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INCOME TAX CONSEQUENCES OF STOCK MARKET TRANSACTIONS

by

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TABLE OF CONTENTS

Chapter		Page
I.	INTRODUCTION	1
	Operations of the Stock Market	1
	Types of Participants	4
II.	ACTIVITIES OF PARTICIPANTS	12
	Sales	12
	Capitalization vs. Expensing	14
	Net Operating Losses	17
	Leveraged Transactions	19
III.	RESULTS OF ACTIVITIES	23
	Gains and Losses	23
	Conversion of Short-term Gain to Long-term Gain	29
	Wash Sales	32
IV.	SUMMARIZATIONS	35
BIBLIOGRAPHY AND REFERENCES		38

CHAPTER I

INTRODUCTION

Income tax consequences of investment policy are many and various. The taxpayer should be acquainted with the aspects of taxation and plan his investment strategy accordingly. The purpose of this paper is to familiarize the stock market participants (dealer, trader, and investor) with various areas of taxation with which he should be concerned. It must be remembered, however, that there is no one method of dealing that is best for all participants. Each participant must plan his own investment policy to meet his own needs.

Operations of the Stock Market

Before exploring the areas of taxation of concern to participants, the reader must have an understanding of the stock market or securities market organization. Throughout literature, the terms "stock market" and "securities market" are used interchangeably. The term "stock market" is the more common terminology and will be used here.

The stock market has three major divisions: (1) the new issues market is a wholesale market in which business corporations or governmental bodies sell entire issues of newly created securities to the investing public, largely through the medium of investment bankers who provide underwriting, marketing, advisory, and other services to the issuers; (2) the over-the-counter market is a nationwide network of

approximately 5,000 dealer-firms, loosely linked by telephone, teletypewriter, and market quotation services, who make retail markets in more than 8,000 publicly held securities; (3) the organized stock exchanges are centralized, auction-type markets in which brokers and dealers who hold exchange memberships buy and sell some 4,500 listed stocks and bonds, largely as agents for their customers.[1]

The most likely divisions in which to find participants active are the over-the-counter market and the organized stock exchanges. The new issues market is beyond the scope of this paper and is not affected by the areas of taxation to be discussed. Therefore, only over-the-counter market and organized stock exchanges will be characterized further.

The over-the-counter or unlisted market is a very extensive resale market maintained by dealers who buy and sell securities as merchandise. In this market, participating firms buy securities and treat them as an inventory of the firm. The firm then resells the securities to others who wish to buy. Any security may be bought or sold by any securities firm. The main bulk of business, however, is usually with securities that are not actively traded on the stock exchanges.

The fundamental operation of the firm in the over-the-counter market is acting as a dealer who is prepared to buy for its own account at its "bid" price any reasonable quantities of the security offered to it by the public or other securities houses, and to sell in the same manner at its "asked" price.[2] The difference between the bid and asked price is the dealer's gross margin or spread. In most cases a stockbroker

is used by an individual investor to find a dealer and arrange for a desired transaction.

A stock exchange on the other hand is an association to provide improved facilities for the execution of customers' orders.[3] All exchanges do most of their business in stocks and they limit their exchanges to a stated list of securities. The main function is to provide a large room for trading where all brokers can trade securities for their customers.

Most exchanges use the "post trading" system which is a continuous auction arrangement under which any security may be traded at any time while the exchange is open.[4] Clendenin and Christy outline the system as follows:

> Basically, the plan provides for the assignment of the securities to a number of different posts or areas on the trading floor. When any broker has an order to buy or sell a security, he goes to the assigned area, calls out his bid or offer, and hopes for an acceptance from another broker who has a corresponding order to sell or buy. When a number of brokers are interested in the same security, each will be desirous of buying at a low price or selling at a high price for his customer. Competitive raising of bids and lowering of asking prices should then produce transactions at prices representing truly free markets. All bidding, offering, and accepting is done verbally. When a transaction is completed the two brokers note each others' name on their "buy" and "sell" order tickets, turn these over to their clerks for bookkeeping purposes, and send reports to their offices by telephone. Meanwhile, stock exchange employees at the post report the number of shares and the price to the exchange's ticker and reporting system; so the transaction can be reported immediately in financial offices everywhere via the ticker tape and other devices.[5]

The post trading system poses two problems, what should be done with orders that cannot be filled immediately and how should needless fluctuations in market prices be eliminated. These problems are minimized by the use of a specialist. A specialist is a stock exchange member who stays continuously at one post and watches all trading in

certain stocks.[6] Brokers leave orders with the specialists who give priority to the highest bids and the lowest selling offers, with orders at the same price ranked accordingly in the order received. The specialist is obligated by agreement with the exchange to buy or sell for his own account when necessary to prevent meaningless price irregularities.[7]

Types of Participants

A closer look at the stock market participants is needed to determine income tax consequences of each. The Internal Revenue Code classifies participants into three classes: the dealer, the trader, and the investor. The classifications will be discussed in that order.

"Dealer" defined

The Regulations under Section 471 deal with the right of a taxpayer in determining income by the use of inventories. With respect to "inventorying of securities" it is only allowed for dealers in securities. It defined dealers as follows:

> A dealer in securities is 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 buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this section.[8]

This definition is well accepted in defining "securities dealer" and includes only those who are actively engaged as merchants in securities selling from a regular place of business. This also includes specialists[9] and those dealing in only one security.[10]

"Trader" defined

The distinctions between a dealer and a trader are very important for determining the results of operations and the taxation of activities. The Code does not give a definition of "trader," but the courts have provided a number. The most influential decision was handed down and is explained in George R. Kemon, 16 TC 1026. It distinguished between "dealer" and "trader" as follows:

> ("Dealer" defined) 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 selling for 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 middleman bringing together buyer and seller, and performing the usual services of retailer or wholesaler of goods. Such sellers are known as "dealers."
>
> ("Trader" defined) 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 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."

