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TRADE OR BUSINESS STATUS FOR THE FULL-TIME, ACTIVE INVESTOR: A CALL FOR A QUALITATIVE STANDARD*

I. INTRODUCTION

Most individuals maintain at least minimal holdings in the stock market or other securities markets. The majority of these investments are maintained to supplement the individual's personal income. Attention to these activities is normally secondary to the individual's full-time occupation. Undoubtedly, this "personal" investor is not conducting the "business" of investing and is thus not eligible to deduct resulting losses and expenses for federal income tax purposes.¹

However, what of the treatment afforded the individual who has no other occupation, but who spends his entire business day managing his own portfolio, collecting extensive information on securities, making decisions on the relative benefits of particular securities, and actually purchasing and selling securities, whether through a broker or not? Should this taxpayer be given tax treatment identical to others who pursue their own occupations? Specifically, should the full-time, active securities investor be regarded as carrying on the "trade or business" of securities investing? This comment argues that he should and that such an investor should therefore be eligible to benefit from the tax status accompanying a trade or business.

Several benefits exist for the taxpayer who is able to obtain trade or business status. In addition to receiving deductions for general business expenses, the taxpayer engaged in a trade or business receives ordinary loss, rather than capital loss treatment.² Further, the taxpayer can establish IRA and Keough plans,³ carryover and

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* The author wishes to thank his wife, Catherine, for her patience, motivation and support over the past three years.

1. Deductions for business expenses are provided by section 162 of the Internal Revenue Code. 26 U.S.C. § 162(a) (1987). See infra note 12. In addition to the deduction for business expenses, there are other benefits to the business taxpayer. See infra text accompanying notes 2-6 for other benefits to the business taxpayer. See infra text accompanying notes 7-8 for a discussion of a disadvantage resulting from trade or business status.


3. Id. § 408.
carryback net operating losses,4 and avoid limitations on investment interest.5 Generally, the benefit of trade or business status lies in the taxpayer's ability to deduct expenses "above the line," while the taxpayer who makes such deductions merely for investment or other personal reasons must take those deductions "below the line."6

Trade or business status is a double edged sword, though. Despite the above mentioned benefits to the taxpayer, certain disadvantages accompany the imposition of trade or business status. The self-employment tax is just such a disadvantage.7 Taxpayers who have made money on their enterprise often construe their activity as something other than a trade or business in order to avoid imposition of the self-employment tax. Also, taxpayers might avoid classification as a trade or business in order to obtain capital gain treatment.8 Therefore, perhaps the best solution to the problem presented here is one favoring neither the taxpayer nor the government.9 Whatever the so-

4. Id. § 172(b).
5. Id. § 163(d).
6. The theoretical "line" generally lies at adjusted gross income (AGI). AGI is the second level of income in the tax structure. The first level is gross income and is defined as "all income from whatever source." 26 U.S.C. § 61(a) (1987). Certain deductions are subtracted from gross income to arrive at the second level, AGI. Id. § 62. These deductions are known as "above the line" deductions. The third level of income is taxable income. Taxable income is that income left after subtracting either the standard deduction or itemized deductions from AGI. Id. § 63.

The advantage of taking a deduction "above the line" is that some "below the line" deductions are limited to an amount in excess of seven percent of AGI. See id. § 213. Thus, the more "above the line" deductions allowed, the lower the total amount of AGI. The lower the AGI, the more likely "below the line" deductions will exceed seven percent of AGI.

7. 26 U.S.C. § 1401 (1987). Section 1401 imposes a nondeductible tax on the net earnings from self-employment. Section 1402(a) defines net earnings from self-employment as gross income derived from the trade or business less deductions incurred in that trade or business. Section 1402(c) states that trade or business for the purposes of the self-employment tax will have the same meaning as used for section 162 deductions.

8. Prior to 1986, capital gains received preferential treatment. However, Congress ended preferential tax treatment for capital gains in the 1986 Tax Reform Act by removing the sixty percent deduction for such gains and imposing the same twenty-eight percent tax rate on both ordinary income and capital gains. Tax Reform Act of 1986, Pub. L. No. 99-514, § 301, 100 Stat. 2216. Despite the current neutral treatment of capital gains, Congress intends that even if the top individual rate should increase in future sessions, the maximum tax rate on capital gains shall not exceed the top individual rate provided in the 1986 Tax Reform Act. S. Rep. No. 313, 99th Cong., 2d Sess. 169 (1986). Therefore, the importance of capital gains treatment may be significant in the future.

9. Olson, Toward a Neutral Definition of "Trade or Business" in the Internal Revenue Code, 54 U. Cin. L. Rev. 1199, 1235 (1986) (urging "a neutral definition, giving neither taxpayers nor the government any special advantage").

Professor Olson also recognizes the danger that a neutral definition might be applied mechanically. However, he cautions that the presence of the danger is no reason to continue without any standard. Id. at 1236.
lution, a standard must be formulated and applied in order to provide predictability and certainty for taxpayers, tax practitioners and the courts alike.

Section II of this comment reviews the legal background underlying trade or business treatment of the investor and securities trader. Part A of section II sets forth the statutory basis in the Internal Revenue Code for determining the investor’s tax treatment. Part B provides the tests traditionally employed by the courts in determining trade or business status. An analysis of the conflicting arguments in the area follows in section III. Section IV proposes that, in basing trade or business status on an examination of the facts and circumstances in each case, the courts should begin to emphasize the qualitative characteristics, in addition to the quantitative characteristics of doing business.

II. BACKGROUND

A. Statutory Authority

The treatment of personal activities is specifically distinguished from the treatment of trade or business activities in the Internal Revenue Code (IRC). IRC section 262 provides that “no deduction shall be allowed for personal, living, or family expenses.” This restriction is justifiable in light of the general policy permitting an allowance for deductions. The federal income tax is theoretically a tax on nothing more than net income. The government allows taxpayers to deduct all expenses incurred in earning that income since such expenses are presumed to have generated the income. Since personal expenses generally do not contribute to the creation of income, they are not deductible.

On the other hand, individuals performing a “trade or business” are allowed a deduction from their taxable income in the amount of all “ordinary and necessary expenses” paid or incurred in

10. 26 U.S.C. § 262 (1987). Although the exclusion of personal deductions in section 262 appears to be all-encompassing, some personal expenses may be deducted by the taxpayer. Included among those expenses specifically deductible are interest payments on indebtedness under section 163, state taxes under section 164, qualified medical expenses under section 213, charitable contributions under section 170, and casualty and theft losses under section 165(c)(3).

11. The general theory underlying the business deduction was enunciated by Justice Roberts in a dissenting opinion. He stated that “[t]he dominant purpose evidenced by the income tax statutes is to tax net income. The policy is to credit against gross income the expenses of the business which begets earnings. The taxpayer is entitled to deduct that which he reasonably and in good faith expended in the effort to realize a profit.” Deputy v. DuPont, 308 U.S. 488, 500 (1940).
carrying on such a trade or business. This deduction is allowed pursuant to section 162 of the IRC.\textsuperscript{18} This section is said to be the business deduction “workhorse.”\textsuperscript{18} Although the phrase is known mostly for its appearance in section 162, “trade or business” appears frequently in other parts of the IRC. Despite the phrase’s extensive use in at least sixty IRC sections and in 170 different places within the code,\textsuperscript{14} the IRC fails to define the phrase expressly.\textsuperscript{18} Under normal circumstances, when Congress leaves statutory language relatively undefined, the evolution of such a definition is left to the judiciary. However, in the case of trade or business treatment, the courts have failed to enunciate a clear standard of activity that is both adequately restrictive and sufficiently broad to circumscribe that behavior specif-

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\item 26 U.S.C. § 162(a) (1987). Text appears as follows:
\begin{enumerate}
\item In general—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—
\begin{enumerate}
\item a reasonable allowance for salaries or other compensation for personal services actually rendered;
\item traveling expenses . . . while away from home in the pursuit of a trade or business; and
\item rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property
\end{enumerate}
\end{enumerate}
\end{enumerate}

\item Id.
\item Bolling & Carper, The Evolving Definition of “Trade or Business”: Ditunno and Beyond, TAXES, Jan. 1985, 73, 73 (citing IRC §§ 62(1), 162(a), 165(e), 166(d), 167(a)(1), 168(e), 172(d), 174, 217(f), 280A(c)(1), 1221, 1231, and 1402(a)).
\item Bolling & Carper, supra note 14, at 73 (“Despite the prolific use of the term and its obvious importance, neither the Internal Revenue Code nor the regulations have promulgated a specific definition of what is meant by the phrase ‘trade or business.’”); Orbach & White, How To Establish Existence of a Trade or Business in Light of Recent Conflicting Decisions, 13 TAX’N FOR LAW. 38, 38 (1984) (“that phrase has never specifically been defined in the Regulations”).

