

Share traders vs share investors – making the right distinction in troubled economic times!

Up until recently, Australia’s sharemarket had enjoyed an extended period of growth, resulting in a huge increase in the number of people actively involved in share market activities. However, in recent times, the downturn in global financial markets has caused sharp falls in Australian share prices, resulting in many share owners incurring realised/unrealised losses.

Traditionally, the distinction between a share trader and a share investor has been an important one because of the different tax consequences that apply to each taxpayer. For example, a **share trader** can effectively deal with profits/losses from the sale of shares on revenue account, whereas a **share investor** is basically required to deal with profits/losses under the CGT rules.

However, following the recent downturn in financial markets, it is expected more individuals will attempt to classify themselves as share traders in order to claim deductions for realised losses.

How to make the right distinction – checklist of factors

The distinction between a share trader and a share investor depends on the specific facts and circumstances of each particular case. However, numerous court cases over the years have established a common set of factors that need to be considered in making this distinction. These cases include the following: *Investment & Merchant Finance Corporation Ltd v FC of T 71 ATC 4140*, *John v FC of T 89 ATC 4101*, *Case S33 85 ATC 297*, *Case W8 89 ATC 171*, *Case X86 90 ATC 621*, *Case 1/94 94 ATC 101*, *Case 9/94 94 ATC 154* and *Shields v DFC of T 99 ATC 2037*.

The following checklist will assist in classifying a taxpayer as a share trader or share investor. The checklist draws on ATO published guidelines (refer to the ATO’s fact sheet titled: “Carrying on a business of share trading”, and ATO IDs 2001/745 and 746) and tribunal/court decisions.

Factor to consider	Share trader v share investor
1. Taxpayer’s intention in buying shares	<p>A share trader will normally buy shares with the intention of making a profit from their sale in the short-term.</p> <p>However, the existence of a profit motive/intention does not of itself mean the existence of a share trader. For example, in Case 1/94, although the taxpayer had purchased shares so they could be sold for a profit, the taxpayer was not a share trader because there was no evidence of any regular, routine or systematic trading in shares.</p> <p>A share investor will normally buy shares with the intention of holding them for the long-term and earning dividend income and/or enjoying any capital growth from those shares.</p>
2. Business-like manner	<p>A share trader will undertake their share activities in a business-like manner, basically as follows:</p> <ul style="list-style-type: none"> (a) The taxpayer undertakes extensive research of companies in which shares are bought (e.g., analysing annual reports). (b) The taxpayer reads financial newspapers (e.g., the ‘Financial Review’), investment magazines, stock market reports, etc., and listens to financial reports, on a regular basis. (c) The taxpayer studies daily and longer-term trends and seeks advice from experts (e.g., share broker). (d) The taxpayer operates a particular pattern or system in selecting which shares to buy and sell (including the use of sophisticated techniques – e.g., charting shares).

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	<p>For example, in Case S33, one of the reasons the taxpayer was considered a share trader was because a system was applied in selecting which shares to buy (largely based on advice received from the taxpayer's husband). This involved a systematic analysis of a company's annual accounts and reports (including a financial ratio analysis – e.g., earnings per share and dividend yield).</p> <p>In contrast, in Case X86, the taxpayer was not considered a share trader. Although the taxpayer sought advice from his accountant and read the papers, he did not operate to any particular plan or system (apart from maximising profits) and did not conduct extensive research into the companies in which he invested.</p>
<p>3. Regularity and volume of share transactions (including Turnover)</p>	<p>A share trader is more likely to:</p> <ul style="list-style-type: none"> (a) buy and sell shares on a regular basis (i.e., there is a regular and systematic pattern of trading in shares); (b) hold shares for only a short period of time; and (c) have a high volume of transactions and turnover (from sales) in an income year. <p>For example, the following share transactions were held to be sufficiently regular, of sufficient volume and of sufficient turnover so as to render the taxpayer a share trader:</p> <ul style="list-style-type: none"> • Case S33 – over a four-year period, the taxpayer entered into 70 share transactions involving 17 companies, generating a turnover of \$166,000 from sales (this was an average of 17 share transactions and a turnover of \$40,000 per year). • Case W8 – in one income year, the taxpayer bought shares on 15 occasions and sold shares on 21 occasions (this was an average of 3 share transactions per month). • Shields's case – over the four week period that the taxpayer was a share trader, he bought and sold shares on 6 occasions. His turnover from sales was just over \$1 million. <p>On the other hand, a share investor is more likely to:</p> <ul style="list-style-type: none"> (a) buy shares on an ad hoc or spasmodic basis; (b) hold shares for a longer period of time; and (c) have a low volume of transactions in an income year. <p>For example:</p> <ul style="list-style-type: none"> • Case 9/94 – the taxpayer was not considered a share trader, partly because there was no evidence of any regular, routine or systematic trading in shares (i.e., the taxpayer's share purchases were spasmodic or ad hoc). Most of his share acquisitions were held for a number of years and were intended to be an investment for retirement (i.e., after the taxpayer had previously burnt his fingers in the stock market, he abandoned any intention to deal in shares regularly/routinely/systematically). • Case X86 (noted at 2. above) – the taxpayer's volume of share transactions was small (i.e., he only invested in 6 companies and only acquired one share parcel in five of those companies).