Stated another way, the term includes a person who buys and sells securities in frequent operations for his own account rather than for the account of customers to such extent that he may be said to be engaged in such activities as a trade or business.[11]

"Investor" defined

The Code does not define "investor" as such. As a rule-of-thumb, an "investor" is a person whose activities are limited to an occasional transaction for and on his own account, less those required in a trade

or business. The immediate question that surfaces is at what point do the activities of an investor become a trade or business.

There is no one definition of the phrase "carrying on a trade or business" that can be applied in all instances. Perhaps some light can be shed on the phrase from extracts taken from the decision of Helvering v. Wilmington Trust Company:[12]

> It is apparent that there are two conceptions possible as to, first, the meaning of the words "trade or business" and, second, the character of the determination that such meaning has been achieved. As to the former, the question is really whether the word "trade" dominates the word "business" or vice versa. From the dictionary it will be noticed that the terms are somewhat interchangeable.
> Trade: "A line of work or a form of occupation pursued as business or calling, as for a livelihood or for profit; anything practiced as a means of getting a living, money, booty, etc.; mercantile or commercial business in general, or the buying and selling, or exchanging of commodities, either by wholesale or retail within a country or between countries."[13]
>
> Legally, business has been defined as activity for profit or as activity for profit by service to the general public.
> "This word (business) embraces everything about which a person can be employed."[14]
>
> That which occupies the time, attention, and labor of men for the purpose of a livelihood or profit.[15]

A look at case law perhaps will help to establish guidelines as to what level of activity is required to change an "investor" to a "trader."

One of the foremost cases is Dart v. Commissioner.[16] The taxpayer was held to be a "trader" as he maintained accounts with a number of brokers and was engaged in hundreds of transactions totaling over $56,000,000 in one taxable year.

In Norbert H. Wiesler,[17] the taxpayer had originally been engaged full-time in his trading activities. However, during three of the four taxable years under review, he held full-time jobs in the banking business, and also maintained his own office with one employee for his trading

account. The taxpayer himself worked at trading for his own account partly during the day and partly after hours. The court concluded that petitioner was engaged in the business of trading securities during all of the taxable years involved.[18]

In I.T. 2103,[19] it was held that a taxpayer devoting all of his time to investment activities was engaged in a trade or business. However, the ruling did not limit itself to the case of the full-time trader, but instead announced the general principle that the term "trade or business" comprehends all activities of the taxpayer for gain, profit, or livelihood entered into with sufficient frequency, or occupying such a portion of his time and attention, as to constitute a vocation. The conclusion of the ruling was that the taxpayer had devoted sufficient time and had entered into a sufficient number of transactions to constitute a trade or business.[20]

In Sol H. Morris,[21] it was held that the taxpayer was engaged in a trade or business where he was the managing member of a joint venture buying and selling securities. The venture completed over 600 transactions involving over $5,000,000 and the greater proportion of the taxpayer's income during the year was derived from that business activity. The court concluded that the applicable test was whether the taxpayer's investments were isolated transactions or were "such that they may, of themselves, be regarded as a regular occupation for the purpose of livelihood or profit."[22]

Finally, in the case of W. T. Wilson,[23] it was held that the petitioner was a "trader" in securities even though his principal vocation was in the retail lumber business and in managing a family corporation. Also his trading activities were not large.

However, not all decisions have been favorable. A 1967 decision of the United States Court of Claims in Wilson v. United States[24] is questionable when the basis of the decision is reviewed. During the period of 1958-1961, the Wilsons were active in purchasing and selling stocks for their own account. They made profits and incurred losses on their activities. Their portfolio of common stocks averaged about $700,000 during the period. The taxpayer devoted two to three hours per day and his wife devoted three to four hours per week in a substantial amount of research on stock-market conditions, trends, and future prospects of stock being considered for purchase or for sale. Interest payments were also made on margin accounts during these years. The opinion handed down is brief enough to be quoted here:

> It is my opinion that the investment expenses of Mr. and Mrs. Wilson during the period 1958-1961 were not paid or incurred in carrying on a "trade or business." In this connection, the Supreme Court has said that "investing is not a trade or business." Whipple v. Commissioner, 373 U.S. 193, 202 (11 AFTR 2d 1454) (1963). Consequently, managing one's own investments in securities is not the carrying on of a trade or business, irrespective of the extent of the investment or the amount of time required to perform the managerial functions. Higgins v. Commissioner, 312 U.S. 212, 218 (25 AFTR 1160) (1941).[25]

In the Wilson case, the court appears to be in error in its conclusion when Whipple and Higgins are viewed in their entireties. The Whipple case[26] involved a taxpayer who held controlling interest in several corporations. The taxpayer attempted to characterize his holdings in the corporations as a trade or business on the basis that the corporations themselves qualified as a trade or business and therefore his holdings should also. The court concluded as follows:

> Investing is not a trade or business. Where the only return is that of a corporate investor, the return arises from the corporate business and not the stockholder's business, even though the return is substantially the product of his services. Full-time service to one corporation is not a trade or business, nor is full-time service to many corporations. However, the presence of many corporations may show that taxpayer was in the business of promoting corporations, where the return is other than an investor's return, such as fees, commissions, or profits from sales of corporations.[27]

The court appears to have taken the phrase "investing is not a trade or business" out of the context in which it was stated and is therefore inapplicable to the Wilson case.

