

Taxpayer's trading activities insufficient to establish trade or business

Nelson, TC Memo 2013-259

The Tax Court has determined that a mortgage broker wasn't in the trade or business of trading securities and upheld IRS's disallowance of over \$800,000 in expenses purportedly claimed in connection with these activities over two tax years. The Court also determined that the taxpayer was liable for accuracy-related penalties.

Background on business deductions. Under Code Sec. 162(a), a taxpayer can deduct all ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. The Code doesn't define the term "trade or business" for Code Sec. 162(a) purposes. The determination of whether a taxpayer's activities qualify as such is a question of fact, and relevant considerations include the taxpayer's intent, the nature of the income to be derived from the activity, and the frequency, extent, and regularity of the activity.

A person who purchases and sells securities may be a trader, a dealer, or an investor. A trader engages in the trade or business for purposes of Code Sec. 162(a) of selling securities for his or her own account. (King, (1987) 89 TC 445) The profits of a trader are generated through the acts of trading themselves. (Estate of Yaeger v. Comm., (CA 2 1989) 64 AFTR 2d 89-5801) Although an investor purchases and sells securities for his or her own account, an investor, unlike a trader, is not considered to be in the trade or business within the meaning of Code Sec. 162(a) of selling securities. (Endicott, TC Memo 2013-199) For a taxpayer's trading activities to constitute a trade or business under Code Sec. 162(a), the trading must be substantial (in terms of the number of trades executed, amount of money involved, and number of days on which trades were executed), and the taxpayer must seek to catch swings in the daily market movements and profit from those short-term changes rather than from the long-term holding of investments. (Holsinger, TCMemo 2008-191) The expenses of a trader that otherwise satisfy the requirements of Code Sec. 162(a) are deductible under that section. (*Endicott*)

Facts. During 2005 and 2006, Sharon Nelson was the sole stockholder of Clear Concepts, Inc., a corporation engaged in the mortgage broker business. Clear Concepts employed Nelson as a mortgage broker and paid her wages of \$266,458 and \$49,065 during 2005 and 2006, respectively.

Also during 2005 and 2006, John Zabasky (who lived with Nelson) was the chief executive officer and sole stockholder of SoftEx, Inc. At the time of the trial in this case, Zabasky had been involved in the trading of

stocks, bonds, and currencies for approximately 25 years.

During 2005 and 2006, Nelson executed securities trades on an investment account that she maintained at TD Ameritrade (account). Zabasky also executed securities trades on that account. Nelson had no clients for any of the trades executed on her account during 2005 and 2006.

During 2005, there were a total of 250 available trading days. 535 trades were executed on Nelson's account on a total of 121 days (on 48.4% of the total available trading days). The purchases for 95 of those trades occurred in the one-week period from Sept. 27 to Oct. 3. The holding period for the securities traded on the account during 2005 ranged from one to 48 days. Over the course of the year, there were eight periods of at least seven days where no purchases or sales occurred on the account. The 2005 trades generated \$470,472.90 of net short-term capital gain for that tax year.

During 2006, there were a total of 250 available trading days. 235 trades were executed on the account on a total of 66 days (26.4% of the total available trading days). The holding period for the securities traded on the account during 2006 ranged from one to 101 days. During 2006, there were only two trading days on which trades were executed on the account during the period of Jan. 27 to May 4, and there were seven periods of at least seven days where no purchases or sales occurred. The 2006 trades generated \$36,852.28 of net short-term capital gain for that tax year.

On Nelson's 2005 and 2006 returns, she included Schedule C, Profit or Loss From Business. She described the "Principal business or profession" in her 2005 Schedule C as "Stock Trading/Trader Status," and in her 2006 Schedule C as "Securities Trader/Trader Status." After Nelson filed her 2005 return and shortly before she filed her 2006 return, she submitted an amended return, including a Schedule C, for the 2005 tax year that IRS did not accept or process. On the amended Schedule C, she described the "Principal business or profession" as "Securities Trader/Trader Status/R.E. Professional."

IRS disallowed all of the expenses that Nelson claimed on the 2005 and 2006 Schedules C-\$504,217 and \$303,910, respectively-and imposed accuracy-related penalties.

Trading activity not "substantial." The Tax Court initially noted that it was unclear what portion of the trades for each year were in fact executed by Nelson. However, it found that, even if it were to assume that she executed all of them, she still wouldn't carry her burden of establishing that she was a trader for both years. Specifically, the number of trades wasn't sufficient to constitute a "substantial" amount for either year. The Court noted that, while the amount of money involved each year (with purchases and sales ranging from \$24.2 to 32.9 million) was "considerable," it wasn't determinative of whether the activity was substantial.

Finally, the Court found that the total number of days spent trading (and extended periods of inactivity) belied her claim that she was a trader.

Accordingly, the Tax Court found that Nelson wasn't engaged in the trade or business of trading securities and thus wasn't entitled to deduct under Code Sec. 162(a) any of the expenses claimed as Schedule C expenses.

Penalties upheld. The Court also upheld IRS's imposition of accuracy-related penalties under Code Sec. 6662(a). The Court agreed with IRS that the facts established her negligence or disregard of rules within the meaning of Code Sec. 6662(b)(1); and Nelson's claim that she spoke with a friend who is an accountant was insufficient to show what advice the accountant provided and whether her reliance on same was reasonable.