



Topic 429 - Traders in Securities (Information for Form 1040 Filers)

This tax topic explains whether an individual who buys and sells securities qualifies as a “trader in securities,” for tax purposes and how traders must report the income and expenses resulting from the trading business. In order to better understand the special rules that apply to traders in securities, it is helpful to first review the meaning of the terms: “security,” “investor,” “dealer,” and “trader,” and the different manner in which they report the income and expenses relating to their investment activities. Internal Revenue Code Section 1236 defines “security” as any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.

Investors

“Investors” typically buy and sell securities and expect income from dividends, interest, or capital appreciation. They buy and sell these items and hold them for personal investment; they are not conducting a trade or business. Most investors are individuals. Sales of these securities result in capital gains and losses that must be reported on [Form 1040, Schedule D](#) (PDF), *Capital Gains and Losses* and on [Form 8949](#) (PDF), *Sales and Other Dispositions of Capital Assets*, as appropriate. Investors are subject to the capital loss limitations described in section 1211(b), in addition to the section 1091 wash sales rules. Investors can generally deduct the expenses of producing taxable investment income. These include expenses for investment counseling and advice, legal and accounting fees, and investment newsletters. These expenses are deductible on [Form 1040, Schedule A](#) (PDF), *Itemized Deductions*, as miscellaneous deductions to the extent that they exceed 2% of adjusted gross income. Interest paid on money to buy or carry investment property that produces taxable income is also deductible on Schedule A, but under section 163(d) the deduction cannot exceed the net investment income. Commissions and other costs of acquiring or disposing of securities are not deductible but must be used to figure gain or loss upon disposition of the securities. Review [Topic 703, Basis of Assets](#) for additional information. An investor is not subject to self-employment tax. For more information on investors, refer to [Publication 550, Investment Income and Expenses](#).

Dealers

“Dealers” in securities may be individuals or business entities. Dealers purchase, and hold securities, and sell securities to their customers in the ordinary course of their trade or business; sometimes they maintain an inventory. Dealers are distinguished from investors and traders because they have customers, derive their income from marketing securities for sale, and may charge their clients fees for services rendered. Because they are in the trade or business of buying and selling, the gains and losses of dealers are classified per section 1236 as ordinary gains and losses. Section 1236 also requires that dealers must keep and maintain records that clearly identify securities held for personal gain versus those held for use in their business activity. Dealers who are individuals must report their expenses on [Form 1040, Schedule C](#) (PDF). They report the income in excess of their trading activities on Schedule C as well; however, they report gains and losses associated with dispositions by using the mark-to-market rules discussed below.

Traders

Special rules apply if you are a trader in securities, in the business of buying and selling securities for your own account. This is considered a business, even though you do not maintain an inventory and do not have clients. To be engaged in business as a trader in securities, you must meet all of the following conditions:

- You must seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation.
- Your activity must be substantial, and
- You must carry on the activity with continuity and regularity.

The following facts and circumstances should be considered in determining if your activity is a securities trading business:

- Typical holding periods for securities bought and sold.
- The frequency and dollar amount of your trades during the year.
- The extent to which you pursue the activity to produce income for a livelihood, and
- The amount of time you devote to the activity.

If the nature of your trading activities does not qualify as a business, you are considered an investor, and not a trader. It does not matter whether you call yourself a trader or a "day trader," you are an investor. As with dealers, a taxpayer may be a trader in some securities and may hold other securities for investment. The special rules for traders do not apply to the securities held for investment. A trader must keep detailed records to distinguish the securities held for investment from the securities in the trading business. The securities held for investment must be identified as such in the trader's records on the day he or she acquires them (for example, by holding them in a separate brokerage account).

Traders report their business expenses on [Form 1040, Schedule C](#) (PDF), *Profit or Loss From Business*. The Schedule A limitations on investment interest expense, which applies to investors, does not apply to interest paid or incurred in a trading business. Commissions and other costs of acquiring or disposing of securities are not deductible but must be used to figure gain or loss upon disposition of the securities. See [Topic 703, Basis of Assets](#). Dividends, interest from securities, and gain or loss from the sale of capital assets are not considered proceeds from self-employment income unless received by a dealer in stocks and securities in the course of their business. Review the [Form 1040, Schedule SE Instructions, Self-Employment Tax](#).

In addition to the deduction of their business expenses on Schedule C, traders are entitled to an additional option not extended to investors, the usage of the mark-to-market election. The tax treatment of sales of securities held in connection with a trading business depends on whether a trader has previously made an election under section 475(f) to use the mark-to-market method of accounting. If the mark-to-market election was not made, then the gains and losses from sales of securities are treated as capital gains and losses that must be reported on [Form 1040, Schedule D](#) (PDF). When reporting on Schedule D, both the limitations on capital losses and the wash sales rules continue to apply. However, if the mark-to-market election was timely made, then the gains and losses from sales of securities are treated as ordinary gains and losses (except for securities held for investment - see above) that must be reported on Part II of [Form 4797](#) (PDF), *Sales of Business Property*. Further, neither the limitations on capital losses nor the wash sale rules apply to traders using the mark-to-market method of accounting.

The Mark-to-Market Election

In general, the mark-to-market election must be made by the due date (not including extensions) of the tax return for the year prior to the year for which the election becomes effective. The election is made by attaching a statement either to your income tax return or to a request for an extension of time to file your return. The statement should include the following information:

1. That you are making an election under section 475(f) of the Internal Revenue Code;
2. The first tax year for which the election is effective; and
3. The trade or business for which you are making the election.

Refer to the [Form 1040, Schedule D and Form 8949 Instructions](#) for further instructions on how to make the mark to market election.

After making the election to change to the mark-to-market method of accounting, you must change your method of accounting for securities under Revenue Procedure 2011-14. In addition to making the election, you will also be required to file a [Form 3115](#) (PDF), *Application for Change in Accounting Method*. The procedures for making an election are described in [Publication 550](#) under the section called "Special Rules for Traders in Securities," and FAQs on our website.

If you have made a valid election under section 475(f), the only way to stop using mark-to-market accounting for securities is to request and receive written permission from the Service to revoke the election. Non-filing of the Form 3115 mentioned above will not invalidate a timely and valid election. To request permission to revoke your election under section 475(f), you must file a second Form 3115 and pay a fee.

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