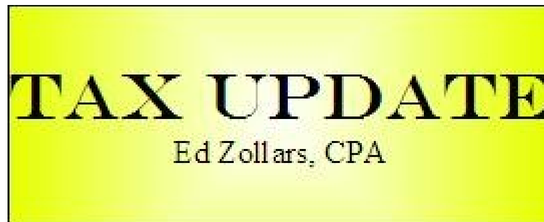

Maybe Not Better Late Than Never—Mark to Market Election under §475(f)
Podcast of December 31, 2006

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Traders and the §475(f) Election

Sometimes the rules we work under in the tax arena are not terribly forgiving for those who are not well informed. This week's example comes from a provision that is not forgiving largely because to allow taxpayers to be saved from their own ignorance would open the door for what the IRS is concerned would be abuses by taxpayers who, not liking the consequences of their original decision, would develop sudden amnesia regarding their knowledge of the election.

The issue we are looking at is the mark to market election that is available to traders under §475(f) under the terms described in Revenue Procedure 99-17. In this case, the taxpayers in question ended up with a "lifetime supply" of capital loss carryover when their attempt to get their late election accepted by the IRS and then the Tax Court fell on deaf ears. The case in question is *Knish v. Commissioner*, TC Memo 2006-268.

Traders in Securities

During the dot com boom of the late 1990s, daytrading came into vogue among many taxpayers who felt that the stock market represented "easy money" they could make just sitting in front of their PC and making trades. Taxpayers who truly got into daytrading would qualify to be treated as a *trader* for income tax purposes.

Note that qualifying as a trader is not a mechanical test, nor is it always clear when a taxpayer crosses the line into that category—and that would be a whole podcast on its own. However, for today's podcast we'll grant that the taxpayers have met those qualifications. Once a taxpayer does so, they are in a trade or business and that means most of their deductions related to the activity now fall under §162 (trade or business expense) rather than §212 (expenses for the production of income). The nice thing about §162 deductions is that, if not incurred as an employee, those expenses are both a) deductible in computing gross income (thus, are "above the line" rather than miscellaneous itemized deductions) and b) can give rise to a net operating loss.

However, that doesn't change the nature of the gain or loss on the sales of the underlying securities. The securities are not "stock in trade" as defined by §1221(a)(1) which would yank them out from under the default classification as capital assets under §1221(a)[1]. Nor do any of the other exceptions to that general definition apply.

Unfortunately, that means that the limit on the deduction of net capital losses found at §1211(b) applies to such losses. While many of our clients *thought* daytrading was a can't lose proposition, the majority found that it's a lot tougher than it looks—and really difficult when you can't do it with hindsight, the way they did when they convinced themselves that this was easy money. Quite often the taxpayer entered daytrading when they came into a bit of good fortune (such as those with stock options in the late 1990s) and proceed to eliminate that fortune via their day trading losses. So such taxpayers end up with a large capital loss carryover and no obvious future source of large capital gains to offset it.

Mark to Market Election

Congress does provide some relief in this situation, but only to taxpayers who properly elect under a special provision of the IRC. That section is Section 475, which provides a unique accounting method that is available to traders who elect to use it.

1 §1221(a) generally includes everything as a capital asset by default, and then proceeds to "throw out" various items. Specifically, the section starts out by defining capital assets as "property held by the taxpayer (whether or not connected with his trade or business)..."

The accounting method option is the mark to market method of accounting for the securities, described in §475(a):

> (f) Election of mark to market for traders in securities or commodities
>
> (1) Traders in securities
>
> (A) In general
>
> In the case of a person who is engaged in a trade or business as a trader in securities and who elects to have this paragraph apply to such trade or business--
>
> (i) such person shall recognize gain or loss on any security held in connection with such trade or business at the close of any taxable year as if such security were sold for its fair market value on the last business day of such taxable year, and
>
> (ii) any gain or loss shall be taken into account for such taxable year.
>
> 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.

At first glance this may not seem to make sense to make this election—after all, presuming your taxpayer is making money trading securities, we'd assume that there's a good chance the positions he/she is holding at year end would be appreciated. Or, at least, we'd like the option of deciding when the market closes whether to take the gains.