In an effort to assist small businesses, the IRS recently defined trade or business as:
\begin{quote}
[A]n activity carried on for livelihood or for profit. For an activity to be considered a business, a profit motive must be present and some type of economic activity must be involved. It is distinguished from an activity engaged in purely for personal satisfaction.

A business usually has regular transactions that produce income. To carry out these transactions, it has to incur a number of expenses . . .
\end{quote}

You should be able to show annually by facts and circumstances that you were in business during that year.

\textit{IRS Pub. No. 334, Tax Guide for Small Business} 2 (1981). With the exception of the concept of livelihood, this definition provides nothing more than the tests currently used by the courts.
ic peace to receive trade or business recognition.\textsuperscript{16} The courts have only highlighted a few factors that weigh highly in their consideration of the facts of a particular case.\textsuperscript{17}

Although personal activities have been specifically treated in section 262 and trade or business activities have been specifically treated in section 162 (as well as elsewhere), a gray area exists between the two sections that has received comparatively less attention. Activities in this gray area, including investment activities, involve some economic activity, yet also resemble personal activities. In 1941, the United States Supreme Court in \textit{Higgins v. Commissioner}\textsuperscript{18} denied trade or business status for the personal investment manager.\textsuperscript{19} A year later, Congress sought to fill the void created by \textit{Higgins} by enacting a new deduction. Apparently, Congress reacted to the \textit{Higgins} decision and sought to provide some deductibility for the expenses incurred by the taxpayer in maintaining his or her personal investment portfolio. Section 212 of the IRC allows a deduction for expenses incurred "for the production or collection of income," or "for the management, conservation, or maintenance of property held for the production of income."\textsuperscript{20} Although the section 212 deduction provides some amelioration for the investor, the benefits of trade or business classification as provided by section 162 are far more favorable.

Perhaps the most significant difference between sections 212 and 162 is the two percent floor imposed by section 67 on certain

\textsuperscript{16} Curtis, \textit{Commissioner v. Groetzinger—Supreme Court Holds That the "Goods or Services" Test is Not a Prerequisite to "Trade or Business" Status, 22 WAKE FOREST L. REV. 221, 223 (1987)} (trade or business "is not defined in the Code, the Treasury Regulations, or the legislative history. What constitutes a trade or business has been left to the determination of the judiciary and has long been a disputed issue" (citing \textit{Noto v. United States}, 598 F. Supp. 440, 442 (D.N.J. 1984), \textit{aff'd}, 770 F.2d 1073 (3d Cir. 1985))); Boiling & Carper, \textit{ supra} note 14, at 73 (The meaning of trade or business "has been developed by the judiciary on a case-by-case basis. This approach . . . has led to a variety of interpretations and an inconsistent application of the phrase."); Orbach & White, \textit{ supra} note 15, at 39 ("Unfortunately, [the cases] suggest no other guidelines or factors with respect to the trade or business determination. Consequently, it has been left to the lower courts . . . to develop trade or business attributes.").

\textsuperscript{17} \textit{See infra} text in section II.B.1. and notes 23-38.

\textsuperscript{18} 312 U.S. 212 (1941). \textit{See infra} text accompanying notes 47-59.

\textsuperscript{19} The term "investment manager" is used to describe one who performs passive investment (e.g., Mr. Higgins) rather than active investment. \textit{See infra} notes 92-93, 113-14, 118-20.

deductions, including those of section 212. This limitation allows certain deductions only to the extent that the aggregate of such deductions exceeds two percent of adjusted gross income. Therefore, if any particular tax year yields a large amount of income for the investor, but his or her expenses related to such investment fall below two percent of adjusted gross income, these deductions will be denied.

As this examination of the applicable IRC sections illustrates, the investor is encouraged to classify his or her activity as that of a trade or business. The securities investor who has incurred great expense and loss, in particular, would benefit by trade or business status. Without a clearer definition of the phrase, however, “trade or business” alone does little to distinguish section 162. The taxpayer needs guidance; how should he conduct himself in order to receive trade or business status? The courts have attempted to interpret the phrase, yet their legacy has not accomplished the objective.

B. Judicial Interpretation of Trade or Business Under I.R.C. Section 162

1. Traditional Trade or Business Tests

The Internal Revenue Code only provides the general language needed to determine the activities that will receive trade or business classification. From there, the federal courts have generated guidelines upon which taxpayers are expected to rely. Generally, the first rule is that every trade or business determination will be made upon an examination of all the “facts and circumstances.” The facts and circumstances test was established in the Higgins case and remains the starting point from which all subsequent courts have determined trade or business status. Upon this underlying layer of facts and circumstances, the courts have highlighted several factors they consider significant. Otherwise, without specifying the important factors, a facts and circumstances test is nothing more than an empty rule. Therefore, over the years the courts have generated three specific

21. Id. § 67.
22. Although these results may appear equitable, when one considers that the deduction would have been allowed had income not been so great, the goal of encouraging the production of income is lost.
24. Olson, supra note 9, at 1234 (stating that an examination of “the facts of each case is a necessary part of adjudicating tax controversies, but some guidance is needed in deciding which facts are important”) (citing United States v. Boyle, 469 U.S. 241 (1985)).
tests to be used in determining trade or business status: (1) the profit motive test, (2) the actively engaged test, and (3) the goods or services test. These tests have been applied generally to all trade or business determinations.

a. Profit Motive

Cases in the investor/trader area require that the taxpayer conduct his business with the intention of creating a profit. In fact, business conduct, by definition, implies that the business person is seeking a profit. Tax deductibility is denied unless the profit motive can be established. This test does not require that the business per-

25. See infra text accompanying notes 26-38. See Bolling & Carper, supra note 14, at 76, 77 (outlining three traditional tests); Slattery & Nordhauser, Trade or Business Status: Recent Judicial Interpretations, 17 Tax Adviser 112, 113 (1986) (also outlining the three tests); see also Boyle, supra note 16, at 739, 743 (recognizing the three traditional tests and adding a fourth: the activity must have actually commenced).

26. Bessenyey v. Commissioner, 379 F.2d 252, 256 (2d Cir.) ("deductibility of 'business-like' expenses or losses is denied unless the taxpayer can show an intention to seek profit"), cert. denied, 389 U.S. 931 (1967); Lamont v. Commissioner, 339 F.2d 377, 380 (2d Cir. 1964) ("It is well established that the existence of a genuine profit motive is the most important criterion for the finding that a given course of activity constitutes a trade or business."); Hirsch v. Commissioner, 315 F.2d 731, 736 (9th Cir. 1963) ("it is clear that Congress intended that the profit or income motive must first be present in and dominate any taxpayer's 'trade or business' before deductions may be taken"); Doggett v. Burnet, 65 F.2d 191, 194 (D.C. Cir. 1933) ("The proper test is . . . whether [the activity] is entered into and carried on in good faith and for the purpose of making a profit . . . and that it is not conducted merely for pleasure, exhibition, or social diversion."); Thacher v. Lowe, 288 F. 994, 995 (S.D.N.Y. 1922) ("if a man does not expect to make any gain or profit out of the management of the farm, it cannot be said to be a business for profit").

27. Stanton v. Commissioner, 399 F.2d 326 (5th Cir. 1968). In addition to the implication that business conduct naturally seeks profit, section 183 specifically denies, with certain exceptions, a deduction for activities "not engaged in for profit." 26 U.S.C. § 183(a) (1987). Subsection (c) of section 183 defines activities "not engaged in for profit" as activities other than those "with respect to which deductions are allowable . . . under section 162 or . . . section 212." Id. § 183(c). Treasury Regulations §§ 1.183-2(b)(1) to (9) (1972) provide the following relevant factors that should be taken into account in determining whether an activity is engaged in for profit:

(1) Manner in which the taxpayer carries on the activity.  
(2) The expertise of the taxpayer or his advisors.  
(3) The time and effort expended by the taxpayer in carrying on the activity.  
(4) The expectation that assets used in the activity may appreciate in value.  
(5) The success of the taxpayer in carrying on other similar or dissimilar activities.  
(6) The taxpayer's history of income or losses with respect to the activity.  
(7) The amount of occasional profits, if any, which are earned.  
(8) The financial status of the taxpayer.  
(9) Elements of personal pleasure or recreation.

