ELECTION OF MARK-TO-MARKET TREATMENT FOR SECURITIES TRADERS

By James H. Combs

Section 475(f) offers to a particular subset of taxpayers who buy and sell securities, securities traders, the opportunity to elect "mark-to-market" treatment of the gains and losses from their trade or business of securities trading.[1] An electing securities trader ("electing trader") no longer reports the gains and losses upon a "realization" event, such as a sale of the securities.[2] Instead, mark-to-market accounting requires a periodic determination of the electing trader's gains and losses on its trading securities. This accounting restricts tax minimization strategies generally available to taxpayers under realization accounting (*i.e.*, the ability to defer unrealized gains and accelerate unrealized losses).[3] Although the electing trader loses the timing advantages inherent in realization accounting, the Section 475(f) election may provide other advantages, such as relief from various limitations on the use of capital losses, that can improve the electing trader's after-tax returns from his securities trading activity. This article provides a brief overview of (i) eligibility to make the Section 475(f) election and the classification as a securities trader, (ii) the operation of Section 475(f), and (iii) the procedures for making the Section 475(f) election.

Section 475 and Securities Dealers, Traders and Investors

A "person who is engaged in a trade or business as a trader in securities" is eligible to make the Section 475(f) election.[4] None of Section 475, the regulations thereunder nor the legislative history provides a definition of a "trader in securities."[5] Nor do other Code provisions and regulations provide direct guidance. Therefore, one must review case law developed in other contexts to determine whether a particular taxpayer engages in a trade or business of trading in securities.

Taxpayers that buy and sell securities generally fall within one of three categories for federal income tax purposes: dealer, investor, or trader. "Dealers" carry on a trade or business and hold securities primarily for sale to customers.[6] "Investors" are generally taxpayers who buy and sell securities for long-term capital appreciation, but their activity does not rise to the level of a trade or business.[7] The securities trader encompasses a third subset of taxpayers who buy and sell securities as a trade or business, but who do not have customers.[8] The distinctions between buying and selling securities as an investment activity or as a trade or business activity have been developed in cases dating back to the first half of the twentieth century.[9]

Higgins v. Commissioner[10] was an early Supreme Court case addressing the issue of whether a taxpayer was engaged in the trade or business based on his securities activities. In the *Higgins* case, the taxpayer attempted to deduct expenses incurred in connection with the handling of his substantial portfolio under the predecessor to Section 162.[11] Higgins maintained two offices, "kept a watchful eye over his securities," had records kept and reports made, and directed purchases of securities through a financial institution. The Court noted that the taxpayer "sought permanent investments," but had some "limited shiftings in his portfolio" due to changes, redemptions, maturities and accumulations. The Court stated that the determination of whether a taxpayer is engaged in a trade or business involves a facts and circumstances analysis. Based on the facts and circumstances before it, the Court concluded that Higgins was not engaged in a trade or business because he "merely kept records and collected interest and dividends from his securities, through managerial attention for his investments."[12]

Over the years, the lower courts developed a test for classifying taxpayers as securities traders rather than investors based on three primary factors: (i) intent to carry on a trade or business, (ii) the buying and selling of securities as a frequent and continuous activity, and (iii) the seeking of profits from short-term price swings rather than from interest, dividends and capital appreciation.[13] The Tax Court recently applied the common law securities trader test in what appears to be the first case arising after the enactment of Section 475(f) that involves the issue of whether a securities trading activity rose to the level of a trade or business.[14] In *Frank Chen v. Commissioner*,[15] a *pro se* case, the taxpayer asserted that his buying and selling of securities (both short and long trades) rose to the level of a trade or business. Chen, who worked full time as a computer chip engineer, completed 323 transactions in the first seven months of 1999, with the bulk of the activity occurring in February, March and April. Chen used "real time" information systems to obtain current market information and his trades were of relatively short duration (less than one month on average).

