale and frequency to those of a trader in securities are almost certain to be classified as dealers subject to ordinary income and loss treatment” (citing *Goodman v. United States*, 290 F.2d 915 (Ct. Cl.), *cert. denied* 393 U.S. 824 (1968), a case in which lawyers who invested in real estate as

that all sales are sales “to customers” even in situations where the taxpayer in question has had only one customer. For example, in *S.H. Inc. v Comm’r*, the court held that a taxpayer, who purchased single plot of land and improved it to the specifications of one specific buyer who was previously committed to acquiring it, had customers and realized ordinary income, even though he had only one customer, and even though the sale was not one in a series of transactions.¹⁹⁷ Similarly, in *Guardian Industrial Corp. v. Comm’r*, the court held that silver waste that the taxpayer extracted from the chemical solution used in taxpayer’s photo-finishing business was for sale “to customers” in the trade or business, even where it was sold to only one customer under a long-term contract.¹⁹⁸ The court noted that

[w]hile the term “to customers” sometimes has been analyzed in isolation to determine whether property is described in sec. 1221(1), the question of whether a taxpayer is selling to customers is relevant chiefly in the case of persons dealing or trading in securities or commodities... Outside the dealer/trader area, the term has been given such a broad meaning that separate consideration of it would not assist us in deciding the instant case.¹⁹⁹

This broad interpretation of the words “to customers” in the capital asset statute can also be found in early court cases. For example, in *Black v. Comm’r*, the tax court in 1941 held that a real estate developer of residential property who had acquired an interest in a building but incurred losses when the lessee of the building became insolvent had held his interest “primarily

minority members recognized ordinary income on the sale of such interests, even though the properties were not developed, subdivided or otherwise altered but were sold in the same condition as when acquired, and noting that a securities trader in the same situation with respect to his securities would not be afforded ordinary treatment)); see also William A. Friedlander, To Customers: The Forgotten Element in the Characterization of Gains on Sales of Real Property, 39 Tax L. Rev. 31 (1983) (arguing that courts have erroneously ignored the “to customers” requirement in the real estate context and should instead give it appropriate effect).

197. *S.H. Inc. v Comm’r*, 78 T.C. 234, 243 (1982) (“the fact that [buyer] was petitioner’s only customer as of the time of the sale does not deny [him] of ‘customer’ status. A restricted group of purchasers may qualify as customers and it has been said that in real estate transactions a sale to any purchaser is, in effect, a sale to a customer” (citing *Pointer v. Comm’r*, 48 T.C. 906, 917 (1967))).

198. *Guardian Industrial Corp. v. Comm’r*, 97 T.C. 308, 317 n.2 (1991), *aff’d*, 21 F.3d. 427 (6th Cir. 1994).

199. *Guardian Industrial Corp.*, 97 T.C. at 317 n.2 (citations omitted).

for sale to customers in the ordinary course of his trade or business.”²⁰⁰ The court rejected the Commissioner’s theory that “customers” only included customers for residential sales (which were the sales the taxpayer primarily dealt in his business), and stated that

[w]here, as here, one is regularly engaged in the business of buying and selling real estate, as was petitioner, *any person* who can be found to buy such property is a customer, as that term is ordinarily understood, and where such property is held for sale under such circumstances it must be deemed to be held for sale to customers within the meaning of the statute.²⁰¹

Thus, it would seem that almost since the enactment of the “to customers” requirement in 1934, courts have given almost no effect to those words outside of the securities context.

Furthermore, courts in the real estate context have also ignored the judicial gloss placed by courts such as in *Kemon* in the securities context on the words “to customers,” that is, the courts’ emphasis that while traders sell in the same markets in which they buy the property for sale (securities) and rely on price changes to make a profit, dealers tend to (like merchants) buy and sell in different markets, purchasing stock with the expectation that they will make a profit from finding a market of buyers to buy the property in excess of cost.²⁰² Instead of giving effect to the judicial interpretation of the “to customers” in *Kemon*, courts in the real estate context have, instead, for the most part relied on a recitation of a list of factors in determining whether the taxpayer is in a trade or business, with these same factors also suggesting ordinary income treatment.²⁰³ Such factors have included the following: the

200. *Black v. Comm’r*, 45 B.T.A. 204 (1941).

