



Too Late to Elect  
September 29, 2008



Feed address for Podcast subscription:  
<http://feeds.feedburner.com/EdZollarsTaxUpdate>  
Home page for Podcast: <http://ezollars.libsyn.com>  
©2008 Edward K. Zollars, CPA

*The TaxUpdate podcast is intended for tax professionals and is not designed for those not skilled in independent tax research. All readers and listeners are expected to do their own research to confirm items raised in this presentation before relying upon the positions presented.*

*The Podcast and this document may be reproduced freely so long as no fee is charged for the use of this document. Such prohibited use would include using this podcast or document as part of a CPE presentation for which a fee is charged.*

*This podcast is sponsored by Leimberg Information Services, located on the web at <http://www.leimbergservices.com>. Leimberg Information Services offers email newsletters on tax related matters, as well as access to a library of useful information to tax practitioners that subscribe to their services.*

## **Mark to Market Too Late**

This week we look at another taxpayer's unsuccessful attempt to convince a court that he should be allowed to make a late mark to market election under §475(f). After failing at the District Court level, the taxpayer appealed to the Ninth Circuit Court of Appeals who, in denying relief, went into some detail about why such lack of relief made sense in this case. The case is *Acar v. Commissioner*, 2008 TNT 186-19. Of interest is the court's discussion of why the taxpayer was not eligible for the type of relief granted by the Tax Court in the *Vines v. Commissioner*, 126 T.C. 279 under Reg. §301.9100-3(b)(iii)

## **Mark to Market Yet Again**

As we've discussed before, if a taxpayer is a trader in securities (a fact specific test) as opposed to an investor, the taxpayer may elect under §475(f) to use the mark to market method of account for the taxpayer's securities. That section provides:

(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.

(B) Exception

Subparagraph (A) shall not apply to any security--

(i) which is established to the satisfaction of the Secretary as having no connection to the activities of such person as a trader, and

(ii) which is clearly identified in such person's records as being described in clause (i) before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe).

If a security ceases to be described in clause (i) at any time after it was identified as such under clause (ii), subparagraph (A) shall apply to any changes in value of the security occurring after the cessation.

(C) Coordination with section 1259

Any security to which subparagraph (A) applies and which was acquired in the normal course of the taxpayer's activities as a trader in securities shall not be taken into account in applying section 1259 to any position to which subparagraph (A) does not apply.

(D) Other rules to apply

Rules similar to the rules of subsections (b)(4) and (d) shall apply to securities held by a person in any trade or business with respect to which an election under this paragraph is in effect. Subsection (d)(3) shall not apply under the preceding sentence for purposes of applying sections 1402 and 7704.

(2) Traders in commodities

In the case of a person who is engaged in a trade or business as a trader in commodities and who elects to have this paragraph apply to such trade or business, paragraph (1) shall apply to commodities held by such trader in connection with such trade or business in the same manner as paragraph (1) applies to securities held by a trader in securities.

(3) Election

The elections under paragraphs (1) and (2) may be made separately for each trade or business and without the consent of the Secretary. Such an election, once made, shall apply to the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Secretary.

Why would we want to do this? Well, it turns out that the provision noted above at §475(f)(1)(D) that invokes the treatment under §475(d), specifically §475(d)(3) which provides:

(3) Character of gain or loss

(A) In general

Except as provided in subparagraph (B) or section 1236(b)--

(i) In general

Any gain or loss with respect to a security under subsection (a)(2) shall be treated as ordinary income or loss.

(ii) Special rule for dispositions

If--

(I) gain or loss is recognized with respect to a security before the close of the taxable year, and

(II) subsection (a)(2) would have applied if the security were held as of the close of the taxable year,

such gain or loss shall be treated as ordinary income or loss.

The key issue is that the amount will not be subject to the limitation for net capital losses, meaning that if the trader has losses having made this election will allow the trader to both go past the \$3,000 limit to offset other income, and also qualify for a net operating loss.

However, even more good news is offered up—because making this election does not override the general prohibition found at §1402(a)(3)(A) that exempts gains from the sale of capital assets from being taxed as self-employment income [§475(f)(1)(D)'s reference to §1402].

The IRS has issued guidance for making the election under Revenue Procedure 99-17. At Section 5.03 the due dates and methods are outlined:

.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 very early due date for the election—it must be made on the prior year's return, and if that return is put on extension then the election has to be made with the extension request.

The point of that is rather clear—the IRS wants to force taxpayers to “make up their mind” early in the year, and not wait until they know the year's results.