The Tax Court found that Chen did not establish that he carried on a trade or business of buying and selling securities. The Tax Court applied the three factor formulation of the trade or business test set forth above: intent, frequency and continuity of activity, and nature of the income derived.[16] The Tax Court stated that Chen's daily trading over a three-month period seemed to clearly satisfy the requirement that trades attempt to catch market swings. However, the Tax Court determined that Chen did not satisfy the "frequent, regular, and continuous" activity prong of the trader test. According to the Tax Court, Chen's securities activities did not meet this test because he had conducted most of his trading activity in only three months of the year and he also had another full-time job. The Tax Court stated that, in the cases upholding securities trader status, "the number and frequency of transactions indicated that they were engaged in market transactions almost daily for a substantial and continuous period, generally exceeding a single taxable year; and those activities constituted the taxpayers' sole or

primary income-producing activity."[17] The Tax Court concluded that daily trading for 3 months was "sporadic," and found that Chen was not a securities trader.[18]

Applying the case law, a taxpayer who does not intend to purchase and sell securities for investment purposes, has a large volume of trades, and has predominantly short-term capital gains can sustain trader status. It also appears to be helpful, in light of the Tax Court's decision in *Chen* (whatever the merits of the court's reasoning),[19] if such trading activity is carried on for more than one year and is a full-time occupation. Qualification as a securities trader would then permit the taxpayer to make the Section 475(f) election.

OPERATION OF SECTION 475(f)

Securities traders have a timing option under realization accounting.[20] However, securities traders are also subject to various loss limitation rules. Section 475(f) provides securities traders an alternative for accounting for securities trading gains and/or losses that can mitigate the impact of these rules. The securities trader has the choice of continuing to use realization accounting or can opt in to the mark-to-market accounting regime of Section 475(f).

Once an effective election is made, the electing trader treats each security "held in connection" with his securities trading business as sold and then immediately repurchased at its fair market value ("FMV") on the last business day of his taxable year.[21] The electing trader's gain or loss for each security equals the difference between his adjusted basis in the security and its FMV.[22]

The mark-to-market income or loss, and any income or loss from securities subject to mark-to-market accounting that are sold before the end of the taxable year, is ordinary in character rather than capital (as would be the case for a dealer or a non-electing trader).[23] This provides the following benefits to the electing trader:

- An electing trader can deduct losses from trading securities against ordinary income, without the limitations imposed by Section 1211.
- An electing trader can carry net operating losses back two years and forward twenty years under Section 172.

The electing trader also is excepted from other rules that address issues arising under realization accounting:[24]

- The wash sale rules of Section 1091 do not apply to an electing trader.[25]
- The constructive sale rules of Section 1259 are limited in their application to electing traders.[26]

Importantly, for securities traders that also hold investment securities, Section 475(f) permits the electing trader to segregate his trading and investment activities.[27] If an electing trader clearly identifies a security before the close of the day on which it was acquired, originated, or entered and the security has no connection to the trading activities of the securities trader, then Section 475(f) will not apply to that security.[28]

PROCEDURE FOR ELECTING UNDER SECTION 475(f)

Section 475(f)(3) states that taxpayers are not required to obtain the consent of the Secretary of the Treasury to elect under Section 475(f).[29] The legislative history provides that the I.R.S. can prescribe the method for making the Section 475(f) election.[30] The I.R.S. has published rules for making the Section 475(f) election in Revenue Procedure 99-17[31] which rules are summarized in relevant part below. These rules are specific and, in private letter rulings ("PLR"), the I.R.S. has not granted relief to taxpayers requesting permission to file a late Section 475(f) election.[32] In order to comply with the I.R.S.' rules, a taxpayer must file a statement by the due date of his original tax return (without regard to extensions) for the tax year immediately preceding the tax year for which the Section 475(f) election is being made.[33] For taxpayers requesting an automatic extension for the filing of their return, the statement must be filed with the extension request on or before the due date for filing the request. A different rule applies to a "new" taxpayer, *i.e.*, a taxpayer that did not file a return in the tax year immediately before the tax year for which the Section 475(f) election is to be effective. New taxpayers must make a statement in their books and records no later than the 15th day of the third month after the beginning of the election year and file a copy of the statement with their tax return for the election year. The statement that the electing trader files must provide information on the election being made (*e.g.*, "Election Under Section 475(f)"), must identify the first tax year for which the election is effective, and must identify the trade or business for which the Section 475(f) election is made.

