

## TAX NEWSLETTER FOR TRADERS

### MARK-TO-MARKET ACCOUNTING

#### Determining if MTM is Right for You

Once a taxpayer qualifies for business trader status, a whole host of tax benefits become available. In our June 2010 newsletter, we discussed the IRS requirements for qualifying for business trader status and the associated tax benefits. One of the tax benefits discussed was the Mark-to-Market accounting method under IRC Sec 475.

Let me first explain how it works. MTM is a procedure performed at year-end, whereby a trader marks all open positions to market price. It functions like the accrual method of accounting on the tax return. In essence, the trader is calculating the sale of all open positions at year-end, using year-end market prices. Then, on the first day of the new tax year, the trader inputs the buy-back of those positions at the same market price. The result is that the MTM election converts unrealized positions to realized positions so that the trader can report those gains and losses on their tax returns.

Making a proper MTM election is critical to ensuring that a trader is entitled to use this accounting method. The IRS has very strict rules on the mechanics and timing of making a valid election. Make sure that you seek help from a qualified tax professional in this area. We have seen many botched MTM elections made by other tax accountants that result in taxpayers paying more in taxes and under-payment tax penalties. We discuss this topic more in depth in our sidebar article titled "Making the MTM Election".

One of the key benefits of the MTM accounting method is that business traders are able to treat trading losses on their tax returns as ordinary losses rather than capital losses. This means that business traders can deduct trading losses in full against other types of income such as salaries, interest, dividends, capital gains, rental income, etc. If classified as an investor, capital losses are limited to a maximum of \$3,000 in excess of a taxpayer's capital gains per year.

It's quite common for new traders to incur losses greater than \$3,000 in their first year of trading. Even some of my more successful, experienced trader clients have a bad year now and then. Having the ability to deduct trading losses as ordinary losses can be a huge benefit to traders. Electing MTM accounting is like having an insurance policy. Let's face it, nobody expects or wants to have trading losses at the end of the year. In an industry where there is an approximate 90% failure rate, losses are inevitable. Why not protect yourself just in case.

#### MAKING THE MTM ELECTION

The filing procedure for the MTM election is extremely important. If not filed in a timely manner, or if you make any mistakes, the IRS will likely deny ordinary loss treatment, with no excuses entertained and no relief allowed. While taxpayers who miss the deadline could pursue a 6-month MTM extension procedure through a private letter ruling (PLR), the process is expensive and the IRS has denied the majority of previous requests. Therefore, if there is any doubt about if you qualify, whether you should take the MTM election, or how to file for it, promptly contact a qualified trading tax specialist who can assist you.

The three-step procedure for electing Section 475(f) MTM is outlined as follows:

1. Make a timely election in the current tax year by the filing deadline of April 15<sup>th</sup> (March 15<sup>th</sup> for C

## Advantages for the business trader making the MTM election include:

- The \$3,000 limitation on deductible capital losses does not apply.
- Net operating losses created by ordinary trading losses can be carried forward to offset future income.
- Net operating losses can be carried back 2 years to offset prior year's income and allows a trader to obtain a refund of taxes paid on income in previous years, or they can elect to skip the NOL carry-back and carry forward the NOL for twenty years.
- Deferred losses on wash sales are fully deductible against gains.
- Tedious recordkeeping requirements related to wash sales are minimized.
- The process of separating and reporting investment profits from trading profits is easier.

Determining whether to make the Mark-to-Market accounting election is an important decision. As mentioned previously, first a trader needs to determine whether they qualify as a business trader in the eyes of the IRS. Traders should seek the advice of a qualified tax professional in this area before making that determination. Our firm works with many traders in determining whether they meet the IRS requirements. Once a trader is confident regarding their trader tax status, they can consider making the MTM election. There are two important considerations a trader needs to analyze before making this election. The first consideration is the type of financial instruments that they will be trading. If a taxpayer is trading capital assets such as stocks, stock options, index options or ETF's then the MTM election makes a lot of sense. Since net losses from capital assets are limited to \$3,000 per year, having the ability to convert capital losses to ordinary would be a tremendous benefit.

If a taxpayer is trading Sec. 1256 contracts, i.e., futures and commodities, then the MTM election might not make sense. For tax purposes, Sec. 1256 contracts enjoy 60% long-term and 40% short-term capital gain treatment. If you are a profitable futures trader then you probably want to stay with your existing accounting method. The current blended tax rate on Sec. 1256 contracts is approximately 23%, which is lower than most traders' tax rates on ordinary income. However, if you expect to have losses in the first couple of years, electing MTM accounting might still be a good idea.

The second important consideration is whether a taxpayer has existing capital loss carryovers from previous years. If so, you may want to hold off making the MTM election. You want your trading profits to be classified as capital gains in order to offset these prior year capital losses. Once you have offset these losses, you can then make the MTM election in a subsequent year. If you elect MTM accounting prematurely, then your gains will be considered ordinary and you won't be able to offset against your capital loss carryovers from prior years. Being able to offset current year trading profits with capital loss carryovers from prior years amounts to tax-free gains in the current year. This could provide a trader with huge tax savings.