Similarly, the quote from Higgins was taken out of its context. In Higgins,[28] the petitioner's financial affairs were conducted through an office at his instructions. The office kept records, received securities, interest and dividend checks, made deposits, forwarded weekly and annual reports and undertook generally the care of the investments as instructed by the petitioner. All purchases were made by a financial institution and the petitioner sought permanent investments, and changes, redemptions, maturities and accumulations were limited. The court held:

> Where taxpayer with extensive investment in stocks and bonds merely kept records and collected interest and dividends from securities, through managerial attention for his investments, and hired others to assist him in offices rented for that purpose, . . . salaries and office expenses paid in connection with management of taxpayer's investments in stocks and bonds are not deductible as expenses paid in "carrying on business" within statute permitting deduction of expenses paid in carrying on trade or business in computing taxable net income.[29]

In general, to determine whether the activities of a taxpayer are "carrying on a business" requires an examination of the facts in each case.[30] It does not appear that the amount involved has much bearing on the facts, but the intent of the taxpayer is important. The best approach appears to derive a profit from a relatively short-term turnover if trader

status is desirable. The longer the turnover rate, the more likely that investor status will be imposed.

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[1]John C. Clendenin and George A. Christy, Introduction to Investments, Fifth Edition (New York, 1969), pp. 185-186.

[2]Ibid., p. 199. Here "bid" is defined as a specific proposal to buy a specific quantity at a named price, and "asked" is a corresponding proposal to sell.

[3]Ibid., p. 210.

[4]Ibid., p. 214.

[5]Ibid., pp. 214-215.

[6]Ibid., p. 215.

[7]Ibid., p. 216.

[8]Reg. 1.471-5.

[9]Helvering v. Fried, 299 U.S. 175 (1936); Rev. Rul. 60-321, 1960-2 C.B. 166.

[10]Claude Neon Electrical Products Corp., 35 B.T.A. 563.

[11]L. T. Alverson, 35 B.T.A. 482.

[12]Helvering v. Wilmington Trust Co. Exec., 124 F. 2d 156, 28 A.F.T.R. 624 (USCA 3), reversing 42 B.T.A. 173.

[13]New Century Dictionary, p. 187.

[14]Black Law Dictionary, 2d Edition, 1910.

[15]Flint v. Stone Tracy Co., 220 U.S. 107, 3 A.F.T.R. 2834.

[16]74 F.2d 845 (4th Cir. 1935), 14 A.F.T.R. 929 (USCA4).

[17]6 T.C. 1148 (1946), aff'd Comm. v. Wiesler, 161 F.2d 997 (6th Cir. 1947).

[18]Milton A. Dauber, "Tax Aspects of Playing the Stock Market: Investing v. Trading," in New York University Twenty-Sixth Annual Institute on Federal Taxation, ed. Henry Sellin (New York, 1968), p. 48.

[19]1924-2 C.B. 92.

[20]Dauber, Institute on Federal Taxation, p. 48.

[21]38 B.T.A. 265 (1938).

[22]Dauber, _Institute on Federal Taxation_, pp. 48-49.

[23]10 T.C. 251 (1948).

[24]19 A.F.T.R. 2d 1225, 376 F. 2d 280 (Ct. Cl. 1967).

[25]_Ibid._

[26]373 U.S. 193, 11 A.F.T.R. 2d 1454 (1963).

[27]_Ibid._

[28]312 U.S. 212, 25 A.F.T.R. 1160 (1941).

[29]_Ibid._

[30]_Ibid._

CHAPTER II

ACTIVITIES OF PARTICIPANTS

Sales

The treatment of selling expenses and proceeds depends upon the classification of the securities held either as a capital asset or as inventory to be sold in the trade or business. Inventory sold in the normal operation of a trade or business is generally treated as ordinary income and capital assets may be subject to special treatment, as will be discussed in the next chapter. Under the 1954 Code as amended, securities held by traders and investors are capital assets.[1] Any gains or losses on securities held by a dealer are treated as ordinary gains and losses[2] with one exception. Securities held by a dealer will be allowed capital asset treatment if before the expiration of the thirtieth day after the date of its acquisition, the security is clearly identified in the dealer's records as a security held for investment, and the security is not held primarily for sale to customers in the ordinary course of business at any time after the identification as to investment security has been made.[3] Both conditions must be met in order for a dealer's investment to qualify as a capital asset.

The treatment of selling expenses depends upon the taxpayer's classification as dealer, trader, or investor. Selling expenses are deductible as a business expense for a dealer for the securities he held as inventory for sale in the ordinary course of business. However,

traders, investors, and dealers that hold securities as investments must treat selling expenses as a reduction in selling price.[4]

Identifying like stock sold may also have a significant effect on the gain or loss resulting from their sale. Where different lots of the same stock have been purchased at different prices and times and have been left with an agent or broker, taxes may be saved by designating which lots are being sold. Designation does not have to be made by identifying the stock certificates. Adequate identification is made if the owner (1) specifies to the agent in writing the sequence in which he desires the shares to be sold, (2) identifies the shares to be sold either by their purchase date, cost, or both, and (3) receives a written confirmation of the specification from the agent.[5]

The average price per share may not be used and if identification is not otherwise possible, the "first-in, first-out" rule must be applied.[6] Under this rule, the stock sold must be charged against the earliest purchases which are still unsold.

Example (1): A taxpayer bought and sold the following shares of ABC Company common stock during 1975:

Bought	Sold
January 2-200 shares	March 10- 40 shares
January 6-110 shares	March 12-200 shares
March 9- 50 shares	April 25- 55 shares

Assuming the taxpayer is unable to identify the various lots from which the shares have been sold, the 40 shares sold on March 10 and the first 160 shares sold on March 12 are treated as coming from the January 2 purchase. The remaining 40 shares of the March 12 sale and the 55 shares

sold on April 25 are taken from the January 6 purchase. The remaining 65 shares are assumed to be comprised of 15 shares from the January 6 purchase and 50 shares from the March 9 purchase.