However, there is an option to get approval for a late election, a provision we discussed quite a while back, which is found at §301.9100-3. As we discussed back in a prior podcast (September 15, 2005 found at [http://ezollars.libsyn.com/index.php?post\\_id=21789](http://ezollars.libsyn.com/index.php?post_id=21789)) there are some automatic late elections under §301.9100-2—but for other regulatory elections the IRS allows for discretionary elections under §301.9100-3 if the IRS deems there to be valid reasons. However, under §301.9100-3(b)(3)(iii) the IRS shows a disdain for Monday morning quarterbacking:

(iii) Uses hindsight in requesting relief. If specific facts have changed since the due date for making the election that make the election advantageous to a taxpayer, the IRS will not ordinarily grant relief. In such a case, the IRS will grant relief only when the taxpayer provides strong proof that the taxpayer's decision to seek relief did not involve hindsight.

## **Today's Case**

The taxpayer in this case was dealing with the fact that it turned out he would have been better off to have made the §475(f) election due to his trading losses. As the Ninth Circuit Court of Appeals noted in the case

Between the late 1970s and 2004, Acar worked as a financial planner while also trading securities for himself. On his 1999 tax return, filed in 2000, Acar claimed a deduction for \$3,000 in capital losses based on losses in the amount of \$954,041 incurred in trading securities. Acar made no election for mark-to-market accounting until February 2002, when he informed the IRS of his desire to make a section 475(f) election for his securities trading beginning in tax year 1999.<sup>3</sup> Acar also provided the IRS with amended tax returns for the 1999 and 2000 tax years. On his amended 1999 return, Acar treated his trading losses as ordinary losses and, on that basis, claimed a refund for a tax overpayment of \$46,396. On his amended 2000 return, Acar claimed as net operating

losses the excess ordinary losses from 1999. Because Acar eventually settled with the IRS regarding his 2000 return, only the claimed refund for the 1999 tax year is at issue here.

In September 2002, the IRS conducted an audit and disputed Acar's claimed refund. The parties litigated the matter before the IRS Appeals Office, which partially disallowed Acar's claimed refund on the grounds that the section 475(f) election was untimely under Revenue Procedure 99-17 and that Acar did not qualify for a time extension under Treasury Regulation § 301.9100-3.

The taxpayer had a few arguments to attempt to justify his right to claim the election that was made well after the required due date. First, he claimed that since the initial year was 1999, he simply didn't have time to make the election:

Acar neither challenges the validity of Revenue Procedure 99-17 nor disputes that his election was untimely under it. Instead, Acar argues that he did not have a reasonable amount of time to file the election before the due date because of the short time period between the issuance of Revenue Procedure 99-17 in February 1999 and the due date for making the election. However, this argument is without merit because Acar testified in his deposition that he did not become aware of the provisions of section 475(f) until early 2002, almost three years after the due date for the 1999 tax year. Accordingly, Acar never could have made a timely election even if Revenue Procedure 99-17 had been issued earlier than February 1999.

That answer does leave open the question whether he might have been granted some leeway if he had elected within a reasonable time period—but, of course, the IRS might have granted the request under §301.9100-3 to extend the election period. But since he waited until three years after the required date to make the election to try and get the late election, the Court no longer bought the idea that the late election was caused by an unreasonably short period to react to Revenue Procedure 99-17.

But the taxpayer indicated that nevertheless he should be able to get relief under §301.9100-3, relief the IRS had denied. The taxpayer pointed out the Tax Court had granted relief for a late §475(f) election in the case of *Vines v. Commissioner*, 126 T.C. 279 and the taxpayer felt that should allow him to make a late election.

However, the District Court did not agree and neither did the Ninth Circuit. The Ninth Circuit Court of Appeals pointed out some unique facts *in Vines*:

In *Vines*, the Tax Court interpreted the "hindsight" exception in the context of a late section 475(f) election and concluded that "the relevant inquiry is whether allowing a late election gives the taxpayer some advantage that was not available on the due date." 2006 WL 1280960 at \*10. The Tax Court in *Vines* concluded that the petitioner had not

used hindsight within the meaning of § 301.9100-3(b)(3)(iii) because

the only fact that changed after the due date for making the election was the discovery of the availability of the election itself. Petitioner conducted no trading activities and incurred no further losses between the time he should have filed the section 475(f) election and the date he actually filed the election. If a late election is allowed, petitioner will not be entitled to anything more than that to which he would have been entitled had he timely made the election.