Id.
b. Actively Engaged

The second trade or business test employed by the courts requires that the taxpayer engage in the alleged business activities in an active manner. Transactions must generally be carried out with regularity, frequency, and a measure of continuity. Similarly, the taxpayer’s activity must have actually commenced. While a single transaction normally does not constitute a trade or business, the taxpayer who initiates the sole transaction is considered actively engaged in the enterprise if it is carried out with the expectation that additional transactions will be made in the same field. Furthermore, courts have held that a taxpayer is conducting a business if he can show “that he devotes a substantial portion of his time to the activities,” or “that there has been extensive or repeated activity over a substantial period of time.”

c. Goods or Services

In an attempt to provide additional clarification in the trade or business area, Justice Frankfurter proposed the goods or services test. Justice Frankfurter’s concurrence in the 1940 case of Deputy v. DuPont stated that a person was not engaged in a trade or business

28. Malmstedt v. Commissioner, 578 F.2d 520, 527 (4th Cir. 1978) ("Success is not the test of deductibility as a business expense. The test is whether the business was undertaken 'in good faith for the purpose of making a profit'").

29. Reese v. Commissioner, 615 F.2d 226, 230 (5th Cir. 1980) ("the lack of continuity and frequency of activity in a particular field of endeavor is a strong indicia that a taxpayer is not engaged in a trade or business in that field"); Stanton, 399 F.2d at 329 ("A taxpayer can show that his activities are a 'business' by demonstrating that he devotes a substantial portion of his time to the activities . . . or that there has been extensive or repeated activity over a substantial period of time."); Thomas v. Commissioner, 254 F.2d 233, 237 (5th Cir. 1958) ("Frequency and continuity of sales transactions have been regarded as important tests."); Dunlap v. Oldham Lumber Co., 178 F.2d 781, 784 (5th Cir. 1950) ("[A] most important factor is continuity of sales and sales related activity over a period of time. . . . Frequency of sales, as opposed to isolated transactions has been emphasized."); Fahs v. Crawford 161 F.2d 315, 317 (5th Cir. 1947) ("Carrying on a business, however, implies an occupational undertaking to which one habitually devotes time, attention, or effort with substantial regularity.").

30. One commentator distinguishes the “activity commenced” requirement as an independent test. Boyle, supra note 16, at 748. For the purposes of this comment, the “activity commenced” requirement is incorporated into the actively engaged test.

31. Reese, 615 F.2d at 230, 231.

32. Stanton, 399 F.2d at 329.

33. 308 U.S. 488 (1940).
unless he held himself out to others as offering goods or services. Following its application in *DuPont*, the goods or services test was used by several circuit courts and by the Tax Court as a mandatory requirement in the determination of trade or business status.

In 1987, however, the Tax Court reversed its previous rulings to hold that the failure to satisfy the goods or services test alone is not enough to lose the trade or business battle. The test was never adopted by a majority of the United States Supreme Court, neither implicitly nor expressly, and has been completely ignored in several cases in which its application may have been appropriate. Thus, when the Supreme Court recently reviewed the continuing viability of the test, it was predictably rejected as an absolute requirement. Presumably, then, only the profit motive and actively engaged tests remain as absolute requirements.

2. The Investor/Trader Distinction
   a. Trade or Business Status Denied to the Investor

Beginning in the 1930's, the distinction between the investor and the trader began to take shape. Early on, the courts used the distinction to deny trade or business status to what they referred to as the investor. As will be seen later, other courts recognized a distinction, but drew the line differently.

*Snyder v. Commissioner* is often cited as the case that initially introduced the investor/trader distinction as a legitimate demarca-

34. *Id.* at 499.
35. See *Grosswald v. Schweiker*, 653 F.2d 58 (2d Cir. 1981) (asserting that the goods or services test is a settled rule within the tax law); *Gentile v. Commissioner*, 65 T.C. 1, 6 (1975) ("Upon stepping up to the betting window, petitioner was not holding himself out as offering any goods or services to anyone."); *Helvering v. Highland*, 124 F.2d 556, 561 (4th Cir. 1942) ("the term has been re-defined . . . and narrowed so that 'carrying on any trade or business' is now said to mean 'holding one's self out to others as engaged in the selling of goods or services'"); *Helvering v. Wilmington Trust Co.*., 124 F.2d 156, 159 (3d Cir. 1941) (quoting Justice Frankfurter's concurrence in *Deputy v. DuPont* and holding that an investor was not "holding one's self out to others as engaged in the selling of goods or services." *DuPont*, 308 U.S. at 499).
37. The goods or services test has been characterized as the "most controversial" of all the tests. *Boyle*, supra note 16, at 746. The controversy allegedly stems from the fact that the Court in *Higgins* did not cite the test proposed just one year before by Justice Frankfurter in *DuPont*. *Id.* Neither was the test cited in the two companion cases to *Higgins*. United States v. *Pyne*, 313 U.S. 127 (1941); *City Bank Farmers Trust Co. v. Helvering*, 313 U.S. 121 (1941).
38. *Commissioner v. Groetzinger*, 107 S. Ct. 980, 987 (1987) ("while the offering of goods and services usually would qualify the activity as a trade or business, this factor, it seems to us, is not an absolute prerequisite"). See infra text accompanying notes 121-26.
tion.\textsuperscript{40} In \textit{Snyder}, the United States Supreme Court held that an individual who maintains a margin account through a broker, is not conducting a trade or business.\textsuperscript{41} Mr. Snyder was concededly a margin investor. Under a margin account, the taxpayer's broker purchases stock for his customer on credit when prices are rising in order to increase the holdings of the account and sells securities when prices are falling in order to cover the credit advanced to the individual.\textsuperscript{42} By Snyder's own admission, his intention was not to draw profits from the account, but to increase his holdings to the extent permitted by his margin of credit.\textsuperscript{43}

The \textit{Snyder} Court set forth a rule that calls for the application of trade or business status to any taxpayer who is "regularly engaged in the business of buying and selling corporate stocks" or who devotes at least a substantial portion of time to speculating in securities for the purpose of making a living."\textsuperscript{44} Such a person is to be designated as a trader. This is apparently where the distinction from an investor lies. Mr. Snyder failed to prove, or even allege, that he spent a substantial portion of his business day attending to his stock transactions. Nor, as the opinion quoted from an earlier case,\textsuperscript{45} could Mr. Snyder be characterized as a "trader on an exchange who makes a living in buying and selling securities."\textsuperscript{46}

The Court's language in \textit{Snyder} appears to have established the level of activity necessary for a securities trader to be considered a trade or business. In cases subsequent to \textit{Snyder}, layers of additional requirements were slowly added as the courts moved the line between the trader and the investor further from the investor. An increasingly smaller set of activities would qualify the investor as con-

\begin{footnotesize}
\begin{enumerate}
\item See Boyle, \textit{supra} note 16, at 755 (stating that the investor/trader distinction was recognized by the Supreme Court as early as 1935 in \textit{Snyder}). The trend toward an investor/trader distinction actually began as early as the 1920's. See Schermerhorn v. Commissioner, 26 B.T.A. 1031 (1932); Hodgson v. Commissioner, 24 B.T.A. 256 (1931); Elliott v. Commissioner, 15 B.T.A. 494 (1929); Schwinn v. Commissioner, 9 B.T.A. 1304 (1928); I.T. 1818, 11-2 C.B. 39 (1923).
\item 295 U.S. at 139.
\item A margin account is defined as the [s]ecurities industry's method of extending credit to a customer. Under such a practice customer purchases specified amount of stock from securities firm by advancing only portion of purchase price, with brokerage firm extending credit or making loan for balance due, and firm maintains such stock as collateral for loan and charges interest on balance of purchase price.\textsuperscript{47}
\item \textit{Snyder}, 295 U.S. at 139.
\item \textit{Id}.
\item Bedell v. Commissioner, 30 F.2d 622 (2d Cir. 1929).
\item \textit{Snyder}, 295 U.S. at 139.
\end{enumerate}
\end{footnotesize}
Perhaps the most influential and frequently quoted case dealing with the issues of an investor's tax treatment is *Higgins v. Commissioner.* In *Higgins*, the petitioner resided in Paris and maintained offices both there and in New York. The employees in the New York office conducted petitioner's financial affairs in response to his instructions sent by cable, telephone, and mail. The New York office "kept records, received securities, interest and dividend checks, made deposits, forwarded weekly and annual reports, and undertook the general care of the investments as instructed by the owner." From a distance, the petitioner "kept a watchful eye over his securities."

*Higgins* established the long tradition of determining a taxpayer's trade or business status on a case-by-case basis. Justice Reed delivered the opinion in which the "facts and circumstances" test was established: "To determine whether the activities of a taxpayer are "carrying on a business" requires an examination of the facts in each case." Although subject to factual review by the Tax Court and other courts, the Internal Revenue Service is charged with the duty of determining what facts will constitute carrying on a trade or business.

