**Comments on IRS Section 475 Clean Up Project – May 14, 2015**

The IRS recognizes problems with tax rules for active traders including Section 475 marked-to-market (MTM) reporting, Section 1091 wash sale loss rules and trader tax status (business treatment).

These problems are connected. Only a trader who qualifies for trader tax status may elect and use Section 475(f) MTM ordinary gain or loss treatment. Otherwise with the default "realization method" (cash method), securities trades are subject to Section 1091 wash sale loss rules and capital gain and loss treatment. Wash sale rules are a huge problem for active securities traders; non-compliance is widespread and the IRS is not enforcing the rules. That is unsustainable.

**Trader tax status is a requirement for Section 475(f)**
Traders, tax professionals, IRS and state tax agents donaders, tax profeand trader tax status (TTS), and the result is botched tax compliance causing significant losses from higher taxes, penalties, interest and professional fees.

Hundreds of thousands of active traders qualify for TTS, trading their own funds as a business activity. Most of them don't know they are entitled to file a timely election for Section 475(f) MTM ordinary gain or loss treatment and exemption from Section 1091 wash sale loss treatment. They also don't realize they can use Section 162 business expense treatment as a sole proprietor or in a pass-through trading company without an election required for Section 162.

Since enactment in 1997, Section 475 and TTS rules remain too confusing to tax professionals and traders. Many local tax preparers conflate the two code sections, not realizing a qualifying trader may use Section 162 but not elect Section 475(f). The IRS needs to do a better job with its guidance.

**Better define trader tax status**
There is no "statutory law" defining qualification for TTS. There is only "case law" and "trader tax" cases have a broad range of criteria without giving a bright-line test, except the Endicott court stated average holding period must be 31 days or less. Traders need similar standards for volume and frequency of trades and hours per day.

Case law rewards losing day traders with TTS and 475(f) elections, but denies both to profitable options traders who may make a consistent living but have less volume and frequency of trades. The average trader with TTS has business expenses of approximately $15,000 and that does not stress the Treasury in terms of tax benefits.

 

The IRS has a history of misquoting TTS case law to traders in tax exams. On several occasions, IRS agents told traders they needed to make their "primary or sole living" from trading, whereas tax law requires "an intention to make a living." Hobby loss rules do not apply to trading because trading is "not recreational or personal in nature."

**Section 475(f) MTM**
Section 475 was drafted for dealers in securities and or commodities. In 1997, Congress expanded Section 475 to include traders who qualify for trader tax status adding Section 475(f). The IRS added the terms "trader in securities" and "trader in commodities." Traders must qualify for TTS to elect and use Section 475.

Securities traders consider a Section 475(f) election for two reasons: exemption from wash sale loss deferral rules and the $3,000 capital loss limitation. Section 475 MTM is ordinary gain or loss treatment. Section 475 trading losses contribute to NOL carry backs and forwards which generate tax refunds faster than carrying forward capital loss carryovers, which otherwise are the biggest pitfall for traders. Section 475 MTM ordinary income is taxed at the same ordinary tax rate as short-term capital gains.

**Better define "commodities"**
The IRS needs to better define the term "commodities" in Section 475 (and throughout the tax code). The definition needs to clearly state that traders may elect Section 475(f) on "securities only" and retain lower 60/40 tax rates on Section 1256 contracts (futures and broad based indexes). While dealers sell bushels of wheat (commodities), traders do not.

I appreciate the ABA's comments to the IRS. Their comments on the definition of commodities are confusing. The ABA addresses dealers and traders, whereas we focus on traders only.

**Suspending Section 475 treatment**
One of the challenges in administrating Section 475 is in the determination of qualification for TTS. Falling short of TTS means the trader must suspend use of Section 475 and use the realization (cash) method until he or she re-qualifies in a subsequent tax year. Suspension treatment is not included in Section 475 rules, yet it should be. The concept is that without TTS, all open positions automatically become investment positions.

**The IRS recently fixed Section 475 revocation rules**
There's good news for traders about Section 475 MTM buried in the IRS annual update on procedures for changes of accounting method. It has always been free and easy to elect Section 475 MTM, yet difficult and costly to revoke that election. With this rule change, the IRS makes revocation a free and easy process. (Read my blog post New IRS rules allow free and easy Section 475 revocation.)