Well, first generally a true trader wouldn't want to have many (if any) positions open through a holiday like New Year's. So this election isn't quite as much against the taxpayer's interests as it might appear at first glance. But, given we'd expect few positions to be open, why would we want to bother with what would then be an immaterial amount?

Because of the rule invoked by §475(f)(1)(D) that applies the ordinary gain/loss treatment found at §475(d)(3)(A). Now ordinary gain isn't that great of a deal (if we have capital losses from other activities we can't use these gains to burn them), but ordinary loss is a big deal if we have large losses. Because now there's no $3,000 limit. As well, these losses now can create a net operating loss under §172 which could allow taxpayers to recover taxes from earlier years (which often they had a lot of—that's why they could srat their day trading activity in the first place).

Note that while the election can be made without the consent of the IRS, once made the

election cannot be revoked without the consent of the IRS (§475(f)(3)).

Election

As should be clear, if a taxpayer had his/her choice they'd make this election once they knew they had underestimated the difficulty of making money from day trading. Well, the IRS thought that maybe this wasn't such a great place to allow for after the fact decision making, and in Revenue Procedure 99-17 provided the rules for making this election.

Section 5 of that Revenue Procedure provides:

> .03 Elections effective for a taxable year beginning on or after January 1, 1999.
>
> (1) General procedure. Except as provided in section 5.03(2) of this revenue procedure, for a taxpayer to make a section 475(e) or (f) election that is effective for a taxable year beginning on or after January 1, 1999, the taxpayer must file a statement that satisfies the requirements in section 5.04 of this revenue procedure. The statement must be filed not later than the *due date (without regard to extensions) of the original federal income tax return for the taxable year immediately preceding the election year* and *must be attached either to that return or, if applicable, to a request for an extension of time to file that return*.
>
> (2) New taxpayers. A new taxpayer is a taxpayer for which no federal income tax return was required to be filed for the taxable year immediately preceding the election year. A new taxpayer makes the election by placing in its books and records no later than 2 months and 15 days after the first day of the election year a statement that satisfies the requirements in section 5.04 of this revenue procedure. To notify the Service that the election was made, the new taxpayer must attach a copy of the statement to its original federal income tax return for the election year.
>
> .04 Required statement. *The statement must describe the election being made, the first taxable year for which the election is effective*, and, in the case of an election under section 475(f), the trade or business for which the election is made.

Note the due date for the election—by the *original due date* (without regard to extensions) for the tax return for the year *preceeding* the year you wish for the election to be effective.

Thus, a taxpayer that now sees they have large trading losses for 2006 needed to have made the mark to market election back last April, either on their 2005 personal income

tax return or attached to their request for an extension of time to file the return.

Knish Case

This brings us to this week's case—that of *Knish v. Commissioner*, TC Memo 2006-268. The Knishes had an S corporation (SPK) that sold off its operating assets in February 2000 and then began a trading operation with some of those assets in 2000 that continued through 2001. Mr. Knish also did some trading with his own personal funds.

Mr. Knish timely filed the 1999 income tax returns for both himself and the corporation and, in neither case, was there a §475(f) election attached to the return. As is clear, that violated the requirements of Revenue Procedure 99-17.

The Tax Court describes Mr. Knish's later attempt to make an election:

> Petitioners and SPK each attempted in 2001 to make a mark-to-market election for their securities trading activity, intending that the elections be effective beginning in 2000. Petitioners and SPK each filed Form 3115, Application for Change in Accounting Method, with respondent and noted at the top that the forms were filed pursuant to section 301.9100-2, Proced. & Admin. Regs (section 9100). Petitioners filed their Form 3115 in October 2001, and SPK filed its Form 3115 in September 2001. Neither petitioners nor SPK submitted any other document to respondent seeking to elect the mark-to-market method of accounting.

As you may recall from an earlier podcast, Reg. §301.9100-2 provides for automatic relief from late elections in certain circumstances, while Reg. §301.9100-3 provides for discretionary relief. This particular item does not appear to qualify for automatic relief, but the Tax Court did address whether discretionary relief applies.