The *Higgins* Court failed to delineate a clear standard of activity required for the investor to be considered a trade or business. Instead of stating what types of activities and the levels of each necessary to qualify as a trade or business, the opinion merely stated that this taxpayer's activities were insufficient to constitute a trade or business. In effect, the *Higgins* Court did nothing more to help define trade or business than to create a passive standard for comparison. Because the petitioner had "merely kept records and col-

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47. 312 U.S. 212 (1941).
48. Id. at 214.
49. Id.
50. Id.
51. Id.
52. Id. at 217.
53. Originaly created as the Board of Tax Appeals, in 1942 the court was renamed the Tax Court. J. Freeland, supra note 13, at 29.
55. Id. at 218. "The Commissioner and the Board appraised the evidence here as insufficient to establish petitioner's activities as those of carrying on a business." Id.
56. For purposes of this comment, a court establishes a passive standard when it reviews the facts in the instant case and concludes merely that those facts do not satisfy the particular rule of law.

A famous example of a passive standard is presented in Justice Stewart's concurring opin-
lected interest and dividends from his securities," the Court was unable to reverse the lower court's decision denying the business deduction.87

The Higgins Court also ruled that the determination of the taxpayer's trade or business status be made without regard to the size of the taxpayer's portfolio or the continuity and extent of the managerial operations.88 No matter how much work and effort is expended in the collection of interest and dividends, nor how high the value of the taxpayer's estate, the Court was unwilling to recognize the taxpayer's passive activities as a trade or business.89

The Tax Court began expanding the distinction between the trader and the investor in Chang Hsiao Liang v. Commissioner.60 The petitioner in that case was a Chinese national who had arranged for an American banker to manage and protect his investments during hostilities in China.81 The banker, Cochran, established an account for Liang at Guaranty Trust Company in New York.82 Between the years 1938 and 1946, Guaranty Trust bought and sold securities for the petitioner only upon Cochran's instructions.83 Cochran made all decisions regarding the purchase and sale of securities in the account and rarely received communication from Liang.84 Although this was Cochran's sole occupation during these years, Liang was not involved at all in the management of his investments.85

ion in Jacobellis v. Ohio, 378 U.S. 184 (1964). Before concluding that a film presented by a theater owner was not obscene, Justice Stewart stated that while he could not define obscenity in concrete terms, he would "know it when [he saw] it." Id. at 197.
57. Id. at 218.
58. "No matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board." Id.
59. Id. Collection of income and maintenance of records are considered passive activities. It is not contended that the "passive" investor should be considered carrying on a trade or business. See infra notes 92-93, 113-14, 118-20 and accompanying text.
60. 23 T.C. 1040 (1955).
61. Id. at 1041. Other than his position as a Manchurian military governor, the petitioner maintained no other occupation. In 1928, the petitioner became acquainted with the banker, Cochran, who was manager of the Mukden, Manchuria branch of the National City Bank of New York. Petitioner established a securities account with the branch. When Cochran left Manchuria in 1932, he and the petitioner agreed that Cochran would continue to manage petitioner's investments in exchange for a monthly salary and a one percent commission. Id.
62. Id. at 1041-42.
63. Id. at 1042.
64. Id. "Cochran exercised sole discretion as to the management of the account, including decisions as to the items and times of purchase and sale and the exercising of proxies." Id.
65. Id. "Cochran performed no similar services for any other person in 1946, and had no other occupation aside from supervising petitioner's account. He bought and sold securities
A new twist on the old investor/trader distinction found its way into the Tax Court's opinion in *Liang*. In determining that Liang's activities were not those of a trade or business, the court relied primarily on the frequency of the taxpayer's trading and the relative length of time the stock was held. Petitioner's account was invested primarily in securities. In the taxable year 1946, the average holding period of stocks sold was 5.8 years. The majority of gains and losses over the period prior to 1946 were from long-term holdings and the ratio of purchases and sales, in dollars, to the value of the entire portfolio was small. These facts were important to the court when it stated its newly found basis for the investor/trader distinction:

The distinction between an investment account and a trading account is that in the former, securities are purchased 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. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis.

Curiously, this language appears in the case without citation to prior authority. This was the first reference by a court to a test based on short-term holdings. The Tax Court, it would seem, went beyond the language in *Higgins* and *Snyder* to add a previously undeclared requirement to the investor's list of factors necessary for trade or business recognition. This extension was made without regard to the original objectives of the business deduction.

Nevertheless, the court concluded that the petitioner's objective

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66. Id. at 1044.
67. Id. at 1043. The opinion only gives sales figures for the year 1946. In 1946, sales totalled $442,886.63, with the net gain from these sales totalling $141,598.84. More than $132,000 of this gain was derived from the sale of securities held longer than two years. Of this $132,000, more than $93,000 was derived from securities held longer than three years and of this $93,000, more than $60,000 was derived from securities held longer than five years.
68. Id. at 1043, 1044. However, the court dismissed such activity, attributing it to world conditions such as the fall of France and the imminent entry of the United States into World War II. Id.
was to produce income and preserve the principal of the portfolio. This coupled with the absence of "frequent short-term turnover" in the portfolio suggested that the petitioner, through his custodian account, was conducting investment activity rather than a trading operation.

b. The Courts Uphold Trade or Business Status for the Investor

In 1943, shortly after Higgins was decided, the Second Circuit set a precedent in favor of trade or business status for an investor. Strangely, in Fuld v. Commissioner, the court failed to mention the rule presented in Higgins. Perhaps more unusual, the Fuld ruling has not been followed in subsequent decisions.

Leonhard Fuld devoted his full-time to "the study of new texts, reading services, charting prices of securities, conferring with his broker, attending meetings of corporations in which he owned securities, and consulting with corporate executives." His sister Florentine, the other petitioner, conducted her affairs in a similar manner and her transactions were almost entirely of the same stocks and in the same amounts as her brother, Leonhard. Most of the petitioners' stock sales were of securities held for more than two years. The main source of their livelihood was the profit from these

69. Id. at 1045. The Tax Court was satisfied "that the primary, if not the sole objective, was that of an investment account established to provide a reliable source of income." Id. They also found that the petitioner "did no more than was required to preserve an investment account for his principal." Id.

70. Id. at 1044. "The absence of frequent short-term turnover in petitioner's portfolio negatives the conclusion that these securities were sold as part of a trading operation rather than as investment activity." Id.

71. 139 F.2d 465 (2d Cir. 1943).

72. Id. at 467. Petitioner devoted an average of eight hours per day to these activities.

73. Florentine Fuld had no trade or business other than buying and selling securities. . . . It was her policy to buy and sell the same securities as Leonhard Fuld and in the same amounts. . . . Her orders were placed with the broker through Leonhard Fuld, who acted as agent only in the physical transmission of such orders and the acceptance of deliveries.

74. Two hundred and forty-nine of Leonhard's sales were of securities that had been held for more than two years. Ninety-eight had been held for two years or less. Two hundred and twenty-nine of Florentine's sales were of securities that had been held more than two years. Eighty-nine had been held for two years or less. Id.
The Second Circuit upheld the lower court's finding that the securities purchased by these taxpayers were held in the course of a trade or business. The court rejected the Commissioner's argument that the goods or services test from Justice Frankfurter's dissent in DuPont should apply here. The court distinguished the facts in DuPont stating that the taxpayer in that case made only a single transaction with a single company. The Fulds, on the other hand, were "actively trading in securities rather than effectuating what amounted to a single deal." In language completely inconsistent with Higgins, the court concluded that its holding was supported by a "long administrative practice" of determining that "persons who buy and sell securities on their own account are engaged in a trade or business."

The next case giving the investor hope in establishing trade or business status was decided by the United States Court of Claims in 1979. Levin v. United States presented a taxpayer who had incurred a business bad debt and declared this bad debt as a business deduction under IRC section 166. He wished to carry back the deduction and receive a tax refund. The court concluded that the taxpayer was carrying on the business of trading.

In 1961, the year in which the debt was incurred, the petitioner

75. The main source of livelihood of both petitioners was from their securities transactions. They maintained no business office, had no customers to whom they might sell securities, practically never sold securities short, and never advertised or held themselves out to the public as dealers. . . . Neither of the petitioners was a director, officer, or employee of any of the companies in which they purchased securities in 1930 and thereafter.

76. Id. at 468.

77. Id. (citing Deputy v. DuPont, 308 U.S. 488, 499 (1940)). See also supra text accompanying notes 33-38.

78. Fuld v. Commissioner, 139 F.2d 465, 468 (2d Cir. 1943). The taxpayer in DuPont attempted to deduct expenses incurred in borrowing a block of stock of the DuPont Company to distribute to executive officers. DuPont, 308 U.S. at 490-92.

79. Fuld, 139 F.2d at 468.

80. Id. at 469.

81. 597 F.2d 760 (Ct. Cl. 1979).

82. 26 U.S.C. § 166 (1987). Section 166 allows a deduction for a business debt "which becomes worthless within the taxable year . . . ." Id. § 166(a)(1). It also allows a deduction for a partially worthless business debt approved by the Secretary of the Treasury. Id. § 166(a)(2).