The change to mark-to-market reporting is treated as a change in method of accounting subject to Sections 446 and 481.[34] Although the I.R.S. may require a taxpayer to obtain its consent before the taxpayer can change its method of accounting, this consent is automatically granted where the electing trader satisfies the rules for making the Section 475(f) election, changes to a method of accounting in accordance with its Section 475(f) election, makes the change for the first tax year for which the election is effective, and meets the following filing requirement.[31] An electing trader must file an I.R.S. Form 3115 (Application for Change in Accounting Method) for the year of the change with his timely filed return (including extensions).[35] A copy of this form must be filed with the National Office of the I.R.S.. The Form 3115 must be labeled with a reference to Section 10A of the Appendix to Revenue Procedure 2002-9.[36]

CONCLUSION

The Section 475(f) election presents securities traders with the opportunity to elect an alternative method of taxation for their securities gains and losses. Securities traders may benefit from better matching of income or losses in their securities positions without the application of various tax law restrictions. When considering how to report one's buying and selling of securities as either a trade or business or an investment activity and whether one is eligible to make the Section 475(f) election, taxpayers must

first determine whether they can sustain the position that they are a trader. The taxpayer must then determine whether a Section 475(f) election will provide benefits (*e.g.*, from the broader ability to utilize any securities trading losses) that outweigh any detriments (*e.g.*, from the loss of any ability to time, for tax purposes, gains or losses from trading securities). The Section 475(f) can prove to be a valuable option for securities traders, but one that must be carefully evaluated.

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ENDNOTES

1. All "Section" or "§" references are to sections of the Internal Revenue Code of 1986, as amended ("Code"), or the Treasury regulations promulgated thereunder. The term "securities" for purposes of Section 475(f) is defined in Section 475(c)(2), and includes stocks, bonds, notional principal contracts, etc. *See also* Treas. Reg. § 1.475(c)-2; Prop. Reg. § 1.475(c)-2.
2. For a discussion of realization accounting, see Bittker & Lokken, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS (2nd/3rd Ed. 2005), ¶5.2.
3. For a broad discussion of mark-to-market accounting before the enactment of Section 475(f), see Kleinbard and Evans, *The Role of Mark-to-Market Accounting in a Realization-Based Tax System*, TAXES (December 1997).
4. Section 475(f)(1). The mark-to-market election is also available to commodities traders. Section 475(f)(2). Section 475(f) was enacted in 1997. P.L. 105-34, § 1001(b).
5. The legislative history to the enactment of Section 475(f) only states that "[t]raders in securities generally are taxpayers who engage in a trade or business involving active sales or exchanges of securities on the market, rather than to customers." S. Rept. No. 105-33 (P.L. 105-34), at 128.
6. *See George R. Kemon, et al.* 16 T.C. 1026 (1951). A definition of a "dealer in securities" for purposes of Section 475 is set forth in Section 475(c)(1). Section 475(a) requires securities dealers to mark securities to market, subject to certain exceptions. This mandatory mark-to-market accounting eliminated the use of previously allowed inventory accounting methods. Dealers had theretofore accounted for their inventory of securities using cost, the lower of cost or market, or market value. This permitted potential acceleration of losses and deferral of gains. *See* H. Rept. No. 103-11 (P.L. 103-66), at 660. Section 475(e) applies an elective mark-to-market accounting for dealers in commodities.