201. *Black*, 45 B.T.A. at 210 (emphasis added) (citing *Goodman v. Comm’r*, 40 B.T.A. 22 (1939)).

202. See, e.g., *Kemon*, 16 T.C. at 1032-33.

203. *Redwood Empire Savings & Loan Ass’n v. Comm’r*, 628 F.2d 516, 517 (9th Cir. 1980) (whether real estate held by a savings and loan association was a capital asset held primarily for sale to customers in a trade or business depended on “a number of factors,” such as “the nature of the acquisition of the property, the frequency and continuity of sales over an extended period, the nature and the extent of the taxpayer’s business, the activity of the seller about the property, and the extent and substantiality of the transactions” (citations omitted)); *Austin v. Comm’r*, 263 F.2d 460, 462 (9th Cir. 1959) (whether real property was held primarily for sale to customers in the course of his trade or business was a question of fact, and “[s]everal tests or factors have been considered by the courts to indicate whether certain properties were held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer’s trade or business, such as the nature of the acquisition of the

purpose of acquiring and holding the property; the existence and extent of improvements and/or subdivisions made to the property before selling it; the frequency, number, and continuity of sales; the “busyness” of the taxpayer’s business (including the relation of the real estate activity to the taxpayer’s primary occupation, if any); the extent of sales efforts (including advertising or lack thereof, solicitations, and the listing of property for sale through brokers or directly); and other miscellaneous factors.²⁰⁴ This analysis is not the same analysis as that considered by courts in the securities context in interpreting whether the taxpayer gets capital rather than ordinary treatment. The courts in the securities area have, since 1934, come to their conclusion by ruling that securities traders *per se* have no “customers,” which essentially obliterates the significance of the inquiry regarding whether the taxpayer is in a “trade or business” in determining capital asset treatment.²⁰⁵ In fact, ironically, the standard employed by courts in the real estate context in deciding the appropriateness of capital asset treatment actually comes closer to the analysis employed by courts in the securities context when deciding whether or not the taxpayer is involved in conducting a “trade or business” at all.²⁰⁶ It also comes closer to the analysis employed by the courts before the “to customers” requirement was added to the statute in 1934.²⁰⁷

Thus, from a structural standpoint, courts in contexts outside of the securities context have not only ignored the “to customers” requirement but have, in fact, replaced that analysis with one identical to the analysis regarding whether the taxpayer was engaged in a trade or business in the first place. In doing so, the courts have in effect brought a judicially created symmetry back into the tax law, replacing the architectural asymmetry

property, the frequency and continuity of sales over an extended period, the nature and the extent of the taxpayer’s business, the activity of the seller about the property, and the extent and substantiality of the transactions” (citations omitted)); *Bistline v. United States*, 145 F. Supp. 800 (9th Cir. 1958); see also *Higgins*, 312 U.S. at 217 (“[t]o determine whether the activities of a taxpayer are ‘carrying on a business’ requires an examination of the facts in each case”).

204. See *Redwood Empire*, 628 F.2d at 517; *Austin*, 263 F.2d at 462; see also, e.g., *Frank H. Taylor & Son, Inc.* TC Memo 1973-82; *United States v. Winthrop*, 417 F.2d 905, 910 (5th Cir. 1969); *Gault v. Comm’r*, 332 F.2d 94 (2d Cir. 1964); *Maddux Construction Co. v. Comm’r*, 54 T.C. 1278 (1970); see generally Phyllis Zinicola, *Real Estate and Section 1221: Business as a Pattern of Activity in the Definition of a Capital Asset*, 35 Tax Law. 225 (1982) (noting use of the “factors” analysis in the real estate context); T.C. Fitzgerald Jr., *Distinguishing Between Dealer and Investor Sales of Real Estate*, 4 S.C.L.Q. 309 (1952) (analyzing some of the factors examined by courts and making recommendations on how to maintain “investor” treatment).