83. Petitioner's appeal was ultimately denied on grounds other than the trade or business issue. The court held that the plaintiff could not claim the deduction and carry it back for the refund he sought because the bad loans were not of a business nature and were not legally worthless. Levin, 597 F.2d at 767.
conducted 332 securities transactions. Since the time he was a young man, Mr. Levin spent almost all of his working hours purchasing and selling securities. Frequently, he visited and met with the officers of companies he was considering for his investment. Because the petitioner was a margin trader, he spent a substantial amount of time with his brokers on Wall Street, often eating lunch with them at the Stock Exchange Club. He kept accurate records of all his stock trades and he regularly attended stockholders’ meetings and lectures sponsored by stock analysts on subjects of interest to him.

First, the court acknowledged the lack of a precise standard, promulgated either by the courts, the code, or the regulations, that characterizes a taxpayer’s activity as that of a trader rather than an investor. However, “it is clear,” the court noted, that “such a . . . ‘businessman’ exists, given the proper facts.” Second, the court attempted to clarify the definition of the trader. Recalling the Higgins rule that the mere collection of income and maintenance of records was not sufficient to give the taxpayer the business deduction regardless of the continuity and extensiveness of the work performed, the court stated what more was required to be considered a trader:

In effect, a “trader” is an active investor in that he does not passively accumulate earnings, nor merely oversee his accounts, but manipulates his holdings in an attempt to produce the best possible yield. That is, the trader’s profits are derived through the very acts of trading—direct management of purchasing and selling.

In essence, the Levin court made an additional distinction between the active investor, who is the functional equivalent of a trader, and a passive investor, who merely receives the benefit of the portfolio by generally overseeing its management. Most importantly, the opin-

84. Id. at 763. The 332 transactions consisted of the transfer of 112,400 shares with a total value of $3,452,125. Id.
85. Id. at 762.
86. Id. at 763.
87. See supra note 42 for a definition of a margin account.
88. Levin, 597 F.2d at 763.
89. Id. “He maintained ledger sheets of all his stock transactions, attended stockholders’ meetings, and generally spent his time purchasing and selling securities on his own account.”
90. Id. at 765.
91. Id.
92. See supra text accompanying notes 58-59.
93. Levin, 597 F.2d at 765 (emphasis added).
94. The court continues with this distinction:
ion failed to mention whether the taxpayer held his securities on a short-term or long-term basis prior to their sales. Apparently, this factor did not play any importance in the court's conclusion.

*Moller v. United States* gave the Federal Circuit an opportunity to apply the active investor standard developed only three years earlier in *Levin*. In fact, *Moller* arose on appeal from the United States Claims Court where the *Levin* standard was applied and the active investor was determined to be a trade or business. The Federal Circuit declined the opportunity to apply a workable standard and instead reversed on the basis of the *Liang* short-term test.

During the tax years 1976 and 1977, Mr. and Mrs. Moller managed four investment portfolios with total values approximating $13,500,000 and $14,500,000 in the respective years. The stocks sold in these years had been held for an average of more than three and one-half years in 1976 and eight years in 1977. The Mollers received over 98% of their gross income in both 1976 and 1977 in the form of interest and dividend income.

Also during these years, the couple devoted their full-time to the necessary investment activities. Each spent between forty and forty-two hours per week at these activities, kept regular office hours, and monitored the stock market and the performance of their portfolios extensively on a daily basis.

The petitioners supplemented their intensive research and mon-
itoring with several support activities: they maintained and updated a watch list of all stocks currently being considered for possible purchase; they kept extensive product research notes on each company's product and industry; they produced stock purchase projection worksheets based on their own research and daily quotations containing projections for comparisons between stocks and projections of the stocks likely to be sold; they collected market information, such as closing prices, type of stock, stock ratings, symbols, and price ranges, on all securities held in the portfolios and those being considered for possible purchase; and, they maintained records on the current status of all stocks held, including information regarding capital gains and dividends distributed.\(^{104}\)

Additionally, the Mollers subscribed to three daily investment publications, ten on a weekly basis, three on a monthly basis, and five were received quarterly.\(^{105}\) Mr. Moller spent between eight and ten hours per week studying these materials and Mrs. Moller spent between seven and eight hours per week.\(^{106}\) The Mollers were in telephone contact with their stock broker on an average basis of every other day.\(^{107}\) Some days they placed ten or fifteen calls to the broker; on others, one or two calls were placed.\(^{108}\)

The Mollers maintained two offices—one in Santa Barbara, California and a second in Scottsdale, Arizona—at which they conducted their investment activities.\(^{109}\) At the Scottsdale office, the Mollers employed a part-time secretary/bookkeeper who worked approximately twenty-two hours per week assisting in the maintenance of the portfolios.\(^{110}\) The cost of employing the secretary/bookkeeper, maintaining the two offices and subscribing to the publications totaled $22,659.91 in 1976 and $29,561.69 in 1977.\(^{111}\) These expenses were allowed as business deductions by the U.S. Claims Court, but were disallowed on review by the Federal Circuit.

The Claims Court recognized the distinction between trader and investor and conceded that the petitioners here were investors because of their interest in long-term growth and dividend income.\(^{112}\) The court indicated that the cases had also distinguished between the

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104. Id. at 1073-74.
105. Id. at 1074.
106. Id.
107. Id. at 1075.
108. Id.
109. Id. at 1072.
110. Id. at 1075.
111. Id. at 1072.
112. Id. at 1075.
passive investor and an investor who is recognized as carrying on a business. It was clear that these petitioners were “anything but ‘passive’ investors. On the contrary, their investment activities were regular, extensive, and continuous, and they involved the active and constant exercise of managerial and decision-making functions.”

The Federal Circuit felt otherwise and reversed the Claims Court decision. The Federal Circuit’s opinion relied primarily on the Liang short-term test. It stated that the investors’ income must derive primarily from the sale of securities rather than from dividends and interest. In determining whether an investor qualifies as a trader, the court identified several relevant factors. These included the taxpayer’s investment intent, the nature of the income produced by the activity, and the “frequency, extent, and regularity” of the securities transactions performed.

The circuit court agreed with the lower court that the taxpayers were investors, but rejected the active/passive distinction. Its argument was that the Higgins rule prevents the recognition of the investor as a trade or business if that investor is merely managing the portfolio, regardless of the amount of time and effort applied to such management or the size of the portfolio. The opinion concluded that the Mollers, merely by spending much time in managing their large portfolio, were not carrying on a trade or business.

3. Trade or Business Status For the Gambler

The issue of trade or business status has also been discussed in a number of cases involving full-time gamblers. An examination of this line of cases is appropriate here in light of the similarity in activities between the full-time gambler and the full-time investor. In fact, the activities of a full-time gambler have recently been treated as those of a trade or business. In Commissioner v. Groetzinger, a full-time gambler wished to declare a net gambling loss as a business deduction. In order to resolve a conflict among the courts of ap-

113. Id. (citing Kales v. Commissioner, 101 F.2d 35, 38 (6th Cir. 1939)). See also Foss v. Commissioner, 75 F.2d 326, 327 (1st Cir. 1935); Washburn v. Commissioner, 51 F.2d 949, 953 (8th Cir. 1931).
115. See supra text accompanying note 68.
117. Id.
118. Id. at 814.
119. Id.
120. Id.
peal, the Court granted certiorari. After a lengthy review of the cases within the investor/trader area, the Supreme Court, once and for all, rejected the goods or services test as an absolute requirement of trade or business qualification. In the absence of the goods or services test, the taxpayer in Groetzinger was able to satisfy the Supreme Court that he was indeed conducting a trade or business.

The Groetzinger Court did not rely on, let alone inquire into, the number of bets placed, nor on any other quantitative tests employed by the courts in the investor/trader cases. Instead, the Court focused on qualitative factors such as the “full-time” nature of the taxpayer’s activity, his intent to make gambling a “livelihood source,” and a sense of “fairness:

If a taxpayer, as Groetzinger is stipulated to have done in 1978, devotes his full-time activity to gambling, and it is his intended livelihood source, it would seem that basic concepts of fairness (if there be much of that in the income tax law) demand that his activity be regarded as a trade or business just as any other readily accepted activity, such as . . . being . . . an active trader on the exchanges.

This background has attempted to point out the inconsistencies resulting both from the lack of an authoritative definition of trade or business and from the almost random application of several tests for determining trade or business on the basis of underlying facts and circumstances. Also, it should be apparent that a different standard has emerged to determine the trade or business status of a gambler: one that doesn’t measure frequency, but that emphasizes the qualitative factors of the taxpayer. This comment does not seek to abandon the facts and circumstances test as laid down by the Higgins Court. Certainly, the courts must approach each case individually. Instead, this comment will show that the current melee of tests and factors should be assimilated into a more predictable standard. The following analysis will point out why.