7. For investors, a category that includes most individual taxpayers, the tax treatment is generally familiar. For example, securities gains and losses are taxed under realization accounting, gains and losses are treated as capital items, capital gains may be taxed at preferential rates, capital losses may be subject to limitations, investment expenses under Section 212 are treated as "below the line" miscellaneous itemized deductions, interest expense deductions may be limited under Section 163(d), etc.
8. Securities traders are taxed in some ways in the same manner as investors (*e.g.*, gains and losses are capital), but in other ways receive potentially more favorable treatment (*e.g.*, trading expenses are "above the line" deductions under Section 162, Section 163(d) is inapplicable, etc.).
9. Case law similarly addresses the distinction between securities dealers and traders. *See, e.g., Kemon, supra.*
10. 312 U.S. 212 (1941).
11. The *Higgins* case preceded the enactment of the current Section 212, so the taxpayer's ability to deduct the expenses at issue relied exclusively on the existence of a trade or business.
12. The Supreme Court last spoke on the "trade or business" issue in the Section 162 context in *Commissioner v. Groetzinger*, 480 U.S. 23 (1987), a case involving the expenses of a full time gambler.
13. Cases that have addressed the securities trader/investor issue include, *e.g., Paoli*, T.C.M. 1988-23; *Moller v. U.S.*, 721 F.2d 810 (CA Fed. Cir. 1983); *Liang*, 23 T.C. 1040 (1955); *Fuld v. Commissioner*, 139 F.2d 465 (CA-2 1943); *Estate of Yaeger v. Commissioner*, 889 F.2d 29 (CA-2 1989). *See* Lorence, Green, and Terhune, *Trader vs. Investor Status – Responding to I.R.S. Positions*, 5 DERIVATIVES No. 12 (August 2004). For a dissection of the considerations involved in determining securities trader status, see Schwartz, *How Many Trades Must a Trader Make to be in the Trading Business?* 22 VA. TAX. REV. 395 (Winter 2003).
14. This case also appears to be the first case to involve a "day trader," a phenomenon that increased in the late 1990s. *See* Robison and Mark, *Online Transactions Intensify Trader vs. Investor Question*, PRACTICAL TAX STRATEGIES (February 2001); Thomas, *Trading, but Not a Trader*, TAX NOTES (July 19, 2004); *Schwartz, supra* note 13.
15. T.C.M. 2004-132.
16. The Tax Court cited *Moller, supra.* Other cases cited by the Tax Court include *King v. Commissioner*, 89 T.C. 445 (1987), *Liang, supra, Boatner*, T.C.M.. 1997-379, *aff'd*,164 F.3d 629 (CA-9 1998), and *Groetzinger, supra.*
17. The Tax Court cited *Levin v. U.S.*, 597 F.2d 760 (Ct. Cl. 1979) and *Fuld, supra*, on this point. For an analysis suggesting that the Tax Court may have been too quick to rule against Chen, see Lorence, Green and Terhune, *supra* note 13, at 4; cf. *Schwartz, supra* note 13, at 440. Other facts presented in the case suggest that Chen, notwithstanding his losses, was not the most sympathetic taxpayer. For example, it did not appear helpful to Chen that he did not initially report his securities trades as part of a trade or business (*i.e.*, he did not report his trades on Schedule C).
18. This conclusion, in turn, obviated the need to review the timeliness of Chen's attempted Section 475(f) election. The Tax Court's decision in *Chen* could have been decided based on Chen's failure to make a timely election under the I.R.S.'