205. *Kemon*, 16 T.C. 1026; *Marrin*, 73 T.C.M. (CCH) 1748.

206. See Section III.a, *supra*.

207. *Schwinn* 9 B.T.A. 1304; see also Section III.c, *supra*.

wrought by introduction of the “to customers” requirement into the tax law. By ignoring the “to customers” requirement, the courts have, with respect to real estate and other types of capital assets (other than stocks and securities), minimized the potential impact of the statutory asymmetry caused by the introduction of the “to customers” requirement into the statute.

b. The Enactment of IRC Section 475(f)

The 1997 introduction of the IRC section 475(f) mark-to-market accounting election for traders in securities and commodities is another example of “structural remediation,” this time by Congress. Under IRC section 475(f), a securities trader may elect to mark-to-market his securities held in connection with his trade or business at the end of each taxable year; that is, he may elect (1) to treat such securities as if they were sold by the trader at fair market value on the last business day of the year and (2) to take the gain or loss on such “phantom” sale into income for that year as ordinary gain or loss.²⁰⁸ The mark-to-market election, once made, applies to the year of the election and all subsequent taxable years of the trader, and may not be revoked without the IRS’s consent.²⁰⁹ Thus, the making of a mark-to-market election affects the *timing* of income recognition by a trader: by forcing the electing trader to recognize gain or loss on securities at the end of the taxable year even if the trader has not disposed of the securities, marking securities to market may result in income recognition before actual receipt of any proceeds from a disposition. It also affects the *character* of income recognized by the trader, causing such gain or loss to be taxed as ordinary gain or loss.²¹⁰

In effect, therefore, a securities trader who makes a mark-to-market election converts what would otherwise be capital gain or loss, reported on Schedule D, into ordinary income or loss, which is reported on Form 4797

208. IRC §§ 475(d)(3)(A), (f)(1)(A); Rev. Proc. 99-17, 1999-7 I.R.B. 52; For this purpose, a “security” is defined to include shares of corporate stock, interests in widely held or publicly traded partnership or trusts, notes, bonds, debentures or other evidences of indebtedness, certain notional principal contracts, certain interests or derivative financial instruments in the above securities, and certain clearly identified hedging transactions. IRC § 475(f)(2).

209. IRC § 475(f)(3).

210. IRC § 475(d)(3)(A)(i). The statute also provides a special rule for dispositions, whereby if gain or loss is recognized with respect to a security to which the mark-to-market rule would otherwise have applied before the close of the tax year (i.e., through a sale or other disposition), the income or loss would also be treated as ordinary income or loss. IRC §§ 475(f)(1)(D); 475(d)(3)(A)(ii). See HR Rep. No. 148, 105th Cong., 1st Sess. 445 (1997).

and eventually tied in to the taxpayer's Form 1040.²¹¹ Making the election may be particularly beneficial to a securities trader who has incurred irrecoverable losses from his trading activities and who wants to use those losses to offset ordinary income. By making the IRC section 475(f) mark-to-market election, the securities trader can convert his capital losses to ordinary losses, which can be used to offset ordinary gains.²¹²

Thus, the IRC section 475(f) mark-to-market election, by allowing the trader to elect ordinary treatment, has the potential, upon being made, to significantly undermine the intent of Congress when it enacted the "to customers" requirement in 1934 to prevent "speculators" from taking ordinary loss deductions for their losses from securities-trading activities, although it mitigates against possible inequities by also requiring ordinary gain treatment and by being essentially irrevocable.²¹³ From a structural standpoint, the mark-to-market election also eliminates some of the structural incongruities inherent in the treatment of a non-electing trader that are caused by the impossibility of satisfying the "to customers" requirement in IRC section 1221(a)(1). Rather than reporting expenses and deductions based on general satisfaction of a "trade or business" requirement on Schedule C while simultaneously reporting gains and losses as capital gains and losses on Schedule D, an electing trader's tax return would show ordinary gains and losses, along with "trade or business"-related deductions.²¹⁴ Thus, structurally speaking, making the mark-to-market election brings a trader's tax picture closer in line with that of other taxpayers engaged in a trade or business by "reversing" the statutory asymmetry discussed in Section II and III above.

