

Tax impact of investor vs. trader status

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If you invest, whether you're considered an investor or a trader can have a significant impact on your tax bill. Do you know the difference?

Investors

Most people who trade stocks are classified as investors for tax purposes. This means any net gains are treated as capital gains rather than ordinary income.

That's good if your net gains are long-term (i.e., you've held the investment more than a year) because you can enjoy the lower long-term capital gains rate. However, any investment-related expenses (e.g., margin interest, stock tracking software, etc.) are deductible only if you itemize and, in some cases, only if the total of the expenses exceeds 2% of your adjusted gross income.

Traders

Traders have it better in some situations. Their expenses reduce gross income even if they can't itemize deductions and not just for regular tax purposes, but also for alternative minimum tax purposes.

Plus, in certain circumstances, if traders have a net loss for the year, they can claim it as an ordinary loss (so it can offset other ordinary income) rather than a capital loss. Capital losses are limited to a \$3,000 (\$1,500 if married filing separately) per year once any capital gains have been offset.

Passing the trader test

What does it take to successfully meet the test for trader status? The answer is twofold:

- 1. The trading must be "substantial."** While there's no bright line test, the courts have tended to view more than a thousand trades per year, spread over most of the available trading days, as substantial.
- 2. The trading must be designed to try to catch the swings in the daily market movements.** In other words, you must be attempting to profit from these short-term changes rather than from the long-term holding of investments. So the average duration for holding any one position needs to be very short, generally only a day or two.

If you satisfy these conditions, the chances are good that you'd ultimately be able to prove trader vs. investor status. Of course, even if you don't satisfy one of the tests, you might still prevail, but the odds against you are higher. If you have any questions, please contact us.

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