The first-in, first-out rule applies to traders[7] and investors. Also, it is possible that a dealer who inventories his securities could use the first-in, first-out rule or the last-in, first-out rule if he qualifies as a specialist.[8]

Capitalization vs. Expensing

Expenses incurred in connection with the purchase of securities, such as commissions and taxes, are not deductible but must be treated as part of the cost of the securities. This is true for dealer, trader, or investor.[9] The difference is in the treatment of the costs. Traders and investors capitalize their costs and increase their basis as the securities are capital assets in their possession.

Dealers, on the other hand, inventory the costs and treat the expenditures as an increase in the inventory basis. (A trader or investor may not inventory securities.)[10] The dealer also has three options which he may choose in valuing his inventories: (1) cost, (2) lower of cost or market, or (3) market value.[11]

If either the cost method or the lower of cost or market method is used, the general inventory rules applicable to business are generally applicable to securities dealers. However, if the market value method is used, the entire inventory must be valued at market, whether higher or lower than cost. As a result, both unrealized losses and gains in the inventory of securities enter into determining taxable income.

Example (2): A dealer in securities has the following securities on hand as of March 31, 1975:

	Cost	Market	Lower of Cost or Market
100 shares ABC Co. common stock	$1500	$1000	$1000
50 shares GHI Co. common stock	2000	3500	2000
200 shares XYZ Co. common stock	6500	7000	6500
25 shares NOP Co. common stock	900	500	500
Total inventory	$10,900	$12,000	$10,000

If the dealer values his inventory on the cost basis or the lower of cost or market the valuation will be $10,900 and $10,000 respectfully. However, if the market method is used, all shares are valued at market for an aggregate of $12,000. In doing so, unrealized gains have been given recognition to the shares of GHI Co. and XYZ Co. and likewise, unrealized losses have entered into taxable income from ABC Co. and NOP Co. shares.

Other deductible expenditures such as custodian fees, cost of investment advice, compensation to clerical help, office rent, safe deposit box rentals, and similar items are treated according to the taxpayer's classification.

Code Section 162 allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. This amount is deducted from gross income in arriving at adjusted gross income. Once again the key to this Section is the phrase "carrying on a trade or business." As discussed earlier, only a dealer or trader qualify as "carrying on a trade or business" and therefore only

they are allowed to treat the above expenditures as a business deduction in arriving at their gross incomes.

The investor, on the other hand, must deduct the expenditures as nonbusiness expenses under Section 212. Nonbusiness deductions are only deductible from adjusted gross income when deductions are itemized.

The difference of the effect on taxable income between the business deductions and nonbusiness deductions may not be apparent at first. The business deduction reduces taxable income whether items are itemized or the standard deduction is taken. The nonbusiness deduction only reduces taxable income if deductions are itemized.

Example (3): During the 1974 taxable year, a taxpayer, single and 42, has gross income of $18,000 and expenses of $1,800 resulting from his activities with various securities during the year. If taxpayer qualifies as a trader and has no other deductions, his taxable income would be $13,450 (gross income of $18,000, less business deductions of $1,800, a $2,000 standard deduction, and a $750 exemption). If the taxpayer was an investor, his taxable income would be $15,250 (gross income of $18,000, less a $2,000 standard deduction and a $750 exemption).

Also, the business deduction reduces adjusted gross income and therefore may provide a greater opportunity for medical expense deductions.

Example (4): Assume the same facts as in example (3) except that the taxpayer itemizes deductions and also has medical expenses of $3,000 for the year. As a trader, his taxable income would be $12,936 (gross income, less business deductions, excess of medical costs over 3% of adjusted gross income of $16,200, and one $750 exemption). If the taxpayer was an investor, his taxable income would be $12,990 (gross income, less

nonbusiness deductions, excess of medical costs over 3% of adjusted gross income of $18,000, and one $750 exemption).

Illustration-1 on page 18 shows the tax treatment of the usual costs incurred in connection with securities transactions.

Net Operating Losses

The definition of a net operating loss must be clear before its tax consequences may be fully understood. A net operating loss is not the same as an accounting loss. A net operating loss exists only if the losses and expenses exceed the income of a trade or business regularly carried on. If such is the case, the net operating loss can be carried back three years prior to the year of loss or forward 5 years subsequent to the loss year. It works as a claim for a refund on past paid taxes or as an offset to future tax liabilities.[12]

Once again, the key to net operating losses is the term "trade or business." A dealer may have a net operating loss arising from his everyday operations. The real distinction arises between the trader and investor. Both are subject to the capital gain and loss rules to be discussed later. The trader is allowed a net operating loss for the excess of his business expenses over the net gain from the sale of his securities; he is "carrying on a trade or business." The investor, on the other hand, treats the expenses as nonbusiness expenses and can use them only to offset nonbusiness income.[13]

Example (5): A taxpayer has ordinary income from investments and employment of $40,000. During the year, taxpayer incurred $45,000 interest expense on his margin account. Taxpayer as a trader is only allowed a $40,000 interest deduction to the extent of his current year's income.