III. ANALYSIS

The spectrum of involvement in securities markets ranges from

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124. “[W]hile the offering of goods and services usually would qualify the activity as a trade or business, this factor, it seems to us, is not an absolute prerequisite.” Id. at 34.
125. Id. at 35-36.
126. Id. at 33.
mere personal investment to the currently recognized trade or business activity of the trader. Along this spectrum lies the part-time, purely personal investor; the full-time, yet passive, investor; the full-time and active investor; and the trader. The courts, at least by their language, have drawn the trade or business boundary to include only the trader. The distinction is faulty for three reasons.

First, by removing the goods or services test as a trade or business requirement, the Groetzinger decision leaves an inconsistent comparison between the active investor and the gambler. Second, under the auspices of the broadly defined “facts and circumstances” test laid down in Higgins, the courts have set vague and arbitrary “tests.” The resulting uncertainty threatens to result in an overabundance of litigation in predicting the amount and type of behavior that will be accepted as that of a trade or business. Finally, these discriminatingly selected factors only measure a limited range of the taxpayer’s activities, rather than an aggregate of the business activities performed.

A. Groetzinger Removes Goods or Services Test

Commentators disagree as to which test the investor/trader distinction hinges on. This issue requires a return to the Higgins case. Through an examination of that case, two theories emerge regarding which test forms the basis for the distinction: (1) the investor/trader distinction hinges on the actively engaged test, or (2) the investor/trader distinction hinges on the goods or service test. Did the Higgins Court base its denial of trade or business on Mr. Higgins’ failure to engage in the activity actively, or was the denial based on his failure to provide goods or services? If the Higgins Court based its distinction on the actively engaged test, then the subsequent removal of the goods or services requirement in Groetzinger should have no effect on the investor/trader distinction. The distinction will survive on the authority of the actively engaged test. If, on the other hand, the Court relied on the goods or services test and

127. See Snyder v. Commissioner, 295 U.S. 134, 139 (1935) (the taxpayer could not be “characterized as a ‘trader on an exchange who makes a living in buying and selling securities’”) (citing Bedell v. Commissioner, 30 F.2d 622, 624 (2d Cir. 1929)). See also text accompanying note 68 for the discussion in the Liang case comparing an investment account and a trading account on the basis of the frequency of trading and the short-term tests.

128. See supra text accompanying notes 47-59. The Higgins case is important because it provides the only Supreme Court authority on point with which the Groetzinger case can be compared. If the rejection of the goods or services test in Groetzinger has any significance to the investor, it is with respect to the origins of the investor line of cases. Higgins is the most authoritative origin of this line.
held that Mr. Higgins’ failure to hold himself out to others as offering goods or services was controlling, then the removal of that test in the Groetzinger case has the effect of destroying the distinction.

The first theory, that the investor/trader distinction is based on the actively engaged test, maintains that the distinction could not logically be based on the goods or services test because neither the trader nor the investor are actually providing goods or services. Such an argument would point out that even the trader

has no control of the price of his “product” nor how it is marketed. He does not provide any services with regard to the sale of his “product”, does not advertise, does not have clients or customers, and does not otherwise act as a middleman in reducing costs of exchange. In other words, a trader of stock and securities is merely a market participant and does not “add to” his “product” as would a businessman.  

In addition, proponents of this theory would argue that the Higgins Court did not refer at all to the goods or services test. Rather, they would point to the Supreme Court’s statement that it was upholding the lower court’s finding that Higgins was not actively engaged. Thus, the theory bases the investor/trader distinction on the failure of the taxpayer’s level of activity to rise to some quantifiable level of activity.

It seems, however, that the Higgins opinion focused on the character or quality of the taxpayer’s activity rather than the quantity of his activity. This theory is stronger than the first for two reasons. First, both the trader and investor are actually providing goods. They sell personal property in the form of securities to other buyers. The buyer is a customer in the normal sense of the word and is purchasing a “product” in the ordinary course of business. Also, it is difficult to conclude that someone who spends forty hours per week at a particular task, whatever that task may be, is not actively engaged in it. Second, the opinion itself was careful to rely on the fact that Mr. Higgins’ activity consisted of the mere collection of

129. Orbach & White, supra note 15, at 41.
130. Contra Bolling & Carper, supra note 14, at 77, 80 (suggesting that the Higgins Court, while appearing to apply the actively engaged test, actually may have been applying the goods or services test, “disguised” as the actively engaged test).
131. See Bolling & Carper, supra note 14, at 80 (it is “difficult to conclude that a person who manages and makes decisions on his own investment portfolio, spends as much as 40 hours per week at his task, and hires people to assist him, is not engaged in a trade or business”).
income and the maintenance of records. In fact, the very holding of the opinion states that despite the level of activity, this type of activity does not meet the trade or business requirement. So, whether or not the taxpayer is actively engaged, if he or she is merely collecting income and maintaining records, trade or business status will be denied. Thus, the controlling test in Higgins appears to be the goods or services test.

Since the Groetzinger holding removes the goods or services test as an absolute requirement for obtaining trade or business status, the only factors remaining as absolute requirements are the actively engaged test and the profit motive test. Furthermore, if the goods or services test is actually “disguised” as the actively engaged test in the investor context, then once the first is no longer required, neither is the second. From this logic, it follows that any activity performed with only the remaining factual requirement, profit motive, is a trade or business. Congress may have actually used this reasoning when it formulated the predecessor to IRC section 212, which allows a deduction for the production or collection of income, because it passed this deduction only two years after the Higgins Court stated that trade or business status would not apply to one who “merely collected interest and dividends from his securities.”

Although this line of reasoning may seem absurd, it points out the inconsistencies left by the Groetzinger decision. Of these inconsistencies, the most important was the Supreme Court’s failure to recognize the similarities between the full-time, active investor and the full-time gambler. The similarities are strong and yet the Court

132. Higgins v. Commissioner, 312 U.S. 212, 218 (1941) (“The petitioner merely kept records and collected interest and dividends from his securities, through managerial attention for his investments.”).

133. Id. (“No matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board.”).

134. One author suggests that the Higgins Court may have “disguised” the goods or services test as the actively engaged test. Bolling & Carper, supra note 14, at 77 (“Perhaps the Higgins court was not really applying the ‘actively engaged’ test, but was really saying that security investors do not hold themselves out to the public as selling either goods or services.”).

135. Bolling & Carper, supra note 14, at 80. In other words, if the Higgins court actually “disguised” the goods or services test as the actively engaged test, then when the goods or services test is eliminated, as it was in Groetzinger, the actively engaged test is also no longer an absolute requirement. Bolling & Carper, supra note 14, at 80.


138. 312 U.S. 212, 218 (1941). See also Bolling & Carper, supra note 14, at 80. (“Recall Congress’s indignation and surprise over the 1941 Higgins decision and the speed with which it took corrective action by enacting the predecessor of section 212.”).
left untouched the active investor's fate while granting trade or business status to the gambler. For both, the return on a particular investment depends almost exclusively on circumstances outside their control. The active investor's stock sales and purchases resemble the bets of the gambler. The active investor's research and investigation of companies actually and potentially within his portfolio are quite similar to the gambler's investigation of the horses upon which he will place bets. Just as the active investor will diversify his portfolio to avoid risk, so too will the gambler avoid putting "all his eggs in one basket." Finally, the stock certificate represents the active investor's gamble that the value will go up in value, while the gambler's betting slip indicates his gamble that his horse will win.139

B. Judicial Reliance on Certain Vague and Arbitrary Factors Within the Facts and Circumstances Test

The advantages and disadvantages of establishing trade or business status have been explored.140 As such, the consequences of reform in this area might affect the taxpayer negatively, as well as positively. Thus, improvement of the investor's individual tax status is not the sole impetus for reform. The need for reform is also evidenced by the amount of unnecessary litigation and uncertainty that has followed the reliance on vague and arbitrary factors in determining trade or business status.

The source of this uncertainty can be traced back to the Higgins case. The Higgins Court offered no assistance to future investors or their attorneys in determining the quantity or quality of activity required to earn trade or business recognition. While the result to the particular taxpayer in Higgins may have been appropriate, courts in subsequent cases could only use the decision for the proposition that facts similar to those presented in Higgins would not qualify a taxpayer as a trade or business. When faced with a different set of facts, a court could not derive a proper standard from Higgins, other than the facts and circumstances test and the three traditional tests. As a result, the development of the law in this area proceeded awkwardly and without the direction of an authoritative standard.

The Groetzinger case also failed to resolve the difficulties re-

139. Orbach & White, supra note 15, at 41 (comparing the trader and the gambler). This comment asserts that the similarities between the trader and the full-time gambler are as compelling as those between the full-time, active investor and the full-time gambler.

