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Day Trader Rules and Tax Treatment

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Day trading is neither illegal nor unethical, but it can be highly risky. Most individual investors do not have the wealth, time, or temperament to make money or sustain the losses that day trading can bring. Day trading in securities is governed by the Securities and Exchange Commission (SEC) Regulation T. Different rules apply for day traders for tax purposes than for SEC governance.

What is a "Day Trade"? Financial Industry Regulatory Authority (FINRA) rules define a day trade as the following: *The purchasing and selling or the selling and purchasing of the same security on the same day in a margin account.* This definition encompasses any security, including options. In addition, a day trade is considered as selling short and purchasing to cover the same security on the same day. Exceptions to this definition include the following:

- A long security position held overnight and sold the next day prior to any new purchase of the same security; or

- A short security position held overnight and purchased the next day prior to any new sale of the same security.

Pattern Day Trader: If a broker-dealer designates a customer as a "pattern day trader," FINRA margin rules require the broker-dealer to impose special margin requirements on the customer's day-trading accounts. *A pattern day trader is an individual who executes four or more day trades within five business days*, provided that the number of day trades represents more than six percent of the customer's total trades in the margin account for that same five-day period. Note: This is a minimum requirement, and some brokerage firms have a different standard. Individuals wishing to day trade should check with their brokerage firm's requirements.

Minimum Equity Requirement: The minimum equity requirement for an individual who is a pattern day trader is $25,000. This $25,000 requirement must be deposited into the day trader's account prior to any day-trading activity and must be maintained at that level at all times. This $25,000 requirement cannot be met by cross guaranteeing separate accounts. Each day-trading account is required to meet the $25,000 requirement independently, using only the financial resources available in that account. If a customer's account falls below the $25,000 requirement, he or she will not be permitted to day trade until depositing cash or securities into the account to restore the account to the $25,000 minimum equity level.

Margin Trading Buying Power: A customer who is designated as a pattern day trader may trade up to four times his or her maintenance margin excess as of the previous day's close of business for equity securities. If a customer exceeds this day-trading buying power limitation, his or her broker-dealer will issue a day-trading margin call. Customers have five business days to meet their margin call, during which time their day-trading buying power is restricted to two times their maintenance margin excess based on their daily total trading commitment for equity securities.

If the customer does not meet the margin call by the fifth business day, the day-trading account will be restricted to trading only on a cash-available basis for 90 days or until the call is met.

NOTE: A broker-dealer may impose a higher minimum equity requirement and/or restrict the day-trading buying power to less than four times the day trader's maintenance margin excess.

For additional information regarding the rules for day trading in a portfolio margin account, please see [FINRA Frequently Asked Questions].

Tax Implications of Day Trading: Very active traders are generally in the same boat as regular investors when it comes to gains and losses. Regardless of how frequently they trade, their sales generate long- or short-term capital gain or loss reported on Schedule D (generally after first passing through Form 8949).

The vast majority of taxpayers who manage their own investments are investors rather than traders. Proving that one's investment activities rise to the level of carrying on a trade or business is a difficult hill to climb. However, a taxpayer's investment activities may be sufficient to constitute carrying on a trade or business, and qualifying requires an examination of the facts in each case.

Caution: For tax purposes, a day trader has no bearing on the SEC and FINRA definition of a pattern day trader and the associated rules. In determining whether a taxpayer who manages his own investments is a trader engaged in a trade or business, or an investor who isn't, courts consider the following:

- The taxpayer's investment intent,
- The nature of the income to be derived from the activity, and
- The frequency, extent, and regularity of the taxpayer's securities transactions.

According to the Tax Court (and this issue has frequently been there), the distinction between a trader and an investor is that a trader buys and sells securities with reasonable frequency in an effort to catch the swings in the daily market movements and thus profit on a short-term basis. On the other hand, an investor purchases securities to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of the securities on the daily market.

Written Election Required – To be a day trader for tax purposes, a taxpayer must make the mark-to-market (MTM) rules election. To make that election, the taxpayer must generally file a required statement no later than the due date (without regard to extensions) of the original federal income tax return for the tax year immediately preceding the "election year." The statement must be attached to that return or, if applicable, to a request for an extension of time to file that return. For the election to apply to the 2020 year, it must have been made by Apr. 15, 2019.

Tax Treatment - Day traders who have elected to follow the MTM rules apply the following tax treatment to their transactions:

(1) Gain or loss is recognized on any security (or commodity) held in connection with the individual's trade or business at the close of any tax year as if the security (or commodity) were sold for its fair market value on the last business day of the tax year.

(2) Gain or loss is taken into account for the tax year as ordinary income or loss.

(3) Wash sale rules do not apply.

(4) Form 4797, not Schedule D/Form 8949, is used to report the gains and losses.

In other words, a stock trader who closes out the year with a net loss can use it to offset ordinary income without any limitations and may wind up with a net operating loss that, starting in 2021, can be carried forward indefinitely. NOLs occurring in 2018, 2019, or 2020 can be carried back 5 years and then forward. This contrasts with the rules for investors, who will net the gains and losses of actual sales of securities (and any other capital assets) made during the tax year, and then use up to $3,000 of the capital loss to offset ordinary income, with any excess capital loss carried forward until it is used up in the next or future years.

SEC and tax-treatment rules associated with day trading can be complicated. Please contact this office for tax assistance.

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