Item	Additional cost of security	Deductible as business expense	Deductible as tax	Reduction of selling price
Stamp tax, state, on stock and bond transactions:				
Investor and Trader	no	yes	yes	no
Dealer.	no	yes	no	no
Selling cost of securities:				
Investor and Trader	no	no	no	yes
Dealer.	no	yes	no	no
Registration fee, registering shares with SEC in order to sell them:				
Investor and Trader	no	no	no	yes
Dealer.	no	yes	no	no
SEC fee passed on by stock exchange and broker:				
Investor and Trader	no	no	no	yes
Dealer.	no	yes	no	no
Short sale dividend-equivalent paid by seller-borrower:				
All taxpayers	no	yes	no	no
Commissions on securities purchase:				
All taxpayers	yes	no	no	no
Commission on securities sales:				
Investor and Trader	no	no	no	yes
Dealer.	no	yes	no	no
Investment advice:				
All taxpayers	no	yes	no	no
Safe deposit box rental:				
All taxpayers	no	yes	no	no
Custodian fees:				
All taxpayers	no	yes	no	no
Accounting and legal expense:				
All taxpayers	yes	no	no	no
Office expense:				
All taxpayers	no	yes	no	no

Source: Commerce Clearing House, Inc., 1974 Federal Tax Course (New York, 1973), p. 2205.

Illustration-1

The remaining $5,000 loss can be carried back and will result in a refund.

However, if taxpayer is an investor, the interest deduction is only allowed to the extent of current earnings, and the remaining $5,000 loss is lost forever. As an investor, he is not in a trade or business involving securities, therefore the interest deduction is a nonbusiness deduction and has no effect in determining net operating losses.

A recent case[14] illustrates the above example. In the case, the taxpayer was primarily involved in the practice of law and in addition, maintained various margin accounts with a number of brokerage firms. The taxpayer claimed a business deduction for interest paid on the margin accounts. He was denied such treatment in determining a net operating loss. The court held that the taxpayer was not in the trade or business of trading in stocks. He had not devoted enough time and energy to stock dealings to show that it was a trade or business and therefore, he could not qualify as a trader.

Leveraged Transactions

The use of leverage can be very significant in determining tax consequences in stock market transactions. Basically, leverage provides the participant with the opportunity to make a substantial gain by use of only a small investment. This is done by using either puts and calls or borrowings.

Before discussing the first method of using puts and calls for leveraged transactions, the nature of each must be fully understood. Puts and calls are basically options. A put is an option to sell stock to another at a certain price during a given period. It is used to protect

against market declines. A call, on the other hand, is an option to buy stock from another at a certain price during a given period. It is used to take advantage of rises in the market.

The first approach in using leverage is with puts and calls. The following examples will help demonstrate their use:

Example (6): A taxpayer has purchased a call for $300. It is exercisable at $20 per share on 100 shares of GOOD Co. common stock during the next year. GOOD Co. common stock is currently selling at $20 per share. The taxpayer has made an investment of $300 compared to an investment of $2,000 that would have been needed to purchase 100 shares of stock. Seven months later, if the stock is selling at $25 per share, taxpayer will most likely sell or convert the option. Assuming he converts the option and then sells the shares, taxpayer recognizes a $200 gain ($2,500 selling price, less the basis of the $300 call and $2,000 paid for the shares) or a return on investment of 66 and 2/3% before taxes. Taxpayer has made a substantial return on a minimum amount of investment. If the market failed to rise, he would allow his option to lapse and would absorb a $300 loss.

Example (7): A taxpayer purchased a put for $200 giving him the right to sell 100 shares of NIFTY Co. common stock at $90 per share anytime during the next six months. NIFTY is currently selling at $91 per share. Assuming the price drops to $85 per share, taxpayer should exercise or sell the option. His gain is $300 (a profit of $5 per share, a total of $500 less the cost of the put) or a return on investment of 133 and 1/3% before taxes. Once again the taxpayer has made a substantial return on a minimum amount of investment. If the market failed to decline, his loss would be restricted to his investment of $200.

The other way of obtaining leverage is through the use of borrowing.

Example (8): A taxpayer borrows 50% of the market price of 100 shares of EFG stock. The stock is selling for $20,000. Taxpayer holds the stock for eight months and then sells the shares for a $4,000 profit. Assuming interest expense for the period is $350, taxpayer has an economic gain of $3,650 or a 36.5% return on investment before taxes.

It must be remembered that puts and calls and borrowings are not without their drawbacks. Puts and calls have the disadvantage of expiring on a certain date, and therefore unless exercised, the total amount paid for the option is lost. Borrowings or loans also expire on a certain date, but there is always the possibility that the loan can be extended or held open until the desired movement in the market occurs.

The greatest tax benefits in using leverage come from the use of borrowing. Any interest costs incurred in borrowing are deductible from ordinary income. The tax laws also provide an additional economic gain when capital assets are involved. This can be a substantial benefit to traders, investors, and dealers who hold securities as investments.

Example (9): Assuming the same facts as in example (8) and in addition, the taxpayer is an investor and is in the 50% tax bracket. The interest expense saves taxes at a rate of 50% while the capital gain is taxed at a 25% effective rate.[15] The percentage of gain after tax is 28.25% or $2,825.

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[1]Section 1221(1).

[2]Section 1236.

[3]Reg. 1.1236-1(a).

[4]See chapter III for treatment of expenses from short sales.

[5]Reg. 1.1012-1(c)(3); Rev. Rul. 61-97, 1961-2 C.B. 394.

[6]Helvering v. Rankin, 295 U.S. 123, 15 A.F.T.R. 1076.

[7]John A. Snyder v. Comm., 295 U.S. 134, 15 A.F.T.R. 1081.

[8]Rev. Rul. 60-321, 1960-2 C.B. 166.

[9]Helvering v. R. C. Winmill, 305 U.S. 79, 21 A.F.T.R. 962.

[10]Wilson v. Comm., 76 F. 476, 15 A.F.T.R. 1156 (USCA 10).

[11]Reg. 1.471-5.

[12]Section 172.

[13]Reg. 1.172-3(a)(3).