procedural guidelines. The I.R.S. presented this argument in addition to the securities trader argument. Some commentators have concluded that the discussion of securities trading in the *Chen* case is *dicta* because Chen made an election that did not comply with the I.R.S.' procedural rules. *See* Lorence, Green and Terhune, *supra* note 13, at 3.

19. *See* Lorence, Green and Terhune, *supra* note 13.
20. Although capital in nature, trading gains and losses generally would not be long-term (and thus potentially eligible for preferential long-term capital gains rates for individuals) because of the nature of a securities trading activity.
21. Section 475(f)(1)(A). The principles of Section 475 set forth in guidance applicable to securities dealers apply to electing traders, unless provided otherwise. Prop. Reg. § 1.475(f)-2(c).
22. Section 1001(a). Section 475(f)(1)(A) also states that "Proper adjustment shall be made in the amount of any gain or loss subsequently realized for gain or loss taken into account under the preceding sentence. The Secretary may provide by regulations for the application of this subparagraph at times other than the times provided in this subparagraph." Proposed regulations have been promulgated by the I.R.S.. Prop. Reg. § 1.475(f)-1 and Prop. Reg. § 1.475(f)-2.
23. Section 475(f)(1)(D) (cross-referencing Section 475(d)). Section 475(d)(3) treats mark-to-market income and losses as ordinary in character. *See also* Prop. Reg. § 1.475(f)-2(b) The Section 475(f) election does not cause a trader to become subject to self-employment tax. Section 475(f)(1)(D); Section 1402(a)(3)(A).
24. The straddle rules of Section 1092, which generally defer losses from a position in securities when there are unrealized gains in an offsetting position, continue to apply to an electing trader. Section 475(f)(1)(D) (cross-referencing Section 475(d)). However, the straddle rules have less relevance when both positions are subject to mark-to-market treatment.
25. Section 475(f)(1)(D) (cross-referencing Section 475(d)). The wash sale rules generally defer a taxpayer's loss from a sale or disposition of securities if the taxpayer acquired substantially identical securities within the thirty days before or after the sale or other disposition. Section 1091(a). This prevents a taxpayer from taking an immediate tax loss for depreciated securities (by selling the securities) while remaining in substantially the same economic position (by purchasing the same securities).
26. Section 475(f)(1)(C). Section 1259 is a more limited mark-to-market provision. Taxpayers that eliminate substantially all of the their risk of loss and opportunity for gain with respect to appreciated financial positions by entering into specified types of transactions are deemed to have sold the appreciated financial position. Section 1259(a).
27. Section 475(f)(1)(B); Prop. Reg. § 1.475(f)-2(a).
28. Section 475(f)(1)(B); Prop. Reg. § 1.475(f)-2(a), (d). If a security initially identified as having no connection to the securities trading trade or business subsequently develops a connection, then Section 475(f) applies to the changes in value that result after the date of such connection. Section 475(f)(1)(B).
29. An electing trader must continue to use mark-to-market accounting for subsequent years. The election can only be revoked with the consent of the Secretary of the Treasury. Section 475(f)(3).
30. H.R. Conf. Rep. No. 105-220, (P.L. 105-34) at 516. See also Prop. Reg. § 1.475(f)-1(a) (a Section 475(f) election must be made in the time and manner set forth by the I.R.S.).
31. 1999-1 C.B. 503, modified in part by Revenue Procedure 2002-9, 2002-1 C.B. 327.
32. *See* P.L.R. 2004-29-011, P.L.R. 2003-04-006, P.L.R. 2002-09-054, P.L.R. 2002-09-053, and P.L.R. 2002-09-052. In Technical Advice Memorandum 2004-23-015, the I.R.S.' National Office advised that a taxpayer did not properly elect under Section 475(f) pursuant to Revenue Procedure 99-17. The taxpayer had not filed the election by the due date (without regard to extensions) for his tax return for the tax year immediately preceding the year in which the election was to be effective. In Chen, supra, the Tax Court did not reach the issue of whether an election that failed to comply with the I.R.S.' guidelines could be effective because it determined that the taxpayer was not a securities trader eligible to make the election. The Tax Court subsequently upheld the requirements of Revenue Procedure 99-17, which are stated to be the exclusive method for making the Section 475(f) election. See *Ronald Lehrer, et ux. v. Commissioner*, T.C.M. 2005-167.
33. One method recommended for establishing a trading activity after the time for filing a return for the calendar year is to establish a partnership to conduct the trading activity. *See* Raby and Raby, *Effect of 'Sporadic' Trading on Security Dealer Status*, 2004 TNT 112-12 (June 10, 2004). The Rabys note that the use of a separate trading entity may also avoid issues relating to the required Section 481 adjustment (discussed below), the termination of the election and the sporadic trading issue. For similar recommendations, see Lorence, Terhune and Green, *Practical Tax Strategies for Section 475(f) Elections*, DERIVATIVES REPORT, Vol. 6 No.7 (March 2005).
34. As a result of the change in method of accounting, the electing trader may have to make a "Section 481 adjustment" as provided in Revenue Procedure 98-60, 1998-2 C.B. 761, if the electing trader has filed returns as a securities trader in prior years and holds appreciated or depreciated securities in its trade or business at the time of the election.
35. A securities trader can file the Section 475(f) election notwithstanding the scope limitations of Section 4.02 of the Revenue Procedure (*e.g.*, taxpayers under audit generally are not within the scope of Revenue Procedure 2002-9 for a change in method of accounting), but certain requirements must be met. Section 10A.02(2)(b) of Revenue Procedure 2002-9.
36. The filing requirement is outlined in I.R.S. Publication 550, *Investment Income and Expenses* (2004), Chapter 4.