We have provided a flow chart that summarizes that decision-making processing for making the MTM accounting election. This chart is not intended to cover all possible scenarios for all traders. However, it is intended to give traders a general overview of the main considerations in making this important election. I strongly urge traders to consult with a qualified tax

corporations and S corporations).

2. Verify that you have indicated the correct application of the MTM election on tax returns filed on time.

3. File Form 3115 (Change of Accounting Method), and an IRC 481[a] adjustment, with the regular tax return filing (in duplicate).

If filing for the MTM election in the current tax year (and for future years), you will need to attach a statement to your prior year tax return or extension, and send it (certified mail) by the due date of your prior year's tax return. For instance, if electing MTM for 2011, attach the selection statement to the 2010 tax return or extension and file by April 15, 2011.

**Tax Tip:** *By setting up a new business entity and electing MTM accounting through your internal corporate documents, you are able to begin using the MTM accounting method immediately as long as you qualify for business trader status.*

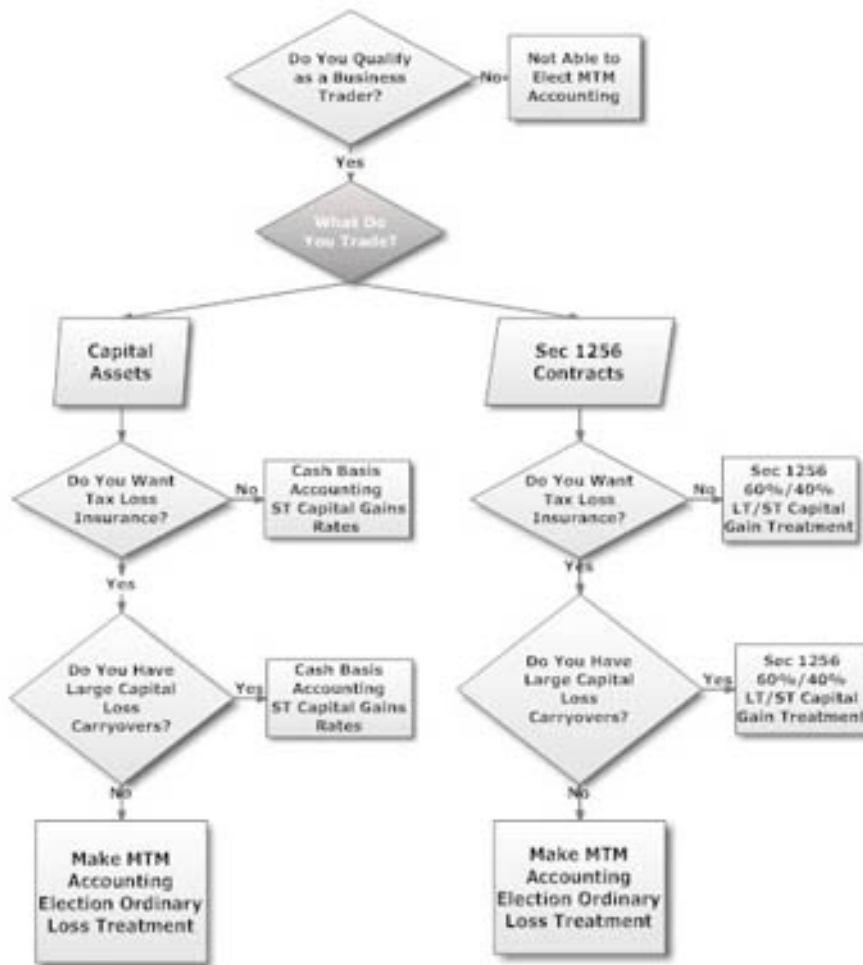
Once you have completed the election statement and filed with the IRS, you will need to ensure that you qualify for trader tax status in the year you are taking the MTM election. If you do, you will need to calculate

advisor when tackling this election. The cost of the tax advisor will be well worth the price, when you consider the tax benefits from doing things properly.

and report a Section 481 (a) adjustment on your current year tax return (Form 4797) and on Form 3115, which is due when you file your tax return. A Section 481 (a) adjustment deals with the unrealized gains/losses on securities held in your trading business, as of the end of the prior tax year.

The last step for electing MTM is to complete Form 3115, which changes your accounting method from cash to Sec 475 MTM for the current year tax return. Form 3115 is a very complicated form, and **must be filed in duplicate**. If this form is not completed properly, or not filed on a timely and accurate basis, the trader's Sec 475 election will not be valid.

### Should a Trader Make the Election for Mark-to-Market Accounting?



#### Disclaimer

Because the tax laws and IRS rules are constantly changing and shifting, and each taxpayer's situation is unique and different, this newsletter is not intended to be an exhaustive work on the tax consequences of trader and investor tax law. Taxpayers should seek competent professional advice regarding investment, trading, and financial transactions on an on-going basis. This newsletter should not be a replacement for legal and/or tax advice. However, we hope that it provides some insight into tax issues and complications involved in the investment and trading industry.

**Pro Trader Tax** is a virtual tax advisory firm specializing in tax planning and counseling, tax preparation, entity formation and retirement plan services for active business traders and investors.

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