[14]Ralph E. Purvis, paragraph 74,164 P-H Memo T.C.

[15]See chapter III.

CHAPTER III

RESULTS OF ACTIVITIES

Gains and Losses

As noted in the previous chapter, the treatment of gains and losses depend upon the classification of the assets involved. Special treatment is allowed capital assets in certain situations. Capital assets include all property held by a taxpayer whether used in a trade or business with the following exceptions:

1. inventoriable assets;
2. property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; and
3. depreciable business property subject to Code Section 1231.[1]

These other assets are ordinary assets and any gain or loss on them is ordinary gain or loss.

Capital gains and losses are gains or losses from the sale or exchange of capital assets. They may be short-term capital gains or losses, long-term capital gains or losses or a combination thereof.[2]

Short-term capital gains and losses result from the disposition of capital assets that have been held for six months or less. Long-term capital gains and losses result from the disposition of a capital asset held longer than six months. Six months is not enough, it must be more than six months.[3]

All capital gains and losses, long-term and short-term, are taken 100% into account in determining adjusted gross income. Where net long-term capital gains exceed net short-term capital losses, 50% of the excess can be deducted in arriving at adjusted gross income. If no short-term capital loss exists, then 50% of the net long-term capital gain is deducted.[4] Net capital losses can be offset against capital gains and generally up to $1,000 of taxable income.[5]

The advantage of being able to treat securities as capital assets should be clear. The trader and investor, along with a dealer who holds securities as an investment, have the opportunity to recognize part of their gains taxfree if the gains qualify as net long-term capital gains.

Example (1): A taxpayer, who qualifies as a trader and is in the 50% tax bracket, had the following capital gains and losses from the sale of securities during the year:

Short-term Losses	Long-term Gains
$200	$2,000
800	500
	1,500

His net long-term capital gain from the transactions is $3,000. Only 50% of this gain is subject to taxation at a 50% rate or a tax liability of $750. This gives the taxpayer an effective rate of 25% on his earnings. In a sense, part of the earnings are taxfree.

Realization

When the potential exists for capital gains and losses, it is important to control the timing of these gains and losses. In regards to capital losses, there is no carryback to previous years that is allowed to individuals, only a carryforward.[6] It should be noted that losses on

the sale of securities are recognized on the date when a contract to sell is made and not on the date of delivery of the securities.[7] Therefore, if a participant desires to take a capital loss in a taxable period, he has until the last business day of the taxable period to execute his contract to sell. Usually, the date the broker executes the participant's sale order is the date of the contract to sell.

On the other hand, the rules for recognizing gain are different. A taxpayer keeping his books and filing his returns on a cash basis does not recognize gain for tax purposes until the taxpayer has actually or constructively received cash or its equivalent under the contract of sale.[8] Therefore, if a capital gain is desired in a taxable period, the order to sell must be given to a broker at least four business days prior to the close of the taxable period to be effective.

Unrealized gains

It is possible to fix an unrealized gain on a security and continue to hold that security with no risk of decline. This is accomplished by using a short sale against the box. Before demonstrating this method, one must clearly understand the nature of short sales and the treatment of their related expenses and gains or losses.

A short sale is a sale of securities that one does not own in the hopes of buying later at a lower price and delivering the purchase to cover his short sale. In order to deliver on the stock within the required time, the seller must borrow stock from his broker. The borrowing customer must:

1. provide cash equal in value to the stock, to be delivered to the lender as collateral for the loan of the stock;

2. make good to the lender the value of any lost dividends or rights or other disbursements; and
3. pay any daily rental or premium which may be agreed on if the stock borrowed is scarce.[9]

Example (2): Taxpayer directs his broker to sell 200 shares of Superior stock short. The broker must borrow 200 shares from his own account and deliver them to the buyer. Taxpayer is now 200 shares of Superior short and owes 200 shares to his broker.

Example (3): Given the same facts as in example (2) and in addition, taxpayer also owns 200 shares of Superior. The process is the same. At the end of the transaction, taxpayer still owns 200 shares of Superior, but in addition, he owes his broker 200 shares of Superior. This is known to be short against the box.

There are two general types of expenses involved in short sales. The first is a payment of a premium that may be demanded by the lender, and the second, is the reimbursement of dividends declared and payable while the short position is open.

Example (4): On May 12, taxpayer sells short 100 shares of stock and borrows them from his broker. His short position is held open until October 1. On July 7, the corporation pays a quarterly dividend of $1. In order to keep the broker whole, taxpayer must return the shares and the $1 dividend at the close of his short position.

Deductibility of selling expenses have been noted previously. It was stated that selling expenses generally must be deducted from the selling price. An exception is made for premiums paid on short sales and for the reimbursement of short sale dividends. The dealer and trader may deduct these as business expenses and the investor must treat the expenditures as nonbusiness deductions.[10]

Section 1233 of the Code contains the taxation rules for short sales. Short sales do not result in a gain or loss until they are covered.[11] Gains and losses from short sales are treated as ordinary gains and losses to the dealer, and capital gains and losses to the trader and investor. To the extent that securities have been held more than six months on the date of the sale and they are delivered to close out the short position, any gain will be long-term.[12]

Example (5): Taxpayer, an investor, purchased 100 shares of stock on January 3, 1974, for $10 per share. On November 11, 1974, he ordered his broker to sell short his 100 shares at $30 per share. On December 12, 1974, he closed out his position by delivering the shares purchased on January 3, 1974. His $2,000 gain is a long-term capital gain.

To the extent that additional securities substantially identical to those already owned are purchased prior to the closing of the sale, the gain is always short-term regardless if the securities just purchased are used to close the sale.[13] As can be seen here, a taxpayer exercising a short sale against the box is subjecting himself to short-term gain if he covers his position with a subsequent purchase of identical securities sold.