140. See supra text accompanying notes 2-8. Because of both the advantages and disadvantages of trade or business status, one commentator has called for a neutral definition, one which favors neither the government nor the taxpayer. Olson, supra note 9, at 1235.
sulting from the Higgins progeny. By leaving the investor line of cases unresolved, the court missed a unique opportunity to at least show a willingness to apply its holding equally to both the investor and the gambler. Instead, the investor is left with a set of vaguely stated factors while the gambler knows with certainty what must be done to qualify for trade or business status.

Cases subsequent to Higgins continued the trend of relying on vague factors. One such vague factor is the taxpayer's duration of holding as emphasized in the Liang case. The Liang test requires that all securities held or sold by a taxpayer be judged by the amount of time they are held by the taxpayer prior to sale. Certainly on an intuitive level, a security held for less than a week can be termed a short-term holding and one held for five years, a long-term holding. But what of those held for a month, three months, six months, a year, or more? What length of time should qualify as long-term? It is conceivable that one court would draw the line at one month while another would do so at one year. The uncertainty resulting from this and other factors examined in the context of a facts and circumstances test is not only a burden on the investor, but a burden on the judiciary, for uncertainty breeds dispute and dispute breeds litigation. An emphasis on an uncertain facts and circumstances test invites litigation, threatens to result in inconsistent judicial rulings, and is, in the words of one circuit court, the reliance on a "non-test."

In addition to being vague, the short-term test also has a questionable origin. The Liang court injected the often-cited paragraph

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141. Justice Blackmun's opinion explicitly left untouched the holding in Higgins. Groetzinger v. Commissioner, 480 U.S. 23, 35 (1987). While not expressed in the opinion, the implication is that the holding in Groetzinger should receive limited application to the facts involving the full-time gambler. Such an implication would leave the line of investor cases still to cope with Frankfurter's goods or services "gloss." Id. at 31, 32. But this result would be inconsistent with the Groetzinger rejection of the Frankfurter gloss, which has its roots in the investment case of DuPont.

142. If the gambler can prove that his activity is performed full-time, in good faith, with regularity, for the production of income, for his livelihood, and not as a mere hobby, he is presumed to be conducting a trade or business. Groetzinger, 480 U.S. at 35-36. The investor, on the other hand, must rely on the "facts and circumstances" test at the least, and the uncertainty of the frequency of trading and the short-term tests at the most.

143. See supra text accompanying note 68. Because the taxpayer's holdings must be short-term in duration according to Liang, the test will be referred to as the short-term test.

144. Chang Hsiao Liang v. Commissioner, 23 T.C. 1040, 1044 (1955) (stating its rule that "[t]he absence of frequent short-term turnover . . . negates the conclusion that these securities were sold as part of a trading operation rather than as investment activity").

into its opinion as a definitional statement.\textsuperscript{146} The paragraph distinguishes between the investment account and the trader account on the basis of long-term/short-term differences. Later in the opinion, the court uses this definition as its basis for recognizing trade or business in the trading operation and not in the investment operation. But the opinion makes the proposition without reference, by citation, to another case.\textsuperscript{147} This proposition was merely invented by the court. As easily as the \textit{Liang} court distinguished the investor based on the duration of his holdings, subsequent courts cited \textit{Liang} for the proposition that the taxpayer must direct his or her activity toward short-term rather than long-term trading.\textsuperscript{148} Such development of the law by fiat is the natural result in an area where no workable standard exists and where the courts are left only with referral to a facts and circumstances test.

Uncertainty is also the product of another vague factor emphasized by the \textit{Liang} court: the frequency of trading. The court's emphasis on this factor also led to its development as an absolute requirement, rather than its maintenance as one of many “facts and circumstances.” This test suggests that the number of trades made by the investor shall be determinative of trade or business status. However, it is difficult to extract a precise numerical guide from the cases using this test. In the \textit{Moller}\textsuperscript{149} case, the appellate court held that the taxpayers were not performing a trade or business after examining the frequency with which they bought and sold securities. The Mollers made 124 and 106 transactions in consecutive tax years.\textsuperscript{150}

On the other hand, in \textit{Fuld}\textsuperscript{151} and \textit{Levin},\textsuperscript{152} where the courts did confer trade or business status, the frequency of trading was greater. Leonhard Fuld’s total sales approximated 347 in the tax year and Florentine’s numbered 318 for the same period.\textsuperscript{153} Mr.

\begin{itemize}
\item \textsuperscript{146} See supra text accompanying note 68.
\item \textsuperscript{147} Had this restriction been the intention of the Court, it would have articulated it as a requirement when it established the facts and circumstances test in \textit{Higgins}.
\item \textsuperscript{148} See \textit{Moller} v. United States, 721 F.2d 810, 813 (Fed. Cir. 1983) (citing the tests from \textit{Liang} and concluding that “in order to be a trader, a taxpayer's activities must be directed to short-term trading, not the long-term holding of investments”); \textit{Purvis} v. Commissioner, 530 F.2d 1332, 1334 (9th Cir. 1976) (relying on the “frequency, extent, and regularity” of taxpayer's transactions “as well as his intent to derive profit from relatively short-term turnovers”).
\item \textsuperscript{149} See supra text accompanying notes 95-120.
\item \textsuperscript{150} In 1976, the taxpayers made eighty-three purchases of securities and forty-one sales. In 1977, they made seventy-six purchases and thirty sales. \textit{Moller}, 721 F.2d at 811.
\item \textsuperscript{151} See supra text accompanying notes 71-80.
\item \textsuperscript{152} See supra text accompanying notes 81-94.
\item \textsuperscript{153} In 1933, Leonhard made “approximately two hundred and forty-nine sales of se-
Levin conducted 332 transactions during the tax year.\textsuperscript{154} Although the gap between the two sets of numbers seems large, these numbers produce no guideline upon which future investors can base their activities with any predictability. The investor making 200 transactions per year, for instance, is unable to determine from these cases whether he is conducting a trade or business. The Federal Circuit attempted to standardize the requisite frequency when it noted that, in those cases where trade or business status was conferred, the taxpayers “were engaged in market transactions on an almost daily basis.”\textsuperscript{155} Considering there are fifty work weeks per year and the securities markets are open a maximum of five days per week, the number of possible trading days per year is no more than 250. Mr. Levin and the Fulds surpassed this number, while the Mollers did not.

But, the Moller court suggested that “almost” daily trading was sufficient.\textsuperscript{156} Wouldn’t the Mollers’ 124 transactions, presumably made once every two days, qualify? In fact, it is possible for one investor to make fewer trades than another during the year, yet trade on a more frequent, “almost daily,” basis. If the second investor lumps all of his or her trades together on only a few days throughout the year, he may have made enough transactions to qualify, but did not trade on an “almost daily” basis. As can be seen, even a determination based on “almost daily” trading leads to no more certainty than one based merely on a general concept of frequent trading. It is this uncertainty, when combined with the resulting unnecessary litigation, that suggests an immediate need for a carefully crafted and predictable standard to define the parameters of trade or business for the investor.

C. Factors Examine Limited Scope of Taxpayer’s Activity

The duration of holding and frequency of trading factors described above also exemplify the limited scope with which the courts examine the “facts and circumstances” of a particular case. Neither

\textsuperscript{154} In 1961, Mr. Levin’s 332 transactions included 112,400 shares and were valued at a total of $3,452,125. Levin v. United States, 597 F.2d 760, 763 (Ct. Cl. 1979).
\textsuperscript{155} Moller, 721 F.2d at 814 (citing Levin, 597 F.2d at 765 and Fuld, 139 F.2d 465 (2d Cir. 1943)).
\textsuperscript{156} Id.
factor suggests more than the time spent merely buying and selling securities. Actual trades represent a mere fraction of the investor’s time spent earning a livelihood. The full-time, active investor devotes a great deal of business time to other activities not measured by the court. Other activities include the research of and contact with companies with which the investor is financially involved; contact with the market and collection of information from it, either through a broker or by other means; attendance at seminars; and deliberation and decision-making. The cases making the investor/trader distinction do so not on the basis of the taxpayer’s total business activity, but on the basis of only one segment of his or her activities.

An example from outside the investor/trader context helps explain the inequities of the distinction. The owner and operator of a small shoe store is in the business of selling shoes to the public. Because of fluctuations in demand, the owner’s inventory rises and falls. Some styles do not sell as well as others and must be held for longer periods of time. Simply because some of his shoes might have been held for a long period of time does not justify the IRS in denying trade or business status to the shoe store owner. Likewise, if the economy in the community collapses and the frequency with which the owner trades his shoes drops to a very low level, his trade or business status is not removed. The owner is still said to be conducting a business because he is maintaining his store, keeping records, and performing other activities that suggest he is still in business. This hypothetical points out that in most business situations it is the entirety of the taxpayer’s activity which is suggestive of whether or not he or she is participating in a trade or business, not just a glimpse at one or two factors.

