

**CHAPTER 8**

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# Extensions

**E**xtensions are always a good idea. Tax issues are complex, and the more time you have to deal with them, the better chance you have of making sure you get all the tax benefits coming to you. On or before April 15, you should file an extension, which gives you an additional six months to file (the extension actually expires on August 15, but a second extension will give you until October 15).

## FILING AN EXTENSION

An extension gives you extra time to file, but not to pay. If you don't pay at least 90 percent of what taxes you owe when you file your extension, your extension will be designated invalid, meaning your return will be considered late and subject to late filing and late payment penalties (5 percent per month up to five months). You are also subject to interest expense on all tax payments made after April 15, whether your extension is valid or not.

Play it safe and pay 100 to 125 percent of your estimated liability. Why pay extra? This amount gives you a cushion for errors in trade accounting, and any overpayment can be applied to current-year estimated income taxes (especially if you are profitable in the first quarter of the following year). A good rule of thumb for traders is to pay your taxes

on a conservative basis (to avoid interest and penalties) but file your tax returns on an aggressive basis (because that's where the real savings are).

### **First Automatic Extension**

If you are not ready to file your individual income tax return by April 15, the due date, you are entitled to file a federal automatic extension by April 15. The application is made on Form 4868 (Application for Automatic Extension of Time to File U.S. Individual Income Tax Return). Some states accept the federal extension but most require their own form.

Filing valid extensions by April 15 automatically changes your tax return due date to August 15. A valid extension means that you must pay a minimum of 90 percent of your tax liability (for federal liability; some states differ) with the extension filing. This is not an extension to pay your tax, it is only an extension to file the tax return.

Remember to attach your MTM IRC § 475 election statement to your federal extension filed by April 15, the election due date. See Chapter 2 to learn more.

### **Second Extension**

If you are still not ready to file your individual income tax return by August 15, the first extended due date, you are entitled to file a federal second extension by August 15. Some states accept the federal extension but most require their own form. A granted second extension changes your tax return due date to October 15. The second extension is not automatic (unlike the first extension), and you need to receive it back from the IRS marked "Granted."

The second extension is filed on an IRS Form 2688, and it must be postmarked by August 15. This filing assumes, of course, that you already filed a valid first extension by April 15, and that you properly paid your taxes with the first extension.

When you file the second extension form, you need to include a reason for the extension. The reason can be something such as, “taxpayer is awaiting additional expense documentation and a complete and accurate tax return can not be filed at this time.” For all practical purposes, these extensions are automatic. We have never had one not granted in more than twenty years of CPA tax practice.

### **Why First and Second Extensions Are Recommended**

With the first extension, you get an additional four months to work on your tax return. With the second extension, you get an additional two months. This additional time helps make sure tax returns are accurate and have the best tax savings results.

Many traders have trading losses in a given year. Many of these traders with mark-to-market (MTM) accounting will be entitled to file a net operating loss carryback refund claim on Form 1045. Filing a Form 1045 refund claim is tantamount to filing amended tax returns for your prior two tax years. This process takes time and requires care. Additionally, the IRS will review these Form 1045 refund claims, and we believe you are better off waiting until after April 15, when fewer agents are around to look over returns. This same concept works for all taxpayers. Technically, a Form 1045 return is not filed with your Form 1040, but it’s wise to prepare them together.

Most traders have complex tax files because they have trader tax status. Traders usually don’t complete their own trade accounting and record organization until the middle of March. If traders use a tax preparation firm, they don’t receive your tax information until March. They then have only one month to complete your tax return. Oftentimes, additional information is needed. For example, if you have elected MTM, you might not have handled the opening and closing MTM values correctly. If you are cash basis (i.e., you haven’t elected MTM), you might not have handled wash sales correctly.

Maybe you have not taken full advantage of home office deductions and all the expenses you are entitled to. More time is needed to get it all right and prepare the return that is most advantageous to you.

Many traders elected MTM accounting for the first time. This election requires additional work because a Form 3115 must be prepared.

The key is knowing whether you may owe money with the extension. Traders with large losses are surely in refund situations, and filing the extension is easy. Traders with large gains owe money, and most of the tax return needs to be prepared to see what you owe.