Example (6): Assuming the same facts as in example (5) except taxpayer purchased 100 shares at $28 per share on December 10, 1974. If the purchase of January 3 is used to close his position, taxpayer has a short-term gain of $2,000. If he uses the December 10 purchase, taxpayer has a short-term capital gain of $200.

If substantial identical securities used to close out the position have been held for six months or less on the date of sale, all gain is short-term gain.[14]

Example (7): Assuming the same facts as example (5), except the sale takes place on June 1, 1974. Taxpayer has a short-term capital gain of $2,000 even though he has held the shares for more than six months. The date of sale is the determining factor.

In respect to losses, substantially identical securities held more than six months on the date of sale results in long-term capital losses.[15]

Example (8): On January 9, an investor purchased 100 shares of stock at $25 per share. Taxpayer, on August 15, sold 100 shares short at $23 per share. December 29, the day of cover, the stock is selling at $30 per share. Taxpayer will use the 100 shares purchased on January 9 to cover his short position, therefore resulting in a $200 long-term capital loss.

As noted previously, selling short against the box is a method used to defer the realization of a gain. This fixes the amount of gain at one level. Any further market fluctuations have no effect on the amount of gain.

Example (9): Taxpayer has 100 shares of BVD stock which he had purchased at $40 per share. He has ordered his broker to sell 100 shares short when the price is at $55 per share. Assuming the price rises further to $60 per share when the taxpayer wishes to close his position, he has incurred an additional $5 gain per share on the shares he holds and a $5 loss per share on the new shares he would have to buy. His economic interest is fixed at $55 per share or a profit of $15 per share. On the other hand, if the price dropped to $50 per share, he can close out his position by delivering the shares in his position at a profit of $15 per share.

What are the advantages of deferring the realization of a gain? By deferring the gain, the taxpayer may be able to have the use of capital interest free.

Example (10): In December, 1974, taxpayer has 100 shares of stock that he believes have established their high. If he sells now, his gain will be recognized in the tax year of 1974, and taxes due on the gain must be paid by April 15, 1975. If the taxpayer sells short against the box and closes his position early in January, 1975, his gain is recognized in the tax year of 1975, and taxes due on the gain are not payable until April 15, 1976. Thus, assuming taxpayer has a long-term capital gain of $40,000 and is in the 50% tax bracket, his tax amounts to 25% of the gain, and he has the use of $10,000 for the year without any interest cost.

Another advantage of deferring gains is the possibility of offsetting them against future losses.

Example (11): Same facts as example (10) except that the gain is a short-term gain. Assuming no other gains or losses during the year, if this gain is included in taxpayer's taxable income in 1974, the entire amount will be taxed as ordinary income. However, if the gain is deferred, it is possible to offset part of it against net losses of the 1975 period. It would also be to the taxpayer's advantage if his taxable income in the future period is expected to be less than the current period.

Conversion of Short-term Gain to Long-term Gain

The most frequent method used involves the use of a straddle, which is a combination of a put and call. Assuming a taxpayer, an investor in the 50% tax bracket, purchased 100 shares of stock at $10 per share in January, he now wishes to close out his position in April when the stock

is selling at $25 per share and also receive long-term benefits. In hopes of doing so, he purchases a straddle, good for seven months, at $200.

If he were to sell the stock in April without purchasing the straddle, there would be a short-term capital gain of $1,500. $750 would be paid as taxes and $750 would be left to the taxpayer. Having bought the straddle, economic loss results only if the stock makes no significant movement. If the straddle is allowed to lapse, the taxpayer would have a net gain of $1,300 ($1,500 gain, less $200 cost of the straddle).[16] This gain is treated as a gain from a short sale due to the put option of the straddle under Reg. 1.1233-1(c)(3) and therefore is a short-term gain. $650 would be paid as taxes and $650 would be left to the taxpayer. The failure of the market to change results in a $100 net of tax loss to the taxpayer.

On the other hand, if the market moves in either direction significantly, the taxpayer will benefit. If the market price should drop to $20 per share over the next seven months, or a drop of $5 per share since the acquisition of the straddle, the taxpayer would sell the put and allow the call to lapse with the following results:

1. $400 long-term gain from the sale of the put at $500 ($500, less $100 basis);
2. $1,000 long-term gain from the sale of 100 shares at $20 per share ($2,000, less $1,000 basis); and
3. $100 long-term loss from the lapse of the call option.

Under Code Section 1234, options to buy and sell are treated as property in the hands of the taxpayer. Therefore, the above put and call are capital assets in the hands of the taxpayer and qualify for long-term

capital gains treatment. The net effect of the transaction would be to give the taxpayer a net long-term gain of $1,300. $325 would be paid in taxes on the gain, and the taxpayer would pocket $975. He has increased his gain by $225 and has in effect converted a short-term gain into a long-term gain.

The greatest economic gain would come about if the market rose substantially. If the market price rose $5 per share during the seven months subsequent to the acquisition of the straddle, the taxpayer would allow the put to lapse and sell the call with the following results:

1. $400 long-term gain from the sale of the call at $500 ($500, less $100 basis);
2. $100 short-term loss on the lapse of the put; and
3. $2,000 short-term gain from the sale of 100 shares at $30 per share ($3,000, less $1,000 basis).

The total gain is $2,300. The taxpayer's net would be $300 (long-term gain of $400, less tax) plus $950 (short-term gain, less tax) or a total amount pocketed of $1,250. Even though the major portion of the gain is taxed as short-term capital gain, the economic advantage of the increased profits outweigh the disadvantage of the short-term tax rates.