**Section 475 election and Form 3115**
Current rules for making a Section 475(f) election are too narrow and complex. In other words, there is a very small window of opportunity to consider and make a 475 election and most traders don't speak with their tax advisor on time. Far too many qualified traders who would

 

benefit from Section 475 miss the boat and that's unfair.

"Existing taxpayers" must elect Section 475(f) by the original due date of the prior year tax return (not including extensions). That provides about three months of hindsight from Jan. 1 until April 15 for individuals and partnerships and March 15 for S-Corps. It's an election statement as there isn't a tax form.

The second step  ue date of the prior year tax return (not including extensions). That provides about threeccountants think it's a one-step procedure and they botch the election by missing either the election statement or the Form 3115 filing (required in duplicate).

A taxpayer must attach the election statement to their extension or tax return and a certified return receipt only proves a tax filing not the election statement. The IRS admits they don't have a system to record the 475(f) election, so they ask a taxpayer for a perjury statement on the Form 3115 representing they filed the election statement on time. The IRS provides relief for late Form 3115s but not late election statements.

**Provide late relief for Section 475 elections**
Tax law (Regulation Section 301.9100-3 relief) allows six months to file a private letter ruling to get late relief on certain elections including Section 475. But to date it has been almost impossible to get this type of relief for a late Section 475 election. The process requires a private letter ruling and the IRS denied all of them to date with the exception of Larry Vines who had a perfect fact pattern. The IRS refuses late relief for Section 475 by claiming prejudice to Treasury and hindsight. It takes almost a perfect set of factors to get by this stringent posture. An open portfolio of unrealized capital losses is currently considered enough of a reason for the IRS to deny late relief for a Section 475 election.

Rather than loosen up here, I prefer the IRS just allow a Section 475 election with more time. Focusing too much on hindsight disenfranchises traders.

**Expand Section 475(f) "new taxpayer" exception**
Under current law, there is an exception for "new taxpayers" like a new entity. A new taxpayer may elect Section 475 by internal resolution within 75 days of inception. If you start trading after April 15, you can't make a 475 election as an individual; but you can form a new entity to make the election within 75 days of inception.

The new taxpayer exception isn't clear or broad enough. The IRS should broaden it to accommodate "new traders" qualifying for TTS, not just a new entity. Individual traders or entities qualifying for TTS after April 15 should be able to elect Section 475 within 75 days of qualification.

I think the IRS should go even further by allowing the election on the tax return filing after year-end. Traders using Section 162 business expense treatment simply claim that treatment on their tax return (Schedule C) where they also choose the cash method or accrual method of accounting for expenses. Why not enact the same procedure for a Section 475 election? Why make Section 475 confusing and different from Section 162 since they are so tied together already?

 

Most tax professionals don't know their client qualified for TTS until tax time and often that's after the April 15 deadline for filing extensions. Their clients often miss the 475 election for the past year, as well as the current year, too.

Taxpayers often don't discuss election opportunities with their accountants until after year-end, not when they launch a new activity. Traders don't even realize that trading can be a business; otherwise they might call their accountant early on. It's unreasonable for the IRS to assume traders can digest the complications of Section 475 and TTS on their own.

**First year hindsight is reasonable**
While extending the 475 election until tax filing time gives traders more hindsight during the first calendar year (and into the next tax year) and new IRS rules for revocation allow reversal in a subsequent year, once revoked, Section 475 can't be re-elected for five years.

Most tax elections are made on a tax return filing, and they are not required earlier in the year - hindsight is allowed. With so many traders missing the boat on Section 475 — and then building up a capital loss carryover hole committing them to the realization method —nit's reasonable for traders to conclude the onerous 475 election rules are intended to disenfranchise traders from using ordinary loss treatment.

The original tax law on Section 475(f) mentioned the IRS would issue a tax form for the election. But, to date the IRS has not issued a form. Even with the S-Corp election Form 2553 due within 75 days of inception, the IRS grants relief for late-filed elections. I dons of inception, the IRS grants relief for late issue a tax form Missing the Section 475(f) election requirement is the biggest problem in Section 475 and it causes the most inequity for traders contrary to the intention of Congress in expanding Section 475 to traders.

**Section 475 "segregation of investment" rules are vague**
I disagree with IRS proposed regulations for segregation of investments from Section 475(f) calling for a separate investment account.