The other key decision to make by April 15 is whether or not you are electing MTM § 475 for the current tax year, the election statement of which must be attached to your first automatic extension.

### **New Reasons Why an Extension Is Wise**

In 2004, the IRS announced significant new exam targets, policies, and procedures—random audits (exams), more audits of high net-worth taxpayers, and more. The IRS needs to help balance the government's budget, so suffice it to say, it is back in the exam business with new support from Congress. When it comes to traders, the IRS is more interested in examining business traders, part-time traders, and money-losing traders.

Considering these developments, it is more prudent than ever to file extensions and mark-to-market (MTM) elections by April 15. Such a move will then allow traders to file their actual tax returns in the summer months or even as late as October 15. It's wise to be conservative on tax payments or refunds and aggressive with your tax return filings.

Filing your tax return after April 15 may significantly reduce your chance of triggering one of the previously stated IRS audit initiatives.

Many advantages and few disadvantages come from using extensions. One possible disadvantage is delaying a refund.

For traders with large losses and carryback refunds, be patient and file in May or June, which offers several advantages:

- You have more time to file and work out a better and more accurate tax return.
- You can consider your activity for the year and how it may affect your tax-filing strategy. For example, if you start to generate large income in an existing year, you might want to be more aggressive in the previous year.

Waiting may lessen your chance of being audited by the IRS or your state tax authority. Many IRS examinations are selected before you file, and many IRS agents are reassigned for training or other duties after the tax-filing season crunch ends on April 15. Most sophisticated taxpayers and wealthy individuals always file close to the last possible day, when the second extension is due October 15.

Read newspapers such as *The Wall Street Journal* near April 15 and August 15. They will provide stories about the many advantages of extensions. The early bird gets the worm, but you are the worm and the IRS is the bird. Patience is a virtue, which does not mean laziness, however, so get your numbers together and file an accurate extension.

### Extension Filing Strategies

Some traders owe estimated taxes for the first quarter of the current year. With an extension filing, you can skip the first quarter estimated tax payment and instead pay an extra amount with your extension for the previous tax year.

When you file your previous year's return, you can apply the overpayment credit toward the current year's estimated taxes.

This strategy solves two problems with one move. You overpay previous year taxes to give yourself a cushion against inaccurate estimates (or changing your mind about being aggressive on expense deductions or other tax-savings strategies) and/or you pay your current year first-quarter estimates.

If it turns out you have little or no credit toward the current year, you just pay more estimated taxes for June 15 or September 15. Your tax return looks better showing a credit applied rather than a refund requested.

### **Consequences of Not Filing a Valid Extension and Filing a Late Tax Return**

If you file your tax return late (i.e., after the valid extension due date or without a valid extension), you will be subject to tax penalties and interest assessed on the amount of taxes you owe.

### **Penalties and Problems Caused by Paying Taxes Late**

We strongly advise you to pay at least 90 percent of your tax liabilities by April 15. This payment will ensure that your extensions are valid and the penalties don't apply.

If you can't pay what you owe, it may be a better idea to file on time to avoid late-filing penalties. See the following.

## **IRS NOTICES AND BILLS, PENALTIES, AND INTEREST CHARGES**

The following is from the Payment Plan/Installment Agreement information on the IRS website.

April 15 is the deadline for most people to file their 2003 individual income tax return and pay any tax owed. During processing, the return is checked for mathematical accuracy, and the tax due is compared to all amounts paid. If there is any money owed, you will be sent a bill. There are several important things you should know about collection notices and bills. Generally, interest is charged on any unpaid tax from the due

date of the return until the date of payment. The interest rate is determined every three months and is the federal short-term rate plus 3 percent. Interest is compounded daily. If you file on time but don't pay all amounts due on time, you'll generally have to pay a late payment penalty of one-half of one percent of the tax owed for each month, or part of a month, that the tax remains unpaid from the due date, up to 25 percent. The one-half of one percent rate increases to one percent if the tax remains unpaid ten days after the IRS issues a notice of intent to levy.