To bring the point home, it is useful to look at the origin of the IRC section 475 mark-to-market election provision. IRC section 475(f), as enacted by the 1997 Taxpayer Relief Act, was an amendment to essentially allow securities traders to elect the same treatment that had already been mandatory for securities dealers since the enactment of IRC section 475 in by the Omnibus Budget Reconciliation Act 1993.²¹⁵ Prior to the 1993

211. See Internal Revenue Service Form 4797, available at <http://www.irs.gov/pub/irs-pdf/f4797.pdf> (last visited Jan. 15, 2008); Internal Revenue Service Form 4797 Instructions, available at <http://www.irs.gov/pub/irs-pdf/i4797.pdf> (last visited Jan. 15, 2008); Internal Revenue Service Form 1040 line 14, available at <http://www.irs.gov/pub/irs-pdf/f1040.pdf> (last visited Jan. 15, 2008).

212. Compare IRC §§ 172(d)(2), 1211(b), 1212(b).

213. The mark-to-market election, once made, may not be revoked except with the consent of the Secretary. IRC § 475(f)(3).

214. See, e.g., Raby, *Nondealer Security Losses*, supra note 5 at 46 ("[t]he Schedule C for an electing trader ... shows gross receipts and cost of sales as well as expenses, and looks more conventional"); compare IRS Form 4797 and Instructions, supra note 211.

215. 1993 Omnibus Budget Reconciliation Act, P.L. 105-34, § 13223(a).

enactment of IRC section 475, securities dealers were required to maintain an inventory of securities that they held for sale to customers, but were allowed to choose between three methods of valuing that inventory: a cost method, a lower-of-cost-or-market-value method, or a mark-to-market (i.e., fair market value) method.²¹⁶ IRC section 475, as enacted in 1993, mandated the use of the third, mark-to-market method for securities dealers, reflecting a congressional belief that the first two methods understated a dealer's income and that marking-to-market at year end was most clearly reflective of income and was also easy to administer.²¹⁷ As enacted in 1993, IRC section 475 required securities dealers to mark-to-market their securities held at the end of the taxable year, that is, to compute the gain or loss recognized for the year as if the securities were sold for their "fair market value" on the last business day of the year, with such gain or loss being ordinary income or loss. IRC section 475(f) merely makes the treatment already required of securities dealers elective for traders, thereby offering traders the option of bringing their tax treatment in line with that of securities dealers. By making the IRC section 475(f) election, the electing trader gets the same treatment as securities dealers with respect to the character and timing of the income side of the equation, as well as with respect to the business deductions side of the equation. The election therefore basically "converts" his asymmetrical treatment under the general tax rule for non-electing traders to the symmetrical, structurally sound treatment accorded to securities dealers, effectively bringing the treatment of traders in line with that of dealers. A non-electing trader, however, would not likewise have his asymmetrical treatment converted into the structurally sound tax treatment experienced by investors.

Finally, it should be noted that the term "dealer in securities" is defined in IRC section 475(c)(1) as "a taxpayer who (A) regularly purchases securities from or sells securities *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."²¹⁸ Ironically, therefore, the IRC section 475(f) mark-to-market election for traders therefore brings the statutory structure

216. Peter J. Connors, *The Mark-to-Market Rules of Section 475*, 543-1st Tax Mgmt. (BNA) A-3 at n.11 (citing Ways and Means Committee Report to 1993 Omnibus Budget Reconciliation Act at 224, 1993-3 C.B. vol. 3 at 240; Senate Finance Committee Report at 129, 1993-3 C.B. vol. 4 at 139).