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Factor to consider	Share trader v share investor
4. Amount of capital that is invested	<p>The amount of capital a taxpayer invests in buying shares is not necessarily determinative of whether the taxpayer is a share trader or a share investor.</p> <p>It is possible to carry on a business of trading in shares with a relatively small amount of capital. For example, in Case W8, the taxpayer was considered a share trader, despite the total purchase cost of his shares (i.e., the amount invested) was only \$19,665.</p> <p>In contrast, a taxpayer may end up investing a substantial amount of capital and still be considered a share investor. For example:</p> <ul style="list-style-type: none"> • Case X86 – even though a total of \$100,000 was invested by the taxpayer, he was not considered a share trader. This was mainly because the number (or volume) of share transactions was small (as noted at 3. above) and there was no regular pattern of trading in shares. • Case 1/94 – the total amount invested by the taxpayer was \$645,903. Despite this, the taxpayer was not a share trader, because his share activities were not regular or systematic.
5. Business plan	<p>Although not compulsory, the existence of a business plan which outlines how a taxpayer's share activities will be conducted, assists in showing that the taxpayer is a share trader.</p> <p>A business plan may show, for example:</p> <ul style="list-style-type: none"> • an analysis of each potential share investment; • an analysis of the market(s) in which the taxpayer proposes to buy and sell shares; • research conducted by the taxpayer as to when or where a profit may arise; and/or • the basis of decisions as to when to hold or to sell shares.
6. Amount of time spent on share activities	<p>A share trader would likely spend a lot more time researching their share activities as compared with a share investor. That is, a share trader is likely to spend time on their share activities each day, whereas a share investor may only spend an hour or so per week.</p> <p>For example, in <i>Shields's case</i>, it was necessary for the taxpayer (who was a share trader) to pay close attention to share prices and volumes each day (i.e., by listening to the news each morning and calling his stockbroker on several occasions during the working day) in order to derive profits from his trading activities.</p>
7. Full time or part time	<p>A taxpayer can be a share trader whilst employed full time in some other occupation. However, if a taxpayer has no other job or occupation and earns their living from share activities, this would indicate that the taxpayer is carrying on a share trading business.</p>
8. Record keeping	<p>A share trader is more likely to keep records of share purchases and sales, including profits and losses on the sale of shares.</p> <p>In the absence of these records, it would be more difficult to establish that a business of share trading was being carried on.</p>

Share traders vs Share investors

The following examples can be used as a guide on how to apply the factors outlined in the above table when determining whether a taxpayer's share activities are share trading or share investing activities. The examples are partly adapted from the ATO's fact sheet: "Carrying on a business of share trading", and ATO IDs 2001/745 and 2001/746.

EXAMPLE – Share trader (adapted from ATO's fact sheet)

Gerry is an electrical engineer who becomes involved in share trading activities. To fund his activities, Gerry uses \$50,000 of his own funds and a \$100,000 loan from his bank.