If you owe tax and don't file on time, the total late payment penalty is usually five percent of the tax owed for each month, or part of a month, that your return is late and the tax is unpaid, up to five months. The late file penalty continues at  $\frac{1}{2}$  percent a month up to 25 percent on unpaid amounts. If your return is over sixty days late, the minimum penalty for late filing is the smaller of \$100 or 100 percent of the tax owed.

You must file your return and pay your tax by the due date to avoid interest and penalty charges. Often the funds necessary to pay your tax can be borrowed at a lower effective rate than the combined IRS interest and penalty rate.

To ensure your payment on a bill for tax is credited properly, be sure to return the tear-off stub on your bill and use our return envelope. Please make your check or money order payable to the United States Treasury. Enter the primary social security number or employer identification number, the tax year and form number and your telephone number on your check or money order, and send it to the address provided.

The penalties for filing late and paying late may be abated if you have reasonable cause for being late. If you're billed for either penalty and feel you have reasonable cause, send your explanation along with the bill to your service center, or call the IRS at (800) 829-1040 for assistance. Generally, interest charges may not be waived; they continue to accrue until all assessed tax, penalties, and interest are paid in full. Also, any reasonable cause exception to the penalty for failure to pay tax cannot be determined until the tax is first paid in full.

If you believe there is an error on your notice or bill, write to the IRS office that sent it to you within the time frame given. You should provide

photocopies of any records that may help correct the error. Also, you may call (800) 829-1040 for assistance. If you are correct, we will make the necessary adjustment to your account and send you a corrected notice.

For more information about IRS notices and bills, refer to Publication 594, *Understanding the Collection Process*. More information about penalty and interest charges is contained in Publication 17, *Your Federal Income Tax*.

## Just Pay It

Some traders know they owe money but don't pay, preferring to use the money to trade. They consider it a "margin loan" from the government.

When it comes to estimated taxes, due on a quarterly basis throughout the year, this strategy may work well for some traders—they may lose money later in the year, and those tax liabilities may disappear.

However, for annual taxes, this strategy can lead to disaster. The prior tax year liabilities do not disappear, and many traders wind up losing their tax money in the markets just after April 15. Be wise and pay what you owe on April 15.

If you can't pay what you owe, pay as much as you can (keeping money in the market is not a reasonable excuse to not pay). While you will still have an invalid extension, you have a chance at penalty abatement because you made a good-faith effort to pay what you owed.

The worst thing you can do is ignore it. If the IRS contacts you before they receive a payment, you don't stand a very good chance of gaining penalty abatement.

Of course if you lost money, you merely need to file an extension.

## Extensions of Time to Make MTM Elections

A large number of traders missed the MTM election for IRC § 475(f) by the due date of April 15 of the current tax year (e.g., April 15, 2004, for tax



year 2004). Without MTM, a trader is stuck with capital loss treatment and cannot deduct trading losses as ordinary losses. This limitation significantly reduces the trader's opportunity for net operating loss refunds.

### **Late MTM Elections**

If you act by October 15, you may be able to receive an extension of time to file your MTM election. Section 301.9100-1 of the IRC, "Extensions of time to make elections," provides relief for late elections. Note the maximum extension period is six months. One serious drawback is you must seek this relief with a private letter ruling.

### **Private Letter Rulings**

The Private Letter Ruling (PLR) procedure is painstaking and expensive, and for traders seeking relief to use MTM (the six month MTM extension relief), the chance of success is extremely small.

As of this writing, the IRS website had published only four PLRs for traders seeking to use MTM, and all were denied.

Here are the four PLR rulings:

1. [www.irs.gov/pub/irs-wd/0209052.pdf](http://www.irs.gov/pub/irs-wd/0209052.pdf)
2. [www.irs.gov/pub/irs-wd/0209053.pdf](http://www.irs.gov/pub/irs-wd/0209053.pdf)
3. [www.irs.gov/pub/irs-wd/0209054.pdf](http://www.irs.gov/pub/irs-wd/0209054.pdf)
4. [www.irs.gov/pub/irs-wd/0304006.pdf](http://www.irs.gov/pub/irs-wd/0304006.pdf)

It is useful to read the IRS rulings in all four cases. In each case, the IRS discussed Reg § 301.9100-1 "Extensions of time to make elections." The trader did not qualify for Reg § 301.9100-1 relief.

