



## Robert W. Wood

THE TAX LAWYER

---

Aug. 15 2011 – 8:28 am

### Business Or Investment?

Tax law contains many important distinctions. One of the classics is between business and investment. Which side of the line you're on has a major impact on your taxes. Often, you and the IRS will have contrary incentives.

If you've just made a pile of money on a big land deal or stock trade, you want to be an investor not a dealer in the business. Investors get capital gain treatment, dealers don't. Conversely, if you're incurring legal, brokerage and other expenses, you want to be in business. Unlike business expense deductions, investment expense deductions are limited, subject to percentage limitations and to alternative minimum tax. See [IRC Section 212](#).

You may face even bigger stakes on losses. If you have investment losses, they only offset investment gains, plus \$3,000 per year of ordinary income. See [IRC Section 1211\(b\)](#). Business losses are unlimited. See [IRC Section 162](#).

A good recent example of this classic dichotomy involved wannabe day trader, [Richard Kay, Jr.](#) The Tax Court considered whether he was in business or a mere investor. Whether investment activities can be elevated to carrying on a trade or business depends on the person's intent, the nature of the income, and the frequency, extent, and regularity of the transactions. See [Purvis v. Commissioner](#).

Ruling for the IRS, the court held Richard Kay was only an investor so most of his losses and expenses were disallowed. Kay manufactured and

distributed ball bearings. He was the sole shareholder, officer, and director and received wages from his company. He also traded securities, trading 73 days and 313 transactions in 2000; 18 days and 72 transactions in 2001; and 21 days and 84 transactions in 2002.

His tax return claimed his principal business as “day trade,” and he claimed \$1,960,060 in stock losses and \$92,577 in expenses for 2000; \$399,162 in stock losses and \$578 in expenses for 2001, along with a \$1,396,943 net operating loss (NOL) carried over from 2000; and \$262,921 in stock losses and \$15,376 in expenses for 2002, along with the same \$1,396,943 NOL carried over from 2000.

The IRS disallowed Kay’s deductions for ordinary losses beyond the \$3,000 limit for his trading activities. The Tax Court agreed with the IRS that Kay was not a trader. To be a trader, the court said:

1. The activity must be substantial (frequent, regular, and continuous); and
2. The person must seek to catch swings in daily market movements and to profit from these short-term changes rather than to profit from the long-term holding of investments.

**Result:** Kay didn’t meet either of these conditions. Kay’s trading losses were capital, not ordinary. As such, they were limited to a \$3,000 a year. Furthermore, Kay wasn’t entitled to carry forward the NOL generated in 2000. Even the expenses relating to his trading activity were not deductible as business expenses. Ouch.

For more, see:

[Think You’re A Trader? The IRS May Disagree](#)

[Arguments For Traders To Use In IRS Exams And In Tax Court](#)

[IRS Publication 550, Investment Income And Expenses](#)

[Topic 429 – Traders in Securities \(Information for Form 1040 Filers\)](#)

*Robert W. Wood practices law with [Wood LLP](#), in San Francisco. The author of more than 30 books, including *Taxation of Damage Awards & Settlement Payments* (4th Ed. 2009, [Tax](#)*

*Institute), he can be reached at [Wood@WoodLLP.com](mailto:Wood@WoodLLP.com). This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*