Another, but less frequent way of converting a short-term capital gain into a long-term capital gain is through a short sale. The only way that this is possible is through the sale of the short position itself. The fundamental idea is that the short sale contract is property. Therefore, if the short sale contract is held more than six months and then is disposed of, a long-term gain is produced on the disposition of the short sale contract.

There is only one case on record that indicates that this method was attempted. The attempt failed. The case can be summed up as follows:

> On July 28 and August 24, 1949, petitioner Frank C. La Grange entered into two short sales of English pounds sterling for delivery on February 28 and March 31, 1950. Immediately prior to the delivery dates, petitioner sold the short sales contracts to his brokerage firm. The amount paid by the brokerage firm was a sum equal to the difference between the proceeds of the short sale and the cost of pounds sterling to cover the short sale. The brokerage firm made no profit from the transactions and could have sustained no loss because it required petitioner to remain fully liable for any loss thereon until delivery of pounds sterling to the purchasers was completed, just as he would have been had he personally made the cover purchases of pounds sterling and thus consummated the short sales. Held, the purchase of petitioner's contracts by his brokerage firm was not a bona fide transaction, and the gain therefrom is, therefore, a short-term capital gain since the holding period of the pounds sterling with which the short sales were consummated was less than 6 months.[17]

However, the opinion of Judge Rice in the above case acknowledged the right to convert short-term capital gains into long-term capital gains through this method of disposition of short sales contracts. The significant fact rests upon the transaction itself. The transaction would appear to be valid if the petitioner retained no effectual liability on the short sales contracts and all liability was transferred to the buyer. In the immediate case, the petitioner retained all liability and the buyer none. Therefore, in effect, petitioner was still in the position to cover for his short sale.

Wash Sales

Under the wash sales rule, if a taxpayer has made a sale or exchange of securities and, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, has acquired substantially identical securities, then no loss on such sale or exchange may be deducted.[18]

Example (12): Taxpayer owns 100 shares of stock that he purchased at $25 per share. Currently, the shares are selling at $15 per share. Taxpayer would like to take advantage of the loss to reduce his capital gains, but he also would like to retain the shares due to their excellent yield. He plans to sell 100 shares at $15 per share to take advantage of the loss and also buy another 100 shares at $15 per share to retain the advantages of the excellent yield. The loss on the transaction would be disallowed under the wash sales rule.

The wash sales rule exempts those who incur the loss through the ordinary course of a trade or business. Therefore, dealers and traders are exempt from the wash sales rule and only investors are subject to its provisions.

The holding period of securities that are acquired during the 61-day wash sale period which result in nondeductibility of a loss on the sale of substantially identical securities, also includes the period for which the taxpayer held the securities on the sale of which the loss was not deductible.[19] The basis of the securities purchased during the wash sales period is their cost plus the disallowed loss on the sale of substantially identical securities.

Example (13): Same facts as example (12). The basis of the new securities would be their cost of $15 per share plus $10 per share from the disallowed loss under the wash sales rule or $25 per share.

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[1]Section 1221.

[2]Section 1222.

[3]Section 1222.

[4]Section 1202.

CHAPTER IV

SUMMARIZATIONS

In looking back on the discussion of the income tax consequences of various stock market transactions, it should be remembered that there is no one method or methods that are completely efficient and entirely consistent. If one existed, it most certainly would be worth untold millions. The various tax strategies presented are by no means an avoidance for the stock market participant's economic activity of risk taking.

A few words of caution should also be given about each of the various strategies presented. The opportunity to use short sales may be restricted due to the difficulty of obtaining a loan of shares in a stock where there is already a large short position in the market. It may also be expensive to obtain a loan of shares because of excess premiums charged by the lender. A large premium may reduce the attractiveness of a modest tax savings. Another factor to take into account is that short sales freeze funds. If the short position is held open for a significant length of time, it means that the funds which are invested are basically sterile, since they are earning no direct income for the participant. Another consideration which must be taken into account is that short sales require collateral. Collateral may be difficult or expensive to obtain and once again, additional funds may be immobilized.

The feasibility of using options rests upon the relationship of each transaction. A put costs money; a call costs money; a straddle may cost up to twice as much as either a put or call separately. Options are successful only when significant market fluctuations are expected.

In reviewing the various types of participants, the trader appears to combine the advantages of both the dealer and investor. The trader has the advantage of being able to treat his securities as capital assets as does the investor. He also does not have to tie up large amounts of funds in inventories as a dealer normally would. The trader also has the advantages of a dealer, such as the use of net operating losses, exemption from the wash sales rule, and the treatment of expenses related to securities as business deductions.

In light of these advantages, it is somewhat surprising that so few of the stock market participants seek to be classified as a trader. The key perhaps is the lack of participants to be able to qualify their activities as a trade or business. As shown in the cases presented previously, the intent and activities of the participants are the weighing factors, not the amount of funds invested. An investor should take a long, hard look at his activities to determine if a minimal increase in the scale of his activities would change his investor status to a trader status. The tax saving consequences of this status change could very well supersede the additional outlay for increased activities.

The use of leverage is an important market strategy for all participants. Perhaps the greatest advantage is to the investor. The investor, who only has a minimum of funds to invest, is able to receive the most for his small investment while minimizing the amount of loss.

The ability to defer gains and losses should be considered by all participants. The tax savings of deferring gains and losses to future periods may very well exceed the additional expense of deferring them if planned correctly.

In conclusion, the planning of income tax consequences of stock market transactions is as important as the stock market transactions themselves. Each participant should plan his activities and tax consequences to provide him the greatest benefits possible. The less that must be set aside for tax liability, the more there is to reinvest or pocket for other activities.

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