Segregation should be done in "form and substance." It's not enough to designate an account as an investment account (in form) because traders often actively trade around core investment positions in an active trading account (in substance). Segregation must be assessed in overall actions by traders. (Read my blog post IRS warns traders on Section 475.)

I agree with Chief Counsel Advice ("CCA") 201432016 stating "the 475 election is made on an entity-by-entity basis, not a separate trade or business basis, and only in the case of separate commodities and securities businesses can a taxpayer make separate elections." I also agree the proposed regulation stating "a trader may identify an investment with 'clear and convincing evidence that a security has no connection to its trading activities.'"

As tax preparers for traders, real world fact patterns can be confusing and it would be good if the IRS issued more guidance on segregation of investments. If a client trades the same symbol for which he invests and uses Section 475(f) for active trading but not investing, should all the

 

symbols traded and invested be consolidated into Section 475(f) or into investment treatment, or otherwise? The proposed regulations offer some solutions but they need more work. Tax preparers need support for taking positions that don't prejudice Treasury. In general, I agree with many of ABA's comments on May 7, 2015 in this regard.

**Wash sale rules are a problem**
A Section 475(f) election is an escape hatch for a qualifying trader from wash sale loss treatment (Section 1091). When the IRS considers changes to Section 475, they should also address significant problems with Section 1091 as these code sections are joined at the hip for active traders.

IRS rules for broker 1099Bs *differ* from rules for taxpayer reporting of wash sale adjustments on Form 8949 (Capital Gains & Losses). The IRS requires brokers to calculate wash sales based on identical positions (same symbol) per account. Conversely, the IRS requires taxpayers to report wash sales based on substantially identical positions (stocks and options) across all accounts including IRAs. With apples and oranges structurally in the rules, there are obviously large, unreconciled differences between broker 1099Bs and taxpayer Form 8949, especially for active traders with multiple accounts and those who trade stocks and options. These 1099B matching problems will overwhelm the IRS in coming years.

**The IRS doesn't enforce wash sales**
Too often taxpayers and tax professionals cut corners choosing to solely rely on broker-issued 1099Bs. They don't comply with different IRS wash sale rules for taxpayers (see above).

Brokers aren't helping with taxpayer compliance; they are encouraging clients to download 1099-B data into TurboTax and they don't sufficiently mention Section 1091 compliance issues. The IRS needs to either enforce or change the wash sale rules to better coordinate broker and taxpayer reporting.

**Cost-basis reporting also has problems**
In 2008, Congress enacted cost-basis reporting to close the "tax gap" on investors. Prior to cost basis rules, Form 1099Bs only reported proceeds on securities, and cost-basis information wasn informatio. Starting in 2011, the IRS phased in the cost-basis reporting rules.

While cost-basis reporting requires wash-sale adjustments, it falls short of the needs of active traders with multiple accounts and those who trade substantially identical positions (stocks and options).

Starting in 2014, 1099Bs reported equity options for the first time. But brokers don't calculate wash sales between stocks and options and options at different expiration dates whereas taxpayers must do so. This will generate many unreconciled differences or non-compliance with Section 1091 rules.

While cost-basis rules help the IRS with millions of investors, they are not working well enough for active traders who are stuck with huge unreconciled differences. The choice is either reconciliation and non-compliance or huge differences and compliance.

 

Cost basis problems are another great reason to open the door wider to 475 elections. It's easier to explain why a Form 4797 (where 475 is reported) is different from a 1099B prepared for the realization method.

**Improve sole proprietor tax return reporting**
A sole proprietor trader tax return is a red flag in the eyes of IRS agents and IRS computer algorithms because Section 162 trading expenses are reported on Schedule C but trading gains and losses are reported on other tax forms. That looks like a losing business without revenue.

There should be a formal way to transfer some trading gains to Schedule C to show a profitable activity or zero it out. Trading gains are not self-employment income (SEI) and they are exempt from SE tax, with the exception of members of a futures exchange (Section 1402i).

Traders work hard every day and they deserve a tax code that respects their unique tax needs. Since the Great Recession of 2008, the markets have experienced tremendous growth and capital gains taxes have skyrocketed.

*Darren Neuschwander CPA and co-managing member of Green NFH contributed to these comment.*

Sincerely,

Robert A. Green, CPA
CEO GreenTraderTax.com
Managing Member Green NFH, LLC

 