The courts limit the scope of their examination to quantitative factors to the exclusion of important qualitative factors. For instance, the frequency of the investor’s trading is a measure of the number of securities exchanged. Frequency weighs the taxpayer’s level of activity without consideration of the nature or character of the activity. Reliance on the level of activity alone, however, is not an effective measure of an entity’s business character. In the cases

159. Boyle, supra note 16, at 759. Comparing the activities of many categories of taxpayers, it is “readily apparent that the level of activity is not an effective test.” Boyle, supra note 16, at 759. Some taxpayers who have been classified as conducting a trade or business
following *Liang*, the courts gave brief discussions of the number of transactions made and the length of time the securities were held prior to sale. However, in none of these cases did the courts discuss qualitative characteristics of a trade or business such as the taxpayer’s level of skill, the extent to which the business is his occupation, the reliance on that business for his livelihood, and the proprietary interest in the business. These factors are equally determinative of a trade or business, yet they go unrecognized by the courts. Moreover, an emphasis on qualitative factors would result in more equitable and consistent decisions.

The reluctance of the courts in examining these factors, at least in the investor/trader context, might be their preconceived, subjective notion that the investor is not conducting a legitimate business. Because the investor does not participate in a classic employer/employee relationship, but rather devotes his full energies to an activity at which most other taxpayers spend very little time, the quality of activity is judged somehow to be less valuable.

The *Groetzinger* decision leaves open the possibility that the investor may qualify as a trade or business. The uncertainty left both by the reliance in *Moller* on certain vague and arbitrary factors and by the *Groetzinger* Court’s failure to take advantage of the opportunity to establish a standard for the investor, signals the need for reform. Unless a new and clearly understood standard is adopted, the issues will continue to be litigated. This comment proposes that a

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160. Some of the qualitative characteristics of trade or business activity can be summed up in a test that measures the “degree of personal effort and skill.” Boyle, *supra* note 16, at 759, 762. When the real estate dealer is analyzed under this test, it is apparent that he “takes a piece of property and works with it to make money. The land itself does not appreciate in value on its own. It is the efforts of the dealer that make the property more valuable.” Boyle, *supra* note 16, at 760.

161. The Boyle article points out that a close examination by courts of what the taxpayer is doing is likely to reveal whether the taxpayer is managing and preserving his investments or whether he is pursuing a trade or business. No distinction should be based on the type of investment asset. For example, the distinction between real estate and securities investors should be eliminated.

162. *See generally* Schwartz v. Commissioner, 24 T.C. 733 (1955) (treating even a single parcel of improved real estate as constituting a trade or business).
standard encompassing qualitative as well as quantitative factors be adopted.

IV. PROPOSAL

In light of the foregoing analysis, the need for a more enlightening standard of categorizing trade or business activity is apparent. In order to provide guidance to the taxpayer, reduce the burden of unnecessary litigation, remove inconsistencies in application, and determine trade or business status with equity, the standard should be formulated to include the full-time, active investor as a trade or business. This will require inching the barrier to trade or business status closer to the investor. The new boundary will include the trader and the full-time, active investor as trade or business entities, and exclude the passive investor.

What is less obvious, however, is who should take the responsibility for reformulating a standard. On the one hand, the Supreme Court has recently placed Congress on official notice that it will defer to that body the “ultimate responsibility” for “repair or revision.” The Court reasoned that the difficulty with a judicially imposed solution to the problems inherent in a facts and circumstances test is twofold: (1) the term “trade or business” has wide utilization in the Code despite the lack of an all-purpose definition by statute or regulation and (2) an attempt to devise and apply a test for all situations by judicial means would be “counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Code.”

Despite these warnings, it is unlikely that Congress will act swiftly in giving statutory meaning to the phrase trade or business. As long as the debate over the investor’s status has continued, Congress has been content to allow the debate to rage in the courts. Except for the section 212 deduction in response to Higgins, Congress has acquiesced to the decisions of the courts without any effort on its part to clarify the statutory meaning of trade or business. By acquiescing, Congress has deferred to the courts for any clarification. Therefore, a judicial remedy is required.

The new standard must begin by recognizing the presence and effect of the facts and circumstances test and by enumerating the fac-

164. Id.
165. Olson, supra note 9, at 1202. Even where the courts disagree, Congress has been reluctant to redefine common law tax principals. Congress will probably continue to use the phrase “trade or business” without formulating a definition. Olson, supra note 9, at 1202. 166. Olson, supra note 9, at 1202-03.
tors under the test that courts should place primary and almost exclusive reliance upon. Without the enumeration, a facts and circumstances test can only produce a minimal amount of certainty. Thus, the new scheme will take the form of an enumeration of several factors or tests the courts should emphasize in making their determination.

Of course, the goods or services test will not be a requirement within the new standard since the Groetzinger Court rejected it and recognized that almost every activity would satisfy its "gloss."167

The new approach should consist of four separate tests. In order to qualify for trade or business status, each test must be satisfied. First, the standard must recognize the continuing importance of both the profit motive and the actively engaged tests. The profit motive test is important because it eliminates any enterprises entered into in bad faith or without the desire to earn profit, the primary congressional objective in enacting the trade or business deduction. The actively engaged test ensures that the taxpayer is not performing the activity on such a low level as to minimize its significance.

In addition to the profit motive and actively engaged tests, the new standard must also include tests that measure the qualitative characteristics of conducting trade or business activity. A test that examines the taxpayer's intent to conduct the activity as an occupation would be such a test.168 An occupational test would be useful because it would not restrict any previously recognized trade or business activities, yet it would broaden the classification just enough to include those taxpayers who have chosen to spend their time pursuing what might generally be referred to as their calling, skill, trade, or vocation. Clearly, the full-time, active investor who makes an occupation of investing would, under this test, be considered a trade or business.

Finally, the standard should include a fourth test that prevents the trade or business recognition of activities that are mere personal or recreational activities. This test would require that the taxpayer rely or depend on the activity for his or her livelihood.169 If the activ-

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167. 480 U.S. at 31, 32.
168. This occupation test is similar to the "personal effort and skill" test as espoused in Boyle, supra note 16, at 759, 762. Both tests seek to measure the qualitative, rather than quantitative, characteristics of the taxpayer in determining whether he is conducting a trade or business.
169. Frazer & Brady, Does Recent Decision Defining Trade or Business Extend Beyond the Full-time Gambler?, TAX'N FOR ACCT., July 1987, at 6, 7. See also Groetzinger, 480 U.S. at 33 (conditioning the gambler's trade or business status on his "intended livelihood source").
ity is used to provide some form of support for the taxpayer's livelihood, such activity ought to be considered a trade or business if the other tests are satisfied. The livelihood test is important in that it excludes collateral activities, but it is not inconsistent with the recognition in the case law that a taxpayer can be engaged in more than one trade or business. This test would simply require that all of the taxpayer's trade or businesses contribute to his or her livelihood.

To summarize, the proposed standard should be composed of the following four tests:

1. Is the activity performed with a profit motive?
2. Is the taxpayer actively engaged in the particular activity?
3. Can the activity be considered the taxpayer's occupation?
4. Is the taxpayer dependent on the activity for his or her livelihood?

V. CONCLUSION

The current state of the law in the area of investment taxation is far from orderly. Much of the clutter is left behind by the Higgins decision and its progeny. The Higgins Court attempted to establish that investment activity of the type Mr. Higgins was conducting would not be considered a trade or business. It left unresolved whether other types of activity might be considered trade or business activity. The cases following Higgins rewrote its proposition as if the Court meant that all types of investment activity fall short of trade or business recognition. In retrospect, the Court established the groundwork for a distinction between a passive and active investor that virtually all courts have failed to employ.

Reform is now necessary in order to prevent further uncertainty and to benefit the full-time, active investor whose activity clearly ought to fall within the category of trade or business. The facts and circumstances test is the framework within which trade or business determinations are made. The courts have used it in different con-

171. In particular, the Moller decision leaves a troubling result. The extensive level of activity exhibited there should at first glance satisfy those who would require a high quantitative level of activity. But the court in Moller implied that it was the wrong "type" of activity that was being performed at such a high level. From this result, it is difficult for the investor to conclude whether his activity is the right "type."
172. For a discussion of the passive standard established in Higgins, see supra note 56.
173. Whipple v. Commissioner, 373 U.S. 193, 202 (1963) (in holding that a taxpayer's involvement, service and investment in a single corporation is not conducting a trade or business, the Court emphatically stated that "investing is not a trade or business").
texts to mean different things. It has led to judicial picking and choosing as to which facts and which circumstances should be examined. A refocusing of the facts and circumstances test with an emphasis on qualitative factors will help to standardize the meaning of trade or business for the investor. A redefined concept of trade or business will rid this area of further uncertainty, deter unnecessary litigation and afford the full-time, active investor the benefits and drawbacks due every other similarly situated trade or business.

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