217. *Id.*

218. IRC § 475(c)(1)(A) (emphasis added); see also, generally, § 1236(a) ("Gain by a dealer in securities from the sale or exchange of any security shall in no event be considered as gain from the sale or exchange of a capital asset" unless (1) "clearly identified" as held for investment or (2) the security was not, at any time after the close of such day (or such earlier time), held by such dealer primarily for sale to customers in the ordinary course of his trade or business") (emphasis added)).

full circle: it allows traders, a group accorded capital gain and loss treatment *specifically* because they have no customers, to in effect opt in to the treatment accorded to securities dealers, a group that is *specifically* defined in IRC section 475(c) by reference to the existence of their customers. Like the courts in ignoring the “to customers” requirement with respect to taxpayers other than securities traders, the legislature, in enacting the IRC section 475(f) mark-to-market election for traders, has made significantly moot the legislatively enacted (and court-aided) distinction made between those taxpayers in a trade or business who have customers and those who do not.

c. An Argument for Change

The above discussion demonstrates that the courts and Congress have already taken steps to minimize the impact of the “to customers” requirement in situations not involving traders, as well as in the trader context. One should also not lose sight of the fact that courts (and the IRS) have also done their part by ensuring that it is difficult to qualify as a trader under current law.²¹⁹ As discussed in Section III above, proving that one is a trader is a non-trivial undertaking. The taxpayer in question must show that his trading behaviors are frequent, regular, continuous, non-sporadic, and must also show that the gain he realizes from the activities are of the appropriate type.²²⁰ While court decisions have varied on a case-by-case basis, the standard is generally quite onerous. In part because of the difficulty of qualifying as a trader before the courts, a repeal of the “to customers” requirement would not necessarily result in the feared widespread abuse by traders taking such losses as ordinary losses. Provided that this high standard is properly applied by courts, sporadically trading taxpayers, taxpayers who hold securities with a too-long holding period (including taxpayers that are investment funds), and “dilettante” taxpayers who buy and sell securities as a hobby would not qualify for trader treatment.

Furthermore, as discussed in Section V.b, above, a trader who has suffered large and irrecoverable losses is already able to make the IRC section 475(f) election to convert such losses into ordinary losses under present law. It is true that the trader is generally required to make the election by the due date (without regard to extensions) of the original federal income tax return for the taxable year immediately preceding the year the taxpayer wants to election to be effective, thereby eliminating the benefits of

219. See Section III.a, *supra*; see also Rev. Rul. 2008-12 (imposing investment interest limitation on non-materially participating limited partner’s distributive share of partnership income).

220. *Id.*

retroactive tax planning.²²¹ However, it would be naïve to think that this deadline eliminates all the benefits of retroactivity. For example, an individual trader expecting to suffer large losses in July 2008 might well be able to make an informed guess as to whether it would be wise to make the election with his 2007 tax return on April 15, 2008, thereby converting those losses to ordinary losses for the 2008 taxable year.

In light of the difficulty of qualifying for trader treatment and the widespread availability of the mark-to-market election, a repeal of the “to customers” requirement need not lead to increased abuses, such as traders taking runaway deductions of ordinary trading losses against other income. Such repeal would also reduce the degree of complexity currently involved in taxing traders. This article therefore recommends a two-pronged approach to dealing with the problems with the current rules on trader taxation. First, for the reasons extensively argued above, the “to customers” requirement in IRC section 1221(a)(1) should be repealed and the currently optional mark-to-market accounting method made mandatory. With these steps, the taxation of traders would be brought more or less in line with that of dealers, including with respect to the requirement that mark-to-market accounting be used for securities held in the trader’s trade or business. This is arguably what the mark-to-market election already does in the first place. Repealing the “to customers” requirement and imposing on traders the symmetrical tax treatment (and mark-to-market accounting approach) currently required of dealers would eliminate the statutory asymmetry and its associated problems, and would also eliminate the simultaneous complexity and inadequacy of having an elective mark-to-market election in the first place.²²² Second, once the “to customers” requirement has been repealed, and the gains and losses of traders rendered ordinary, the IRS could then help to prevent taxpayer abuses by promulgating more specific and stringent guidance regarding the precise requirements that must be met in order to qualify for trader

221. Rev. Proc. 99-17, 1999-7 I.R.B. 52, Section 5.02. However, for taxpayers for which a tax return was not required to be filed for the tax year preceding the election year, the election must be filed no later than two months and 15 days after the first day of the election year.

