



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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Dear ██████████:

This responds to your letter to the Commissioner of Internal Revenue, Charles O. Rossotti, dated March 23, 2000, in which you ask for information about the tax reporting of "day trades." You indicate in your letter that many of your clients have been told to report the proceeds and cost basis of their trades on the Form 1040 Schedule D, and all other "related expenses" on the Schedule C. You express concern that this would allow for "unlimited amounts of taxable loss while safeguarding any potential gain against self-employment tax." This letter is not a private letter ruling, but will provide you with general information about reporting sales of securities.

To determine how to report the gain from the sale of securities, it is necessary to determine whether the securities are "capital assets" in the hands of the taxpayer. A capital asset is defined in § 1221(a) of the Internal Revenue Code as property held by the taxpayer (whether or not connected with his trade or business), excluding, among other things not relevant here, "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".

It is well-established Service position that shares of stock not held for sale to customers in the ordinary course of a business by a person who is not a dealer in securities are capital assets. Rev. Rul. 56-153, 1956-1 C.B. 166. The distinction between a "trader" from a "dealer" has been made as follows:

[A] primary distinction for Federal tax purposes between a trader and a dealer in securities or commodities is that a dealer does not hold

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securities or commodities as capital assets if held in connection with his trade or business, whereas 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. [footnote omitted]

King v. Commissioner, 89 T.C. 445, 457-58 (1987), acq., 1988-2 C.B. 1. Other case law similarly provides that securities held for an individual's own investment or speculation are considered capital assets. Swartz v. Commissioner, 876 F.2d 657 (8th Cir. 1989); Van Suetendael v. Commissioner, 152 F.2d 654 (2d Cir. 1945) (per curiam) (securities "could not be classified as stock in trade or property subject to inventory unless they were held by the taxpayer primarily for sale to customers"); Mirro-Dynamics Corp. v. United States, 247 F. Supp. 214, 217 (S.D.Cal. 1965), aff'd, 374 F.2d 14, 16 (9th Cir. 1967) (securities bought and sold solely for taxpayer's account may not be considered business inventory). See also 1.471-5 of the Income Tax Regulations (defining a dealer in securities 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; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom).

Taxpayers who engage in trades on the Internet are no different from those who use a broker to execute their trades. If the taxpayer is not a securities dealer and thus holds securities as capital assets, the sales of those securities are reported on the Form 1040 Schedule D, where the trader reports the amount realized and adjusted basis of the securities sold. Purchase commissions are included in the adjusted basis of the security, and selling commissions reduce the amount realized from the sale of the security. Investment fees and expenses incurred to produce income are reported as miscellaneous itemized deductions on line 22 of Form 1040 Schedule A, but they are deductible only if they exceed 2% of the taxpayer's adjusted gross income. The Form 1040 Schedule C is only used to report income or loss from a business operated as a sole proprietor. The net profit or loss from such a business is treated as ordinary income or loss. Such a taxpayer also is responsible for filing appropriate self-employment taxes.

Whether an individual who "day trades" is or is not a securities dealer is a factual question to be determined in a given case. Probably most day traders are not dealers and thus must use the Schedule D to report capital gains and losses and the Schedule A to report investment expenses that exceed the 2% limit. It is clear, moreover, that the taxpayer cannot have it both ways: He cannot report gains and losses as a trader on the Schedule D and take a dealer's unlimited deduction for "other related expenses" on

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the Schedule C as an ordinary loss. Such “best of both worlds” treatment is clearly not allowed under the Code and Regulations.

I hope that this information is helpful to you. If you have any further questions, please contact Susan Kassell of this office at (202) 622-4930.

Sincerely,

Michael D. Finley
Chief, Branch 3
(Income Tax & Accounting)