It was key to the decision that the taxpayer had, effectively, no more information about the result of the election (at least as it impacted the treatment of his activities for trading) when he made the late election than he would have had for a timely election.

As a practical matter, this would be a unique case—most often a taxpayer won't stop trading prior to April 15. As well, if this was the first year the taxpayer was doing this trading, the fact it stopped before April 15 would tend to lead to making it difficult to convince the court the taxpayer was truly a trader.

The Court went on to note the Tax Court had distinguished the *Vines* situation from that in other cases:

However, the *Vines* court contrasted the case before it with *Lehrer v. Commissioner*, T.C.M. 2005-167, 2005 WL 1607743 (U.S. Tax Ct. 2005), in which "[t]he taxpayers sought retroactively to convert their capital losses into ordinary losses several years later, with continued trading in the interim, in order to escape a deficiency and a section 6662 accuracy-related penalty." *Vines*, 2006 WL 1280960, at \*10 (citing *Lehrer*, 2005 WL 1607743, at \*1). The *Vines* court found that "[t]he taxpayers in *Lehrer* are the classic example of taxpayers who seek to use the benefit of hindsight." *Id.*

In a subsequent case, the Tax Court concluded that a taxpayer used hindsight under the regulation when he filed a § 475(f) election years after it was due, while having continued to trade securities in the interim, in order to convert capital losses to ordinary losses. See *Knish v. Comm'r*, T.C.M. 2006-268, 2006 WL 3725132, \*5 (U.S. Tax Ct. 2006) ("A taxpayer attempting to make a mark-to-market election years after it is due (while continuing to trade in the meantime) in 13482 ACAR v. CIR an attempt to convert capital losses to ordinary losses is a classic example of a taxpayer seeking to use hindsight." (citations omitted)); see also *Mezrah v. Comm'r*, T.C.M. 2008-123, 2008 WL 1912432, \*4 n.5 (U.S. Tax Ct. 2008) (explaining that in *Knish* the Tax Court found § 301.9100-3 relief "unavailable . . . because the taxpayers used hindsight to make the mark-to-market election when it was most advantageous.").

In this case, the taxpayer clearly had more information available at the time he tried to make the election than he would have had had a timely election been made.

However, the taxpayer argued that the Treasury had indicated that minimizing one's tax was a valid reason to allow for late elections. The Ninth Circuit notes

Acar argues that our interpretation of "hindsight" conflicts with the preamble to the final Treasury regulations of § 301.9100. In the preamble, the Secretary of the Treasury stated:

There are two policies that must be balanced in formulating the standards for § 301.9100 relief. The first is the policy of promoting efficient tax administration by providing limited time periods for taxpayers to choose among alternative tax treatments and encouraging prompt tax reporting. The second is the policy of permitting taxpayers that are in reasonable compliance with the tax laws to minimize their tax liability by collecting from them only the amount of tax they would have paid if they had been fully informed and well advised.

Requirements Respecting the Adoption or Change of Accounting Method, 62 Fed. Reg. 68167-01, 68168 (Dec. 31, 1997).

However, the Ninth Circuit does not see any conflict, noting

We find no conflict between this general statement and our specific application of the "hindsight" exception. The preamble states as one of its policies that a taxpayer should not pay more tax than he would have if he had been "fully informed and well advised." That statement does not suggest, however, that a taxpayer should be permitted to take advantage of knowledge that he could not have had when the election was due but that allows him, several years later, to elect retroactively the most advantageous accounting method.

Finally the fact that the election might prove less than optimal in the future (since IRS permission would be needed to change the method back) did not mean that hindsight was not used currently.

Acar also argues that he could not have used "hindsight" in filing the election in February 2002 because any advantage that the election would give him as to earlier years would be outweighed by the possibility that in subsequent years he would make trading gains, not losses, and that therefore the election would become disadvantageous. This argument is without merit. Whether a taxpayer might come to regret his election in later years does not affect whether the taxpayer uses "hindsight" at the time he makes a retroactive election. A taxpayer who makes an election several years after having continued to trade in the interim still has "some advantage that was not available on the due date," *Vines*, 2006 WL 1280960, at \*10, even if in subsequent years the election becomes disadvantageous. In any event, a taxpayer may revoke the election with the consent of the Secretary of the Treasury. See I.R.C. § 475(f)(3).

## **Conclusions**

The lesson of this case is that, yet again, it's going to be difficult to make a late §475(f) election though, as the case noted, there may be cases where the late election will be allowed. As well, it's useful to consider the Court's view on what constitutes "hindsight" vs. what types of cases might not involve such prohibited hindsight.