222. See, e.g., James S. Eustice, *Abusive Tax Shelters: Old “Brine” in New Bottles*, 55 *Tax Law Rev.* 135, 142 & n.39 (2002) (“the current realization-based income tax, lacking extensive mark-to-market rules for readily tradable assets, leaves the timing of gain or loss recognition in the hands of the holder of the property...Taxpayers’ ability to select which gains or losses are to be recognized for tax purposes, and when that event is to occur, is a common theme in many tax shelter transaction planning scenarios”; “[w]hile § 475 has imposed a mark-to-market regime for certain traded securities, it has done so only on a limited basis for limited classes of taxpayers”); Sheppard, *supra* note 5, at 721-22 (arguing that mark-to-market accounting should be required for securities traders).

taxation.²²³ Such guidance could, for example, state exactly what level of activity is required to qualify as a trader or could clarify that partnership and individual “traders” that undergo a change in investment strategy from short-term to long-term investments during the tax year are not considered traders. This guidance could perhaps be incorporated into federal income tax return filings by requiring taxpayers claiming trader status to declare or certify on their tax returns that they have fulfilled certain requirements (for example, by making such taxpayers check a box stating that they are claiming trader status). Such an approach would make it harder for taxpayers to claim trader status while making it easier for the IRS to identify taxpayer abuses. This two-pronged approach would go a long way toward ameliorating the problems, discussed above, associated with the current tax treatment of traders. It would also help to discourage taxpayers who do not qualify as traders from taking the position that they are in fact traders, thereby reducing litigation costs. Such an approach would therefore eliminate much of the complexity, irrationality, and costs inherent in the current statutory structure, including the costs of fact-specific litigation, and the costs of the complexity surrounding the making of the IRC section 475(f) mark-to-market election for traders.

SECTION VI: CONCLUSION

This article has argued that, in addition to a number of policy concerns, there are significant structural problems in the current treatment of taxpayers who are traders in securities. The current structure of the statute leaves the degree to which the treatment of traders is fair or unfair especially sensitive to capital gain rate changes. Furthermore, the current statutory structure is prone to widespread proliferation and abuse, given the increased magnitude of trading activities in the present day.

These structural problems stem from the requirement that, in order to be subject to ordinary income or loss treatment on sales of securities held in their trading business, traders must sell such securities “to customers,” which courts have held that traders do not do. The 1934 addition of the “to customers” requirement came about as a response to the “abusive” behaviors of a small group of securities speculators and was aimed at preventing them from using ordinary deductions from their losses from speculation to offset other ordinary income.²²⁴ However, as with many other narrowly focused “anti-abuse” provisions that have been introduced into the Code, the small differences intended by the introduction of these two words have become

223. See also Schwartz, *supra* note 5, at 436-37.

224. H.R. Conf. Rep. No. 73-1385, (2d Sess.), at 22 (1934); see also Peter Miller, *supra* note 125, at 844-45 & n.38 (1950); Bittker & Lokken, *supra* note 23, at ¶ 47.2.

magnified in the light of modern-day exigencies and changes in the tax law, and have hence led to unforeseen difficulties.

This article has also shown that there have already been “structural remediation” attempts by the courts and by Congress, which serve to effect a *de facto* repeal of the “to customers” requirement and to render the statutory structure less imbalanced. In light of these remediation attempts, this article has advocated a two-prong approach towards reinventing trader taxation: the elimination of the “to customers” requirement and simultaneous requirement of dealer-like mark-to-market accounting, and promulgation of strict and concrete guidance containing clear and stringent standards for “trader” qualification. Such an approach would help to correct the current statutory imbalances and would also help promote rationality and eliminate unnecessary complexity in the taxation of traders. Done properly, these goals could also be accomplished without opening up additional loopholes for abuses by traders.