As you might have guessed, Mr. Knish didn't turn out to have stellar performance in picking stocks. In fact, he generated large losses which, presuming his §475(f) election is valid, created net operating losses that he attempted to carry back. As might also be expected, the IRS denied a current deduction for all losses in excess of $3,000, forcing them to be carried forward as capital losses, arguing that Mr. Knish did not have a valid §475 election.

But I Asked Nicely...

The taxpayers decided to ask the IRS to grant the election by pursuing a letter ruling. The Tax Court noted the results of that endeavor:

> Petitioners and SPK both requested that respondent issue letter rulings concerning the effectiveness of their mark-to-market election under section 475(f) for 2000. Petitioners and SPK also stated in their ruling requests that they

> should be granted administrative relief from a late election under section 9100. Petitioners and SPK each withdrew their requests for letter rulings when they learned that the pending letter ruling requests would be decided adversely to them.

Not getting relief via that means, Mr. Knish ended up in court over the issue.

On to Court

The IRS argued both that there was not a valid election and, just in case the court held that the election was valid, that the activity did not rise to the level of a trade or business (an issue that's always a potential bone of contention when a taxpayer gets into and out of trading over a rather short period). The Tax Court only decided the issue of the validity of the election.

Note that the IRC itself did not provide a time period under which the election had to be made. The Court held the IRS had the authority to set that date:

> We look to the legislative history of section 475 to determine congressional intent because the statute is silent as to the procedures that must be followed to make a mark-to-market election. See *Lehrer v. Commissioner*, supra. The legislative history indicates that the Secretary has authority to prescribe the time and manner of the mark-to-market election. H. Rept. 105-148, at 446 (1997), 1997-4 C.B. (Vol. 1) 323, 768; see *Lehrer v. Commissioner*, supra.

The court noted that the elections that were made did not come close to meeting the requirements of Revenue Procedure 99-17:

> Petitioners and SPK argue that they made effective mark-to-market elections for 2000. We disagree. Petitioners and SPK were required to attach a statement electing the mark-to-market accounting method to their respective tax returns for 1999 to timely make a mark-to-market election for 2000. *Id.* Neither petitioners nor SPK attached any election statement to the 1999 return.[3] Instead, petitioners filed their election statement in October 2001, and SPK filed its election statement in September 2001 with respect to their returns for 2000. They did not attach any election statements to their returns for 1999. The election statements they did file were each nearly 18 months late. Accordingly, we conclude that petitioners and SPK did not make effective mark-to-market elections in compliance with Rev. Proc. 99-17, supra, for tax year 2000.

Mr. Knish then argues that even if it wasn't effective for 2000, it should be effective for 2001. The Court disagreed, noting:

> Petitioners argue in the alternative that their and SPK's ineffective attempts to make mark-to-market elections for 2000 should nevertheless be construed as valid elections for 2001. We disagree. Petitioners have not cited any authority for us to ignore the year in which they designated the election to be effective. There is no basis in Rev. Proc. 99-17, supra, to construe the unsuccessful attempted mark-to-market elections for 2000 to be effective elections for 2001 instead. Rev. Proc. 99-17, supra, requires that the statement used to make the election specify the first taxable year for which the election is effective.[4] *Id*. sec. 5.04, 1999-1 C.B. at 505. Petitioners' and SPK's election statements designated 2000, not 2001, as the first taxable year for which the election was to be effective. Petitioners and SPK accordingly never made an election for 2001. Instead, petitioners ask us to construe their invalid attempt to make an election for 2000 as a valid election for 2001. We decline to do so.
>
> Moreover, the unsuccessful attempted elections for 2000 were untimely even for tax year 2001. Mark-to-market election statements for 2001 would have had to be filed with SPK's and petitioners' tax returns (or requests for extensions) by the due dates of petitioners' and SPK's tax returns for 2000.[5] *Id*. sec. 5.03. Petitioners and SPK each attached their Forms 3115 to their respective tax returns for 2000 that they filed in October 2001 and September 2001 pursuant to extensions. Although petitioners and SPK each requested extensions to file their returns for 2000, they each failed to attach their Forms 3115 to their requests for extensions to file as required. SPK's and petitioners' requests were therefore similarly untimely for 2001. See id. We conclude that petitioners and SPK did not make effective mark-to-market elections under section 475(f) for 2001.