Gerry conducts daily analysis and assessment of developments in equity markets, to identify any daily/long-term trends. The resources he uses include financial newspapers, investment magazines and stock market reports. Gerry's objective is to identify stocks that will increase in value in the short-term to enable him to sell at a profit after holding them for a short period.

During the year, Gerry conducts 60 share transactions (35 buying and 25 selling). The average buying transaction involved 500 shares at an average cost of \$1,000. The average selling transaction involved 750 shares at an average selling price of \$1,600. All the transactions were conducted through stockbroking facilities on the internet. The average time that shares were held before being sold was twelve weeks.

Gerry's activities resulted in a **tax loss of \$5,000** after expenses (including interest expense).

According to the ATO, Gerry's activities show **all** the factors that would be expected from a person carrying on a business (i.e., as a share trader), as follows:

- His activities demonstrate a profit-making intention (even though a loss has resulted) – that is, Gerry buys shares with the intention to make a profit on their sale in the short-term;
- His activities are repetitive, regular and systematic;
- His activities are organised in a business-like manner; and
- The volume of shares turned over is high, and Gerry has injected a large amount of capital into his share activities.

EXAMPLE – Share trader (adapted from ATO ID 2001/745)

Since resigning from full time employment, Marie has repeatedly traded in shares, as well as completing an intensive share trading course.

Marie has a trading plan and conducts extensive research and analysis using a variety of resources including the internet, libraries, computer programs, and screening techniques. Marie keeps monthly summaries of her trades and annual financial reports. All her buy and sell contracts have also been retained.

Whilst Marie's trading activities have not resulted in any profits, sufficient funds are available to keep her activity on-going for an indefinite period.

According to the ATO, Marie is carrying on a business of trading in shares because her circumstances are similar to those in the *Shields's Case*. That is, Marie's activities are conducted in a business-like manner and her system of trading is complex and requires a degree of knowledge and skill (it also involves the use of scientific calculations and trading models using skills and knowledge gained from her intensive training course).

Other influencing factors include the capital invested, the availability of funds to continue trading, and the business records maintained.

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EXAMPLE – Share investor (adapted from ATO ID 2001/746)

During the year, Anita bought 20,000 shares in six different companies at a cost of \$60,000. By the end of the year, she had sold 13,000 shares, which generated total sale proceeds of \$29,000. Her share activities were funded from her own savings and a bank loan.

Anita's shares activities have the following characteristics:

- She does **not** operate to a business or trading plan, other than to hold the shares for the short to medium term;
- She only spends a few hours per week on her share activities;
- Minimal records are kept by Anita; and
- She makes buy and sell decisions based on professional advice obtained from brokers' newsletters and e-mails. Some assistance is also sought from internet chat rooms, newspapers, and business programs on television and radio. Apart from this, no other research is conducted by Anita in relation to her share activities.

On occasions, Anita sold shares quickly to avoid substantial losses. Anita has conducted limited trading recently because of a downturn in the market and the absence of available funding. This has led to certain shares being retained, to avoid further losses being incurred.

According to the ATO, Anita's activities are conducted in a similar manner to that of a **share investor**, mainly because of the following reasons:

- There is **no** trading plan;
- Her method of operation is simple;
- Anita mainly relies on professional advice to make decisions about her investments;
- Limited time is spent on her share activities;
- Anita does **not** have a contingency plan in place to absorb market downturns and cannot secure a sufficient level of funding required to continue her activities; and
- Limited records are kept.

EXAMPLE – Share investor (adapted from ATO's fact sheet)

George is an accountant. He has bought 200,000 shares in twenty 'blue chip' companies over several years. His total share portfolio cost \$1.5 million.

George bought the shares because of consistently high dividends. He would not consider selling shares unless their price appreciated markedly. During the income year, George sold 20,000 shares. His sales generated a total gain of \$50,000.

According to the ATO, although George has made a large gain on the sale of shares, he would **not** be considered to be carrying on a business of share trading, because:

- his intention was to hold onto the shares for the long-term so that he could earn dividend income and enjoy some capital growth; and
- there is **no** evidence of any regular, routine or systematic trading in shares.