Note that the Court holds that even if this 3115 had been filed before April 15, 2001, the fact that it attempted to be valid for 2000 would have rendered it not a valid election for 2001 since it specified the earlier year—an election that no longer could be made.

But a Rev. Proc. Is Not a Regulation!

The taxpayers next tried to argue that the IRC requires the IRS to issue regulations to govern these provisions, and that therefore they should not be bound to a Revenue Procedure. The Court did not accept that reasoning, holding:

> Petitioners also argue that Rev. Proc. 99-17, supra, is invalid because section 475(g) restricts the Commissioner's ability to prescribe the time and manner of the mark-to-market election only by regulation, not by issuing procedures. We disagree. We have previously considered the validity of Rev. Proc. 99-17, supra, and concluded that the Commissioner issued it under the Secretary's general authority to prescribe the time and manner of the mark-to-market election.

> *Lehrer v. Commissioner*, T.C. Memo. 2005-167. We also noted in Lehrer that the taxpayers' election was so late that even without looking to Rev. Proc. 99-17, supra, for guidance, we would still have concluded that the taxpayers were not entitled to change their method of accounting. *Id*. (citing *Pac. Natl. Co. v. Welch*, 304 U.S. 191, 194-195 (1938), and *Wierschem v. Commissioner*, 82 T.C. 718, 722-724 (1984)).
>
> We conclude, as we did in Lehrer, that Rev. Proc. 99-17, *supra*, was validly issued under the Secretary's authority to prescribe the time and manner of the election. *Lehrer v. Commissioner*, *supra*. Moreover, petitioners' and SPK's attempted elections were nearly 18 months late. We find, as in Lehrer, that these attempted elections were too late to allow petitioners and SPK to change their accounting method even absent the guidance of Rev. Proc. 99-17, *supra*.

So we have the court both holding that the Revenue Procedure is valid and, even if it were not, the election in this case is so late that it's unreasonable to allow the election even if no guidance existed.

How About §301.9100-3?

Finally, the taxpayers argue they should have been granted late election relief under §9100. While the Court noted that this argument appears to have been raised late, they did not see it as valid in any event.

The Court notes that in order to qualify for releif under Regulation §301.9100-3 the taxpayer must show they acted reasonably and in good faith, and that a grant of relief would not prejudice the interests of the Government. The Court goes on to note that:

> A taxpayer is deemed not to have acted reasonably and in good faith if the taxpayer uses hindsight in requesting relief. Sec. 301.9100-3(b)(3)(iii), Proced. & Admin. Regs. The Commissioner ordinarily will deny relief if specific facts have changed since the due date for making the election that make the election advantageous to a taxpayer. *Id*. A taxpayer attempting to make a mark-to-market election years after it is due (while continuing to trade in the meantime) in an attempt to convert capital losses to ordinary losses is a classic example of a taxpayer seeking to use hindsight. *Vines v. Commissioner*, supra at 293-294 (describing the facts of *Lehrer v. Commissioner, supra*, as a classic example of taxpayers seeking benefit of hindsight); *Acar v. United States* , 98 AFTR 2d 2006-6296, 2006-2 USTC par. 50,529(N.D. Cal. 2006). This is precisely what petitioners and SPK are attempting to do.

While the taxpayers cited the *Vines* case as an example of one where the Tax Court did

hold that §301.9100-3 should be granted for a late §475(f) election, the court noted that in the Vines case the taxpayer filed the election only a few months late, and conducted no trading activity between the date the election should have been filed and when it was actually filed—so Mr. Vines did not get to include "additional information" on later losses when he finally got around to making his decision.

Tax Professional's Issue

This election poses risks for tax professionals. First, you and your staff need to recognize that the election exists and if your firm becomes aware that someone has started day trading between now and April 15, 2007 you need to consider discussing the option of the election with the client. Unfortunately due to the date requirements in Revenue Procedure 99-17, this is not something that can be dealt with after tax season.

As well, it's important to document that you gave the client full disclosure of the option prior to the date the election was due, and that the client elected not to make the election. Once 2007 ends, taxpayers may find they would have been much better off had they made the election. If they find that they weren't informed that this election existed, you may find yourself in an uncomfortable position.