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Deduction checklist for share traders/share investors

The following checklist provides a **general guide** as to the deductibility of those expenses that are commonly incurred by share traders and share investors. The checklist also illustrates that a wider range of deductions is available to a share trader compared to a share investor.

Nature of expense	Deductible?		References
	Share trader	Share investor ①	
1. Purchase cost of shares	Yes	No ②	S.8-1, S.70-15
2. Brokerage fees – related to buying and selling shares	Yes	No ②	S.8-1, ATO ID 2002/844
3. Stamp duty – related to buying shares	Yes	No ②	S.8-1, ATO ID 2002/844
4. Interest – related to moneys borrowed to buy shares	Yes	Yes ③	S.8-1, IT 2606, TR 2004/4, and former ATO ID 2003/841
5. Travel expenses: ④ <ul style="list-style-type: none"> • to attend company AGM • to consult with a broker 	Yes Yes	Yes Yes	S.8-1, IT 39, ATO ID 2002/948
6. Share market information services – e.g., internet-based services such as news articles, share prices and volumes, broker research, etc. ④	Yes	Yes	S.8-1, TD 2004/1
7. Newspapers/investment journals – e.g., the 'Financial Review' and the 'Personal Investor' magazine ④	Yes	Yes	S.8-1, TD 2004/1
8. Internet access – related to managing a share portfolio (e.g., buying and selling, and research) ④	Yes	Yes	S.8-1, TD 2004/1
9. Computers ⑤	Yes	Yes	Division 40, Division 328
10. Seminars ⑥	Yes	Yes	S.8-1
11. Computer software ⑦	Yes	Yes	Division 40, former ATO ID 2002/106
12. Telephone/mobile phone costs – related to accessing live market share price information and/or liaising with share brokers, as part of carrying on a share trading business or managing an income-producing share portfolio	Yes	Yes	S.8-1, ATO ID 2002/831

Share traders vs Share investors

- ① *Where a share portfolio of an investor is managed with the sole aim of generating assessable capital gains, **no** deduction is allowable for expenses that relate to the portfolio, under S.51AAA of ITAA 1936.*
- ② *A share investor can include these costs as part of the cost base of their shares under the CGT rules – refer to S.110-25 of ITAA 1997.*
- ③ *Generally, a share investor can **only** claim a deduction for interest on moneys borrowed to buy shares where it is reasonable to expect that assessable dividends will be derived from those shares.*
- ④ *Deductions are basically **not** allowed to the extent they are incurred in the course of setting up an income-producing share portfolio (or are preparatory to setting up a share trading business), or to the extent they are of a private or domestic nature. Refer to TD 95/60 and TD 2004/1.*
- ⑤ *A deduction can be claimed for depreciation related to a computer, to the extent that the computer is used in a share trader's business or in managing a share investor's income-earning share portfolio. Any private use of a computer **cannot** be claimed. Refer to Division 40 and Division 328 of ITAA 1997.*
- ⑥ *A deduction is **only** allowed to the extent that the seminar relates to a share trader or share investor's current income-earning activities. For example, in relation to a share investor, a deduction will be available to the extent the seminar deals with how to manage the taxpayer's dividend-earning share investments (including how to maximise dividend yields on those investments).*

*The ATO will **not** allow a deduction to the extent that a seminar enables the taxpayer to gain the required knowledge and skills to establish a strategy or structure for trading/investing in shares. Refer to FC of T v Maddalena 71 ATC 4161.*
- ⑦ *A share trader can claim depreciation over 4 years (previously 2½ years) for the cost of software (acquired after 13 May 2008) that is used in the course of carrying out their share trading activities.*

This will also be the case for a share investor who uses the same or similar software to manage a share portfolio with the aim of deriving and/or maximising their dividend income. However, where there is a gross disproportion between deductions claimed and the amount of dividend income, the ATO may limit the taxpayer's deductions (potentially to the amount of income derived). Refer to Fletcher v FC of T 91 ATC 4950, TR 95/33 and paragraph 8 of TD 2004/1.